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HIGH LEVEL SEMINAR - APRIL 2021

Organised in association with the Portuguese EU Council Presidency

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The Eurofi High Level Seminar 2021 was organized virtually on the eve of the informal Ecofin meeting in association with the Portuguese EU Council Presidency. More than 220 speakers from the EU public authorities and the financial industry participated in the 30 sessions of this Seminar, which were followed by more than 1100 participants.

The EU post-Covid recovery measures and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Seminar, as well as the main remaining vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance.

In the following pages you will find the summaries of all the panel discussions that took place during this international Seminar and the transcripts of the speeches and exchanges of views. We hope you enjoy reading this report which provides a detailed account of the views expressed by the public and private sector representatives who took part in this event on the different economic and policy topics that were addressed.

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SESSION SUMMARIES

I

POST-COVID RECOVERY AND STABILITY

EU RECOVERY PACKAGE IMPLEMENTATION

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

1. NGEU: a potential game changer for economic growth

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

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

1.2 A historic breakthrough

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

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

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

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

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

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

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

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

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

1.5 Reforms and investment must go hand in hand

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

1.6 A big leap forward in terms of greater European integration

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

1.6.1 A bold and unprecedented step

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

1.6.2 The right instrument at the right time

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

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

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

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

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

1.8 This EU package has impressed markets

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

1.9 This move towards fiscal cohesion and solidarity is reassuring

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

2. NGEU: a potential game changer on capital markets

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

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

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

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

2.2 NGEU should promote the international role of the euro

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

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

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

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

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

3. The main risks, challenges and key success factors

3.1 The main risks

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

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

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

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

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

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

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

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

3.2 The main challenges and key success factors

3.2.1 Quickly Implementing the NGEU package remains challenging

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

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

3.2.2 Two years for implementing reforms and investments is short

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

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

3.3 Key success factors

3.3.1 The need for credible plans being appropriately implemented

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

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

3.3.2 Spending wisely

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

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

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

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

4. Critical problems unresolved

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

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

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

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

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

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

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

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

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

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

PRIORITIES FOR FOSTERING INVESTMENT IN THE EU

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

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

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

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

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

1.2 Europe will be slower to recover than the United States

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

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

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

2. Diverse structural impediments to investment

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

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

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

2.2 Structural impediments to investment in Europe

2.2.1 Business demography

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

2.2.2 The absence of a single market for services

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

2.2.3 The high level of corporate debt

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

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

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

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

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

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

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

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

2.5 There are both cyclical and structural factors at play

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

3. Regulatory and tax barriers

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

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

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

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

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

3.3 Accounting standards also hinder investment

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

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

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

4.1 Normalizing monetary policy

4.1.1 Monetary policy can help but cannot solve structural issues

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

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

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

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

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

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

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

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

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

4.3 Implementing structural reforms in all parts of the EU

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

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

4.3.2 Supporting viable SMEs

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

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

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

4.4 Setting the right incentives for private investments

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

4.4.1 Disregarding EIOPA's advice regarding Solvency II

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

4.4.2 Lengthening the duration of banks' corporate loan portfolios

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

4.5 NGEU: an ambitious answer to EU investment needs

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

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

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

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

4.5.2 Public finance is part of the solution

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

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

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

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

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

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

While strong national and European policy responses have contained the economic impact of the pandemic, there are spill-over risks from corporates to banks and sovereigns. This nexus is vital at the moment for supporting the economy. But it also means sovereigns are increasingly exposed to corporate risk, and vice-versa. This might be a financial stability issue if many businesses suddenly were to go bankrupt. Rising credit losses for banks may require governments to provide more support and pay out on guarantees. This would further increase pressure on public finances. Conversely, rising risk premia could also affect banks through their domestic bond holdings.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.3 Four reasons to be positive

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

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

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

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

3. Cautiously normalising monetary policy

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

3.1 Normalising monetary policy is challenging

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

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

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

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

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

3.2.1 Ultra-low or even negative interest rates weaken insurers

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

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

3.2.2 The EU economy needs a balanced Solvency II review

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

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

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

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

3.4 Time to start gradually exiting very accommodative monetary policy

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

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

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

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

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

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

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

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

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

LESSONS FROM COVID ON NON-BANK FINANCIAL INTERMEDIATION

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.2 The role of liquidity buffers and liquidity management measures

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

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

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

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

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

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

2.3 The liquidity of underlying short-term money markets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.1 Interconnectedness between the banking and non-banking sector

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

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

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

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

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

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

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

4.2 Potential stability risks associated with direct investments

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

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

SESSION SUMMARIES

II

DIGITALISATION AND PAYMENTS

DIGITAL FINANCE STRATEGY: IS THE EU PROPOSAL UP TO THE CHALLENGES?

1. Opportunities and challenges of digitalisation in the financial sector

1.1 Digitalisation trends and opportunities in the EU financial sector

The Chair introduced the session by emphasizing the transformational effects of digitalisation on societies and economies, including the financial sector and the acceleration of this trend during the pandemic. An industry representative stated that at their firm – a leading European bank - the number of digital customers has been steadily growing in the last five years and that Covid doubled the pace of this growth in 2020. Digitalisation is an irreversible trend and is now fundamental to financial services. More than 55% of their active customers are digital, which corresponds to about 50 million digital users of their systems, platforms and channels daily across a number of countries. Going forward, their objective is to continue providing customers with digital solutions that anticipate and fulfil their changing needs in a simple, personal and fair way.

An industry representative concurred that digitalisation is a key driver of the evolution and integration of the EU financial industry. New technologies have changed the ways that customers interact with market infrastructures in particular. Tech developments in relation to data analytics, cloud computing, machine learning, artificial intelligence (AI) and blockchain are all opening up new possibilities. The COVID-19 pandemic has accelerated digitalisation. For instance, exchanges operated remotely during the pandemic and performed extremely well despite the uncertain and volatile market conditions.

Tomorrow's markets will increasingly thrive in a digital economy, the industry representative believed. In today's markets, every exchange system is on premise for the most part. The rest of the ecosystem sits within the data centre as well, and connectivity operates in a hub & spoke model. There is an opportunity to lift all of these bespoke environments into the cloud and look at the industry on a broader basis in terms of having a universal platform for transactions. As the economy becomes increasingly digital the cloud will enable companies around the globe to connect in new ways through the formation of a mesh-style network that leverages modern APIs and actors will be able to scale communications more easily and quickly thanks to this.

1.2 Questions and challenges raised by digitalisation for the EU financial sector

An official noted that with digital finance it is sometimes difficult to distinguish the hype from real progress. Many of the issues now on the table were already discussed 20 years ago about the internet. Finance is an area that lends itself very well to digitalisation because almost all services can be delivered digitally, but other aspects such as trust are also important. The brick-and-mortar model has persisted particularly for banks, because meeting advisors physically still contributes to building this trust.

New technologies including big data, AI, the blockchain and the development of apps that provide a great deal of convenience offer new opportunities, but the current digital strategy of traditional banks is often not very advanced, the official believed. In many cases it boils down to enhancing payment and transaction services. The way traditional banks react to the development of new payment service providers challenging one of their few remaining segments is usually by creating their own payment service provider or optimizing their in-house solutions but it is not much more advanced than that. More fundamental evolutions as to how financial services can fit into the new digital ecosystems are being discussed but good answers have so far not been found in Europe. One idea would be that financial service provisions could be an add-on to a wider digital platform offering a variety of services ranging from booking holidays to buying music. With a payment function integrated into the platform the provider would have access to much more data than a traditional financial institution. Combining the data from the platform with financial data would allow the development of a range of models for evaluating credit risk or consumer preferences and would help to develop and offer services in a much more effective and profitable way than at present. The question of what that type of evolution means for traditional banking and the European financial system is still open however. That model exists in China, for example, but has not arrived in Europe yet, because there are regulatory implications that need considering such as GDPR and technology-neutrality. Attempts to create new currencies have also triggered strong reactions in Europe in particular, justified by the systemic questions they raise.

An industry representative observed that digitalisation is both an opportunity and a challenge for the traditional financial sector. Beyond facilitating the access of customers and businesses to financial services, digital transformation plays a critical role for European banks in adjusting economically to the new low interest rate environment. At the same time huge investments are needed to accelerate these innovations and new digital entrants are competing for banks' customers and businesses and their existing profit pools, including in payments. Digitalisation also entails huge challenges for financial institutions in terms of potential cyber security and data protection risks. Another industry representative observed that while new technologies may increase the risk of cyber-criminal activities, they also support the development of more effective tools for fighting financial crime.

An official noted that digitalisation also raises new questions in terms of supervision. Supervisory bodies are mainly populated with financial experts. They also have some IT experts but do not always have all of the competencies required to assess the operational risks associated with new technologies and tend to outsource these assessments to independent experts. At present there are rarely enough people within the financial regulatory and supervisory authorities who can really understand for example how IT operational cloud risk or digital risk interconnect with traditional financial risks or the specific risks that sophisticated algorithms may create.

2. Expected impacts of the Digital Financial Strategy (DFS) on the acceleration of digitalisation in the financial sector

The Chair stated that the European Union is supporting the digital transition as a priority, and is encouraging in particular the financial sector to embrace these trends and seize the opportunities brought by the digital revolution. The European Commission aims to make the benefits of digital finance widely available to European consumers and businesses, based on European values and the sound regulation of risks. To do so, the Commission published the Digital Finance Strategy (DFS) last September 2020.

In this strategy the Commission set out four priorities. First is tackling fragmentation in the digital single market for financial services in order to help consumers access cross-border services and help European financial firms scale up their digital operations. The second objective is to ensure that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency. Then there is creating a European financial data space to promote data-driven innovation. Finally, there is the objective of addressing new challenges and risks associated with the digital transformation. The DFS is accompanied by two legislative proposals, one on crypto-assets, the Markets in Crypto-assets (MiCA) regulation, and one on digital operational resilience, the Digital Operational Resilience Act (DORA), as well as a strategy for retail payments, which is an area where the pace of innovation is particularly fast.

The panellists welcomed the proposals of the DFS, considering that they identify the right priorities for accelerating digitalisation in the financial sector, and highlighted certain priorities among the different proposals of the Digital Financial Package.

An official suggested that, when considering what is happening in other regions of the world, the European financial data space is probably the most crucial element, because what is needed to promote digitalisation is making better use of the vast size of the single market in terms of data. The European financial data space should provide an opportunity to really make use of that scale for financial innovation. That is probably the one area where other countries like China are performing better than Europe at the moment. In China this comes at the expense of other aspects such as data privacy, but Europe should be able to do this in a more trustful way.

An official considered that the main drivers that the DFS identifies for accelerating the digitalisation of the EU financial sector are quite relevant. Removing fragmentation in the digital single market is essential, as well as adapting the EU regulatory framework to facilitate digital innovation and fostering data-driven finance. At the same time the challenges and risks with digital transformation need to be tackled, particularly cyber-risk which could be the next biggest financial stability risk. There are some risks associated with digitalisation, but there is also the need to move forward and what the Commission has proposed is definitely the right direction.

The proposals placed on the agenda by the Commission as short-term priorities for 2021 also seem particularly relevant for facilitating digital innovation in the current context, the official added. On MiCA, work is progressing quickly in a context where cryptoassets are gaining attention. One challenge is finding the right balance between protection and not hindering innovation in this area. In addition there is an upcoming debate on the prospects of central bank digital currency which may affect the core of financial services and thus have significant consequences. On cyber resilience DORA is a major step forward because more investment is needed in cyber resilience. It was not an easy task, but there is now a significant consensus on this proposal that was very well designed. Finally the strategy on payments is heading in the right direction, the official considered. Pan-European instant payment solutions need to be improved and in this regard the European Payment Initiative[1] is of major importance because it proves that incumbents can support the improvement of cross-border payments. It is indeed important to be able to rely on both incumbents and newcomers for achieving this objective and to keep an ability to master the whole value chain in this regard, avoiding excessive fragmentation.

An industry representative agreed that the DFS and its strategic objective to embrace digital finance for consumers and businesses is very welcome and identifies the key critical areas. One of these is data and access to digital platforms. Everyone agrees that data is a core asset in the digital economy, and the benefits of the recent sharing of data on payments as part of the revised Payments Services Directive (PSD2) have been seen. There is no reason why non-financial data should not follow the same path. There needs to be work towards enhancing data sharing and openness across and within other sectors, always in compliance with data protection and competition rules. That openness will bring huge benefits. Large digital platforms should be required to give access to third-party providers under fair, transparent and objective conditions, with financial authorities ensuring that these conditions are respected within the financial ecosystem.

A second critical area is the direct supervision of critical third-party technology providers, in particular for cloud services, which have become essential for banks due to the flexibility and the time to market benefits that they offer. The Commission's DORA proposal which introduces a new framework for the direct supervision of critical third-party providers is welcome in this regard. In the absence of a cross-sectoral digital authority, the financial authorities will be better positioned with DORA to oversee the cloud service providers critical for the financial sector. This oversight can improve the

1. The "European Payments Initiative" is an initiative launched by 31 European banks/credit institutions and 2 third-party acquirers to create a new pan-European payment solution leveraging Instant Payments and cards. This solution aims to become a new standard in payments for European consumers and merchants.

overall resilience of the financial sector and ensure that financial services in Europe have access to the best technology available.

The third aspect that the industry speaker highlighted is the importance of ensuring a regulatory level playing field between non-financial players that are becoming an intrinsic part of the financial ecosystem, specialising in specific areas of the value chain, and more traditional financial institutions. Rules should be the same for the same activities and same risks. That principle is necessary to ensure a fair, competitive and safe landscape. It is important that the European supervisory agencies should assess whether to apply a more proportionate approach across the financial ecosystem activities in order to ensure consumer protection, fair competition and market integrity, and also safeguard the stability and security of the financial ecosystem. It is also important to ensure that traditional players should not have undue constraints from these new rules related to digitalisation.

Another industry representative stated that their organisation – a major stock exchange - welcomes the digital financial package published by the European Commission last year, which is moving in the right direction. It is indeed important that the EU financial services rules should be fit for the digital age, in particular allowing the uptake of new technologies such as cloud services, AI, distributed ledger technology (DLT) and crypto-assets. Allowing the testing of new technologies as with the DLT pilot regime is also important. The rules relating to these new technologies need to be well-designed and strike the right balance between safety, customer protection and innovative possibilities, as was highlighted in recent draft reports published by the European Parliament on these proposals. The speaker also concurred with the importance of ensuring a level playing field between traditional market players and technology companies and enforcing the 'same activity, same risk and same rules' principle in rule-making.

An official noted that the DFS is pointing to very important systemic elements, such as interoperability, and provides an appropriate focus on the digital transformation of the EU financial system, which is very relevant for this sector, where digitalisation is largely underway.

Answering a question from the audience about how digitalisation may help to tackle new requirements such as anti-money laundering (AML) or ESG, an official replied that legislators should endeavour to integrate digitalisation as much as possible in the way regulation is being designed. It would be useful to include in the review of the non-financial reporting directive (NFRD) for example, the idea of how such data should be gathered and with which access. This is also true for other financial requirements such as those concerning reporting, where there are many unnecessary or unwanted overlaps that may be reduced by digitalisation.

3. Expected impact of the DFS on the integration of the EU financial market

An official considered that the DFS should support the integration of the EU digital financial market to a certain extent, first, with the focus put on on interoperability aspects, specifically of data, while respecting data protection rules. A second important element is the emphasis on underlying fragmentation factors such as the barriers created by AML privacy protection and cross-border IBAN issues.

Another aspect is whether the DFS proposals can have an impact on the integration of the European financial market in general. Concerning the achievement of the Capital Markets Union (CMU), the DFS will contribute to this objective for example by helping existing EU capital market legislations such as MiFID and CSDR to adapt to the digital age or by supporting the CMU objectives such as the implementation of a European Single Access Point (ESAP) and the sharing of corporate data. Effective progress in the integration of EU capital markets measured by the effective reduction of cross-border costs however cannot be achieved solely by digitalisation, because the reasons behind this fragmentation are much deeper.

On the retail side, i.e. the capacity for consumers to access cross-border financial services, overcoming the current fragmentation and increasing the use of digital services requires increasing trust in digital financial services and institutions, the official believed. Cyber-security is an important factor here for a large number of customers and is rightly included in the DFS action plan. Interoperability is also important for integrating tools and processes that support the services provided for retail investors and allow a reduction of costs. The objective of developing financial literacy, which is another important element, is not included in the DFS but is part of the CMU.

An industry representative explained that their company is aiming to become the world's best open financial services platform with a strategy hinging notably on the development of a digital native retail consumer business and the launch of a disruptive payment company. At the core of this strategy is the ability to grow the business in a cost-effective way and improve customer experience, which require using automation and AI, while leveraging scale in a sustainable way. There are two very important areas in the DFS that will help to create synergies and economies of scale: the interoperability of digital identities and the principle of passporting across Europe, and one-stop-shop licensing. Those actions will simplify the cross-border operations and enable banks to provide better customer experiences for a larger number of customers, and at the same time create the size and economies of scale needed for growing the business. This will allow the leveraging of what technology and digital disruption bring for achieving a wider scale and size in the current environment.

EU FINANCIAL DATA SPACE AND CLOUD INFRASTRUCTURE

1. Opportunities and challenges associated with the development of cloud services in the financial sector

1.1 Current trends of cloud service use in the financial sector

An industry representative explained that there is momentum for cloud services adoption in Europe, particularly in the financial services industry. Cloud has generally evolved as one of the key enablers of digital transformation. Digital native and challenger banks were early adopters of cloud and are now followed by more traditional financial players.

There are several trends underway in the financial industry concerning cloud services. One is the ongoing transformation of the core IT infrastructure of financial institutions, with a movement away from legacy systems and a progressive adoption of cloud-based systems, which are proving to be more agile and often more secure and resilient. Second, moving to the cloud can help traditional players to facilitate and speed up innovation regarding their key processes. Third, cloud services can also support regulatory processes, allowing supervisors and regulators to receive more up-to-date information in a more structured and automated manner. Finally, there is a great deal of innovation happening in the know your customer (KYC) and anti-money laundering (AML) fields thanks to the cloud, where the industry is deploying artificial intelligence (AI) and machine learning solutions to move away from rules-based systems and address AML issues with a more risk-based approach.

The Chair noted that the speed of change is remarkable in this area. Until recently, the focus was mainly on cloud adoption and transitioning customers to the cloud. But now the cloud appears to have become a major driver of transformation at the heart of many key financial processes such as risk management and reporting, which also calls for greater attention from supervisors than before.

1.2 Main opportunities offered by the use of cloud services

A policy-maker stressed that cloud computing can boost the cost, efficiency and agility of data processing, and therefore make European businesses more competitive. It can also facilitate data sharing across different business actors of the same ecosystem and can foster the emergence of an innovative data system in different sectors. Cloud is therefore at the heart of the open banking evolution due to its potential for supporting commercial relationships between different types of financial institutions, including fintechs, which have often been operating in the cloud from the very beginning.

The cloud can also unlock access to a number of emerging technologies, such as AI and blockchain, thus helping to trigger a second wave of digital transformation in the financial sector and allowing the financial sector to remain at the forefront of this transformation. Operating on a pay-per-use basis, cloud can make these technologies easily accessible and scaleable, without having to use a traditional IT infrastructure. This can lead to major savings in terms of capital expenditure. A Commission study found that the average organisation can reduce its IT infrastructure cost by 30-50% when moving to the cloud. Cloud also facilitates access to important added-value services. Financial institutions are, for instance, running on the cloud AI systems for robo-advice, credit scoring applications and chatbots that engage with consumers. There can also be cloud-native running of DLT for digital currencies or DNS resolvers on the cloud that preserve privacy and help to reach a high level of security.

Finally cloud computing can help to address problems of interoperability between legacy IT systems and new systems which are multiplying with the speed of evolution of technologies. These problems often happen in large financial institutions where multiple pieces of software and multiple databases in silos co-exist. Cloud computing has the potential to change this paradigm by providing fully interoperable and, ideally, vendor-neutral solutions.

An industry representative stated that it is very important to consider the practical use cases of cloud in the policy discussion. Using cloud services enables a real reduction of IT costs. This is mainly true when using public cloud service providers (CSPs) and hyperscalers, because whilst setting up a private cloud might be a first step it will not provide the same benefits. Secondly, buying services out of the public cloud for data analytics or AI offers access to higher processing capacities, which allow for example the evaluation of more complex financial instruments requiring many calculations. Finally, another advantage of the cloud is its flexibility. With the pay-per-use model, computation power can be bought when it is needed and there can be a progressive revamping of applications and IT systems on the cloud. With this ‘continuous development’ financial institutions are able to provide clients with innovations on a more frequent basis.

A regulator explained that the supervision of companies with activities in the cloud has revealed several opportunities. On the industry side, these include a greater capacity to innovate and enhance products and customer experience with greater convenience. The use of cloud services can also increase competition, flexibility and choice in the financial sector, and can help financial institutions to transition from their legacy systems. Cloud services can also support regulatory and supervisory activities by facilitating access to supervisory and regulatory technology (SupTech and RegTech). These are innovative technologies that can be embarked on underlying cloud infrastructures and can ensure the continuity of regulatory and supervisory activities with the financial entities concerned.

1.3 Conditions and challenges associated with the development of cloud services

A policy-maker suggested that different factors of success need considering when moving to the cloud. First, financial institutions should be encouraged to adopt a multi-cloud strategy with a balance across multiple cloud providers in order to avoid putting all their eggs in the same basket. Second, proper attention should be paid when negotiating cloud contracts. There are many potential problems of asymmetry in negotiating power with CSPs and even fairly large financial institutions find it challenging to negotiate cloud contracts in some cases. That is why the European Commission is currently developing standard contractual clauses for cloud use by financial institutions. Another factor of success is to establish a cloud centre of excellence in the organisation. Organisations should adopt a central IT risk strategy with a multi-cloud element, as also mandated by the new Digital Operational Resilience Act (DORA) legislative proposal.

An industry representative noted that the broader uptake of cloud services raises several challenges for the financial sector. There is a skills challenge, because moving to the cloud is a relatively new journey which comes with many change management aspects. Although this issue is probably less acute in finance than in other sectors, the industry is still defining the optimal path for moving to the cloud in a safe way. There are also potential concerns related to concentration risk and vendor lock-in, which regulators are working to address. From an industry perspective, open-source technology and multi-cloud approaches that foster portability and interoperability are ways to address this problem and to insure financial institutions against the possible failure of the systems of one given provider. A third challenge is regulatory fragmentation. Whilst a very significant effort has been made by the European supervisory authorities (ESAs) in the past few years to define a harmonised approach to outsourcing rules, there is still fragmentation at the member state level in their implementation and supervision. It is hoped that further policy efforts, including with DORA, will help to alleviate these problems.

A regulator added that while the technological sophistication brought by cloud services delivers clear benefits to financial services firms and their customers, it also changes the nature of the operational risks that need to be managed and mitigated by financial institutions and may create new complexities e.g. in terms of data localisation. Concerning the further source of complexity brought by the variations that exist across regulatory requirements, the regulator confirmed that.it is one of the objectives of DORA to address this issue and create more convergence at the regulatory level.

A public representative observed that a further challenge that is not specific to cloud is that technological innovation is often faster than regulation. However, the EU institutions are conscious of this and are trying to improve the way regulations and frameworks are updated.

1.4 Main opportunities and challenges associated with enhanced data use and sharing

An industry representative stated that data access, data sharing and the cloud are the basis of a potential revolution in the insurance industry in particular. Insurance companies aim to move away from being perceived as just traditional claims-driven companies and reimbursement agents to becoming ‘lifetime partners’ of customers, providing a range of assistance and prevention services. This may be supported by the combination of insurance and technology, and in particular the Internet of Things which allows access to continuous flows of data that come on a real-time basis. Historically the industry has been based on single data points, especially for underwriting purposes, but this is now evolving. With continuous flows of data from customers, timely assistance and prevention can be effectively provided, above and beyond paying claims.

There are a number of challenges however that the insurance industry is facing in this context of increasing digitalisation. First is the risk of inertia that is common to large incumbent multinational companies facing legacy systems and localised regulations that constitute barriers to change. Another challenge is providing sufficient value to customers for sharing their data and also safeguarding the use of data when it is processed in the context of AI or aggregated with other data sources. A further challenge is the competition brought by big technology firms and new entrants that do not have the same legacy systems and operating models and which requires a level playing field to be established.

2. Priorities for the regulation and supervision of cloud services and data use and sharing

In the second part of the discussion, the panellists commented on the main regulatory initiatives underway related to cloud services and the use and sharing of data.

2.1 Digital Operational Resilience Act (DORA) and the ESA cloud outsourcing guidelines

A policy-maker stated that having an appropriate regulatory architecture for cloud services is important for ensuring legal certainty and is beneficial for both the financial services industry and cloud service providers (CSPs). The objective of DORA is to address the threats to operational resilience in the financial sector associated with the use of new technologies including cloud, by further harmonising and streamlining existing rules on ICT[1] risk management and ICT-related incident reporting. The risk-based approach taken in DORA is directly inspired by the Network and Information Security (NIS2) directive, which provides legal measures for improving cyber-security in the EU, but DORA looks at the specific requirements of the financial sector. DORA aims at addressing different issues mentioned in the context of cloud agreements - such as the risk of vendor lock-in, the imbalances in contractual negotiation, the exit strategy when a bank or financial institution wants to switch providers, or concentration risk - by introducing a certain number of high-level requirements for contractual agreements between

1. ICT: Information and Communications Technology

financial institutions and third-party IT providers. It also introduces oversight by the ESAs over critical CSPs.

In terms of implementation, DORA will be supplemented by Level 2 and Level 3 guidance at a European level. Level 2 will be materialised by the existing cloud outsourcing guidelines published by the ESAs in 2019 and 2020 that provide an appropriate basis for the implementation of DORA. The proposal is to also put in place Level 3 rules by developing standard contractual clauses for cloud outsourcing specifically for the financial sector, based on the Level 1 DORA guidelines and the outsourcing guidelines of the ESAs. It is believed that this more harmonised framework at the EU level will help to speed up the time to market for cloud projects in the financial sector and support innovation. This three-level architecture should also facilitate supervisory convergence for cloud outsourcing across the EU.

A regulator emphasized that the ESA cloud outsourcing guidelines were a pioneering work that gave the initial structure and perspective on how cloud service provision should be structured and on the issues that should be taken into consideration for its proper oversight in the financial sector. While there are three different guidelines from the ESAs, these enjoy a high level of convergence. For instance, all three guidelines mention general principles of governance, define requirements for an appropriate outsourcing policy (e.g. in terms of documentation, allocation of responsibilities) and describe how the outsourcing process should be carried out from the pre-outsourcing phase to the exit strategy. The guidelines also define risk management and due diligence requirements and the determination of whether a CSP is of critical importance for a financial entity. This therefore provides financial institutions with an appropriate basis for negotiating and structuring their cloud contracts and supervisors with guidelines for conducting the oversight of cloud-related risks. The DORA proposal builds on these guidelines to a large extent and has many aspects in common.

An industry representative stated that cloud is essential for the competitiveness of the financial sector and should be thought about not just from a risk standpoint but also from the standpoint of what is required to enable its effective implementation in Europe. Indeed the major CSPs invest a great deal in securing their operations, which may contribute to actually reducing operational risks in the financial system. In this regard DORA is a step forward because it provides a common framework and will help to reduce the current fragmentation of rules. It is necessary however to make sure that the specific risks associated with cloud (compared to the outsourcing to a data centre) are understood. The current proposals are also very focused on applying outsourcing rules to cloud services and could potentially be extended to any ICT services sold on a pay-per-use basis and which can be bought and terminated quickly.

A public representative emphasized that concerning cyber-security there are a number of intersections between DORA and NIS2. This is normal because DORA builds on NIS2 but the connection between the two legislations needs to be more clearly established. Further work and coordination is needed on a number of issues: for example according to the NIS 2 proposal, CSPs should be from now on classified as 'essential entities' and should thus be subject to both the requirements of DORA and NIS 2, but there is no clear hierarchy between DORA and NIS 2 requirements in that regard. This brings a clear issue of taxonomy in incident reporting and potential overlaps in the requirements for CSPs. The question is whether this redundancy is intentional because the regulator sees the need for increased oversight of CSPs or if it is unnecessary duplication. There is also an issue regarding the coordination between the lead overseer introduced in DORA and the national competent authorities (NCAs) defined in the NIS2 Directive. Strong coordination is needed between the EU and Member State level, otherwise that will lead to fragmentation.

An industry representative stated that DORA is a novel framework. Indeed, it is for the first time bringing ICT providers into the scope of financial services oversight and this must be done appropriately. DORA could create a genuine opportunity to enhance understanding, transparency and trust between ICT service providers, financial entities and regulators and ultimately stimulate innovation in the European financial sector. However, to ensure its effectiveness a certain number of issues need to be considered. The consistency of DORA with the NIS Directive is critical, the industry speaker stressed. DORA is not lex specialis for providers who may be subjected to other parallel frameworks and might end up being confronted with two packages that have conflicting recommendations, issued from different authorities that have not sufficiently coordinated. In this perspective there is a need for legislation to harmonise and deduplicate requirements, including between DORA and existing frameworks like the ESA Outsourcing Guidelines and the NIS Directive - in particular in the view of the new NISD2 proposal. Legislation must also be proportionate and fit-for-purpose, especially through the requirements that recognize the technological realities of evolving ICT services in the public cloud context - that are provided in a multitenant, one-to-many environment. There is a need to maintain technology neutrality and boost innovation, which is encouraged by open markets and the free flow of data, and also to protect the availability and integrity of digital services and cloud customers' privacy, whether they are subject to DORA or not. It is to be hoped that these issues will be addressed in the on-going legislative process.

2.2 Data Services Act (DSA)

A public representative noted that the DSA proposed in December 2020 could be of importance for data-related issues. The actual work is still on hold because some internal decisions are being waited for. This regulation builds on the principle of the e-Commerce Directive. It is going to touch upon the liability exemption and the general monitoring prohibition. In that matter, the regulation can be divided into two main aspects. The first one is guaranteeing data safety for customers and safety online in general. A second is how to regulate the industry and the main providers.

An interesting new insight, the public representative believed, is that it will be ensured that there is a proportional obligation depending on the size of the provider and the number of users the provider is serving. The objective with the DSA is to ensure by regulation that the fundamental rights of the users are safeguarded. Usually this objective is in the hands of the providers and requires a great deal of effort with the pre-existing directives and frameworks. This remains a priority for the European Parliament, especially in the current environment where the exposure of online users in education and working spaces has increased in the last few months.

An industry representative noted that, generally speaking, with the pace of change that all observe in technological developments, the continued review of existing regulations and policies is essential. It has to be ensured they are up to the standards of the current technological developments and foresee any changes in the future. This is, for example, very applicable to GDPR, which is a great regulation that has set the standard on a global basis. Nevertheless, there should also be consideration of how other regulatory environments diverge from the EU, and from GDPR specifically, because this divergence may limit access to some potential developments that could be better exploited at a European level if GDPR was reviewed.

An industry representative added that for the data privacy and security issues there will be more practices going forward. There have been some discussions about whether someone putting their name on a video platform already presents a data privacy issue for example. Those kinds of things have to be settled, otherwise the application of these requirements becomes very difficult for the industry.

Conclusion

The Chair summarised that cloud services and data access and sharing are at the heart of the transformation of the banking and insurance sectors. Use cases show that cloud services are entering more into the core tasks and processes of financial institutions. On the one hand, this offers new opportunities to improve services and better serve customers. On the other hand, this implies important changes to business and operating models, which may raise new risks and financial stability issues. However, cloud outsourcing and other innovative technologies may also contribute to mitigating stability risks in the financial sector.

Everybody on the panel agreed that the initiatives of the Commission, in particular the DORA initiative are moving in the right direction. However some technical issues and potential inconsistencies between DORA, NIS 2 and the ESA cloud outsourcing guidelines need to be addressed for enabling the European financial industry to reap the full benefits of data, digital innovation and the cloud.

IS THE CURRENT EU FINANCIAL FRAMEWORK FIT FOR THE DIGITAL AGE?

1. Opportunities and challenges associated with digitalisation in the financial sector

1.1 Opportunities and conditions of success of digitalisation

An industry representative stated that adopting new technology can improve service delivery and customer experience while also enhancing resilience, security and meeting regulatory requirements. For example, cloud services and related analytical and artificial intelligence (AI) tools help financial firms of all sizes to innovate and differentiate themselves by redesigning their operating and business models and implementing more data-driven decision-making. In the past, the focus concerning cloud services was mostly on cost reduction. However, as financial institutions have become more familiar with the technology and as it has evolved, the emphasis is now more on agility, resilience and innovation gains. These are key competitive advantages in a constantly evolving environment where market participants are faced with new participants, products, value chains and also risks. Modern technologies can also be used by financial institutions for enhancing resilience and efficiency, leveraging globally distributed infrastructure to build redundancy in all components of the ecosystem and also standardising and automating processes. Technology can also be used to prevent and detect fraud or misuse of services to a degree that was not possible in the past.

Another industry representative noted that digitalisation is used in various ways in the asset management sector. AI and machine learning are increasingly used across various functions. For example, AI can support the assessment of issuers' annual reports, which helps portfolio managers to carry out their analyses. AI can also facilitate the handling of fund prospectuses, which are used for compliance activities.

A regulator considered that technologies such as AI, blockchain, big data or cloud computing can provide a significant contribution to the financing of the economy and also benefit investors and citizens. These technologies can for example be used to improve all steps of the capital market value chain such as custody, trading, clearing, settlement and asset management. Technology may also support the development of new asset classes and lead to a more decentralised financial system, which may help to improve future funding and saving opportunities.

An industry representative pointed out that the banking sector was quick to adapt to the digital revolution and promote its benefits to customers. There are four key high-level principles to be followed so that technology can benefit the industry and its clients. Technology must improve business efficiency without weakening resilience; improve customer outcomes without undermining protection; respect privacy; and be inclusive. These principles resonate with Europe's instincts on applying digital technology to banking. Reconciling them in the product and service offering is challenging, but also represents an opportunity.

1.2 Challenges and risks raised by digitalisation in the financial sector

An industry representative noted that the pandemic has accelerated the speed of digitalisation. This raises new questions for regulators. Tech spending needs are increasing which is capital-dilutive, so there is a prudential aspect, and there is also a potential skills and knowledge gap with these new technologies for financial players and supervisors. A second challenge is related to the entrance of new players in the financial system and the potential unlevel playing field between them and traditional players, if they are not subject to the same requirements e.g. in terms of customer protection.

A regulator agreed that digitalisation may bring new risks. For example, technology can facilitate access to more information, but that does not guarantee its quality. It is increasingly common for investment decisions to be based on unreliable information such as opinions or informal recommendations e.g. seen on social media. This may create new speculative trends with risky bets, leveraged positions and possible gamification issues, with insufficient attention being paid by investors to the underlying economic features and risks of investment choices. Green washing and tech washing are other issues that may mislead investors. Empowering investors with digital tools provides many benefits but also comes at the cost of assuming possibly inappropriate investment choices. In addition to these micro-level risks, there are also more systemic risks potentially associated with digitalisation, including cyber and data protection risks. Technology may also accelerate the development of new competition from non-bank financial intermediation.

2. Regulatory and supervisory challenges associated with digitalisation in the financial sector

2.1 Challenges for regulators and supervisors

An official stated that the biggest challenge for supervisors in an environment that is rapidly changing with digitalisation is being able to provide appropriate guidance, particularly in areas with no EU legislation, or which are grey zones. Initial coin offerings (ICOs) was one of these areas, for which market participants were asking for more clarity before EU legislation was proposed. Some domestic regulators have run the risk of providing guidance even if they knew that it might not conform exactly with what would be agreed later at EU level. The same situation happened concerning crowdfunding, for which different legislations were implemented across member states. In order to reduce regulatory uncertainty, the official's institution – a central bank - has decided to help proactively the financial institutions that are willing to engage in technological innovation. One successful example is a sandbox that has been developed for market participants willing to test new developments using DLT (distributed ledger technology).

A regulator agreed that with technological developments there is a risk for regulators of 'regulating the unknown', since the full implications and impacts of these new technologies cannot be fully envisioned or understood beforehand. The Chair observed that in such cases learning-by-doing and taking a proactive approach is the right way forward.

An official considered that regulators are still in a learning phase, when it comes to defining the right policy approach for coping with the emergence of new technologies and related impacts in terms of distribution channels, products, services and, particularly, new players. Supporting regulators and policymakers in this regard is at the core of the work conducted by the BIS Financial Stability Institute (FSI) on digitalisation.

2.2 Challenges for the industry

An industry representative emphasized that there are still structural issues in the EU regulatory framework that may hinder the digitalisation of banks and other financial institutions, such as the lack of a consistent regulation of underlying products. While regimes such as UCITS are unified at the European level, other prevalent financial products such as mortgages are still nationally regulated with regulations that differ across EU jurisdictions. The Capital Markets Union (CMU) and Banking Union initiatives will foster a more pan-European approach, providing more cost-effectiveness and resilience, but these projects are still to be completed.

There is also a lack of clarity in the regulatory framework concerning how emerging technologies such as blockchain or AI apply to financial sector use cases. Issues remain for example with respect to the reconciliation of the blockchain data storage approach with the right to be forgotten. There are also questions regarding the possibility of experimenting with AI using personal data without breaching GDPR data protection rules. These are important questions, as digitalisation is expanding in all sectors of finance. The development of innovation hubs and the work conducted by regulators in areas such as crypto-assets, DLT, AI and digital platforms should however contribute to addressing these issues.

An industry representative mentioned that globally cloud service providers (CSPs) face two main challenges. The first is supporting customers in their compliance with regulatory requirements so that cloud-based applications match supervisory expectations. The second is dealing with regulatory requirements that apply to CSPs, such as DORA (the Digital Operational Resilience Act proposed by the EU). In both cases, coherent and harmonized cross-border regulatory requirements are critical for the ability of firms to adopt technology including cloud, AI and machine learning. Financial frameworks must also evolve with on-going technological innovation. This is necessary for market participants and their customers to fully benefit from these innovations and for the European financial sector to remain competitive at the international level.

3. Existing and future policy actions related to digitalisation in the financial sector

3.1 Ongoing policy actions related to digitalisation at the international and EU levels

An official stated that the financial policy framework has not evolved significantly at the international level with the advent of digitalisation. Some sectoral regulations have been updated in areas with significant fintech penetration, such as wealth management, payment services or insurance, but rules have not been extensively modified. New players therefore compete with incumbent companies using rules that existed before they emerged. The creation of new regulatory categories, such as digital banks, is more an exception than the rule. Clearer and more determined policy action can be seen for cryptocurrencies. For example anti-money laundering and combatting the financing of terrorism (AML/CFT) rules have been adjusted by international standard setters, notably the Financial Action Task Force (FATF), the global AML / CFT watchdog, to incorporate crypto-asset service providers.

The Chair noted that the EU has gone through a learning phase regarding digitalisation, but there is now a move from learning to the implementation of regulatory policies as more is known about new technologies. The Commission has published a digital finance strategy, as well as proposals on operational resilience (DORA), cryptocurrencies (MiCA) and DLT (DLT pilot regime).

An official commended the European Commission for having put forward a clear digital policy agenda. If that agenda is delivered as planned, the EU will be in a leading position compared to other jurisdictions in terms of digital finance policy.

3.2 Areas where further policy work is needed

An industry representative suggested several areas of improvement related to the on-going EU digital policy initiatives. The first one concerns cybersecurity. Cybersecurity tools are increasingly used to strengthen resilience against attacks, which also means a greater use of third-party providers. The DORA regulation strengthens obligations on users to conduct due diligence on these providers, but this can be quite challenging because some of these providers are major global firms, possibly limiting access to information – which is made even more difficult if based in third countries. New powers should therefore be granted to users for ensuring that their own due diligence requirements can be fulfilled over third party providers. In addition, in the DORA proposal, the European Supervisory Authorities (ESAs) are made central, whereas the European Union Agency for Cybersecurity (ENISA) plays a secondary role. ENISA should play a greater role in particular regarding the reporting of critical cybersecurity incidents as it is better equipped to deal with them as well as avoid being hacked (as compared to sectoral financial authorities). A more stringent, clear and common approach to cyber-resilience between existing financial players and new entrants is also needed. A common approach should also apply to AML rules.

A second area to consider is DLT/blockchain, the industry speaker emphasized. This is an area that will provide the fund industry in particular with huge opportunities and where EU harmonisation will be very beneficial. DLT may indeed increase the speed and reduce the cost of settlement of securities and asset transactions, as well as facilitate fund distribution. The DLT pilot regime aims to facilitate the safe testing of DLT solutions with lighter regulatory requirements in order to enable both existing CSDs and MTFs, as well as new entrants, to build new DLT-based solutions. It is important that the pilot regime should be implemented in a way that leverages the efficiency benefits provided by DLT and its decentralised nature, thus allowing new entrants to provide settlement services at a lower cost and with increased efficiency. A third critical area is crypto-assets for which a regulatory framework is needed at EU level, to ensure that there is a minimum level of safety before developing investment in that area.

A second industry representative emphasized that new technologies can support cross-border financial services, which are essential for the efficiency of the EU financial sector, but an effective cross-border coordination and dialogue is needed among regulators in order to reduce regulatory and supervisory friction across the EU and alleviate obstacles to digitalisation.

A third industry representative suggested that the maintenance of a level playing field between incumbent financial institutions and new digital entrants providing similar activities or products is an objective that deserves further attention. For example some products provided by new entrants such as e-wallets are substitutable for bank deposits, but do not offer the same protection because they are not subject to a deposit protection scheme. There is a question as to whether this is understood by customers and whether the level of protection and the regulatory requirements should be further aligned. The obligations in terms of interoperability placed on different institutions operating in the financial space should also be considered. Measures have been taken with the Revised Payments Services Directive (PSD2) to allow new payment providers to access bank accounts, but reciprocal access to the platforms of these new entrants should be part of the framework as well, because that is not the case at present.

An official considered that the main challenge going forward for the international regulatory community related to digitalisation is the treatment of big tech platforms offering an array of financial and non financial services. Big techs run a unique business model characterised by a 'DNA loop' – 'D' for data superiority, 'N' for network externalities and 'A' for the array of activities performed. Big techs are potentially disruptive as they can affect the functioning of financial markets in particular, providing benefits but also posing significant potential risks, including market integrity and financial stability risks. Adopting an appropriate regulatory approach to big techs is vital. It would be a mistake to adjust the regulatory perimeter only on specific policy domains, following a pure activity-based approach. The risks that big techs may generate as entities by the combination of the activities they perform and the DNA loop characteristics must also be tackled.

4. Key elements of the policy approach needed for tackling digitalisation developments

4.1 Adapting financial regulation and supervision to the new digital world

An official stated that it is difficult to find the right balance in regulation between innovation and protection. The evidence should always be under review to determine whether the right innovation is taking place in the financial system, whether market integration is sufficient and whether there is an appropriate level of competitiveness of EU tech players. At present, the balance is not quite right. Europe appears to be behind the curve in terms of tech development to a certain extent and needs to catch up. It should be determined whether that is a result of the EU regulatory and legislative environment and notably the stronger focus in Europe compared to other jurisdictions on values such as data privacy or consumer protection. A protective view towards consumers is necessary, but some of them are looking for more attractive opportunities or more return even if that means taking more risk. That is what happened in the US with the Robinhood episode, despite the regulations in place and the protections they offers. Investor education can help but it is also important to provide a framework in the main areas of retail finance that is adapted to customer needs and preferences. Otherwise consumers will look for a solution that suits them better and that might be more risky. This is why keeping a balance in protection rules is important. A regulator agreed that the challenge for regulators is protecting investors and savers from risks, without limiting their opportunities.

An industry representative referring to the challenges raised by the ever-changing ecosystem and possibly 'regulating the unknown', suggested that financial regulation and supervision should follow certain principles in order to support the digital transformation of the financial sector. A first principle is taking a customer-centric view, as proposed by a previous speaker, since the customer will ultimately shape the ecosystem, products and services. Secondly, in order to be effective, regulatory frameworks and supervisory practices should be adapted to the digital world and its evolutions. For example, some regulators will argue that localisation of data is needed to ensure resilience and security, but in reality localisation has no bearing on data security or the ability of a supervisor to oversee the institutions which control the data. What is important is having regulatory requirements in place for ensuring that technology is used in a safe way and that data is protected. Having sufficiently harmonised rules and coordination in terms of supervision is also important and more could be done in this respect.

4.2 Activity-based vs entity-based regulation

A regulator stated that mixing activity-based and entity-based rules is necessary for promoting and controlling innovation in the digital era. Although the big techs' footprint is still limited in most EU financial sectors, despite a presence that is already significant in the payments sector, it is wise to consider entity-based rules that might deal with the possible impacts of their huge market power on financial stability, operational resilience, data protection and competition, together with activity-based rules that are essential for ensuring a proper level playing field between incumbents and newcomers. It is also important to ensure that the true nature and implications of new technologies such as AI, big data, cloud services and DLT and their interconnections are clearly understood before tying them to specific activity rules.

An official considered that the risks posed by the emergence of big tech platforms offering a wide array of financial services with the specific ‘DNA loop’ business model require comprehensive policy reform and potentially adopting an entity-based approach. Different jurisdictions have started moving in this direction, including the US (in the context of the House of Representatives report on competition in digital markets) and China (with the measures taken by the market regulator and the central bank to force Ant Group to restructure as a financial holding company). This is also the case of the European Commission whose Digital Services Act and Digital Markets Act proposals put forward specific entity-based rules for big techs.

The regulatory framework should try to minimise competitive distortions to the extent possible and promote a level playing field but not at the expense of essential policy goals such as financial stability or market integrity. Sometimes in order to meet such public policy objectives or preserve public interest, it is necessary to treat players differently, because they can generate different types of risks when performing the same activity. In such cases an entity-based approach will be warranted, rather than applying the same rules to all players in a given market segment according to the ‘same activity, same regulation’ principle of the activity-based approach.

For example regarding AML/CFT or consumer protection, it is agreed that all players should have comparable rules, and this is broadly the case in most relevant jurisdictions, as shown in a paper published recently by the FSI. The situation is different for financial stability risks, which can emerge from the combination of activities that a given institution performs, rather than from a given activity. In the case of banks, the main risk comes from maturity transformation, which is a combination of deposit taking, investment and underwriting activities. It is generally agreed that a prudential regulation imposed at entity-level is needed in this case. Big techs can also generate important risks to market stability and that can only be addressed by imposing specific constraints on big techs concerning for example data use, data portability or the way their platforms are managed. There are other areas where an entity-based approach and therefore specific rules for big techs could be warranted, such as fair competition (given the potential effects of the DNA loop) or operational resilience.

Therefore, contrary to what is often said, more and not less entity-based rules are needed in addition to activity-based regulation. Entity-based rules could help not only to achieve and preserve primary policy objectives such as financial stability, but also to minimise competitive distortions between different types of competitors, in particular between banks and non-banks, the official concluded.

CRYPTO-ASSETS AND STABLECOINS: PROSPECTS AND WAY FORWARD

1. Multiple private and public initiatives underway on diverse parts of the payment value chain

A representative of the public sector stated that, at the back end of the system, central banks have moved to fast payments architectures and are now working on connecting their fast payments architectures between themselves. More recently, new private closed-loop solutions have emerged, using, in particular, stablecoins. At the front end of the system, there are new interfaces, mobile payments, face recognition and QR codes, and new means of payment through stablecoins and possibly crypto. Initiatives may lead to faster, cheaper payments, an improvement in the customer experience and more efficient ways to support the economy, but may risk instability or harm to the investor, maybe from fragmentation. The new world of payments and money can be summed up by a quotation from Antonio Gramsci: 'The old world is dying and the new world struggles to be born. Now is the time of monsters.'

2. Current international coordination and initiatives regarding innovation in payments

The representative informed that the Bank for International Settlements (BIS) is part of the current coordination around innovation in payments. There is a G20 mandate on enhancing cross-border payments. There has been active work on stablecoin regulation at global level, at the Financial Stability Board (FSB) and in each jurisdiction. Practical initiatives are being launched by different central banks. BIS is active in its convening role, creating an innovation hub and innovation network to produce proofs of concept and prototypes meeting problem statements identified by central banks and regulators.

3. The current challenge for banks is to preserve the efficiency of existing payment means while contributing to reassuring and providing trust in the uncertain context of the many possible (r)evolutions in the area

An representative of the industry commented the institutions have probably changed more in the last 10 years than it did in its first 189 years. In addition, the institutions have changed the way they think much more in the last 14 months than in the 10 years prior to that. As traditional banks, attacking the future is all about optionality. A bank needs to continue to evolve, ensuring that what already works for society continues to work, but also to see "how deep the loophole goes". In 30, 20 or maybe 10 years, it is not unreasonable that payments will take place without middlemen, because the recipe is out there. Experimentation and always being on the edge to provide for optionality is important. The future is uncertain, so a portfolio of options is the best choice. Change should be seen as an opportunity, not just a threat.

4. Covid has brought payments trends and infrastructures beyond convenience improvement

An industry representative commented that Covid has changed human behaviour and payments behaviour. People plan so that they do not have to touch things. Use of cash is declining. Experimentation with pay with your face and pay with your voice is underway. In addition to convenience, there are now deeper drivers for these changes, such as anxiety. This might change the adoption curve of new technologies. Subscription-based and pay-as-you-go offerings have been accelerated due to the pandemic. The first glimpse of micropayments is being seen and, subsequently, machine-to-machine payments. That is relevant in terms of shaping the payments system to cater for emerging trends.

5. Incumbent banks and infrastructure focus on their distinctive added value on payments

An industry representative stated that the finest characteristic that the banking and finance industry has to offer is trust. There should be control, not anarchy, in the new payment world.

An industry representative commented that international card networks are one of the original disruptors, or the oldest fintechs. The institution represented was indeed built on the electronic movement of money. Now money is evolving through stablecoins, retail central bank digital currency (CBDC), emergence of new networks and underlying technologies. The international institution will evolve with it as a payments network, but also as a technology provider to other networks. The transactions handled are a promise of a secure payment and international acceptance and, as such, a promise that goes beyond the mere movement of money.

A representative of the public sector noted that substitution between CBDC and bank deposits could undermine deposit banking. Central banks are working on possible mitigants such as caps on CBDC holdings.

An industry representative stated that these concerns should be left to industry banks.

A Central Bank official added that there is the possible danger of an outflow of the deposits of the banks. In the case of a possible CBDC, there is a liability directly against the central bank and this must be addressed from a central bank perspective.

6. The role of policy makers regarding trust, security and resilience is essential to enable stablecoin initiatives

An industry representative indicated that their institution has decided to allow for the settlement of USD Coin (USDC) over its network. USDC is a regulated stablecoin backed by the US dollar and transacted over the Ethereum blockchain network. It is expected that both stablecoin and regional CBDCs will be part of the changing payment landscape. New use cases have emerged around stablecoins, notably with respect to cross-border business-to-business payments, trade settlements and remittances. Stability should be considered. New forms of digital money will only be widely used if they can maintain a stable value. Visa welcomes the focus of regulators on consumer protection aspects of stablecoin. Appropriate anti-money laundering (AML) and safety checks are needed across this new ecosystem.

7. International and EU cooperation for removing technical and regulatory obstacles and improving the operational and cost efficiency of existing and future cross-border payment avenues is a key contribution to the necessary innovation which enables further interoperability and competition

The industry representative commented that the FSB roadmap notes that stablecoins are one avenue to make cross-border payments faster, cheaper, more transparent, and inclusive. However, they are just one avenue. Their institution supports work being done to remove regulatory and technical obstacles. Visa continues to innovate on the infrastructure side. Visa has a real-time payments platform that pushes digital remittances and has allowed for the cost of remittances to drop below the 3% target for 2030. The institution has also launched a non-card platform, B2B Connect, which is an alternative to correspondent banking and allows banks to connect directly.

There is a risk that different jurisdictions will use different technologies and technological protocols. The institution would like to contribute to the interoperability of new payments systems through universal payment channels. There should and will be a multitude of different payment systems, technologies and solutions for cross-border payments and it is welcomed that regulators and central banks focus on ensuring payment systems are open and interoperable. The institution does not want to rely on any one solution.

International cooperation is key. AML and countering the financing of terrorism (CFT) laws are often seen as an obstacle for efficient cross-border payments. There is new momentum at the European level, and it is hoped that this extends to the international level, with respect to regulation of stablecoins.

8. Regulators have no choice but to address the regulatory challenges – consumer protection, AML, liability sharing in the value chain, reliability, etc – of the whole landscapes regarding digital currencies and assets

A public sector representative noted that there has been a great deal of discussion about stablecoin regulation. Recently, there have also been many developments in the crypto world. Decentralised finance is vibrant and lots of new financial services are being provided. From a regulatory perspective, that could represent a new shadow banking emerging.

A policymaker commented that the developments in crypto markets, with the currently exploding valuations that by now also attract serious business, are mostly in the non stablecoin area. The current global market valuation recently exceeded $2 trillion US and is now at around €2 trillion. Only a small fraction of that market, probably less than 5%, is made up of crypto-assets that have a stabilisation mechanism. Crypto-assets are mostly not used for payments. The policymaker added that the Commission's proposal on markets in crypto-assets covers the entire crypto asset space and not just the area of stablecoins. Stablecoins are covered by the proposal, but the proposal is not limited to them. The Commission aims to provide legal certainty and an enabling framework for crypto-asset markets. Should crypto-assets in general, or stablecoins more specifically, become a significant feature in payments in the European Union, opportunities and risks can be addressed through payments legislation.

It is still too early to talk about flourishing private initiatives regarding stable-coins. Stablecoins on the market have proven to be relatively stable but are still very small compared to the overall size of the crypto asset markets and are used mainly as settlement coins on crypto-asset trading venues. CBDCs, including a potential future digital euro, could enable future developments. There are opportunities for plenty of innovation and competition, for example between wallet providers. The Commission is working closely with the European Central Bank (ECB) to explore the best way to issue a potential digital euro. The roles existing financial institutions might play are being explored. Crypto-assets and the potential CBDCs of the future are complementary, not mutually exclusive.

The existing EU AML framework is currently under review. The framework should leave the internal market intact and allow for the free movement of capital for legitimate purposes while ensuring an effective fight against money laundering and terrorist financing.

9. A swift adaptation, in the EU and globally, of central banks to the blockchain developments in the payments and security transaction settlement areas, is necessary

A public sector representative noted that there has been very fast progress on CBDC globally, with the Bahamas as the trailblazer and China moving fast with pilot projects. In its work on CBDC, the Bundesbank recently tested the interface between a blockchain platform and the conventional real-time gross settlement (RTGS) system to settle securities in central bank money. The Bundesbank can settle tokenised assets without CBDC, but the digital euro project is also underway.

A Central Bank official explained that the recent experimental project built a technical bridge between the blockchain technology and the TARGET2 system. Security transactions on a private distributed ledger technology (DLT) system were settled in central bank money. This is a so-called trigger solution: the security transaction on DLT automatically triggers the corresponding payment via the trigger chain operated by the Bundesbank into TARGET2. There is a strong demand in the market for a solution that enables the settlement of the cash leg of DLT-based transactions. In the context of CBDC, this provides an additional way to bring efficiency and innovation into the market for securities settlement and could be complementary to the digital euro. The solution uses infrastructures that are already in existence. As such, the Eurosystem could implement such a solution in a relatively short space of time.

The public sector representative stated that the Swiss centre of the BIS innovation hub has compared settlement with a central bank token that is a wholesale CBDC and settlement through the traditional RTGS.

10. The digital euro is another form of the single currency intended to ensure safety (KYC, AML, CFT) and privacy, as well as systemic financial and operational resilience, while supporting innovation in the retail digital landscape

The public sector representative noted that privacy is a priority for consumers when considering a CBDC.

A Central Bank official commented that central banks have developed centralised systems and are now moving towards decentralised infrastructure. Interoperability between decentralised and centralised infrastructure will be needed. Developing a token-based CBDC is a possibility. The Eurosystem and the ECB are working on the development of a retail CBDC. The outcome of a consultation demonstrated the importance of privacy and security for users. The systemicity of digital euro infrastructure must be considered, aiming to ensure resilience by design. Implementation through different technologies or infrastructures avoids a single point of failure. Financial security of a digital euro will be substantial, since it will be a perfectly safe central bank liability. It will be another form of the single currency.

Compliance with know your customer (KYC), AML, CFT and tax evasion regulations is also necessary. Privacy does not imply anonymity. Digital euro transactions could be visible to intermediaries in order to allow them to comply with AML CFT requirements while ensuring the protection of data. DLT is a potential solution in this area. Selective privacy could be applied for low value payments.

An industry representative commented that an offline supported CBDC might address issues around privacy and anonymity.

11. Defining the appropriate timeline and shape of a digital euro is a complex pragmatism challenge, the solutions to which involve both innovative technology and existing intermediaries and infrastructures

A Central Bank official commented that there should be a readiness to swiftly issue a digital euro should the need arise to safeguard monetary sovereignty. However, a digital euro could pose risks to the financial system and impact financial intermediaries. The benefits and risks must be measured holistically. Mitigation measures can be considered as regards the risk of bank deposit substitution, but these measures could have consequences for the attractiveness of a digital euro. Some risk might be mitigated with proper design and calibration. It is important to preserve the role of private intermediaries as interfaces in the distribution of a digital euro. The digital euro will be discussed at governing council level by mid-2021.

An industry representative agreed with the need to preserve the role of existing private intermediaries. Integration of a potential digital euro with the existing payment system will be important for acceptance.

12. The technical solution and arrangement architecture underpinning the digital euro will depend on priority use cases still to be chosen

An industry representative stated that initial reflections on offline usage rely on using existing payments systems. A digital euro could be additive to a digital payment mix if it is viewed as a digital equivalent to cash. Visa can also envisage a tokenised digital euro.

A public sector representative emphasised that offline capability is very important for retail CBDC.

A Central Bank official stated that an offline capability for CBDC is an important aspect. A digital euro will have to include such a function. This will help that people have the same degree of trust in a digital currency as they have currently in cash.

Another Central Bank official commented that a cash-like digital euro will need to have offline capability. Offline capability will be less important for some other use cases. As such, a step approach for the development of the digital euro might be necessary, with not all use cases being accommodated from the beginning. Cross-border payments are among the envisaged use cases, but more understanding is needed around interplay and interoperability. Another interesting use case relates to smart contracts. Private monies could provide these types of services. This is also true for wholesale payments. There could be complementarity between private commercial money, or even stablecoin payments, and CBDC payments. Banque de France has experimented with issuing CBDC on blockchain in order to settle securitised tokens.

13. A digital solution that plays the same role as cash is required

An industry representative commented that offline support of a digital euro is a key design characteristic. Customers will likely require a digital parallel to cash. Otherwise, there is a position to be taken by the free-floating cryptocurrencies of the world, which might not be in the interest of the greater good. In Scandinavia, very little cash was used before the pandemic, and it has now almost disappeared. If digital is a person's preference, they will use some kind of digital alternative to physical cash. It is necessary to develop a solution that is backed by central banks.

A public sector representative noted that all central banks have stated that they want to retain banknotes in light of their importance for some use cases and some communities.

14. Possible consequences of digital money on the international monetary system

A Central Bank official commented that the digital transformation is also a way to move flows, maybe of currency. The distribution of stablecoins through big techs is concerning for regulators, because it could be very powerful through the social network. There is a question of monetary sovereignty. Big techs are either American or Chinese, so there is a link with the question of the international monetary system and international competition. Europe does not have any big techs, so it is important to support the international role of the euro, develop pan-European solutions and be ready to issue a CBDC if needed.

CROSS-BORDER PAYMENTS GLOBAL ROADMAP

1. The challenges faced by cross border payments and related players globally

A central bank official observed that cross-border payments are seated at the heart of international trade and economic activities. Several shortcomings hamper their efficiency in terms of cost, delay, transparency, and accessibility.

An official stated that enhancing cross-border payments has become a central theme of the Central Bank Committee on Payments and Markets Infrastructure (CPMI). Europe does not either have one monolithic, cross-border payment channel and there are doubts that it ever will. In addition, developing competition and innovation is needed to deliver the multiple services that are going to match the diverse needs.

2. Significant cross-border payment initiatives

2.1 Private and public sector solutions

An industry representative noted that cross border payments are more complex than domestic ones. Time zone differences contribute to delays. Payments following the sun are more quickly executed than those travelling against the local operating hours. Straight through processing and 24/7, real-time operating capabilities will reduce the impact of time zones. New technologies like APIs can already support speed. Improved compliance checks and data standards such as ISO 20022 will greatly ease the flow. A great deal of work has already been done by the financial industry over the past five years to address frictions in cross-border payments, mainly through the Global Payments Innovation (GPI) SWIFT initiative. Regulatory barriers and capital controls are the most significant friction. The regulations, processes and everything related to compliance will require much more collaboration notably to improve the level of harmonisation.

2.2 The SWIFT-led GPI initiative triggered a strong adhesion, and steep progress will soon be perceived

A Central Bank official stated that in the payments industry the unprecedented pace of change is driven by innovations in technologies and business models.

An industry representative noted that transformation is well underway, even though the industry has not done what it should have done regarding cross-border payments over the last decade.

An industry representative stated however that the GPI initiative required a change in thinking, with the SWIFT-led platform strategy leveraging the corresponding network by a coalition of the willing taking the lead. Over time, what will be seen is more and more players joining that journey, and then the superior experience that is being created will become the standard.

2.3 Key success factors to make significant progress are de-risking, harmonisation, and cooperation, which enable competition and innovation

An industry representative stated that global customer expectations on safety and security in the cross-border payments space are changing at a very fast rate. Significant investments have been made in recent years, both on the cash side but also on the areas of pay-out to wallets, cards, and also regarding Bank Management Systems (BMS) of bank accounts and access to real-time payment systems. The current fragmented payments landscape is no longer fit for customers' expectations. The main objective of the project is the harmonisation of cross-border payments across all dimensions. A much more solid and harmonised foundation will generate the desired effects like enhanced competition, more transparency, reduced costs and increased qualities. Resolving these issues requires exactly the comprehensive approach that is suggested and will only be successful if it is done in a very close collaboration between the regulators, policymakers, and the private sector.

An industry representative observed that the payment models are being disrupted and that this is driving change. The trick to thinking about this transformation is how to replicate the superior client experience that is available in a closed loop ecosystem. It is very important that the industry learns from the disruption that is going on. In the last 10 years cross border payments have not evolved in the way that they have needed in order to meet the increasing expectations of clients. The industry has not taken the advantage offered by technology as it has evolved over the last number of years. One critical reason is the very team sport nature of cross border payments, which are dependent on many players in the ecosystem. The end user experience is always going to be impacted by the weakest link in that chain.

A Central Bank official stated that beside the set of building blocks on addressing de-risking and the cause of de-risking, the common theme that can be identified in the CPMI 19 building blocks is competition and innovation. Both incumbents and new players need to feel welcome and should obviously be subject to the same compliance rules. Three application of these rules needs to be made more efficient to make entry into the market easier and to stop the de-risking trend.

An industry representative highlighted the issue of legal barriers, and the fact that progress may be difficult to achieve in a cross-border context when there are different laws and different implications.

3. The ambitious G20 roadmap is a pragmatic and cooperative approach which is intended to be technology and business model neutral

A Central Bank representative noted that the multidimensional set of frictions at the root of existing shortcomings have recently been given a strong political impetus under the aegis of the G20 in view of a matter arising of significant progress. Agreeing on such a roadmap was an incredible success. It is important to move from design to implementation. Momentum is there to improve, but the G20 roadmap is an opportunity to move forward.

An official stated that there are two additional challenges. A comprehensive programme is needed to ensure the improvements sought in this area are broad based, and to make sure that further multiple channels can be developed and enabled to work together. The overall objective is to improve in four key areas: faster, cheaper, more transparent, and more accessible, while maintaining the safety and security across both wholesale and retail payments at the same time.

A Central Bank official observed that the G20 roadmap do not represent another risk factor or additional risk. It is a great opportunity because it is neutral and the roadmap does not endorse any specific model or solution or technology, so it is neutral. The roadmap is a multi pronged action plan targeting a whole range of frictions and inefficiencies. It tries to build on existing approaches, arrangements, and systems in order to get some practical results over the short-term. However, there are also more ambitious targets that can be achieved only over the medium term. The roadmap implies a close involvement of the private sector. The aim is to get to a new equilibrium in which all stakeholders can be better off.

4. Specific wholesale challenges

4.1 Payment Versus Payment (PVP) is an essential arrangement to address wholesale cross border payments' foreign exchange risk

An industry representative stated that examining PVP in the cross-border payment area is very important as very often, particularly for wholesale activity, cross-border payments implies an foreign exchange transaction in two different currencies almost by definition. PVP increases efficiency and safety of financial markets, and also mitigates principal risks. Regarding the systemic dimension of those transactions, a December 2019 BIS report suggests that the current volume of settlement that does not benefit from a PVP mechanism is over $8 trillion USD equivalent per day.

4.2 Despite ever-growing globalisation, many currencies still do not benefit from PVP

An industry representative highlighted the fact that there are still several major currencies that do not benefit from PVP protection, and therefore transactions in these currencies remain exposed to settlement risk. The share of the transactions in these currencies is growing as globalisation is growing.

5. Change management success factors

5.1 Preserving the soundness of existing systems and arrangements, requires 11,000 institutions across the globe to evolve at the same time

An industry representative noted that further evolution and transformation of the legacy and the existing systems are needed, but recognition is needed of the assets and the strengths of the existing system. The safety and soundness element needs to be part of the future, as well as the ubiquity, openness and reach of the existing systems, with payments across 200 countries.

An industry representative added that his institution has been very supportive of the SWIFT GPI initiative which will be launched in November 2022. The SWIFT correspondent banking model is ubiquitous across the world. If the change can be executed by building on the existing ubiquity and existing integration, then there is a much higher chance of success in terms of executing change at scale in a way that could deliver consistent end-user experience. There is a challenge of getting 11,000 institutions to make a transformative change at the same time. Everybody was fearful of leaving; the industry did not want to disenfranchise the players in the system that were not ready to make that change.

An industry representative noted that to be successful in that area there needs to be good collaboration between the public and private sector. For example, a strong public-private partnership of banks and central banks was key to CLS's creation following the failure of Herstatt bank, and that partnership continues today.

6. Cross-border payment efficiency is expected to benefit from CBDCs provided they are compatible with domestic payment systems and that there is international coordination including on regulation and supervision from the outset

6.1 Any international payment arrangement must be interoperable across borders and with national payment systems from the outset

A Central Bank official explained that the ECB worked with Riksbank and Banca d'Italia on implementing instant payments, cross currency, cross border, relying on its infrastructure Target instant payments settlement (TIPS) and achieving payments-versus-payments (PvP). Also here compliance issues need to be revisited: Instant payments have a higher rejection rate cross border than domestically even within the euro area.

A Central Bank representative moved the conversation onto new infrastructures and how they can contribute to driving change in cross border payments. One candidate was the central bank digital currency (CBDC).

An official stated that CBDCs are the 'shiny new car' and everybody has a great deal of interest in them. A BIS CPMI survey showed that that cross border payment efficiency is an important motivation for CBDC issuance by many central banks. There is real value in creating CBDCs that are interoperable and based on compatible domestic systems. There needs to be international coordination from the outset, but these arrangements have not been implemented broadly. The development of existing payment systems and infrastructures requires significant progress in the more traditional areas of payment systems and arrangements in the G20 roadmaps.

6.2 Inefficiencies resulting from frictions due to regulations and supervision must be fixed in various areas such as KYC, AML, and data protection at the EU and international levels

An official stated that technological changes alone are not going to deliver the improvements that are being sought. Europe also needs better regulatory alignment between jurisdictions. The prospect of stablecoin proposals is a completely new payment rail outside the banking system. Analysis is ongoing regarding how the existing Principles for Financial Market Infrastructures (PFMI) could apply to the governance arrangements of stablecoin arrangements. CPMI and IOSCO have been reviewing the applicability of the BIS's standards and stablecoin arrangements.

An industry representative observed that the financial sector has made huge investments in compliance in the last few years at an enormous cost, mainly driven by the levels of fragmentation Europe currently has. Elements like suspicious activity reporting and similar regulations are under local implementations and are not harmonised. New entrants are not encouraged.

A Central Bank official stated that the G20 roadmap would not necessarily imply an increase in regulatory costs. Europe has already committed to reducing compliance costs. The private sector is closely involved, so market forces can do the job of addressing inefficiencies and friction. The roadmap also enhances cooperation among public authorities.

CURRENT EU RETAIL PAYMENT INITIATIVES: STAKES AND CHALLENGES

1. Retail payments in the EU: context and stakes

1.1 Most national retail payment solutions lack scale in the EU

An official noted the dramatic changes in the European payment landscape fuelled by COVID-19, the waning use of cash and new technologies like instant and crypto, in addition to the growing market dominance of digital platforms. Most payment solutions are still domestic. National cards or digital solutions for e-commerce or peer-to-peer (P2P) payments lack scale to compete with big techs from outside of Europe. There is a risk of a growing dependence on those.

1.2 Payments digitalisation has been accelerated by lockdowns

An industry representative highlighted the acceleration in payment digital alternatives and digital payments. This is primarily due to e-commerce, driven by the lockdown, and a change in customer behaviours, driven by a desire for a more secure experience at the point of sale. There has been an acceleration of the previous, already significant, growth in e-commerce. Cards in general have gained share at the expense of cash and bank notes. Use of contactless has been driven by the health authorities recommending usage and an uplift in the threshold. P2P payment system payments are also increasing in some markets. These changed behaviours will likely continue after the health crisis.

An industry representative commented that the last year would have been very different if digital payments had not been available. Economies need to be resilient, and payments play a vital role in this.

1.3 Regulatory challenges in the EU retail payment area to reduce existing fragmentation

A policymaker commented that the pandemic has accelerated change in the payment sector. The regulatory framework must remain fit for purpose. Despite the progress made on the harmonisation of the regulatory framework for payments in recent years, in particular the single euro payments area (SEPA), the retail payments markets in Europe remain fragmented along national borders. International card schemes are dominant in the cross border EU payment world, reinforced by the arrival of big techs. Risks of crypto-assets include issues of consumer protection and possibly even financial stability and monetary sovereignty if they are not properly regulated.

2. EU policy priorities

2.1 Eu policymakers are currently focused on fostering competition and innovation, EU payment autonomy, consumer protection, resilience, AML and instant payments

An official noted that legislators, central banks, regulators, and competition authorities are working towards a more appropriate framework for a resilient, innovative, diverse, and competitive payments landscape. This includes supporting emerging pan-European payment solutions, such as the European Payments Initiative (EPI). The market power of big techs, international card schemes and payment markets is increasing.

A public decision maker stated that fair competition and European autonomy are a priority. The impact of the Digital Markets Act (DMA) and Digital Services Act (DSA) is ongoing. The aim is to be fully aware of how services, including payment services, are used in the EU and to act to mitigate any dependency. The Payment Services Directive (PSD2) demonstrated that opening segments of the financial markets can be positive for consumers. Competition must be fair and should not disadvantage incumbent players relative to newcomers. For example, reciprocal access to relevant data should be pursued. New fintech solutions should respect European values and rules on consumer protection and anti-money laundering (AML). At the European level, action is being taken around dependency, for example the EPI and the Digital Operational Resilience Act (DORA). DORA ensures supervisors increase their awareness of their dependence on information and communications technology (ICT) providers outside the EU.

A policymaker stated that the specific and targeted measures in the retail payments strategy aim to create an innovative, integrated, and competitive retail payments sector in Europe. Instant payments play a key role in this strategy and can become the new normal in Europe. Enablers include adequate consumer protection measures, effective ways to address instant fraud and a smooth sanctions screening process. The European Commission does not intend to simply impose a date for the introduction of instant payments but takes a holistic look at the issue. A targeted public consultation is ongoing. The European Commission will then consider the possibility of a legislative proposal. A comprehensive review of PSD2 will be carried out.

2.2 Achieving an effective level playing field across the EU and developing the EU retail payment market agility, require further political efforts

An industry representative stated that driving the level playing field and ensuring competition has been a key objective of the latest batch of EU regulation on retail payments, such as PSD2 and IFR; however, it has not yet materialised, so it is important to get it right this time around.

2.2.1 Simplified licencing rules in the single market

An industry representative noted that the removal of the exception acknowledged by legislators in PSD1 on open access rules, led American Express to exit the licensing partnership in 16 European member states. The rules make it more difficult for innovative fintech players to enter the space and compete with dominant four-party schemes, which has directly contributed to less competition in the sector and was acknowledged in EY's IFR report last year. A one-size-fits-all approach does not make sense. The open access rules issue is important as it links to EPI, since a combination of parties might be required in order to make EPI work outside of Europe.

An industry representative stressed that openness is essential as the future is unknown and resilience is a key concern. Permanent pieces of kit that have the seeds of their own obsolescence in them should only be built very cautiously. Visa Europe used to be owned by 441 banks. There were no fintechs on board. There are now 200.

2.2.2 An effective ability of payment services providers to issue credit lines across the EU

An industry representative noted the disadvantage and unlevel playing field caused to non-bank PSPs by the restriction in PSD2, which says that Payment Institutions (PI) can only issue credit up to 12 months in their home member state. This severely restricts and places PIs at a serious disadvantage compared to banks when offering personal loans and credit cards, and further limits customer choice. Furthermore, consumers tend only to seek credit in their home market and not shop cross-border for credit. The lack of a cross-border credit market also undermines one of the Consumer Credit Directive's main goals and EU's vision. The upcoming review of the CCD is a good opportunity to fix this. How non banks or cross-border firms can access national debt registers should also be explored.

2.2.3 A swifter on-going adaptation of payment-related regulations to actual progress, technology, business models and markets is necessary

An industry representative commented that, since legislation started around 15 years ago, including PSD2 and Interchange Fees Regulation (IFR), the payment landscape has evolved. There are still some opportunities to be optimised, such as those around competition, transparency, choice for the customer, rules, and harmonisation.

2.3 It is also necessary to address the consequences of the Wirecard scandal regarding citizens' confidence in EU financial supervisors and regulators

A public decisionmaker stated that the Wirecard scandal has had a devastating effect on the reputation of the EU in the fintech space. Strong action is needed to ensure consumers retain trust in financial institutions, supervisors and legislators. The governance of the European supervisory authorities should be reviewed, not just the powers. Wirecard has cast serious doubts on what was thought to be an adequate architecture for supervision and cooperation at European level. The main message to the soon-to-be-chosen new leaders of the European Securities and Markets Authority (ESMA) is that the European Supervisory Authorities (ESAs) should be more ambitious and feel confident asking challenging questions of national authorities.

3. Respective roles for the private and public sector

An industry representative suggested that payments can be considered in a similar way to Maslow's hierarchy. Maslow talks about water, air and security. Security is also discussed in payments. The second level of Maslow's hierarchy is love and belonging. In the context of payments, it can be thought of as openness and access, which is what engenders competition. The last level of Maslow's hierarchy is about self-esteem or self-actualisation. The equivalent in payments is the things different people want from payments and how to engender the innovation that enables that. All use cases are different. The top of Maslow's hierarchy is where the private sector needs to thrive. At the bottom of the hierarchy, the public sector needs to be deeply involved in conversations around resilience, security, and fraud prevention.

3.1 Central banks are partnering with the private sector to close existing infrastructure gaps on the payment area

3.2 Wholesale payments are essential to make effective monetary policies

An official noted the role of central banks as providers of market infrastructure. A Central Bank official (Juan Ayuso) commented that market infrastructures are in some respects, like real-sector infrastructures as there are fewer than socially needed and usually the best way to fill in the gap is collaboration between the private sector and the public sector. Central banks however use central bank money to build the infrastructures. This material is the highest possible quality. The soundness of the infrastructure has a direct effect on the central banks' ability to fulfil the tasks they have been assigned. Wholesale payments are at the core of the monetary policy transmission mechanism, which may be why many central banks provide the infrastructure for wholesale payments.

3.3 The current fragmentation of retail payments in the EU requires Central Bank action

A Central Bank official stated that retail payments are not so crucial in the monetary policy transmission mechanism, but the Eurosystem has also been assigned the task of promoting the smooth operation of payment systems. When economic and monetary union (EMU) was launched, most retail payments took place within the boundaries of the different countries. As such, fragmentation at the end of the 90s was not a big challenge. It was more of a problem with the advent of the SEPA initiative. The current degree of fragmentation in retail payments in Europe is a serious obstacle.

3.4 While TIPS targets helping to achieve the European reach of instant payments and supporting cross currency retail payments, the private sector focus is on value-added services

A Central Bank official commented that central banks are better equipped to provide the rails, leaving to the private sector the provision of the value-added services. This is the principle behind TARGET Instant Payment Settlement (TIPS), the market infrastructure that Eurosystem provides for instant payments.

A Central Bank official stated that central banks are aiming to ensure pan-European reach for instant payments through the TIPS infrastructure by the end of 2021. All payment service providers in TARGET2 that adhere to the SEPA Instant Credit Transfer (SCT Inst) scheme will be reachable in TIPS. In addition, Automated Clearing House (ACH) instant payments settlement will move from TARGET2 to TIPS. The intention is to support the G20 roadmap on cross border payments. The Eurosystem is investigating what role central banks can play, for instance investigating the use of TIPS for cross-border instant payments in Swedish krona and euro together with the Swedish central bank.

A Central Bank official commented that payment service providers should offer instant payments under attractive conditions rather than treating them as premium services, and also with additional functionality being provided.

4. Data is a major issue for an efficient digitalisation of the EU economy

An official commented that data opens a wide range of new business models, but also drives the market power of digital platforms. Personal data must be protected while data monopolies are broken up.

A policymaker commented that data is an issue for competition policy. Potential data usage has increased exponentially, and data has already become an essential input for many activities. Those holding data may become gatekeepers. Big tech companies have access to increasing amounts of data and are attempting to gain a foothold in the payment market with this. In addition, platforms create network effects that may be detrimental to consumers.

4.1 Emerging strong network effects and data portability asymmetry and interoperability issues exist

A policymaker commented that data portability can be an effective remedy for anti-competitive conduct. The General Data Protection Regulation (GDPR) includes the principles of purpose limitation and data minimisations. In the context of open banking, PSD2 limits the kind of data and the purpose for which it must be provided. Competition and data protection concerns are complementary. Competition authorities have started using data protection as a benchmark for assessing competition.

The policymaker noted in addition the perceived asymmetries in regulations around data portability. Fintechs and big techs are not subject to the same requirement that banks are under PSD2. Interoperability is important so different ecosystems can provide access to data to different operators.

4.2 Private stablecoins require close monitoring to ensure populations benefit fully from them

A policymaker commented that the main advantage of private stablecoins from a competition perspective is that they bring efficiencies to payments. Consumers will benefit from more competition, leading to lower prices and more innovation. Populations that are currently unbanked may get increased access to payment methods. Private stablecoins may raise issues related to financial and monetary stability, AML and combating the financing of terrorism (CFT). EU legislation aims to embrace innovation through regulating and supervising crypto assets and to address security threats, for example in the proposal for DORA. Regarding competition between private stablecoins and central bank currencies, private stablecoins need to be monitored. There is currently no competition enforcement, but products such as Diem and Novi are being reviewed proactively.

5. EPI

5.1 EPI is an essential EU initiative

An official stated that EPI will better balance competition and contribute to European autonomy. European standards could be integrated throughout the payment chain.

5.1.1 EPI challenge for banks and success factors

An industry representative commented that interlinking existing national payment solutions has been found not to work. European or international players have more money for innovation and to convince merchants and people to use their systems. The European banks understand that there is a need to invest together to compete with the big players.

A Central Bank official stated that a main goal of the Eurosystem retail payments strategy is the development of a pan-European solution for payments at the point of interaction (POI). Other goals include the full deployment of instant payments, the improvement of cross-border payments and support of innovation and digitalisation in the European payments' ecosystem. Concurrently, the case for a digital euro is being explored.

5.1.2 The ECB and the Eurosystem have welcomed the launch of the EPI

A Central Bank official noted that EPI meets all the European Central Bank's (ECB) objectives. The ECB remains open to other initiatives that would meet its objectives. It is crucial that EPI extends beyond the current set of the participants.

The CEO of the EPI Interim Company commented that international competition is the biggest challenge in the retail payments space. Banks are being disintermediated, not just in payments but now in financing. European players cannot easily compete on innovation and new technology in payments but also in financing. The European market is still very fragmented, which does not allow European players to compete with international players. The business model for banks no longer enables the substantial investments that are necessary. Dependency is another challenge. EPI can address these challenges and aims to be a competitive European solution. EPI will bring the size to invest collectively in innovation. Aligning will overcome fragmentation, helping European players to become independent.

5.2 EPI's key success factors

5.2.1 Addressing first consumer and merchant needs and efficient decision making

The CEO of the EPI Interim Company stated that EPI includes 'the rules', the 'rails' and the standards, but also a value proposition that is meaningful enough to compete for the interest of the consumers and merchants. This will only work if the banks respect the needs of the merchant and the consumer. Alignments will provide efficiency and the synergies that are crucial to become more competitive. TIPS is already present, but the front-end side is also needed. EPI can contribute to the e-commerce and m-commerce spaces, where banks are underdeveloped and there is no European solution, and in the cross-border space. The evolution of EPI is a massive process. It is difficult and complex to align different markets coming from heterogeneous environments, potentially with diverging priorities, leading to some kind of nationalism.

5.2.2 A wait-and-see attitude of too many banks and payment service providers hampers swift progress regarding instant payment and EU autonomy, and weighs on the role of EU banks on e commerce

A Central Bank official commented that the attitude of 'If it is not broken, let us not fix it' leads to complacency. Europe has become dependent on international card schemes and banks have missed an opportunity to develop a presence in the e commerce space.

An industry representative stated that EPI needs help to develop a viable business model and reduce investment uncertainty. The regulator should prevent any attempts by market players to unfairly limit the rollout of EPI across Europe, as some of the big market players oppose EPI, and underline the importance of adopting the open international standards.

5.3 EPI's timetable

The CEO of the EPI Interim Company indicated that new members will be welcomed to EPI by the end of the year. A market launch is expected in the current year. The aim is to go live in 2022, initially in the P2P space and then in e commerce and face-to-face retail transactions. There will be a migration phase of a couple of years.

6. CBDC

6.1 CBDC should also support future evolutions of an EU digitalised economy

The Chair indicated that the Eurosystem and a growing number of central banks worldwide are considering the potential issuance of central bank digital currency (CBDC). CBDC could provide future proof payment solutions.

6.2 Among the various scenarios requiring Central Banks to issue CBDC many feature negative developments in retail payments

A Central Bank official noted that a recent ECB report on CBDC identifies seven possible medium-term scenarios, many of which include elements related to negative developments in retail payments. The back end part of CBDC infrastructure could or should be provided by central banks. The private sector could then focus on providing the front-end part of the service.

SESSION SUMMARIES

III

ESG AND SUSTAINABLE FINANCE

PROSPECTS OF GLOBAL AND EU ESG STANDARDS CONVERGING

1. ESG standards: what is at stake

1.1 Encouraged by the actual correlation between financial and non-financial performance, investors play a key role in leading companies to addressing essential challenges of current generations

An official commented that a single shared, standardised language is needed for corporate information. The biggest challenge of this generation, in addition to COVID-19, is climate change and the related social inequalities and human rights violations. To tackle this, companies are required to be sustainable to make it easier for them to receive funding.

An industry representative explained that the sustainable finance package originally intended that disclosure would change the behaviour of the underlying companies that need the capital flows, either from investors or the banking and insurance vectors.

Another industry representative stated that active asset managers use data that corporates disclose to help their transition. Different frameworks can make reporting burdensome for issuers. There is increased data evidence of a correlation between financial and non-financial performance. Current investment decisions are therefore also based on non-financial data, already in current decision making even ahead of respective regulatory obligations coming into force.

An industry representative reported that the top three reasons given in the Zeronomics survey for organisations not fully supporting the aims of the Paris Agreement were a lack of finance, the need for regulatory certainty and the lack of clear standards on the net zero definition and targets. Standard Chartered Bank is supportive of the International Platform on Sustainable Finance (IPSF) and grateful for the work of the International Organization of Securities Commissions (IOSCO).

1.2 Companies' disclosures are essential to empower investors and enable a sustainability dynamic

An official noted that policymakers and regulators aim to avoid unintended side effects on the efficient functioning of the financial markets. Transparency and standardisation are at the centre of international debate.

An industry representative commented that investor demand for ESG funds is rising. The supply from asset managers is increasing, with the sustainable finance disclosure regulation (SFDR) article 8 and 9 products coming to the market. The asset management industry is starting to integrate more ESG factors into the investment process. The foundation and nucleus of all this is corporate disclosures.

1.3 There is an opportunity to leverage the increasing global political alignment to deliver transparent, comparable, and standardised information

An official commented that there is an urgent need for public and private standard setters on non financial information to deliver consistency and compatibility. There is still no single definition of sustainability.

2. Policymakers' efforts at EU and global levels

2.1 The EU is now focusing on making the Non Financial Reporting Directive consistent with the various recent ESG initiatives

A policymaker indicated that the non financial reporting directive (NFRD) will be reviewed and updated to ensure it is consistent with other EU legislative interventions.

2.2 This review is part of the Commission's agenda to foster sustainability transition, which also represents a recovery opportunity for the EU in the Covid-19 crisis context

A policymaker confirmed that sustainable finance is high on the Commission's agenda. Sustainable finance is a part of the Commission's plan for a quick, efficient, and sustained recovery.

2.3 NFRD: giving the investors the detailed and precise information that they need and addressing information consistency and comparability issues at the European level

A policymaker explained that the NFRD review aims to widen the scope of the NFRD. Obligations stemming from the directive will be made more concrete, detailed and specific. The directive covers sustainability in the ESG interpretation, including social issues, human rights, and governance. Standards are different everywhere. Information is not comparable and therefore not useful for investors. Some companies do not report at all. European standards for reporting on non-financial issues will build on and coordinate with standards that already exist.

2.4 The focus of policymakers should also be on making the information needed assurable

An official commented that the public sector is needed because, no matter how effective the work of market participants, consistency and comparability in reporting is necessary. Public sector intervention ensures that information is assurable.

3. Although human capital is an actual priority in the EU, related value-creation metrics and information require steep improvements

An industry representative noted that there is agreement among most speakers on the need for comparability, global standards and ensuring any actions are useful for end investors and companies. Focus should be on human capital and practical suggestions. The NFRD was one of the first reporting standards that included human capital and a need for diversity data. In analysis carried out by their Group, human capital is of equal importance to other ESG considerations (as climate change), but there is very little reporting on it.

An industry representative advised that frameworks should align with the sustainable development goals (SDGs). Covid has highlighted the importance of inequality. Without human capital, no economy or company can remain competitive. International collaboration could begin around an issue as simple as human capital. The Securities and Exchange Commission (SEC) has recently noted the importance of human capital. Companies are requesting simple, clear, understandable metrics. Europe is doing well on diversity of workforce but lagging on diversity of senior management. Better data on global breakdown of ethnic diversity and how companies invest in the workforce is needed. Human capital would be a great platform to ensure the S is included in ESG and to get strong international collaboration.

4. Emerging markets should be further considered to progress climate change issues

An industry representative noted that the biggest and fastest source of emissions now, and the area that has suffered almost twice as much damage already from climate change, is the emerging markets. It is also where there is the biggest opportunity to leapfrog to low-carbon business models. There is a lack of capital going into tackling sustainability in these areas. Feedback has been received from investors and other actors around the lack of common standards. Standards should encourage capital to move to where it can have a huge impact.

5. The journey toward convergence starts with meaningful, monitored and verifiable data

An industry representative commented that basic information can be built on. The largest companies can make the biggest difference in the shortest time, so the initial focus should be on reporting by large companies. The required quality and consistency of data is not present in the financial services sector now. When data is in the audited accounts, it is possible to have a reasonable definition of what is assured and what has an opinion against it. When it is presented as a non-financial disclosure, it should not be a marketing document.

6. A centrally developed set of standards might lack agility and fail to deliver an optimal flow of capital

6.1 Frameworks are often static and backward looking, which leads to lost development opportunities and industry-specific transition pathways being ignored

An official stated that well-functioning capital markets enable capital to flow to the people who can use it best. Pre-planned capital markets operating according to a centrally developed set of standards cannot do this, because they channel money to wherever the people who wrote those standards thought would be the source of the solutions. Issuers and investors want a common framework, but the price of that framework will be high in terms of lost opportunities.

6.2 Information on the transition pathway and comparisons of the impact of investments should improve capital allocation globally

An industry representative emphasised the importance of a definition of transition. Reporting and definitional frameworks in the green markets are often static and backward looking. The technologies that will drive the future are unknown. Several industry-wide transition pathways across eight of the most carbon intensive industries will be published later in the current year. The banking and finance sector tends to celebrate volume over almost everything else, often at the expense of impact. Where and what is just as important as how much.

An official commented that the aim is the creation of a market that delivers the outcomes that public policy is seeking to achieve.

7. A framework for markets that can operate across borders is needed. However, balancing regional priorities will be challenging

7.1 A framework for markets that can operate across borders is needed

An official reported that the UK was the first country to announce its intention to make TCFD disclosures fully mandatory across the economy by 2025. The EU's ambition on sustainability reporting has been world leading. The NFRD will significantly strengthen sustainability reporting. International activity is needed because no one jurisdiction can fund a shift on its own. There are real-world geographical differences in how objectives will be achieved. A set of baseline international sustainability standards is needed, building from the TCFD architecture. In addition, individual jurisdictions have to develop their own disclosure requirements.

7.2 Existing regional or national ESG preferences and philosophies that are reflected in regulations raise competition and comparability concerns: a global solution is necessary

An industry representative commented that regulations inform the investors' definition of ESG. On the supply side, capital flows are international, and corporates operate with global supply chains. Diverging ESG rules across the globe make comparability difficult. There is also the potential challenge of corporates exploiting regulatory arbitrage across global supply chains. The NFRD is wider in scope than the TCFD and has a dual materiality approach, meaning that the data is not comparable.

An official commented that ESG is an emerging markets issue. A report published by IOSCO through the Sustainable Finance Network identified the multiplicity of sustainability frameworks and standards, greenwashing and challenges to investor protection as problems. There is an urgent need to improve the consistency, comparability, reliability and auditability of sustainability reporting.

7.3 Looking beyond what is material to a particular company, through a double materiality lens, is very foreign to the US disclosure regime

An official explained that the US materiality framework encompasses much of the sustainability factors under discussion only when they are material to the long-term financial value of the company. The US disclosure regime is a materiality based, principles-based regime and accommodates many different companies and industries.

7.4 Achieving global consistency with respect to ESG reporting will be as difficult as it is for financial accounting

An official stated that objective financial accounting standards are a key part of the disclosure regime. These change as companies and technology change. Achieving global consistency with respect to financial accounting is difficult and doing the same for ESG will be hard. Focus should instead be on ensuring quality of disclosure.

8. Policy making: ways forward

8.1 Against a plethora of initiatives, many propose the IFRS to be instrumental in fostering consistency and convergence

An official stated that baseline standards that can be applied internationally are needed. The International Financial Reporting Standards (IFRS) Foundation is the custodian of international financial reporting standards. The UK Treasury is very supportive of the International Regulatory Strategy Group's (IRSG) work. Political support and technical input from jurisdictions will be necessary to support the work of the IFRS.

An official stated that global standards need to be strong on governance. IOSCO supports establishing the sustainability standards board under the IFRS Foundation, given the governance there. IOSCO will endorse those standards once they are reviewed and found fit for purpose.

8.2 The challenge will be to leverage the work already done by multiple initiatives and to avoid competing on policy making

An official noted that much work is being done by the voluntary standard setters and the alliance of standard setters, building on the TCFD recommendations. In that context, technical work is already being done by the IFRS Foundation and IOSCO. The approach considers climate first with other issues not too far behind. Continued engagement and governance through the monitoring board is needed, also the recognising of the role of the European Commission.

An official commented that the EU has a longstanding commitment to promoting and developing effective international standards and is in a unique position to integrate common baseline international reporting standards and to be at the vanguard of leadership on the issue globally.

An industry representative stated that the solution should be collaborative, not competitive. A minimum set of standards should include clear, globally comparable definitions.

An industry representative commented that the current situation is challenging, and small steps should be taken initially. Collaboration is necessary for global markets to function well.

An official noted that there is value in homogeneity, but there are also costs to homogeneity, such as undermining the existing framework.

8.3 Achieving flexibility will be key

An official commented that the IFRS's approach will be delivered through building blocks, enabling individual jurisdictions and regions to supplement those baselines.

An official agreed that the building blocks approach is important. More is probably made of double materiality and single materiality than necessary. A European Financial Reporting Advisory Group (EFRAG) report discussed dynamic materiality and how the superset of sustainability topics would eventually become part of enterprise value creation.

An industry representative commented that dynamic materiality can help bridge the gap between pure financial materiality and double materiality. What is material to investors is changing.

An industry representative commented that the high bar already present for financial services reporting should be used to ensure that data provided is relevant. The more detailed and less flexible the rules are, the less likely global collaboration is.

8.4 The EU will go ahead favouring coordination and consistency with different standards and initiatives

A policymaker stated that global markets require global responses. European standards will build on the work that has been done already, aiming for the highest possible level of coordination, consistency, quality and even complementarity with the different standards. Slight adjustments for different markets and business models might be needed. Global coordination and the work that has been done by IOSCO, the IFRS Foundation, the Financial Stability Board (FSB) and G20 is important.

EU SUSTAINABLE FINANCE TAXONOMY IMPLEMENTATION

1. The EU sustainable finance policy agenda

1.1 Sustainable Finance at the forefront of the policy agenda

A policy decision maker remarked that the delegated act regarding the taxonomy is expected to appear within weeks and proposals on the Non-Financial Reporting Directive are also expected.

A policymaker stated that back in 2018, when the first action plan on sustainable finance was submitted, the subject was somewhat exotic and marginal. Three years later, it is at the centre of the debate and at the heart of the European and global financial system reforms.

1.2 The EU sustainable taxonomy is a bedrock of the EU sustainable finance policy

A policymaker noted that the EU taxonomy is at the heart of the proposed reforms. It is a classification system for environmentally sustainable economic activities. The desire is to create a trustworthy tool that helps to translate environmental objectives into clear criteria for investment purposes, and to define which activities are in line with the 2050 net neutrality objective. Sustainable activities are explained, so investors can be guided if they want to invest green and sustainably. The other goal of the taxonomy is to give guidance regarding the journey to sustainable economies. The policymaker (Marcel Haag) stated that while firms and the financial sector must transition, they cannot do so all at once. The move is from less sustainable to more sustainable.

1.3 Complementary legislative pieces and the renewing of the EU sustainable finance strategy

A policymaker explained that the intention is to submit the (first) delegated act on the Taxonomy later in April. There is also work on the data challenges. A review of the Non-Financial Reporting Directive will be submitted before the summer. Another delegated act on the taxonomy-related information companies will have to publish will be submitted. How to consolidate and further develop the Sustainable Finance Framework will also be considered. The intention is for a renewed sustainable finance strategy to be submitted before the summer.

A policymaker stated that the desire is to converge towards the taxonomy. The European Parliament and the Commission have a very important job, and a great deal of power in defining where a large amount of investment is going to go in the next few years. They must continue to be as rigorous as they have been because that will become the standard globally.

1.4 Making consistent green bond principles with the EU taxonomy is also necessary to further foster sustainable investment

A policymaker stated that the Commission is joining the ICMA Green Bond Principles, but given the programme is structural the taxonomy is something to converge with. The sooner the delegated acts are published and the clearer and more user friendly the taxonomy is, the easier it will be for sovereign issuers and sub-sovereign issuers to engage in this investment.

1.5 Investor protection is essential for sustainable finance to succeed

A regulator emphasised that the tool must be powerful enough to protect investors from greenwashing. Were there to be an accident involving inappropriate use of green labels, trust may disappear very rapidly.

1.6 EU public institutions are on track

A regulator confirmed that there are real challenges. At the European level, thanks to the European Parliament, the Commission and the EU Council of Ministers, agreements at level one and to some extent level two, have been reached for a rather comprehensive framework, which is very ambitious. It is the most comprehensive framework existing worldwide, supported by all co-legislators on a consensus basis.

1.7 Challenges faced by the definition of the regulation

A regulator warned that however the devil is in the detail. Regarding implementation challenges, the framework at the European level is very impressive. At the legislative level two, the choices made at level one, must be implemented. Each member state needs to be on board. In his jurisdiction, appropriate external communication was launched. Sustainable finance at the European level there is a step-by-step approach and attention also must be paid to avoiding a one-size-fits-all approach.

1.8 Pragmatism is required to combine the EU and global sustainable finance agendas

A regulator stated that, on the link with the worldwide agenda, when the discussion at the International Organization of Securities Commissions (IOSCO) level started regarding non-financial information standards, it was asked who needed to be in the first line and the answer was the International Financial Reporting Standards Foundation. They have experience with due process as well as technical legitimacy and can address the agenda.

A very ambitious but prudent agenda is being set up by the Commission. There will not be competition between Europe and the global agenda. However, the speed may not be the same.

In addition, EU political decision makers are paying attention to the social aspect and human rights dimension. The starting point at the worldwide level is the classical aspect relating to sustainable finance. At the end of March 2021, the Financial Stability Board (FSB) stressed that it welcomed the steps being taken by the trustees of the International Financial Reporting Standards (IFRS) Foundation, supported by IOSCO, to accelerate convergence in sustainability reporting. It must be understood who is best placed to come with additional regulation. For some aspects it will be the Europeans. For some extensions it could be at national level. For other aspects, finding consensus will require a opting for a building block approach. Europe cannot achieve the green transition alone.

2. Key success factors of the EU taxonomy

2.1 To be conducive to transition the taxonomy must evolve continuously

An industry representative stated that the obvious goal is net zero, and protecting the environment, the climate, and the planet. Europe is leading now and will continue to lead with regard to this challenge. However, certification of the taxonomy must be based on transition. Companies that are at present brown but have every intention to become green need to get exposure to capital to fund that transition. If this transition is not managed properly and effectively, incumbent companies that have every intention of being part of the solution could be stifled, which would be cataclysmic. Europe can also export the technologies, the skills, and the services.

A policymaker stated that the taxonomy already provides for transitional activities. The feedback on the delegated act indicated that more clarity is necessary, along with more sophistication when it comes to transitional activities.

However, more can be done to support companies on this transition, and the expert platform on sustainable finance has been asked to help develop the transition framework further.

An industry representative noted that the taxonomy gives the targets but it is not a tool for transition. He explained that they have developed a an internal tool to assess the transition of clients through a kind of colour or rating on the way the company is organising and progressing on its transition to the net zero target. However, this tool is not taxonomy compatible as it is a tool while the taxonomy gives the landing zone.

2.2 Implementing the taxonomy is a huge challenge which requires gathering beforehand some key success factors which will prevent any taxonomy-washing

An industry representative suggested that Europe should leverage the work on the taxonomy and come to the implementation phase as soon as possible, while maintaining the consistency of the taxonomy, including its science-based foundation.

There are important caveats for starting the implementation. There is the data issue, as was mentioned. To apply the taxonomy first, at the company level, a granular analysis of each activity is needed, in a context where the data to perform this analysis is hardly available. Thus, the conditions for a safe implementation must be thought about. This includes starting quickly to benefit from the learning curve as the implementation of the taxonomy will take time. In parallel it is necessary to build what is missing in terms of reporting tools, guidelines, completing the taxonomy, etc. There should be a transition period where companies can test, so when eventually official numbers are disclosed, they are actually reliable. Otherwise, publishing unreliable numbers could lead to what could be called taxonomy washing.

3. Sustainability data stakes, challenges, and success factors

3.1 Transparency is a precondition to accessing funding, cheaper funding

An industry representative noted that what works everywhere in the world is data transparency, to the extent good and granular data can be used to provide comparability. The interest an entity has can completely change the dynamic of the conversation related to sustainable finance.

An industry representative stated that there is the underlying issue that for the issuer, equity or debt, there is a prize for being on the right side versus a stick for being on the wrong side of the taxonomy, namely access to funding and to cheaper funding. That provides a reason to disclose more, better, and clearer data but also an incentive to manipulate data for the best numbers possible. It is therefore important for investors in these businesses to have some level of standardisation and accountability on the information being provided. If Europe does not get this disclosure part right with auditable, standardised data at corporate issuer level, then the risk is that, as this topic flows out of Europe, control will be lost over what is material.

3.2 Aligning bank reporting with the EU taxonomy is prevented by SMEs not reporting such information

An industry representative favoured taking a progressive approach, because there is a 'big wall' to contend with: the green asset ratio.[1] Currently it is only a 'wall' because the data is not there to assess the size of the green part of the outstanding of the bank. According to the EBA, the data from SMEs should be included in the reporting of the bank, but SMEs have no regulatory obligation to publish the information regarding the alignment of their activities with the taxonomy.

The taxonomy is not a tool for supporting, encouraging, and recognising the transition to a low carbon economy. The risk is not being seen as the pioneer of sustainable finance in Europe, and instead being the bad student of sustainable finance in the world due to not being able to issue the right level of green outstanding. The way the taxonomy is designed is somewhat opposed to how companies are financed. The taxonomy has an activity approach, while banks assess their counterparties by considering the company rather than the various activities it encompasses.

3.3 Technical and regulatory requisites for producing much-needed data

An industry representative stated that a key success factor is creating an EU data repository for SMEs. On the other side is leveraging technology much more. The problem lacks borders, so there is a need for a common perspective. Artificial intelligence and machine learning can do much to support the needs of the financial

1.The Green Asset Ratio (GAR) shows the proportion of assets that are environmentally sustainable (Green Asset) used to identify whether banks are financing sustainable activities. The GAR is based on the EU Sustainable Finance Taxonomy and is "Paris agreement" aligned.

industry in meeting the objectives. This can make for a much more global approach. Without a global approach the level of financing will be reduced. If the level of financing for the transition is reduced it will never be possible to get to where is needed.

An industry representative remarked that both data accessibility and the numeric format are important, and hence probably a European single access point (ESAP) also. There are many data requirements. The role of the non-financial reporting standard should be to define this data or make precise the data already required.

4. The ever-growing demand of investors regarding ESG information globally

4.1 Investors and asset managers have increasing expectations regarding EGS information although reliability and comparability of data remains challenging

An industry representative noted that their firm has been able to go out to financial institutions, particularly asset owners and asset managers. On a global basis, 75% really want to use environmental, social and governance (ESG) criteria, integrating these factors in their investment decisions. This is very positive compared to the current number. However, regarding securities investments, the comparability, and reliability of ESG data are real issues to be addressed.

A regulator stated that one challenge is how to go from many interesting initiatives and self-regulation to regulation. There are many labels in all jurisdictions. Usually, they are very successful, but they are very fragmented. EU investors should not have the impression that the labels on financial products, which are usually self-regulated, are not interesting or that there is no capacity to believe in the sustainable aspect of them.

It must be very clearly stated, especially from the European side, that the taxonomy, if developed in isolation, could lead to greater fragmentation of practices, and could even inhibit the growth of global sustainable finance. What is needed is one standard that considers some specificities at a regional level.

4.2 The priority focus may differ across regions in the world, which raises consistency issues

An industry representative stated that Europe is much more advanced than any other region on ESG, particularly on the climate agenda. In the US there would be more discussions about E and S. In Asia it is probably more on the Social and Corporate Governance aspects.

A consistent theme is the need to make things simple. Europe can be at the forefront of any conversation on this topic because of the splendid work that has been done so far. Maintaining that science-based approach and the simplification for looking at the taxonomy would probably be best for maximising the results in terms of international co-ordination.

An industry representative stated that Europe's leadership in net zero targeting is exciting. Key to European success is that European investors want financial security, but also with a strong element of sustainability. Europe has created a regulatory framework and is putting the taxonomy as the basis of certification. An industry representative (Hideaki Takase) appreciated that much progress has been made by the EU, which is a frontrunner in the discussion. To achieve the goal the global economy must work together.

The new prime minister of Japan declared that the country aims to achieve net zero by 2050. The banking industry and companies in Japan need to work together to contribute to that target. Multiple taxonomy frameworks complicate bank operations across multiple jurisdictions. Investment in the green area is important, but more important is the necessity of the transition from high-emitting sectors to more sustainable and energy efficient solutions.

The question is how to leverage the EU taxonomy, adding the global context and creating a consistent framework. A good example of global co-ordination is the International Platform on Sustainable Finance (IPSF). Many companies from the private sector joined this body to discuss how to coordinate. Due to new technologies and ongoing business, the taxonomy needs to be dynamic and flexible, not a static framework.

5. Challenges posed by the global convergence of sustainable finance standards

5.1 The current European leadership should benefit from the involvement of the EU in several international fora

A policymaker stated that Europe has a chance to remain a leader in sustainable finance. The priority is to do what it has been committed to and to do it right. There is engagement internationally in several fora. The G20 has started a working group on sustainable finance that will be led by the US and China. There is the G7, COP26 and so forth. There is no contradiction between having an ambitious European agenda and the international conversation. Efforts must be made to align internationally and then allow for regions and nations to go beyond the internationally agreed standards.

5.2 An effective transition toward economic sustainability should not be watered down by seeking convergence at the global level

An industry representative stated that as the leader in this area the EU should not leave everyone behind. This is a global standard and a very important global challenge. The hope is that good global coordination will accelerate.

However, a policymaker believed that the world will converge towards where it sees more rigour, and the taxonomy has the potential to provide that. 'Rigour' is not something static, but a mutually exclusive, collectively exhaustive list of differently classified activities with a dynamic sense. This is very similar to what is happening with data protection. The regulatory power of Europe can attract others because it is seen as more rigorous. Ambition should not be lost. It can be designed to be more user friendly, and with non-financial disclosures it can be made possible for small and medium-sized enterprises (SME) to provide data, but it should not be less rigorous for the sake of universality.

CLIMATE RISK IMPLICATIONS FOR THE EU FINANCIAL SECTOR

1. Addressing the climate-related risk

1.1 Developing the new risk managements metrics and practices needed to assess climate related risk will take time

A regulator commented that there is a broad agreement on two things in climate risk: firstly, it has far-reaching consequences, much will depend in the long term on what we do in the short-term, and it affects very directly financial firms. While it does not originate with financial firms, they should not underestimate their impact on what they do for them and for society at large. Secondly, the traditional risk metrics are not sufficient. Data gaps are huge. Without better disclosure of the "known knowns" and "known unknowns" using a common language, little can be said about risks and transition. And the more we wait the more costly.

A Central Bank official stated that there are many challenges. There is huge uncertainty related to the size and timing of these risks stemming from climate change, meaning that the historical data is of very little use. The work has barely scratched the surface of really understanding how climate risks drive the uncertainty of traditional financial institutions. Physical risk and transition risk tend to be spoken of in one sentence, whereas there is a huge difference in how they affect financial institutions and what data is needed to address these risks. It is very hard to estimate when there will be tipping points in consumer behaviour, political behaviour or technological breakthroughs. Europe needs to work on a forward looking strategy.

An official noted that while climate risk drivers are relatively new in the risk landscape, they can be adequately captured by traditional financial risk categories. Since for a bank, climate ultimately translates into credit, market, liquidity risk, or operational risk. Considerable work remains to be done to translate this theory into practice. Climate is an extremely long-dated risk and that makes measurement challenging. A globally agreed taxonomy is necessary and more data is needed to make existing regulatory and supervisory frameworks work well.

An industry representative commented that existing metrics need to be used, because at the end of the day it is financial risk. There are also challenges specific to climate change, such as the time horizon. With climate, there is much more emphasis on understanding where business is being done and the location of the underlying asset for an investment or a loan. There is a very long way to go when it comes to physical risk. Working with historical data only gives a distorted image of what the future holds, because the physical impacts of climate change are going to be different and beyond anything that was expected in the past. In Europe there are less frequent extreme weather events, but the problem is that the models are not set up to capture that kind of existential risk. The models are better suited to capturing incremental changes, but the type of potential dramatic changes that are in the system are not necessarily easy to represent in the form and the type of models that are currently used.

An industry representative stated that there needs to be an acknowledgement that society is at the beginning of the journey in terms of modelling and understanding such risks. The same is true when looking at net zero carbon, not just physical risk. The technological changes that are required for moving away from fossil fuels entirely, are a little bit beyond what the models can currently capture.

1.2 Investors as well as insurance companies share the same priorities; but commonly agreed concepts and definitions are needed to access adequate and reliable information

An industry representative commented that this is as much an opportunity as a risk. It depends on what type of insurer someone is and whether they are a life insurer or general insurer, looking at the two sides of the balance sheet. It is important to really understand the transition risks and what is going on in the real economy. The disclosure and getting hold of this data is very important, but the problem is the lack of standards. It is difficult to tell who is greenwashing and who is really acting. Recent reports from the CA 100+ and the Transition Pathway Initiative show that fewer than 10% of the total companies are getting anything right.

An industry representative stated that there are plenty of initiatives in the private and public sectors, but no commonly agreed definitions, concepts, or expectations and this makes it hard for firms and authorities to perform an in depth assessment of the current situation and draw meaningful comparisons. Certain players will get attached to what they have been doing so far, while others may prefer to wait and see. Europe is far from having a very precise understanding of environmental, social and governance (ESG) physical and transitional risks from a whole-firm perspective, let alone from a system perspective. This is mainly because the information is difficult to obtain. If Europe was to get there it would also be necessary to complement that with a more forward looking approach in terms of transition risks.

A Central Bank official noted that national banks tend to be frontrunners in the fight against climate change, but the road ahead is challenging. The approach focuses on three main priorities: data and disclosures; risk management; and governance and strategy. The previous place had been one of no taxonomies or regulatory approach, but Europe is now starting to have a common language. It is time to stabilise the referential that everyone uses, so everyone can use the same language and use comparable concepts. It is not just for banks to steer transition for the broader economy.

An official (agreed that something is needed that is globally harmonised. Currently the contents of the information vary, depending on where the reader sits and what system they are under. Data is needed.

1.3 Data credibility requires addressing an unprecedented complexity

An official agreed regarding "the known unknowns". There are a number of data gaps and the market is starting to meet them. If companies can help banks adjust existing risk management tools and measurement methodologies by incorporating the knowledge that organisations bring, it will go a long way to bringing the kind of data that is needed. There is some talk about whether the risk weights need to be changed, to reflect climate risk. Banks are now making some of those decisions on their own.

An official noted that 10 or 15 years ago it was possible to see insurance industry companies focusing on their internal ecological footprint, as if they were trying to show the world that they were responsible. However, in the last three or five years there has been an explosion in ambition. Modelling risks are seen, the investment side is seen, and a number of tools are seen to measure and represent the risks. It is very hard to predict the future. One way of calculating the risk, as well as the transition risk, is working with scenario analysis.

An official wondered if companies have recently moved on that. When looking at what climate means from a net zero, forward-looking perspective, it is a completely different approach and a very demanding one.

An industry representative agreed that it becomes incredibly complex. Their organisation has committed to provide hundreds of billions of dollars in sustainable financing for the next 10 years. The devil is in the detail of how to count against those hundreds of billions of dollars. Biodiversity is potentially a dimension that is even more complex than climate, but the whole point is to help the clients transition. It is important that there are no other players that are less scrupulous and end up financing the same businesses that banks are exiting from and reaping the profit.

With respect to ESG data, the drive toward standardisation should not end in excessive simplicity. It is incredibly complex, and the method is difficult. Standards are needed regarding data, but they need to reflect the complexity in a scientific way.

1.4 Structuring an appropriate transition path for economies requires further collaboration between financial institutions, corporates, and public authorities

An industry representative stated that climate risk is the defining risk management challenge and a strategic opportunity for any financial institution that is operating within the EU. Everything should focus on the endgame about how to get emissions down to "Net Zero" in order to reach a 1.5-degree world in 2050. Financial institutions have a really important role in achieving that. The first step is to start the journey. Companies need to examine the conditions for an effective climate risk management, looking at clients, communities, culture, calculations, controls, conduct, contracts, and communication.

An industry representative noted that one aspect that has not been deeply touched upon is client engagement. The industry representative's company has developed a client energy transition framework, and started with three sectors: oil and gas, coal mining, and utilities power generation. It will gradually phase out lending to clients unaware of ESG, comprising approximately 10% of exposures. It is not just a banking job; it is a collaboration with the client, but it is also a collaboration with governments and policies. Sometimes clients are faced with a conundrum, which is whether to continue to do traditional business, which is very profitable, or invest in a less profitable and less certain type of renewable business that is still in start up mode. Government policy should also keep pace with the direction of travel.

An industry representative stated that their company works with banks, investors, and insurance organisations that are looking to improve their risk management processes and prepare for these incoming regulations. There are significant variations in the market in terms of the depth of reporting, analysis, and awareness. Those variations can even be seen between regions. There are differences between small and large institutions; that is very important because smaller institutions are certainly not as far along in the process.

1.5 Although developing views in the very long term is a challenge, climate-related risk is also an opportunity for the insurance sector to leverages existing knowhow

An official agreed with much of what has been said, as their expertise is insurance and pensions. While the investment side is interesting, what is special for insurance is that climate risks and sustainability are not just the concept of an operational risk or of transforming into liquidity. They are also areas for opportunity. The dialogue is a developing area, but the insurance industry was way ahead of the regulators to begin with.

An industry representative explained that on the underwriting side it is about how to link climate risks with the financial risks, and whether they are market risk, credit risk or operational risk. In insurance there are other risks in pricing and reserving risks, and natural catastrophe risk modelling, which is very well understood. The challenge is how to apply those metrics to transition risks and physical risks. That is very complex in the detail, with simulations of climate over very long periods into the future. The industry representative's organisation has already started to offer its clients services about that, helping them understand the impact of physical changes in the climate that might impact their physical assets such as their factories and supply chains. The aim is to help people understand the transition and communicate that in a standardised way to investors.

2. ESG and climate related challenges

2.1 Supervisors at national, regional, and global levels are addressing ESG challenges, which require however strong political commitment and support

A regulator noted that the European Banking Authority (EBA) has been mandated by the Commission to take a deep look at three things: ESG risk management and supervision in the EU; realistic methodologies to assess the alignment of banks and investment firms with the EU taxonomy; and the key features of a harmonised disclosure framework for these firms. In May it will release the conclusions of a pilot exercise carried out with 28 banks from 10 EU countries which will shed light on what can currently be said of the carbon footprint of some of their non-SME portfolios using different approaches.

An official explained that the Basel Committee's public version of its workplan was scheduled to be released that week. The Committee's work programme over the coming years has placed climate risk high on the list. A dedicated taskforce on climate risk was set up in 2019, co-chaired by Frank Elderson, from the ECB and Kevin Stiroh, who leads the Federal Reserve supervisory work related to climate change. Two analytical reports have been produced, which explore how climate risk drivers arise and impact both banks and the banking system at large, and the current practices that banks and supervisors use to measure climate-related risks.

An industry representative observed that there is a great deal of piloting going on in the market, especially from larger institutions. It is important to have the right balance between the push to raise the bar that is coming from all the regulatory agencies and governments and leaving flexibility. That flexibility is what enables everyone to understand how far they can go.

An industry representative noted that to be successful in this enterprise it cannot just be the financial services sector that applies the pressure; it also has to be government, with democratic acceptance of the decisions that governments make. Companies have to work closely with people to help them make the transition and to understand what the different pathways are.

An industry representative stated that when thinking about the 'S' of ESG there are significant transition risks that are faced, even in Europe. One example is the coal sector and the massive challenge that will place on the economies of Poland, the Czech Republic, and Germany as they transition out of a coal based economy. Insurance companies provide a great deal of support through helping manage employee risk, but also with managing the pension risk through the life insurance sector. Companies must work in concert with covenants to work on the societal risks, the transition risks and the adaptation.

2.2 Other ESG areas such as loss of biodiversity, deforestation and water scarcity show many similarities in terms of stakes and risk to climate-related ones

A Central Bank official commented that climate was the first issue on their agenda, but what goes for climate will also probably go for other environmental developments. A report issued last year signalled the loss of biodiversity. There was a vast decline in ecosystem services, and therefore it is reasonable to argue that this decline will have a similar effect on the real economy. The same is true for water scarcity and deforestation. It is important to include all of society to make it a just transition, as well as asking what role a central bank and supervisor can play in that regard. People tend to enter an atmosphere of political sensitivities around things that are mostly relied on by governments or that governments are initially responsible for.

A regulator stated that the mandate is ESG. The regulator's organisation has been focusing its efforts far much more on the 'E' of ESG than on the other initials because that is the area where urgent work needs to be done. There is a complex issue in terms of getting the data and the risk management tools right. If the framework is not sufficiently well accepted and harmonised, then there is a great risk that firms will jump the gun to some extent under the pressure of investors and different groups. It is important that firms, investors, and customers should be in a good position to assess not only what the situation is now and what is known about it, but also what it has a hard time knowing about it.

An industry representative stated that carbon pricing would help address ESG, but it has a subset. There is a need to have greater price and data transparency across everything. It does not just concern emissions and carbon pricing; it concerns natural capital and how to put a proper value on price. There cannot be healthy banks unless there are healthy economies, and there cannot be healthy economies unless there are healthy societies. Society does not have room for Basel III or Basel IV when it comes to the climate.

3. The top priorities of the panel

Panellists stated that their top priorities are temperature alignment, disclosure, a uniform standard, roadmaps, adaptation, not to overshoot the 1.5-degree temperature increase, and carbon markets.

SESSION SUMMARIES

IV

CMU PRIORITIES AND IMPLEMENTATION

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 infrastructures 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.

SESSION SUMMARIES

V

BANKING AND INSURANCE REGULATION

CHALLENGES FOR THE EU BANKING SECTOR IN THE COVID CONTEXT

According to the outcome of the discussion, the banking sector has not contributed to the economic crisis and is part of the solution. Due to the support provided by monetary and fiscal policies, loan moratoria and prudential flexibility granted to banks by supervisors, the pandemic has not translated into higher NPL ratio so far. But high uncertainty surrounds economic outlook. NPLs are expected to increase in the coming months as the impact of the COVID-19 crisis on the real economy intensifies and the current economic crisis exacerbates pre pandemic challenges and notably the low profitability of European banks. In such a context, preventing insolvencies of distressed but viable forms and achieving a genuine banking union are essential for preserving economic and financial stability.

1. This time is different, but we are in a situation of high uncertainty

The Covid crisis is very different from 2008, which was a financial crisis. European banks entered this pandemic with stronger capital positions, higher liquidity buffers and better asst quality. So, this time, they have helped to mitigate the impact on households and corporates. But the future is uncertain. We do not know the damage to the banks' balance sheets and the structural changes that will be caused by the present crisis.

1.1 A very different type of crisis

A Central Bank official highlighted three important differences of the current crisis with the 2008 crisis. The first is that the origin of the current crisis is not macroeconomic imbalances in economies; it is a health crisis. The second is that banks' balance sheets are in a better shape. Third, the overall regulatory framework is very different. Much was learned in this respect from previous crises.

1.1.1 The policy response

A Central Bank official stated that the policy response was different. It was much faster, better coordinated and broader. Monetary, fiscal, employment, social, regulatory and supervisory policies were used in hitherto unseen dimensions.

1.1.2 Banks are part of the solution thanks to exceptional support from public authorities

An industry representative noted that credit risk is one of the most important challenges of the crisis. Banks are part of the solution by channelling state-guaranteed loans. Banks need to make full use of their capital and liquidity. We are fortunate the banking system has entered this crisis with quite strong capital buffers. It is also a challenge because the current crisis compounds profitability challenges and increase the sovereign-related exposures.

However, all of the measures have proven to be very effective. Despite the significant drop in gross domestic product (GDP), there is not a surge in bankruptcies or defaults. To the contrary, in some cases there has been a record low number of bankruptcies. The question is whether they have been delayed or avoided. Banks are seeing that the crisis impacts different sectors differently. Companies are being more productive and adapting to digital, and the measures are increasingly targeted rather than being full lockdowns.

A Central Bank official added that the support measures have prevented insolvencies in companies affected by Covid, but also prevented insolvencies by some companies who would otherwise have failed in normal times of market dynamics. A Central Bank official summarised the impact of Covid on the banking system as so far so good. However, the major risk is still ahead with the materialisation of insolvency risk in the corporate sector. The extent of the impact will be a function of public support and the capacity to limit the risk.

1.2 We still do not know what is going to happen

1.2.1 The health crisis is not over yet

A public representative noted we are still in the second wave of the pandemic. The vaccination process is slow, there are some countries with lockdown measures on the table, there is no free movement around Europe and new variants are spreading around the world. Though the European and national answers from an economic policy perspective have been correct and timely, there are many doubts about the recovery.

1.2.2 The extent of economic recovery remains uncertain in Europe

A Central Bank official stated that a weak economy produces a weak banking sector, and vice versa. The dimension of the recovery over the coming two years is quite uncertain. In terms of economic policy, the current year will be more difficult than the previous.

A Central Bank official noted that there are some encouraging experiences. There was a great readiness by citizens and companies to return to a normal situation and to usual behavioural patterns as soon as the virus recedes. Also, when the health situation deteriorated again in Q4 2020 and Q1 2021, it was demonstrated that there is great resilience in the economy, as many companies and consumers have well adapted to the Covid- related constraints. The affected parts of the economy are much smaller compared to the first wave at the beginning of the prior year. Future macro-financial developments crucially hinge on future progress in vaccination, and whether the encouraging data from the past two weeks will continue. If these factors come together, the stress in banks will be relatively manageable.

1.2.3 It is not known what will happen if these massive support measures are phased out

A policymaker noted that the problem is that it is not known what will happen if the massive support measures are phased out. It is now said that the cliff effect might not be that bad. However, the ratios should be considered. Insolvencies were up to 60% lower in 2020 than in 2019, which is not healthy. There is a risk of fragmentation after the crisis. There is a need to at least be prepared.

2. With extensive support measures, the effects of the crisis on banks' balance sheets, in particular on credit risk, have been limited but visible

While the pandemic economic impact has not resulted so far in an increase of non-performing loans, for SSM banks, an increase in corporate defaults is expected. Credit risk must be therefore proactively managed, and provisioning must remain prudent.

2.1 Banks will inevitably experience increasing non-performing loan (NPL) levels

A Central Bank official noted that a full reflection of the current crisis is not yet seen in banks' balance sheets. The most visible indicators, like NPLs, have not started to deteriorate yet. This is mainly because of the strong monetary, regulatory, and economic policy responses to the pandemic. On the regulatory side, there are capital requirement reliefs, and on the fiscal side there is strong support for citizens and companies. But the early signs of asset deterioration can be seen in the form of the migration of loans from stage one to stage two[1] and some to stage three. In addition, some countries have reported moderate increases in the non-performing exposures (NPE) ratio. Some further deterioration of the situation in the banking sector can be expected in the coming months. Countries that entered the crisis with a higher share of NPLs will probably have more difficulties coping, and this is also true for the mainly smaller banks which are more exposed to small and medium enterprises and sole proprietors.

A policy-maker agreed that a rise in NPLs should be expected. The new action plan tried to focus on the leftovers of the 2017 plan, focusing mainly on secondary markets and insolvency frameworks. An industry representative noted that for the time being there is confidence that companies have been able to adapt and that the measures have been quite effective and well-designed. A public representative emphasised that there must be willingness to review economic policies to solve the health crisis. The size of European help and current measures may be in place for longer than is currently thought. The European Commission's action plan on NPLs is very prudent, although less ambitious than desired. The European response to NPLs may need to be reviewed.

2.2 A cliff effect scenario is not anticipated

An industry representative stated that a cliff effect is not expected at the end of the moratoria. There is not a surge in defaults. NPLs will be around 2-3%. Although the banks have seen a significant increase in the cost of risk, it is not through stage three but mainly through building reserves in stages one and two and forward-looking provisioning. It will all depend on the pace of the unwinding of measures, but the recovery could be swift and strong. Much of the government loans or support measures sits in excess cash and has not been fully used.

2.3 Credit risk management at bank level is key

A Central Bank official noted that from a supervisory perspective credit risk management at bank level is key. The provisioning practices are also important. Nonetheless, the collective reaction to this crisis was good, swift and potent, and each party has to play its part in the next phase.

2.4 The banking sector should be able to adjust to the changing environment

2.4.1 The pandemic may lead to structural changes and a shift in consumer preferences

A Central Bank official noted that the relatively strong decline of insolvencies in many countries shows that, by doing as has been done, part of the normal market mechanism was prevented from functioning. When coming back to markets, which should happen, some pick-up in losses should be expected. Firms need to come back to market conditions for doing business when their activities are no longer restricted. That is not a monetary policy or financial-stability issue in the first place, but it is important for the dynamics of the economy. It is very challenging to assess what a viable non-financial company is. It depends tremendously on the demand, which is affected by the current situation, but there could also be some structural changes and the market should play its role in adjusting to that.

2.4.2 The banking sector should be able to adjust to these changing environments

A Central Bank official stated that there are differences across countries for banks, in terms of public and fiscal interventions and the degree to which banks have added forbearance and the like. Over the next 12 months, it will be seen what happens when returning to market dynamics. In some countries, there is a quite pronounced K-shaped recovery because consumers have been prevented from spending in the way that they normally would. Perhaps the most important issue for the financial system is the housing market, which has been boosted by spending constraints on many services as well as a growing need for quality space for offices, teaching, exercise etc. at home. Over a two-to-four-year period, what is going on in the housing market and what will happen on the other

1. Impairment of loans is recognised – on an individual or collective basis – in three stages under IFRS 9:
Stage 1 – When a loan is originated or purchased, expected credit losses (ECLs) resulting from default events that are possible within the next 12 months are recognised (12-month ECL) and a loss allowance is established.
Stage 2 – If a loan's credit risk has increased significantly since initial recognition and is not considered low, lifetime ECLs are recognised. The calculation of interest revenue is the same as for Stage 1.
Stage 3 – If the loan's credit risk increases to the point where it is considered credit-impaired, interest revenue is calculated based on the loan's amortised cost (that is, the gross carrying amount less the loss allowance). Lifetime ECLs are recognised, as in Stage 2.

side of a potential housing/construction boom should be closely observed.

3. The profitability of European banking institutions remains a source of concern

The pandemic has exacerbated the chronically low profitability of European banks, reflecting ultra-low interest rates and depressed margins, legacy assets from the previous crisis and competition from non-banks.

3.1 The profitability of the EU banking industry is particularly affected by lasting negative interest rates

An industry representative noted that for many banks the interest-rate level is the biggest profitability challenge in the near future, as interest rates were not going up. Indeed, the European Central Bank (ECB) will always err on the side of caution here, given the structural weaknesses in the eurozone economies that have been exacerbated by the Covid crisis.

3.2 Achieving return on equity (ROE) in double-digit figures in the current regulatory context is particularly challenging

An industry representative's firm needs to maintain the position on ROE. Some central bankers say that their ROE levels should come down, but the market still expects ROEs in double-digit figures. The question is how to do that if risk pressures arise, and capital buffers remain. There is an ever-expanding level of regulatory costs (contributions to Funds, costs associated with Know Your Customer requirements…). His firm spends about €1 billion a year on dealing with them, which is largely misspent according to a recent article of The Economist. Then there are taxes, and governments will have to find ways of getting out of their huge debt numbers. In certain countries governments seem to take the view that banks should contribute at potentially double the levels compared to other market players.

3.3 Cross-border mergers and the Banking Union (BU)

According to a leader of the industry, completing BU remains of paramount importance. Cross-border mergers are extremely difficult and largely ineffective as long as the BU is not completed (Home/host issues leading to ring fencing practices…). Covid-19 should serve as a catalyst to complete BU.

4. Supporting solvent firms is crucial

Corporates and SMEs all over the world have suffered from the lockdown and the drop in demand. Bold support measures have been adopted by governments, which postponed payment difficulties. It is crucial in this context to ensure the viability of solvent firms that face temporary problems and/or an increase in debt as a result of the pandemic.

4.1 Banks have a key role to play in distinguishing solvent from insolvent firms

An industry representative explained that there are three types of firms: solvent firms that do not need help, solvent firms that need help and insolvent firms. The second category should be concentrated on. The worst mistake to make is not helping solvent and viable firms. By providing support to firms that are not viable or that do not need help, public resources may be wasted, but not helping solvent and viable firms would provoke permanent and unfair damage to the healthy part of the economy.

Banks have a very important role to play, because they have skin in the game as a result of the lending relationship with the affected companies and therefore can help in distinguishing between solvent and insolvent firms. Tools must be designed that align the incentives of the government, banks and corporates to inject equity into firms that are solvent and inject public aid where it is needed. A last resort is debt-restructuring, with longer terms and conversion to equity loans or debt relief.

4.2 The eventual return to normality of financial regulation should be calibrated carefully

A Central Bank official noted that on the supervisory side the major stance was to provide flexibility to banks to use their buffers to absorb the shock. This capacity has not been used to a large extent and must remain in place. For macroprudential policies, the most important issue is that the risks moved from the banking system to the non-bank financial institutions, so it is important to not focus only on the banking system.

4.3 When returning to normality, the countercyclical capital buffer should fairly quickly be set up again.

A Central Bank official stated that when back to normality the countercyclical capital buffers should get back on track. This is not only due to the housing market but also there being an extraordinary fiscal and monetary situation, plus pent-up demand. In addition, there are underlying challenges in the banking system, including overcapacity legacies. The banking sector should continue to consolidate and there is a need to be able resolve failing banks in an orderly manner, which remains challenging.

4.4 Member States should improve their national insolvency framework to facilitate orderly winding-up of non-viable banks/firms

An industry representative noted that non-viable firms require an efficient and quick resolution framework that facilitates a fresh start. The latter requires making the insolvency framework swifter and more efficient. A policy-maker added that banks and fiscal authorities need to work together to identify debtor distress early and engage in timely and appropriate restructuring to prevent insolvencies of fundamentally viable firms. Without this, banks' asset quality could deteriorate sharply. The preventive restructuring framework would be very useful. Unfortunately, only a few member states have transposed this 2019 directive.

A Central Bank official stated that the issue is how long the support should be prolonged for. The quick answer is: long enough but not too long. There is a need now to move to a more targeted and equity-focused type of support. A Central Bank official noted that supervisors should have an active role in guaranteeing that banks reinforce their efforts in the timely identification of situations where borrowers are facing financial difficulties, and the setting up of sustainable solutions for viable customers that allow them to continue their activities while recovering their ability to repay debts.

5. The crisis highlights the need for completing the BU

The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock. The asymmetric impact of the Covid crisis makes it all the more urgent to achieve an EU agreement on a credible way forward to complete the Banking Union.

5.1 The crisis has increased fragmentation across the BU area

An industry representative indicated that the crisis has increased fragmentation, but this is masked by the massive support measures. The risk is that once all these measures start to be unwound the underlying fragmentation will appear. The fragmentation has been masked by the massive liquidity injection by the ECB and the coordinated regulatory response from the European authorities in terms of regulatory, supervisory, and accounting flexibility, as well as the fiscal support measures at the EU level. As a result of this, sovereign spreads remain low. Most of the funding of EU Treasuries has been provided, directly or indirectly, by the ECB, but there are some indicators that home bias has increased with an increasing concentration of sovereign debt in the hands of domestic banks. This implies a latent increase in the doom loop between banks and sovereigns that potentially works in both directions.

A Central Bank official noted that all EU countries promptly adopted measures to support firms and households. However, the design of these measures varied widely. In terms of fragmentation, the implications of the support measures depend on their impacts on banks and sovereigns, and, ultimately, on borrowers. The European banking sector is now in a much more favourable situation than before the previous crisis, with a significant improvement in banks' capacity to absorb the potential losses of the crisis. However, the risk of a less pronounced recovery until vaccination allows for more definitive withdrawal from lockdown measures, and may lead to more acute solvency issues that, if not addressed at the non-financial sector level, will lead to a significant increase in losses in the financial sector

5.2 The crisis highlights the need for a single banking market

An industry representative warned that the risk is that the underlying fragmentation is exacerbated when support measures are unwound, especially if countries exit the crisis at different speeds and with different measures, and there is divergence in the degree of Government support in the exit of the crisis. This is because there is an incomplete BU that is intrinsically unstable. There is no rationale for having an incomplete BU. The review of the crisis-management and deposit-insurance framework that has been put forward by the Commission is an excellent opportunity for completing the BU, and to address the weaknesses of the crisis-management framework seen in recent years.

A Central Bank official stated that regarding the fully mutualised European Deposit Insurance Scheme (EDIS), completing the third pillar of the BU is necessary but not sufficient. There should also be further improvements to the crisis-management framework. More work is now needed on the management of crises for small and medium-sized banks that will fall outside the resolution.

A public representative added that a proposal is expected from the Commission to review the crisis management framework. The dual system of EU resolution and national liquidation needs to be reviewed. There is a need to be better prepared to intervene in order to solve banking problems in the future if the health crisis lasts for longer than expected.

A policy-maker emphasised, regarding the EU crisis management framework, especially the Bank Recovery and Resolution Directive (BRRD), there is a need for a more general overhaul, but not now. Currently it is fit for purpose. Macroprudential policy has worked to some extent. The countercyclical buffers have been released and dividend restrictions imposed.

BU is key and this fragmentation has to be overcome. A single market for banks is needed. The key is to build sufficient trust among all member states for the remaining issues, in particular on EDIS and the crisis-management framework. The same holds for the macroprudential framework. There is no need to react immediately. But there is a question of whether things are good enough countercyclically and whether there is something that needs to be changed in the overall setting of macroprudential tools. The review of this framework is coming at the end of 2022. Next Generation EU is also important when coming out of the crisis.

POLICY PRIORITIES FOR THE EU BANKING SECTOR

European banks have shown resilience during the pandemic but suffer from a persistent low level of profitability. Pre existing vulnerabilities, such as banking overcapacity, lingering cost inefficiencies and increased competition from non banks, particularly fintech and big tech firms, are forcing banks to adjust their business models and make themselves more sustainable in order to continue to support the post Covid recovery. The solutions to the profitability challenge are well known but often difficult to implement. Digitalisation enables banks to improve cost efficiency and offer better products to customers while facilitating the integration of the European banking sector, but these innovations raise new regulatory challenges around level playing field and consumer protection.

1. Improving the competitiveness and profitability of the EU banking sector remains challenging

The EU banking system faces a lack of competitiveness and structural under profitability, which disrupts on bank valuations. The low profitability in European banks is caused by a range of factors, including lasting low interest rates, excess capacity, low cost efficiency, the high cost of regulation and a lack of scale.

1.1 The European banking industry is not profitable

An industry representative mentioned several key factors concerning competitiveness, highlighting the importance of overcapacity. There is still overcapacity in some areas of banking. The cost income ratio is an important subject, but in the last seven or eight years the European banking sector has demonstrated its ability to tackle costs. The European banking sector – whether in wholesale banking, retail banking or asset management – is a broadly a low margin environment compared to the US, which benefits from a large domestic base. There are many parts of the US banking sector where margins are simply higher than in Europe. Lastly, the cost of regulation is very important here. It is clear that the US banking sector and US regulators are more sensitive to the cost and effectiveness of regulation, whereas Europe is only now starting to consider this.

1.1.2 Low profits and high costs remain a key challenge

A regulator agreed that the first challenge for the EU banking sector is profitability. For many years, the banking sector has been unable to obtain a return on equity commensurate with the expected cost of equity. Last year, return on equity was around 2%. Given the macroeconomic environment, the European Banking Authority (EBA) considers cost to be the key component of profitability which could be adjusted going forward. An industry representative agreed on the need to tackle low profitability in the banking industry. The main reasons for low returns are: low interest rates; non bank competition, especially new digital entrants; the cost of regulatory compliance; and the expected increase in non performing loans (NPLs) resulting from the pandemic. There may or may not be overcapacity in the industry, but there is a lack of scale in some areas. Low profitability becomes a prudential issue, however, because the industry cannot grow and support economies.

1.1.3 The weak prospects for profitability continue to weigh on valuations

An official considered that it is extremely challenging to have such a low ratio of average valuation compared to book value. Average valuation compared to book value is approximately 0.6 compared to the US, where it is perhaps more than double. The challenge of bank profitability incorporates a number of issues. First, there is the technological challenge concerning how people buy financial services and execute payments. There is also a challenge concerning scale. Those who are technologically better prepared will ‘win the race’. There is also a discrepancy between the profitability of the sector and the risk perceived by stock market investors.

1.1.4 A comparison between the EU and US: profitability, capital and the cost of equity

An industry representative described how the European banking sector has been very resilient throughout the pandemic. There are three interesting comparisons to make between the EU and US banking sectors, based on profitability, capital and the cost of equity. In 2019, the US large banks’ return on equity was 14.2%; the European Union banks’ return on equity was only 7.4%. One reason is a larger net interest margin (NIM), but the other principal reason is more scale and greater efficiency. US banks have a cost income ratio of around 60%; in the large European banks it is around 70%. In terms of capital, US and EU banks have exactly the same Common Equity Tier 1 (CET1), but the US banks have a much better leverage ratio. In terms of the cost of equity, the US banks have a more attractive revenue mix, better efficiencies, and more sustainable and higher margins. This clearly leads to a lower average implied cost of equity for large US banks of 9% to 11% versus 11% to 13% for the large European banks.

1.1.5 A monetary profitability loop in Europe

An industry speaker noted the loop between the European monetary context and the constraint on profitability. Indeed, interest rates and bank profitability are connected. Lasting negative interest rates in Europe are pressurising net interest margins and weakening the profitability of EU banks. The monetary situation is very different in the US, where interest rates are higher, which helps explain why the European banking sector is less profitable than its US counterpart.

1.1.6 Persistent low bank profitability is accompanied by excess capacity

A regulator noted that excess capacity is another important challenge. The sector will need to restructure in order to enhance efficiency. It is important for banks to favour sustainable business models in the future. The authorities must take action to allow this restructuring to happen in the smoothest and most efficiency enhancing way possible. An industry representative stressed that there is no consensus on the concept of overall capacity. In France, for example, there is an ongoing debate about banks' ability to maintain a network of branches and ATMs. Indeed, the availability of cash was one issue which contributed to the famous 'yellow vests' movement in France. There is a well known conundrum around maintaining profitability without a physical presence. The usual suggestion is that a bank can cut costs by adapting its footprint, but there is a clear link between the amount of physical infrastructure owned by a bank and the profitability of its client base. Without a physical presence, it is difficult to serve clients. Cutting costs by adapting a bank's footprint will never be the whole solution.

2. Solutions for addressing the profitability challenge are well known but difficult to implement

There are established ways for EU banks to return to sustainable profitability. Banks must continue to make efficiency gains by cutting costs and making more intensive use of new technologies. Improving the EU crisis management framework and increasing consolidation in the sector would help address excess capacity. Banks should be able to consider the Banking Union as their domestic market. Completing the Banking Union is therefore vital; it would notably favour the emergence of effective transnational banking groups. But this is difficult to achieve: solving the home host dilemma and achieving agreement on a common deposit insurance framework remain controversial issues.

2.1 Policymakers need to avoid cliff edge risks

An official highlighted the extraordinary role that the banking system has played in handling the crisis in coordination with central banks and public authorities. It will be crucial to see what happens to the unprecedented public guarantee schemes, which are a shared responsibility between states and banks. There will have to be restructuring in some of the most affected sectors, and it is important not to create a cliff edge in the economy by not supporting these sectors and the viable companies that were particularly affected by the crisis.

2.2 Making efficiency gains by further cutting costs

2.2.1 There is further progress to be made on cost reduction in Europe

A regulator agreed that overcapacity is an important issue in European banks. While there has been some progress, cost income ratios in EU banks remain broadly higher than those of their global peers. Additionally, performance on cost income ratio remains extremely uneven across Europe. Even banks with the same business models have very different cost income ratios. From a supervisory point of view, revenues are also concerning. Banks have very few sources of revenue and the cost of risk has been very low lately, which means that margins in Europe remain very weak. At these low levels of revenue, one of the key issues is diversification. National consolidation creates more synergies, but cross border consolidation provides more diversification.

2.2.2 Reducing cost and exploiting synergies in a cross border banking group

An industry speaker described how their institution, a cross border banking group, has the benefit of both in country scale and scale across Europe, with 25 million active customers and around 70,000 employees. Even without consolidation, it is possible to find cost savings on a pan European and cross border basis, even in retail banking. The institution is seeking to develop a common operating model and has announced €1 billion of cost savings, which is roughly 13% of their cost base. Additionally, this institution also has scale in country. Increasing profitability cannot only be about shutting down branches and reducing its physical footprint. Instead, there must be a proper transformation of the banking model in Europe.

2.3 Improving the EU crisis management framework to address overcapacity

A public representative stressed the importance of crisis management. Europe needs a credible system and reliable system for banks to exit the market, while the current bailout intensive system (e.g., NordLB, Veneto Banca, Banca Tercas…) does not encourage them, and instead keeps many banks in and out of the 'bailout hospital' for many years. The precautionary capitalisations (e.g., Monte Paschi) cannot continue. In the US, the Federal Deposit Insurance Corporation (FDIC) is a well-funded and independent body, which has managed the consolidation of thousands of banks and hundreds of billions in assets. The FDIC's resolution process has been a massive success, and Europe does not yet have anything like this. To promote banking consolidation, we must also solve the home host issue and deposit insurance is critical for this endeavour. Europe needs a commitment not just to consolidation but to forcing bank exits if a bank is unable to compete. A regulator agreed that EU institutions should improve the process of an orderly exit for players without a sustainable model, thus helping to reduce overcapacity and unhealthy competition and promote thus financial stability.

2.4 Completing banking union is of the essence

2.4.1 Addressing the issues around ring fencing

An industry representative suggested that there is a need for the regulatory toolbox to be amended to avoid trapping liquidity and capital inside national barriers. This goes against the principles of the single market and does not help to foster economic growth in all member states. A deposit insurance programme is only one element of this; Europe also needs a harmonised set of rules to enable large European banks to compete.

2.4.2 Settling the home host dilemma

An industry speaker outlined the significance of the home host dilemma. This explicitly adds a substantial amount of cost to European regulation in terms of liquidity requirements and capital allocation. Everybody agrees that there is a problem, but now there is a need to develop solutions to ease the mistrust between home and host states. The industry should seek to tackle the European Deposit Insurance Scheme (EDIS) over the next few quarters; progress on EDIS could unblock much of this mistrust.

2.4.3 Achieving consensus on a Banking Union remains difficult

An official agreed on the importance of achieving a genuine Banking Union. Hopefully, by the end of the first half of 2021 there will be a roadmap for a Banking Union, though this will not be an easy task. It is important for the industry to reflect on the schedule for a Banking Union and determine the appropriate milestones. Banking union compromises many different elements – such as EDIS, cross border integration and the management of sovereign risk exposures in different geographies – which makes it extremely difficult to find consensus between member states. The industry and the public authorities should consider how valuable it would be to make a Banking Union happen in one go. This would create value and employment for the whole economy, not merely the banking sector. An industry speaker welcomed the suggestion that a Banking Union could be achieved in one step but is sceptical that this can be achieved in light of the progress made over the last few years.

2.4.4 There is a window of opportunity on EDIS after the elections in Germany and France

An industry speaker described how their institution is already engaging on EDIS schemes with member states, the Commission, national governments, and national banking associations and banking sectors in EU member states. There will be a window of opportunity next after the elections in Germany and France to try out EDIS and hopefully to unblock some of the issues around the home host dilemma.

2.4.5 Breaking the deadlock on the Banking Union

A regulator suggested that benefits of a Banking Union have not yet been realised, especially in the eurozone, where there is no longer a division between home and host but a single supervisor. It could be a game changer merely to send the signal that the issue of a Banking Union is unblocked, even if not everything is resolved. There might not be a complete upheaval of the market, but it is important for the industry to explore all of the possibilities here, including consolidation, branchification and the free provision of services, building on digitalisation.

2.5 Banking consolidation

2.5.1 Banking consolidation requires progress on a Banking Union and the home host dilemma

A public representative noted that the European Central Bank (ECB) has been trying to encourage consolidation with its new guide on the supervisory approach to mergers, cross border liquidity management and intragroup financial support agreements. These measures are welcome, but there will not be further cross border mergers and consolidation until there is progress on banking union. Some issues in the banking sector could be addressed regulatorily, such as the home host issue. This discussion often focuses on liquidity waivers and so on, but fundamentally the issue is about the fact that regulators force banks to have duplicated capital at the consolidated and subsidiary levels.

2.5.2 Completing the Banking Union would lead to more consolidation

An industry speaker agreed on the need to complete the Banking Union. Europe must align policies, remove additional barriers, and create a single rulebook and a single deposit insurance scheme. That will naturally lead to more consolidation, including across borders.

2.5.3 Consolidation is only a solution for wholesale banks

An industry representative distinguished the situations of retail banks and wholesale banks in relation to consolidation. There is no clear evidence on building cross border synergies in retail activities due to the specificities of different banks. In addition, there are specific tax regimes, cultures, and savings habits in different countries, all of which reduces the prospects for eliminating overcapacity in EU retail banking.

A regulator highlighted the specific need to increase efficiency across the EU. Technology and digitalisation might be able to assist the process of a Banking Union. There are difficult questions here such as the home host issue, but there are also interesting mechanisms such as the provision of services via branches, the cross border provision of services and digitalisation. In the area of payments, there is a broad degree of cross border provision. As this technology is introduced to a wider set of services in the banking sector, it could enhance these services and realise some of the cross border benefits of the single market by making banks more effective and profitable.

3. A harmonised legal and regulatory environment for a digital banking sector

Digitalisation is becoming an integral part of banks' business models. Of course, digital transformation has important upfront costs in IT infrastructures and new skills, but in the medium term it provides clear opportunities to increase cost efficiency. Regulation and supervision should be technology neutral, and tackling fragmentation is critical. Europe will not be able to compete globally with a fragmented legal and regulatory environment that stifles innovation or allows regulatory arbitrage. Above all, Europe must harmonise protection rules and Know Your Customer (KYC) standards and promote a level playing field around innovative technologies, ensuring that the principle of 'same activity, same risks, same rules' remains the norm throughout the digital transition.

3.1 Digitalisation can facilitate the integration of the EU banking system

An industry representative agreed that technology will enable the industry to make greater progress in the future. For example, anti-money laundering (AML) laws are an excellent example of an area where greater harmonisation could be realised through technology. The efficiency of technology could be leveraged to a far greater extent if there were the same rules in all EU jurisdictions with combined supervision to ensure that the application and interpretation of the rules was aligned. A regulator stressed that the ECB is seeking to invest in digitalisation. It will not happen immediately, but there is potential to optimise the interactions between supervisors and banks.

3.1.1 Open finance responds to consumer needs

An official highlighted the importance of open banking, which was introduced by Payment Services Directive 2 (PSD2). This enabled the entry of players that were able to innovate in the market and exploit their superior technological 'know how'. EBA observations suggest that this was positive for the development of market participants' business models. The Commission will propose legislation on a broader open finance framework by mid 2022.

3.1.2 EU regulation should promote innovative technologies in financial services

An official stressed that regulation should focus on what is substantial. It is important not to hinder innovation and to accept that the technological revolution is about demolishing the borders between sectors. It is important for the public authorities to keep pace with innovation, not to prevent innovation and not to try to regulate everything. This should be achievable, for instance, with the Regulation of Markets in Crypto-assets (MiCA) regulation. Additionally, the Consumer Credit Directive (CCD) review, which was postponed until the third quarter of 2021, will be important in addressing the consumer protection issues which arise from the emergence of new operators and new forms of consumer credit.

3.1.3 The EU regulatory regime for crypto assets could be adopted quickly

An official noted that Portugal is somewhat positive about the MiCA regulation. This process will hopefully be concluded during the first half of the year. This is very important, because there is currently no legal certainty for crypto assets. Considering the trends in this space, this is very necessary. This work should progress in the first half of the year, but it involves complex technical issues.

3.1.4 Digitalisation is becoming an integral part of banks' business models

An industry representative welcomed the European Commission's drive to foster innovation and a more competitive and diverse ecosystem for finance, particularly digital finance. Parts of the digital revolution have happened already, and this process was accelerated by Covid. It is very positive to see regulators encourage digitalisation. The same rules and the same supervision must apply to the same activity. An industry speaker agreed that it is essential for the industry to keep pace with innovation. There is increased competitive pressure from new entrants and Google, Apple, Facebook and Amazon (GAFA), who are building amazing customer experiences.

3.2 Key success factors for increasing the digitalisation of the banking sector in Europe

3.2.1 Harmonising consumer protection rules and KYC standards

An industry representative reiterated his belief that scale matters. Given the size of the challenge facing Europe, it is extremely important to ensure that there is less overcapacity, more consolidation and bigger scale. The industry representative's institution is able to achieve this because of its scale. Even if a bank creates one app for all of its markets in Europe, there are still many barriers around consumer protection and KYC standards. Removing these barriers would have substantial benefits in terms of overall scale, technology and the investments necessary to better serve customers.

3.2.2 Developing EU solutions to ensure data protection and increase European data sovereignty

An industry speaker explained how data is an important matter for the European sovereignty. Some actors are extremely predominant in areas such as the cloud. If Europe wishes to move towards open banking and banking as a service, the use of public cloud infrastructure is almost compulsory, but there is no credible alternative in Europe. If Europe wishes to keep pace with its competition, there is a clear need to develop practical solutions while protecting client data.

3.2.3 A level playing field for incumbents and new entrants concerning innovation and access to data

An industry speaker highlighted the importance of the level playing field. If operators are in the same industry, using the same kinds of models with the same kind of risk, they should apply the same rules and the same supervision. Some new entrants may be seen as 'free riders' in the system.

3.2.4 Europe should aim to be a single prudential and regulatory jurisdiction

An industry representative observed that the consolidation of the US banking industry did not happen overnight; rather, it started 30 years ago. Frankly, it is not realistic to expect that Europe will be able to replicate what happened over 30 years in a short period of time. Clearly, there is a need for greater support from the regulators. There should be one supervisory body, the ECB, and much greater harmonisation. In the US, there is one counterparty that looks over the industry, which makes the banks more efficient. Efficiency comes not only from the banking system but also from the regulators and central bankers with oversight of these banks, who can accelerate change and transformation.

IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

An official described how the European Commission announced reviews of the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD). There is a new acronym in the world of banking union: CMDI, which stands for Crisis Management and Deposit Insurance. Since the introduction of the Single Resolution Board (SRB) and Single Supervisory Mechanism (SSM), there has only been one resolution case, which raises questions about the effectiveness of the system and the scope for further refinement.

The discussion focused on the resolution framework, the State aid framework, the review of the deposit insurance framework and the potential for a common European Deposit Insurance scheme. It emerged from the discussion that the review of the EU crisis management framework requires a comprehensive approach. Defining and implementing the public interest criteria in a single way, addressing differences in national insolvency laws and aligning state aid rules with the EU crisis management framework will make it more effective. The discussion also highlighted the specific challenges and potential solutions concerning crisis management for small and mid sized banks. The European Deposit Insurance Scheme (EDIS), however, is still a controversial subject.

1. A holistic approach to addressing the weaknesses of the EU crisis management framework

A policy-maker emphasised that Europe has a very sophisticated crisis-management framework that does not seem to be suitable for all types of bank. This creates risks around circumvention, raises level playing field issues, and does not create confidence within the Banking Union. Regulators must take a comprehensive approach and ensure that the 'pieces of the puzzle' are connected. The Commission's analysis includes BRRD and SRMR, but it will also need to consider DGSD, national insolvency rules and coordination with state aid rules. The Commission sees EDIS as central to an optimal outcome, but no decision has been taken on whether or not to table a fresh EDIS proposal. As a concrete priority, the Commission wants to ensure that EU resolution and national insolvency rules apply to the right institutions and form a coherent framework with the right incentives in a level playing field. The industry must develop solutions that allow flexibility in insolvency and determine whether there is a need for more harmonised tools.

An industry representative stated that the crisis management framework has improved and strengthened the resilience of banks. The 'proof of the pudding' is the fact that there have been very few challenges to individual banks. The industry representative stated that it is rare to agree entirely with a legislator, but there was very little to dispute in the policy maker's (Martin Merlin) comments.

1.1 The CDMI review should define clear rules to avoid any increase in the sovereign bank loop

An industry representative described how the crisis management framework has helped reduce the sovereign feedback loop, noting however that there are banks in many member states with considerable levels of public debt. This is aggravated by the fact that in some member states these dependencies have increased as deposit guarantee scheme (DGS) funds have been transferred to national treasuries to lower indebtedness. This is not always a bad investment in terms of credit risk, but it increases the sovereign feedback loop. The review should provide clear rules to avoid this.

1.2 The European banking industry needs evolution, not revolution

A regulator agreed that the resolution framework works, adding that there is nothing, however, that cannot be improved. What is needed is evolution rather than revolution; revolution always ends in chaos. There is a need to have a clear view on the end goal, including EDIS and an update of the Banking Communication in the CMDI review. Then policy makers would agree on a clear and time-bound calendar for the transnational period towards the steady state.

1.3 Taking a step-by-step approach

An industry representative noted that the Banking Communication could be rewritten or at least clarified in terms of how it works with the resolution regime. Indeed, 'the pieces of the puzzle' need to come together, but this is complicated by the fact that the pieces are all moving at the same time. It would be better to take a step by step approach rather than trying to do everything at the same time.

2. Defining and implementing the public interest criteria in a single way

2.1 A European approach to the Public Interest Assessment (PIA)

Banks without a positive PIA should exit the market in the most efficient way possible. An industry representative stated that the resolution process begins with the independent and serious decision of the PIA at the European level. There is a need for a European component to this decision or European supervision of the way the decision is made. This could be handled by the Single Resolution Mechanism (SRM) or the SSM, because they have an opinion on whether a bank is viable or not. Ultimately, that is the relevant question. The national decision is not always as independent and cool headed as it could be.

2.2 Harmonising the rules related to the PIA

An industry representative noted that the landscape is much more diversified for smaller EU banks, which complicates the application of resolution and liquidation rules. Therefore, the SRB's work to further refine the PIA is welcome. The SRB is better placed than member states' competent authorities to apply this test. The BRRD should also be clarified to better define this element.

2.3 Clarifying the existing legal provisions concerning the PIA

A regulator agreed on the need to clarify the legal provisions concerning the PIA, though this speaker is cautious regarding the legal amendments, as the SRB is already carrying out policy work in this regard. The SRB is in the process of expanding the PIA to an assessment of how to manage a system-wide stress scenario. The scope of this should be broadened for a positive result. The logical consequence of a positive PIA is that banks need to be resolvable. These banks need some Minimum Requirement for own funds and Eligible Liabilities (MREL) and they need to be operationally resolvable. The legal framework is adequate, but there is work to be done.

2.4 Ensuring a smooth exit for banks that do not pass the PIA

A regulator described how there is both one European resolution regime and 21 plus insolvency regimes within the Banking Union. If the industry seeks a more European approach, national procedures must be harmonised. Banks without a positive PIA must exit the market in the most efficient way possible. An industry representative noted that the Banking Union is not complete, because the market is not sufficiently integrated. Resolution procedures at the national level are producing 'zombie banks', which increase national fragmentation, are bad for domestic consolidation – and therefore profitability – and make the European banking market less attractive to investors.

2.5 A wider approach to the PIA

A policy maker considered that a wider approach to the PIA will ensure that resolution is applied in all cases where insolvency under national law is not appropriate. The more that can be done through EU wide harmonised rules, the easier it will be to achieve a level playing field and to enhance confidence. However, expanding the application of the PIA is not sufficient. Having more banks in resolution means that resolution must be a credible and feasible strategy. If a bank is put in resolution and requires funding from the Single Resolution Fund (SRF) or a DGS, the conditions of that funding should not be an insurmountable obstacle. While there should be strict conditions attached to funding, those conditions must be realistic.

3. Challenges and possible solutions for medium-sized banks

3.1 To be resolvable, banks need to have enough loss absorption capacity (MREL)

An industry representative suggested that, following a PIA, if a bank is in scope of resolution, the bank should need some MREL. Business model, size, country, local market and rating must be taken into account. If flexibility is applied, it should happen at EU level. National competent authorities (NCAs) must apply the rules if they wish for financial institutions to be covered by the BRRD.

3.2 A way forward for medium-sized banks

A regulator explained that mid sized banks are generally equity and deposit funded. There cannot be a group of banks for whom resolution is too cumbersome and insolvency also does not work. To solve this problem, these banks should be made resolvable. It is useful to consider the best use of a DGS in this process. When seeking to resolve a bank, there will either be a transfer strategy, which is a resolution strategy, or a plan for the bank to exit the market, in which case the DGS safeguards depositors. If the bank must be sold, it is important to consider the franchise being sold. It is not a good idea to bail in the customers who want to sell. This raises questions about whether the transfer should be supported. Transfer tools are not a 'free lunch'; they have a cost. In the current system of super priority, the DGS will not experience many losses. If Europe wants to move to a US style system, it should reassess depositor preference to ensure we make the best possible use of DGS funds.

3.3 The importance of the funding side to support early intervention

A policy maker highlighted the importance of funding. The Commission considers that EDIS would make the industry more effective. EDIS is a natural complement to the crisis management framework. The liquidity support in a 'hybrid EDIS' could minimise the risk of shortfalls and an overreliance on taxpayers' money. A hybrid EDIS providing liquidity to support DGSs could use some of the tools in the current framework, including DGSs in resolution and well-framed preventative measures and alternative measures. The industry must consider the synergies that could be created between a sufficiently ambitious EDIS and the SRF; the smart use of these instruments could lead to flexible and balanced funding solutions.

Broader use of DGS resources in liquidation and resolution would facilitate the use of transfer tools but this proposal is not consensual.

3.3.1 Apart from resolution, deposit guarantee schemes should not be used for purposes other than guaranteeing deposits

An industry representative cautioned that Europe should be very careful about deposit guarantee schemes to be used for purposes other than guaranteeing deposits following negative PIA. The industry must 'go back to basics'. In the case of resolution, the question is whether this is being handled properly at the national level. Another industry representative agreed that it is not a good idea to use a DGS for preventative measures. A DGS is for liquidation. Other measures exist for this purpose; they are clear, and they have been applied in the past.

3.3.2 DGSs could support the wind down of non-systemic banks, given the prior establishment of strict least cost tests and adequate loss sharing

A regulator highlighted the issue concerning failing small and mid sized deposit funded banks which do not pass the PIA. Reformed DGSs could form one important part of a possible solution, but the Banking Union should strive for EDIS as a European solution. It is important to be realistic: neither the European nor the banking Union are clearly at this point yet, which is why it is essential to address the issue within the current framework. However, allowing member states to implement diverging setups for DGSs would be a step towards fragmentation. The banks being discussed almost entirely fall under the competence of national resolution authorities and not the SRB. DGSs are national financial instruments. In any near term solution, resolution will have to occur on a national level or be embedded in a harmonised European framework. Currently, a DGS mostly has a paybox function in a bank's insolvency: it pays out covered deposits and then seeks to recover funds as a super senior creditor. This approach is not always the most cost efficient or the cheapest, however. There could be cases where a more flexible usage of a DGS could be beneficial. Contributing to a standardised P&A tool could be more efficient and less costly than paying out covered deposits and then recovering funds. Moreover, continued access to accounts and deposits could positively contribute to financial market stability.

The regulator suggested that, if DGS funds were also used for such transfer operations, the same strict conditions for accessing the SRF should hold true for the use of DGS funds. Furthermore, a comprehensive implementation of a least cost principle should be a key element of any DGS intervention. The criteria for this test must be harmonised within the EU. Any DGS contribution must be conditional on the market exit of the bank. In order to prevent moral hazard and excessive losses for the DGS, additional safeguards for DGSs will be required. A dedicated mandatory layer of gone concern instruments above the regulatory capital requirements could be one way forward. A side effect of this would be an increased level playing field between these resolution banks and liquidation banks. A maximum threshold introduced to limit the financing of a transfer tool via DGS funds is another feature which should be evaluated.

Two regulators mentioned the need to set down adequate rules for access to funding in resolution. This would require revisiting the conditions that limit the uses of DGS in resolution, especially the current super priority of covered deposits.

4. Aligning State aid rules with the EU crisis management framework

4.1 Reviewing the state aid rules for banks in the context of the broader CMDI review

A policy maker considered that any reform should include a consideration of state aid rules, particularly the use of liquidation aid. There is a need for a careful evaluation of the requirements to access funding under the resolution and state aid frameworks in order to assess whether further alignment and coordination is appropriate. The Commission's current plan is to present a proposal concerning the resolution and the deposit insurance framework at the end of the year. First, the Commission will draw out lessons from the ongoing consultation and political discussions between member states. There is also a commitment in the Eurogroup to come forward with a work plan for a Banking Union by June, the content of which will have to be taken into consideration before a proposal can be tabled.

A regulator noted the importance of addressing the Banking Communication. It is a difficult proposition to have a clear framework for burden sharing and creditor hierarchy while creditors are still able to get a better result from the insolvency process if they are convincing. It is vital to eliminate the existing loopholes in the framework and ensure that the Banking Communication is aligned. An industry representative highlighted the tiny number of resolution cases. The Banca Tercas case shattered the industry's ideas about the process. In that case, judges said private money is not public money. On the other hand, the money from the DGS comes from the compulsory contributions of banks and is then passed to customers to serve the public interest, which is not very different from a tax.

4.2 A holistic review of State aid rules and the crisis management framework will ensure a coherent set of rules for both frameworks in the future

A policy maker explained that state aid control comes directly from the Treaty. Its function is to assess injections of public money to private entities. The 2008 Banking Communication – as expanded in 2013 – specified the minimum requirements for aid to banks to be compatible with the internal market: aid to banks must remedy a serious disturbance in member states' economies and prevent distortions of competition. The Banking Communication was a realisation of the State aid regime as it exists in the Treaty.

The policy maker stated that the Commission is evaluating, among many other issues, the suggestions of perceived inconsistencies around the burden sharing requirement. The Commission has also noticed the suggestions of inconsistencies between the PIA and the concept of serious disturbance. However, the PIA comes from the BRRD and is a relative test; it assesses whether the resolution objectives would be better achieved in resolution rather than liquidation and insolvency proceedings. The serious disturbance test, however, is an absolute test in the EU Treaty, which assesses whether such aid could remedy a serious disturbance or not. The European Commission regularly evaluates and reviews State aid rules in the light of new market and regulatory developments. European policy makers are reconsidering its regulatory framework in the context of the COVID crisis and the potential effects of this crisis on the real economy. The European Commission will review the Banking Communication at some point, but reviews and evaluations should be carried out consistently – and in a holistic fashion together with the BRRD and the entire crisis management framework. For instance, the bail in rules in the BRRD came after the bail in rules in the Banking Communication. The Commission considers it essential to take a holistic approach on these issues. The policy maker explained that, while the outcome of the Banca Tercas case does not seem to please many stakeholders, the solution could not consist in simply qualifying these situations as incompatible aid: consistency with previous case law needs to be ensured. Moreover, contrary to banking legislation, state aid principles apply to all sectors of the economy, hence cross sectoral consistency needs to be ensured when exercising state aid control. For the time being, since the EU legislator has chosen to respect national specificities in the design and functioning of national DGS the the Commission will carry out case by case assessments to assess whether an operation by a DGS is imputable to the state or not. If all DGSs were subject to the same rules, the Commission could judge whether there is imputability to a public budget. As long as there is a choice between a private or public DGS, the Commission will have to proceed with this case-by-case assessment.

5. EDIS remains a contentious issue

5.1 EDIS is what is missing from the EU crisis management toolbox

A regulator suggested EDIS is a necessary third pillar of the Banking Union to ensure financial stability and to overcome the sovereign bank loop. However, there have been innumerable attempts to create a roadmap for EDIS. Europe must 'hit the road' at some point. There will need to be interim steps on this journey, but these steps should contain a clear idea of the ultimate destination. While the SRB is committed to making banks resolvable and to broadening the PIA, the industry must work to achieve resolvability. There is a need to align the insolvency framework and ensure there is room to manoeuvre for the use of DGS funds, but ultimately EDIS is the best option.

5.2 Clinging to the idea of EDIS is an impediment to reaching an optimal European solution

An industry representative stressed that, outside the virtual debate on the 'acronyms invented in Brussels', banks are coping with the fallout from the COVID crisis. In all likelihood, the industry will have to overcome an increase in non performing loans (NPLs). It is therefore a particularly bad time to consider replacing the EU's well-functioning Banking Union and harmonised deposit guarantee scheme with EDIS. It is not a sound argument simply to repeat the mantra that the third pillar of the Banking Union must be EDIS. The industry could address some of the real shortcomings here without the introduction of EDIS. On the home host issue, a less restrictive allocation of liquidity within a banking group could be reached without endangering the deposit insurance system in the host country. Responsibility for deposit insurance should lie with the parent company's deposit guarantee scheme. Second, to foster cross border consolidation, the industry needs a system of adequate premium refunds when an institution leaves as a result of a merger. Ultimately, the inflexible focus on the EDIS model is causing the deadlock. Principally, the Commission is not open to the idea of changing or withdrawing its EDIS proposal. The so called hybrid model is not fundamentally new; a fundamentally different proposal would ensure the continuation of well functioning Institutional Protection Schemes (IPSs). EDIS would prohibit the use of funds for preventative measures, which would eliminate this effective toolbox.

The Commission should build on the subsidiarity inherent to the CMDI framework: a clear distinction between systemically important banks under the direct responsibility of EU institutions and non-systemically important banks under national responsibility. Changing this foundation cannot be justified economically or politically. It would contradict the idea of a diverse Europe and undermine local responsibility. The European Court of Justice's recent ruling in the Banca Tercas case highlighted the validity and importance of using preventative and alternative measures to support troubled members of a guarantee scheme from within their respective peer group. By definition, these measures must be economically more advantageous than mere reimbursement of depositors in the event of liquidation. Following the reasoning confirmed by the Union's highest court, the CMDI review should seek to strengthen the role of existing DGSs and IPSs within crisis management by committing to preventive and alternative measures. In addition, national authorities should be provided with additional tools to deal with banks going into insolvency. This would improve the proper functioning of the banking union and maintain the diversity of the EU banking system at the same time.

5.3 Making full use of the Banking Union as a single jurisdiction could break the current deadlock

An industry representative stressed that there are still issues to address concerning capital movements, liquidity and the cross border elements for cross-border banking groups. Considering that from a supervision perspective the Banking Union is a single jurisdiction, such obstacles are not justifiable. This underlying flaw of the banking union's first pillar (supervision) also undermines the functioning of the second pillar (resolution). This issue should be addressed as the policy makers and the industry should consider the move to EDIS. These two pillars must be very stable. The current dynamics in Pillars 1 and 2 undermine the acceptability of any EDIS-like structure as a Pillar 3. As long as the Banking Union is not a single jurisdiction, solutions – i.e. the sale of a business – will be found at the national level. This holds back future integration, risks amplifying domestic issues and hinders any way forward on EDIS.

HOW SHOULD BASEL BANKING STANDARDS EVOLVE NOW?

1. The Basel reforms already in place have proved effective

A Central Bank official described how the Basel III reforms are the policy response of the Basel Committee to address the weaknesses exposed by the great financial crisis of 2008 09. The recent Covid crisis dramatically showed the importance of having a robust financial system which acts as a shock dampener when unexpected events occur. With many elements of the Basel reforms already in place – such as the new capital framework and the new treatment of credit risk – banks faced last year's crisis in a much better position than 10 years earlier. As a longstanding member of the Basel Committee, the Central Bank official emphasised that it is pleasing to see that the work of the Basel Committee does not appear to have been in vain. Another Central Bank official suggested that the EU banking sector has shown significant resilience in recent times because of the improvements observed over the last decade, particularly in terms of solvency, liquidity, and asset quality. Indeed, the work of the Basel Committee has certainly not been in vain.

1.1 The temporary adaptation of transitional periods for implementing international banking and accounting standards was essential to weather the crisis triggered by the pandemic

A Central Bank official explained that the timetable for the implementation of the last parts of the reforms was agreed by the Basel Committee and confirmed by its oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS). When the Covid crisis hit, GHOS postponed the deadline for implementation to January 2023. This one year postponement was needed to free up operational capacity in the banking system and it helped support the real economy during the crisis.

Another Central Bank official agreed that the broad and timely fiscal and monetary measures that were implemented during 2020 were well complemented by the measures taken by financial supervisors and regulators, including the Basel Committee. These actions guaranteed that institutions could continue to finance the economy and absorb losses, which so far have not been very significant. There have been some changes to the timeline, but the Basel Committee took great care to find alternative transitional periods for the implementation of expected credit loss from the IFRS 9 accounting framework. The Capital Requirements Regulation (CRR) 'Quick Fix' was also important in ensuring that banks could manage the crisis.

2. Policy makers consider it necessary to complete the implementation of the international banking standards in the EU

2.1 There is a need for caution on the timing of the withdrawal of regulatory relief measures

An industry representative agreed that, during the Covid crisis, banks have been part of the solution together with monetary, regulatory, and fiscal policies. The impact of the economic crisis on banks' balance sheets has so far been limited because public institutions absorbed most of the shock. Banks will also absorb some of the shock eventually, but the materialisation of this risk depends on public policy. The pandemic is not over. There is still a need for the public authorities to support the economy and the most affected businesses. If this support is given, casualties will be limited.

However, the industry representative cautioned that procyclical regulations such as 'Basel IV' could 'derail the train'. At a time when Europe wants to support businesses and encourage a green and digital recovery, 'Basel IV' would freeze hundreds of billions of euros, which represents a financing capacity of thousands of billions of euros. The implementation should respect the political mandate not to increase significantly overall capital requirements or cause significant differences between different regions of the world. Another industry representative agreed, warning that the implementation of Basel III risks choking off the supply of capital to the banking industry in Europe and further distorting a playing field which is already balanced away to the detriment of the European banks. A Central Bank official noted that the pandemic is not yet over and there is still uncertainty about the pace of recovery and whether the effects of the crisis are temporary or permanent. It is important to evaluate carefully the timing of the withdrawal of relief measures to avoid cliff edge effects and permanent damage to households and companies.

2.2 Policy makers expect that the Basel framework will make the EU banking market more efficient

A Central Bank official stressed the importance of ensuring a gradual return to normality in regulation. The long transitional arrangements should allow a smooth adoption of the latest Basel reforms. For example, the 2028 deadline on the output floor will give banks enough time to rebuild their capital buffers. Implementing the Basel III standards will demonstrate the resilience of the EU banking sector to the market and will surely result in better and cheaper funding. The implementation of the Basel III standards is also about the level playing field between banks inside and outside the European Unio. The regulatory stability and comparability ensured by common standards will attract investors and further strengthen the EU banking sector. A Central Bank official agreed that the timely and consistent implementation of the remaining Basel III reforms would ensure a global level playing field and further strengthen the regulatory framework. As a first step, regulators should phase out the COVID 19 relief measures carefully and return to normality, which means restoring the pre Covid regulation standards. A public representative emphasised that global banking standards are essential for promoting financial stability and enhancing the quality of banking regulation and supervision in a multilateral world.

2.3 However, the effects on the lending of increased capital requirements are restrictive

An industry representative stated that, after years of endless academic debates, it is now well understood that higher capital requirements translate into less lending capacity in the real economy. €200 billion corresponds to roughly €2.1 trillion of loans being prevented by the need to freeze additional capital in the balance sheets of banks. €2.1 trillion is roughly three times the €700 billion in the European recovery plan. It is exactly because of this fact that regulatory flexibility was provided by regulators and supervisors at the onset of the COVID crisis: to free up capital in order to allow banks to lend more to the economy.

3. Key objectives for EU policy makers: taking account of European specificities and ensuring that there is no significant overall increase in capital requirements

3.1 The political debate on how to implement the last batch of regulations will start in Q4 2021

A public representative explained that a proposal is awaited from the Commission to start the political debate with the European Parliament and the Council on the remaining Basel III reforms. The Commission will table a proposal in September. Implementing the Basel regulations is not a question of 'if' but 'how'. This must also be the message to the public: it is not a question about whether global regulation is implemented in Europe; it is only a question of how this is done.

3.2 The Basel framework is confronted with the many specificities of banking in different regions globally

An industry representative emphasised that Basel III is not sensitive to the structure of the European banking sector in respect of factors such as the large level of unrated corporates, the structure of mortgage lending and how derivatives are managed. Basel III is misaligned to the financial structure of Europe, especially given the degree to which the economy is financed on banks' balance sheets. Today, the European banking industry faces regulatory challenges which create subtle disadvantages, including the treatment of derivatives; the implementation of the Fundamental Review of the Trading Book (FRTB), which may be different in the US and in Europe; the securitisation markets in the US and Europe; and the distortive impact of Freddie Mac and Fannie Mae on balance sheet structures. Additionally, there are subtle differences in the pillar 1 and pillar 2 implementations, for example around PruVal, which does not exist in the United States, or the treatment of capitalised software intangibles. The treatment of domestic systemically important banks (D SIB) in Europe also has several distortive effects, including in the treatment of transnational assets and liabilities in the D SIB calculation, which harms intra European financial activity.

3.3 It is important to ensure a level playing field between banks in Europe, the US and Asia

The Basel III framework will further distort the competitive differences between the European and American banking sectors, to say nothing of any future competition from Asian banks. An industry representative thought that the framework will exacerbate existing distortions and level playing field issues between the US and Europe. In relation to the level playing field, a Central Bank official noted that the implementation of FRTB would very much depend on accounting standards. A public representative emphasised that the European Parliament is keenly aware of these issues. It is important not only to discuss the level playing field between the EU and US, but to understand the level playing field between the different banking companies and sectors inside the European Union. However, an industry representative suggested that the idea of the unlevel playing field between large banks and smaller banks in Europe is a myth, because large banks have additional buffers. For instance, there are special buffers between 1% and 3% for large global systemically important banks (G SIBs), additional buffers for systemic risks and an additional buffer on the leverage ratio for G SIBs.

3.4 EU banks' capital requirements could increase by 25%, while US banks' capital would remain flat or decrease

An industry representative outlined how the Basel III final framework is intended to apply to banks' capital on a neutral basis, but quantitative impact studies have indicated that the European banks' capital requirements would increase by 25% while US banks would be largely flat or even decrease. The European banking sector would require another €350 billion of capital. Leveraged on balance sheets, this represents as much as €8.5 trillion of lending capacity to the economy.

3.5 Additional objectives for EU policy makers

A public representative emphasised that the European Parliament and the Council adopt legislation, not the Basel Committee. Europe accepts the common goals of the Basel Committee, but Europe must European ise the Basel rules. It is important to consider Europe's structural specificities and the consequences for institutions, users and citizens. There should be no significant increase in overall capital requirements. Some elements are essential for an effective financing landscape, such as a stronger small and medium sized enterprise (SME) supporting factor and the credit valuation adjustment (CVA) exemption for corporates. On the output floor, Europe must find a Basel compliant solution that implements the common goals of reducing the variability of risk weighted assets (RWAs) and ensuring better comparability. The Banking Union also needs capital and liquidity waivers in order to improve the integration of cross border groups. Based on the Commission's proposal and impact assessment, there should be progress on this subject in the summer, thanks also to the contributions from the European Banking Authority (EBA) and the affected authorities, central banks and stakeholders, and the experience of COVID 19.

An industry representative noted that there are some solutions involving the output floor and its implementation, agreeing that there are many vital topics for discussions about the output floor such as how unrated corporate treatment is implemented, how to consider mortgage lending on bank balance sheets and derivatives. A Central Bank official considered there to be a problem concerning the level of the output floor. Yet Europe should be cautious about not meeting international standards, because there might be issues concerning competition if European banks are seen as less regulated or as having less strict regulation.

An industry representative stressed that there exists now an opportunity to fine tune the European solution. This should be achieved through detailed technical work before launching a public debate. However, it is important to consider what happens when a public debate is launched. In the years after Europe officially endorsed Basel III in 2010, there was a decrease in the amount of loan funding in Europe because the banks were forced to deleverage. This will happen again if the banks prepare themselves for the next part of Basel III.

A Central Bank official suggested that the full effects of the current crisis are yet to unfold, and many challenges lie ahead. Not less importantly, the final part of the Basel framework that has not been implemented concerns financial risks. This was fixed with what was called Basel 2.5, but there is a general view that it is not satisfactory that there was no comprehensive review.

3.6 The private sector still considers the policy targets to be ambiguous

An industry representative clarified the issues concerning the technical measurement of capital impact in the consideration of having no significant additional capital requirements. In the EBA's EU adapted scenario, there is a reference to a 13% increase in capital requirements. Adding 13% to the current capital requirements is an addition of €200 billion. At the same time, the EBA quantifies the additional capital required as €17 billion. This is a very significant difference. The EBA explains the figure of €17 billion by stating that they are only measuring the shortfall, i.e., the gap between the capital ratio of the bank and the minimum requirements once 'Basel IV' is implemented. Implicitly, this means that the EBA considers that after implementing 'Basel IV' the only requirement that would be imposed on banks would be the level corresponding to the minimum distributable amount, which is in the regulation. This means, for example, that there would be no additional Pillar 2 guidance (P2G) and no management buffer added to that. The Commission's impact study must clarify this subject so that policymakers can make well informed decisions.

3.7 The banking industry considers the idea of a progressive implementation to be illusory

Turning to the question of timescale, an industry representative considered that, as long as the Covid crisis prevents a return to normality, it is probably too early to discuss additional constraints and capital requirements. This is especially the case because the framework proved to be effective when the crisis came. When a reform is proposed for discussion, the markets immediately anticipate the final stage of the reform and ask all the banks when they are going to comply with the final rules. There is an idea of progressive implementation, but in reality, the banks rush to implement the final stage of the regulation.

4. The output floor is a hotly debated subject

4.1 The output floor penalises decentralised banks and banks with a low risk profile

An industry representative explained how the output floor measures the difference between the standard and the RWAs as measured by models. He reminded the audience that these models were introduced not by the banks but by supervisors at the end of the 1990s, because they considered that the standard was not a good measure of the risk. The output floor is highly detrimental for corporate banks using models for two reasons. First, the more decentralised a bank is the more it is penalised by the output floor. Corporate banks are very decentralised and therefore heavily penalised. Second, the lower the risk of a bank, the more it is penalised by the output floor. Corporate banks have low risks and are therefore heavily penalised. Indeed, in a centralised bank, different risks are mixed into the same structure. Because the average risk is closer to the standard, the impact of the output floor is reduced compared to the individual risk of each entity. When the output floor is applied to low risk retail banks in a banking group, there is a huge difference between the real risk and the standard. When these risks are added together, it gives a huge amount which cannot be averaged with the higher risk of the entity dealing with market financing, for instance. This is the mathematical consequence of averaging the whole risk or counting each risk separately. In each case, the averages are different.

A Central Bank official stated that there is a question of scope when dealing with the output floor. There had been a discussion of whether the output floor should apply at the consolidated centralised level or the individual unconsolidated level. Smaller banks have lower portfolio risk, but in some countries small banks tend to use the standard approach. The output floor might also be better for competition for small banks, because they stick to the standard approach due to its ease of implementation.

4.2 It is essential to address the variability of risk assessment approaches

An industry representative considered the output floor to be particularly impactful in Europe, given the structure of European balance sheets. While there is variability in the implementation of the risk weighted models across the sector, the output floor would be particularly impactful for companies with relatively low risk weighting on their balance sheets. A Central Bank official suggested that it is inherent in the concept that the output floor bites more for banks with a low risk-weight.

An industry representative stated that there is a myth concerning the so called variability of RWAs, which is the origin of the output floor. There are reports from the EBA which indicate that there is no greater variability of models in Europe than the variability of the standard approach. The solution to these issues is simple: first, apply the output floor at a consolidated level to neutralise the impact of differences in banks' structures; and second, apply the output floor as a backstop, as mentioned by the Basel agreement, using the 'parallel stack' approach to determine the minimum capital requirement without changing the solvency ratios. An industry representative noted that this assessment could be carried out as a quantitative impact study using a model portfolio. This would lead to a proper assessment of variability.

However, a Central Bank official stressed how banks have an understandable incentive to minimise their capital requirements, but at the same time this can be a source of concern for supervisors. There is clearly some variability, including variability based on the standard model, and variability is the essence of risk weighting. It is obvious that banks with different risk profiles should have different risk weights. That is achieved by using both standard models and advanced internal models. The point is not to avoid variability across banks; rather, there is variability when the same standard portfolio of assets is put through different models used by different banks. Another Central Bank official suggested that the alternative to the output floor would be regulatory convergence of the internal models of banks. It is incongruous for models to be used for regulatory issues but also as a true and fair view of risk for the purposes of steering and control. The perfect model must be flexible and to the point. If there is variability between models, there must be some form of standardisation. The output floor is the solution to this.

5. The future of international banking standards

5.1 International banking standards must still address emerging challenges

A public representative stressed that global banking standards should evolve in parallel to the implementation of Basel III. The sector must be able to respond to common global challenges such as climate related risk, digitalisation, cyber risk, operational resilience and increasing debt levels. These risks exist across borders and sectors, and they have broad financial stability implications. Given its taxonomy and the environmental, social and governance (ESG) factors, there is a huge opportunity for Europe to be a rule maker rather than a rule taker of global standards. A Central Bank official noted that the pandemic has accelerated digitalisation and new ways of doing business in the financial sector, which should be reflected in future banking regulation and supervision. It is important for supervisors to ensure the accurate inclusion of ESG risks in existing risk models.

5.2 Achieving effective and systematic countercyclicality within banking standards

A Central Bank official emphasised the importance of seeking to learn lessons from the pandemic regarding the effectiveness of the implemented elements of the framework. This assessment could focus on the useability of capital buffers and avoid short term quick fixes. Europe should conduct an evidence based evaluation and implement rule based stabilisers which are available but not subject to excessive discretionary action. Micro buffers will only be effective if they follow a strict risk by risk approach.

KEY ISSUES IN THE INSURANCE SECTOR AT THE GLOBAL LEVEL

1. How the insurance sector has been impacted by the crisis on solvency and profitability

An expert stated that the insurance sector faced two shocks in 2020. The first was a long-term shock coming from increasing natural disasters. The second was COVID-19.

The Global Insurance Market Report of the International Association of Insurance (GIMAR) indicated that the insurance sector has mainly been affected on solvency and profitability, and less on liquidity and asset exposure. Most reinsurance companies suffered from heavy losses due to claims. The most striking shocks have been in the economic branches of services to industries and transportation.

The lines devoted to household insurance, especially casualty, have been hit less. Sometimes the combined ratio improved. For the reinsurance sector, the consequences were seen at the beginning of the year. Most of the threats have been removed with an increase in tariffs. The solvency ratios have been affected by the financial results in the low interest rates environment. In addition, at the end of the year the various values of the listed companies followed the economics of the sectors to which they belong.

On the solvency side, the sector has been resilient and even if the ratios have diminished the amount of security is there. The real problem faced has been the pressure on costs. It resulted from the digitalisation imposed to deal with the changes in distribution channels and the subsequent evolutions of the organisation of companies, in a context of fast development of remote working due to the pandemic. In addition to cost-cutting, some attention has been given to liquidity. On the asset side, attention has been given more to downgrades of certain corporate portfolios.

An industry representative confirmed that capitalisation is still high. Solvency II regimes worked as intended in helping to preserve the bulk of capital.

2. One challenge going forward is to close the resilience gap in the societies

2.1 Modelling pandemics is challenging

An industry representative stated that much of the data in pandemic models is based on past pandemics. Each pandemic will evolve differently. It is important to note that this pandemic is still ongoing, which means that it is important that the risk of mutations as well as the risk that the pandemic lasts for longer than expected are taken into account when looking at the pandemic.

2.2 Claims regarding business interruption was an unexpected challenge

An industry representative stated that the biggest element of the pandemic that took the industry by surprise is the non-damage business interruption. This followed the decisions by governments to enact lockdowns. These varied greatly from country to country. Even Western, liberal democracies went into severe lockdowns. Non-damage business interruption claims were consequences of lockdowns on the insurance industry.

Public private partnerships are one way of helping society remain resilient when faced with large risks that are very difficult to diversify. Continuous efforts should also be made with regards to the closing of the protection gap.

3. The Insurance Capital Standard (ICS) and the holistic framework for the assessment and mitigation of systemic risk

3.1 The first year of the monitoring period of ICS

An official confirmed that, based on the experience of the previous year, the first of the ICS monitoring period, progress is on track. There was strong participation from volunteer groups and engagement in the first year of monitoring. There was also engagement with supervisors. COVID-19 provided a real-life lens through which to look at the performance of the ICS under a global stress situation.

The prior year taught the importance of having global solutions to global challenges, which the ICS aids with. It helps to provide a common language for supervisory discussions of group solvency and internationally active insurance groups and it enhances global convergence of group capital standards. There is a gathering momentum for increased participation from insurance groups in all parts of the world. Engagement and interaction are needed to ensure that ICS is designed to best capture a range of business models and market characteristics.

3.2 The implementation of Holistic Framework

A regulator explained that one impact of COVID-19 was that the holistic framework was not fully implemented during the year. Nonetheless, the holistic framework was very useful for assessing the impact of COVID-19 globally on the insurance sector. The holistic framework is not a set of rules but more of a process. It is a framework to take supervisory actions.

3.3 Three key ICS building blocks

A regulator stated that there are three main challenges for the success of the framework. The first is the setup of a proper macroprudential assessment at national level. This is the basis for having a clear idea about the sources of systemic risk at the national level and bringing them together at the global level.

The work of IAIS on the application paper on macroprudential supervision is very useful in this regard. The paper includes a number of clarifications on many critical aspects. There may be improvements to make when assessing at jurisdictional level how the sectors could impact the system individually or collectively.

The second critical aspect is having tools that are not only effective but are harmonised in order to measure the sources of global systemic risk. The work of IAIS on the liquidity metric is very important. A liquidity requirement is not needed for insurance; rather, a metric is needed: something that allows measurement of the exposure to liquidity risk at global level. In the future ICS could also be a way of measuring risk.

The third point, which is the most critical, is related to the ability of supervisors to work together and to bring all of the results of the national analyses together to discuss what, globally, the main exposures and the main threats coming from the sectors are.

4. The challenge of the global standards is to achieve comparability and address the various stakeholders' needs beyond supervisors

An industry representative indicated that their firm, as a global company, encourages global standards because it makes life easier to have proper decision-making and comparability. The principle of global standards, whether they are reporting requirements or capital requirements, makes a great deal of sense.

With Solvency II and the Swiss Solvency Test the idea is to have something that reflects the risk profile of the firm the firm thereby providing information that can be used, not just to manage the company but also by stakeholders. It has to be similar to what competitors are doing in order to see how resilient the industry is overall.

4.1 Key points of attention during the monitoring period to achieve comparability: improving the representation of the reinsurance sector, internal models, reducing national fragmentation

An industry representative noted that the holistic framework and ICS need to be well thought through so the comparability makes sense. The reinsurance industry is, on the ICS side, not sufficiently well represented in order to have a risk profile that reflects their firm properly as a global player. The firm also worries about the use of internal models. Over the years it has tried to develop internal models to reflect the risk profile more accurately, thereby helping the decision-making of senior leaders and providing comparability for the shareholders.

The other challenge is fragmentation. There is a counterbalancing of local jurisdictions wanting to stick to what they know because that is how they work, whether it is on the regulatory side or the industry side.

4.2 Producing global standards-related data is burdensome and they pose confidentiality and cybersecurity concerns

An industry representative noted that there are large amounts of data to deliver, and sometimes it is not known where that data will go. There are therefore various risks around confidentiality and the hacking of regulators' or international trade associations' systems. The firm, as a risk knowledge company, is aware that it cannot always completely mitigate everything. These risks are however, weighed to determine whether the effort really is worth the expected outcome. The internal model or the comparability between national jurisdictions, if they apply the ICS, will be key to believing that this will help the industry.

5. Trends shaping the insurance industry

5.1 Assessing and supervising the impact of climate change on the global insurance sector

A public decisionmaker noted that there are huge ongoing projects that will shape the insurance industry. There are emerging risks and issues that need to be dealt with sooner rather than later, for example cyber risk, digitalisation and sustainability. The IAIS is involved in those key challenges.

An official stressed that for climate risk, the insurance sector needs to be front and centre in helping to manage a smooth transition to net zero, and that insurance supervisors also have a key role to play.

This has thus far been achieved through the work on risk assessments and assessing the impact of climate change on the global insurance sector, as well as through the work on developing supervisory practices. An application paper is being finalised, which will be a comprehensive guide for insurance supervisors on how to build climate considerations into their day-to-day supervisions.

On the asset risk assessment, there is already good work looking at climate risk to insurers' investment exposures. It would be interesting to look at the liability side as a next step. There are many scenario analysis and stress-testing exercises being undertaken in different jurisdictions. If it is possible to contribute to global convergence or standardisation around that, that would be very helpful.

IAIS will also have a stocktaking of its principles and standards to identify any gaps. The IAIS' work is being carried out in coordination with the Financial Stability Board, which is looking at a cross-sectoral assessment of stability risks from climate change. The IAIS is contributing an insurance sector perspective to these discussions.

5.2 Sustainability risks: addressing both the physical and the transition risks requires insurance companies to reinvent themselves

An industry representative noted that for sustainability as a bucket it is important to understand the difference between the physical risks and the transition risks. Transition risk is reasonably new. Many in the industry also subscribe to the Paris Agreement and net zero by 2050, but it is a huge challenge across the globe. For the industry, it is important to not only start stepping out of certain areas and industries, but also to encourage them to reinvent themselves and to look at the opportunities available.

6. Key supervisory and regulatory challenges for the coming years for both the sector and the supervisors

6.1 A combination of traditional risk exacerbated and new risk emerging challenge the industry and the supervisors

A regulator stated that the current risk context is very complex because there are traditional risks, such as those connected to the low interest rate environment, the exacerbation of credit risk due to COVID-19 and other still important traditional risks like the ageing population. In addition, new risks are now increasing in their relevance. There is for example the market conduct, operational and reputational risks coming from digitalisation, , cyber risk, climate risk. For supervisors, the problem is keeping up with this risk development. Supervisors should be well equipped and well-resourced to deal with this new context. Europe has the added value of Solvency II, which is already a risk-based system, and so could be used for dealing with the new risks without changing the framework.

6.2 Digitalisation is changing business models in the insurance sector

A regulator stated that digitalisation is a reason for changing the business model of insurers. This will be an important challenge for supervisors who, at a national level, do not always have the relevant expertise and knowledge. The challenge is to promote the development of digitalisation within a safe context, because it presents an opportunity for companies and consumers.

6.3 Technology is where the new area of risks is coming

An industry representative stressed that with cyber-attacks it is a matter of when an entity will be attacked and how they can protect themselves. For companies going into the public cloud there is only a handful of suppliers which are very concentrated, so there is concentration risk. Technology is also evolving very quickly, so there is upskilling risk.

6.4 Addressing the protection gap in a changing world

A regulator noted that, as the COVID-19 crisis has stressed, the protection gap is a major issue for households, companies, and society in general. It is important to take care of aspects like the prevention of risk and the possibility to cover catastrophic events. Supervisors are not the main actors in this regard but should be part of the solution.

SOLVENCY II REVIEW: KEY ISSUES

1. The current context

1.1 Solvency II has proven to be a robust framework, but it must evolve to address emerging challenges

The review of Solvency II is particularly relevant in the current unprecedented economic context that has resulted from the pandemic, as well as in the context of emerging risks arising from climate change and low-for-long interest rates.

The robustness, strength, and flexibility of the supervisory framework has been demonstrated considering the current crisis. Countercyclical mechanisms provided by the current Solvency II regime were helpful in dampening the effects of market volatility. The framework has also helped to avoid procyclical behaviours.

However, some aspects of Solvency II still need to be improved upon in order to take into account the current economic environment as well as upcoming challenges. In particular, the current pandemic and the climate-related risk context have unveiled challenges for the insurance sector related to business interruption protection and the existing insurance protection gap. Considering this, the European Insurance and Occupational Pensions Authority (EIOPA) delivered its final piece of advice on the Solvency II review in December 2020.

1.2 The EU insurance sector has demonstrated its solvency and flexibility in the current challenging context

An industry representative stated that the insurance sector is often not given enough credit for being flexible, and yet it demonstrated flexibility in coping with the pandemic and subsequent economic crisis, which has been a real stress test for the insurance business across almost all business lines. Thanks to the massive application of digital technologies, the industry was able to maintain business continuity and offer services to its customers while simultaneously protecting agents and employees.

The internal capital position and the initial level of solvency allowed the industry to cope with the short-term volatility caused by the deterioration of the financial market at the beginning of the pandemic. In the first and second quarter, internal operating profits and a well-diversified portfolio allowed for the compensation of higher claims or less premiums in some lines of business with reduced claim frequency in the other lines. By demonstrating stability in the face of Covid, the insurance sector is still perceived as a safe place to invest money in the long-term.

1.3 The review should address various emerging challenges

A regulator stressed that the main challenge in relation to the Solvency II review is reality, be that the reality of many years of low interest rates, of the ongoing Covid epidemic or of climate change, which has a particular impact on insurers given their role as risk managers for the whole economy. The challenge for EIOPA and the 27 national supervisors is to consider what changes to Solvency II should be recommended considering these realities.

A regulator commended EIOPA's technical advice on the Solvency II review as a 'very good starting point', noting that it is now for the European Commission to come forward with its official proposal, which is expected to be adopted in July. In preparing that proposal, the European Commission should take into account the range of different issues such as: an ageing population; the role of institutional investors in achieving political goals such as the Capital Markets Union and the European Green Deal; the risks attached to equity and debt instruments; and policyholder protection.

1.4 Fundamental changes are not necessary

A regulator stated that fundamental changes to Solvency II are not required, particularly in light of the strength that has been demonstrated in coping with the current adverse realities. EIOPA's approach to Solvency II is therefore 'evolution, not revolution'.

Another regulator concurred that Solvency II has proven to be an effective tool and an effective framework in the wake of the Covid crisis, bolstered by the lessons learned from the financial crisis at the beginning of the decade. Evolution is therefore preferable to revolution, with fine-tuning and completing the framework where necessary in order to, for example, take account of the current environment of negative interest rates, and deepen the integration of the insurance sector across the whole European Union.

An industry representative stressed that all participants share a common goal, which is to make this review a success. There is a consensus among the community of both insurance undertakings and supervisory authorities that, while the Solvency II framework is not perfect, it is working, and it is important not to break what is actually working. The implementation of Solvency II has helped EU insurers to better align the capital level with risk, to build up resilience and to enhance risk management practices. Crucially, the framework has allowed insurers to withstand the Covid crisis without suffering damages that the current level of capital would not allow them to support, and to do so without calling for public support.

Another industry representative agreed that no fundamental changes are needed, and that adaptation is preferable to revolution, notably with regard to long-term business models. The ability of insurers to take risks and to invest in the economy with long-term strategies needs to be recognised and facilitated rather than impeded.

2. The main issues to be solved

2.1 Specific changes

2.1.1 Addressing the low-for-long situation specific to interest rates

A regulator noted that EIOPA has identified the need to change the treatment of interest rate risks to cater for the environment of negative interest rates and to ensure that enough capital is held by insurers against this risk.

Another regulator added that the way in which capital requirements for interest rate risks are calculated should be corrected in order to take account of the changes in the economic environment and the appearance of negative interest rates. A question that remains unresolved is where the cap should be in the downwards scenario.

2.1.2 Regulatory phase-in periods to dampen the impact of the Covid-19 crisis in the short term

A regulator stated that the long-term perspective of EIOPA's advice needs to be disentangled from the short-term impact of the current Covid-19 situation. An 'emergency brake' has therefore been proposed to the application of the extrapolation of interest rates when interest rate levels were below that of the end of 2019.

2.1.3 Fine-tuning the volatility adjustment

A regulator called for the volatility adjustment (VA) to be fine-tuned so that it can be better applied to longer-term and illiquid liabilities. A permanent VA component would be applied to these illiquid liabilities because the short-term volatility is not relevant since assets are being held that are intended to be kept. The macroeconomic component of the VA also needs to be fine-tuned. In particular, the VA tool needs to provide adequate relief where market fragmentation arises because of divergent economic realities across the different countries in the euro area.

2.1.4 Attention is required on possible asset bubbles

A regulator noted that EIOPA has provided a cautious position on a so-called 'green supporting factor' in a separate 2019 opinion. EIOPA is also proposing to move the frontier here in areas such as the inclusion of climate change risks in the own risk and solvency assessment (ORSA).

Another regulator noted that the insurance sector is a fundamental player in the post-Covid economic recovery and in the green and digital transformations. The policies that need to be in place to ensure that the insurance sector can play its role do not arise simply from the prudential regime, but, as a prudential regime, Solvency II must remain risk-based and evidence-based. Where uncertainty remains about the risks stemming from new assets, Solvency II needs to fully reflect appropriate risk-sharing mechanisms.

2.1.5 A macroprudential approach to recovery and resolution provisions to address notably systemic risks

A regulator highlighted the need to supplement the current microprudential framework of Solvency II with the macroprudential perspective, both in relation to systemic risk and recommendations on recovery and resolution, as well as minimum harmonised insurance guarantee schemes.

Another regulator stated that the recovery and resolution element, together with the insurance guarantee schemes, are fundamental pieces to add to the regime.

2.1.6 Cyber-risk

A regulator noted that digitalisation provides opportunities in terms of new products such as cyber-risk insurance and autonomous driving liability insurance, but that it also increases the possibility of cyber-attacks and insurance fraud.

2.2 The framework requires more proportionality

A regulator stressed that the Solvency II review should make proportionality a practical reality rather than just a theoretical principle, so that the regime is more fit for purpose, particularly for small- and medium-sized insurers.

Another regulator noted that a more risk-sensitive regime can lead to greater complexity, and that the appropriate balance therefore needs to be struck. The measures need to be logical and understandable with outcomes that can be anticipated in different scenarios.

2.3 The framework should accentuate the role of the insurance industry as a long-term investor

A regulator highlighted EIOPA's advice, which concluded that a more favourable but still prudent treatment of long-term investments is possible, as reflected in the recommendations for changes to the VA, to the risk margin and for equities that backed long-term and illiquid liabilities.

An industry representative stressed that excessive conservatism is a threat to the whole sector as it brings prohibitive costs. For these reasons, the VA and the long-term equity reduced shock need to work effectively as they represent key elements for the long-term investments in bonds and equities.

Another industry representative stated that, although market and asset prices are volatile, the fact that insurers are long-term asset holders needs to be reflected.

2.4 Addressing the remaining factors of procyclicality that prevent insurance companies from fully behaving as long-term asset holders

An industry representative stressed the need for the Solvency II framework to reflect the economic reality of low, or negative, interest rates, which are set to last. Furthermore, weaknesses in the current framework have been magnified during the financial turmoil, which mainly revolve around the excessive volatility left in the framework.

Another industry representative added that the low interest rate environment is probably the biggest challenge facing the industry. Low rates are putting pressure on the European life insurer where products with guaranteed returns in the past still represent the lion's share of the total portfolio.

An industry representative stated that the prolonged low interest rate environment is the key economic issue that needs to be addressed under the current review. Although Solvency II is strongly supported by the insurance industry, some excessively conservative elements remain.

Solvency II already comprises several mechanisms to address the low interest rate environment, such as stress testing in ORSAs. EIOPA is also performing sector-wide stress tests, checking the industry's resilience against further declines in interest rates. Most importantly, insurers are required to hold risk capital against a further decline in interest rates. For internal models, this capital is calculated based on forward-looking assessments of implied price information. For the standard formula, negative rates have not been adequately tackled so far, so the changes suggested by EIOPA are supported in principle, although the calibration may still be too conservative.

The current extrapolation methodology defines an interest rate curve beyond the last liquid maturity, defined as the last liquid point at the 20-year mark up to the ultimate forward rate at the 60-year mark. There is no reliable market for very long maturities, and objective definitions of very long-term rates are not possible. Any type of extrapolation method therefore includes subjective elements. Excessive market volatility driven by short-term events should not be transferred to the valuation of long-term stable insurance liabilities. Under EIOPA's new proposal, the starting level of the extrapolated part of the interest rate curve is dependent on swap rates beyond 20 years, now up to 50 years. These are not liquid and therefore are prone to excessive volatility. EIOPA has also introduced a new parameter that extends the maturity of the ultimate forward rate up to 100 years. As a result, a substantial decline in the solvency ratios for insurance companies can be expected, alongside an increase in solvency volatility.

There is also ample evidence that long-term forward rates are poor forecasts for actual future rates. The situation is aggravated by the current environment where interest rates are being distorted by unparalleled asset purchase programmes of central banks.

2.5 Conservative calibrations and inaccurate risk assessment approaches hamper the ability of the sector to invest

2.5.1 Inappropriate regulatory treatment of the low-for-long context risks further reducing insurance undertakings' long-term guarantees offerings and related investments

An industry representative stated that an 'emergency brake' is proposed to dampen the implications arising from proposed extrapolation methodology. It is phased out until 2032 but it also comes with a range of restrictions regarding capital distributions in combination with specific reporting requirements. To mitigate the resulting solvency effects, issuers will be pushed to divest from real long-term assets, relinquish the long-term offering of guarantees or increase costs to customers.

2.5.2 An over-calibrated risk margin reduces investment possibilities

An industry representative stated that there is currently excessive conservatism in calibrating the risk margin, which deters long-term investments. EIOPA has acknowledged one of the three strong justifications for lowering the risk margin, which is the introduction of a factor to recognise that the risk is not constant over time. Nevertheless, the risk margin represents €160 billion for the entire European insurance industry. It also introduces volatility in the framework because the risk margin increases when interest rates get lower. Other changes are needed to get to an appropriate level, and the cost of capital embedded in the risk margin should also be in the works.

2.5.3 The proposed liquidity ratio does not yet reflect the ability of insurance undertakings to avoid forced sales

An industry representative disagreed with the excessive conservatism and elevated procyclicality of EIOPA's proposed liquidity ratio, which does not assess whether the product features and the associated risks are indeed under control. Where an asset and liability management (ALM) policy ensures the availability of sufficient levels of asset inflows to avoid cases of forced sales, there is no reason to reduce the compensation of artificial volatility. The ability to earn risk-corrected spreads needs to be fully recognised, and an adjustment makes sense only if it is based on an actual risk of forced sales.

2.5.4 Spread behaviours do not appropriately capture the probability of counterparts' default

An industry representative maintained that the risk of default that the risk correction is meant to encapsulate can only be derived from historical data series. No one point in time of spread behaviour is an adequate estimate of defaults. The proposed new calibration would therefore be highly procyclical where there are exaggerations of spreads. In addition, there is an overstatement of the credit risk in the Solvency Capital Requirement (SCR).

2.6 The likely future cashflow gaps and the risk of forced sales are not appropriately captured

An industry representative stated that EIOPA's opinion is reflective of how long-term equity investment strategies are put in place and greatly improves the eligibility criteria of article 171a. However, an unwelcome change is envisaged under the demonstration of the actual resilience of the investment portfolio to short-term losses, where there is a punitive liquidity ratio for non-life portfolios. Changing eligibility criteria to long term equity investments as suggested by EIOPA would further impede long term investments. Any liquidity ratio approach should be based on cash flows rather than stocks and on an adequate liquidity monitoring horizon (1 year to 5 years maximum).

2.7 The need to reflect the specificities of the insurance business model

A regulator noted that the review provides an opportunity to improve the efficiency and effectiveness of Solvency II so that it better reflects specific features of the insurance sector. The regime needs to reduce existing protection gaps, foster innovation, protect the international competitiveness of the European market, and protect policyholders.

2.8 The proposed macroprudential measures do not account for the recently demonstrated soundness of the sector or the efficiency of the regulatory framework

An industry representative disagreed with the macroprudential policy in EIOPA's proposal, which may have been taken from the Global Systemically Important Institutions (G-SII) framework since the existing Solvency II framework had allowed for a high level of protection, and additional capital buffers would only be detrimental for competitiveness.

2.9 The proposed regulatory treatment of systemic risks increases the nexus of the insurance sector with the banking system

An industry representative noted that EIOPA's proposal would coerce insurers to increase the use of derivatives in their asset liability management and hence increase the nexus to the banking system, which is problematic from a prudential perspective.

3. Additional policy objectives

3.1 Regulatory uncertainty

An industry representative stressed that there is no need for additional uncertainty or volatility arising from regulation, particularly in the current difficult context where the Solvency II framework has worked rather well. Care must be taken not to introduce too many addendums or capital burdens that could undermine the Solvency II approach.

3.2 The appropriate level of regulatory capital

An industry representative stated that the solvency ratio should not be substantially affected in the long term or the short term. In addition, the rules for setting and updating the calibration in the legislation should be clearly specified. Ultimately, there is an opportunity to better align the framework with the underlying economic risk, which should not be missed.

A regulator stressed the importance of balance. The goal of the Board of Supervisors was to deliver a balanced package. With the figures at the end of 2019, there was no desire to have additional capital requirements or additional volatility, per se, because the system worked well and there is no need to go beyond the capital requirements as such.

EIOPA's goal was to have this balanced package without considering the interest rate risk calibration and to do so only at the European level. It can be questioned whether this is the right definition of balance or whether such a definition should do without the interest rate risk. In addition, it can be questioned whether such a definition should take account of the member state level, product levels and the future needs of society. In terms of extrapolation, it can be argued that the right balance has not been achieved with regard to all these aspects. Ultimately, a focus on the term 'balance' could lead to a better outcome.

REDESIGNING EU AML POLICY

1. General background

1.1 Anti-money laundering (AML) has been a hot legislative and regulatory topic

A policymaker described how anti-money laundering (AML) has been a hot topic ever since the appearance of large-scale money laundering activities both internationally and within the European Union. The European Union has responded with targeted legislation in the form of the 5th Anti-Money Laundering Directive (AMLD5). Starting in 2020, EU legislators have also given extra powers to the European Banking Authority (EBA). However, more action is needed to address illicit and criminal activities. Therefore, in the last year the European Commission announced an action plan and a package of legal proposals. The policy maker considered that a more forward looking view should be taken on this issue.

1.2 The banking industry is challenged by the size and complexity of the problem

An industry representative acknowledged that the banking industry had been somewhat ineffective in its attempt to handle the size and complexity of this problem. This criticism applies equally to banks, the authorities, and the European system. CEPS published a paper on AML indicating that European firms spend over €110 billion on AML compliance each year but only 1.1% of illicit funds are interdicted. It is no surprise that only two days prior The Economist called the system 'hugely expensive and largely ineffective'.

The industry representative described how thousands of employees in Europe manually check alerts which have a 95% to 98% false positive rate. The recent CEPS paper indicates that only 10% of the 1.1 million annual SARs (Suspicious Activity Report) are investigated, although the industry representative considered that the true figure could be well below 10%. One Nordic country sees 75,000 SARs a year and has 32 people to handle them, which equates to over 2,200 SARs per person. This overwhelming volume demonstrates the need for more resources.

A public representative explained that after the pandemic there will be a huge effort for recovery. Given the amount of money that will be needed, it is important to avoid the perception that some people are escaping their obligations in terms of paying tax or declaring their financial movements.

1.3 There is an existing political impetus on AML

The public representative reiterated the need for Europe to deliver on AML. The Parliament is prepared to deliver in terms of legislation here. A policymaker noted the substantial degree of harmony between the panellists regarding the priorities around AML despite their different backgrounds, adding that the Commission is currently working on an AML package. This package will hopefully be finalised in a few weeks' time, and then the Commission will move into intense negotiations. The policymaker suggested that there is a considerable degree of convergence between the views of the panellists, albeit with some entirely legitimate nuances. There is a substantial problem around money laundering within the Union and beyond, which demonstrates the importance of continuing to work on this issue. When the Commission publishes its proposal, it will be important to move forward quickly on AML with all the relevant stakeholders.

2. Challenges and potential solutions

2.1 Additional regulation should help to address an inconsistent implementation of AML legislations

A public representative stressed the existence of significant divergence in the implementation of AML directives across member states. The public representative supported the idea of moving towards regulation to address the aspects of AML policy that are currently being insufficiently implemented by some member states.

2.2 Improving supervision still requires unprecedented structural efforts at both national, EU levels on a cross sectoral basis

The public representative emphasised that the integration of the national Financial Intelligence Units (FIU) remains insufficient.

The ultimate problem is that efficient money laundering is usually conducted on a cross border basis. Money laundering cannot be addressed adequately by national authorities, which means there is a need for increased and effective cooperation on this at the European level.

An official stressed the importance of reducing regulatory arbitrage and creating a level playing field. It is important to avoid a race to the bottom, which could be created by an insufficiently harmonised implementation of the existing legislation. At the same time, it is essential to avoid creating an unnecessary bureaucracy which increases the overall workload but does not contribute to the prevention of money laundering. The official stressed the importance of allowing space for digital solutions when designing rules.

An official though that rules and harmonisation alone will not prevail against money laundering, if entities concentrate solely on following the rules without considering the bigger picture. Apart from better legislation, the three crucial elements in this fight are more resources, more digitisation, and more cooperation. The official explained that the idea of more cooperation means enabling a better exchange of information. In the financial sector, data sharing only takes place to a very limited extent. More extensive forms of data exchange such as the pooling of transaction data could help prevent the exploitation of information gaps, which enables arbitrage by criminals, and would also result in more accurate suspicious transaction reports.

However, an official stressed adherence to data protection rules as another important public objective. Digital tools and solutions will reconcile the two important objectives of AML and data protection, which should demonstrate why digital transformation is a priority for the Financial Action Task Force (FATF) under the German presidency.

A regulator stressed that AML must be considered both as a prudential risk factor and in terms of consumer protection and consumer experience. While there is a trade-off between proper AML protection and proper data protection, this should not hinder effective collaboration and data sharing.

A public representative stressed the importance of effective supervision. The EBA has been given a larger role here, but the Council has recently suggested that the EBA might also need additional competences.

The public representative supported this proposal, although there is a potential problem due to the fact that the EBA's focus is the banking sector. There is a question as to whether the most effective way to supervise the non banking sector is through an entity that is particularly focused on the banking sector. An industry representative suggested that, until a credible EU authority is established, the de facto regulator of financial crime in Europe is the United States, because the US authorities have the most power and force in this area.

Another industry representative agreed on the need to focus on banks, noting that the banks are eager and willing to contribute on AML, but stressed the fact that recent developments have demonstrated that the topic is much broader than banking. AML efforts must include funds, brokers and family offices, for example.

A regulator stressed the importance of understanding the diversity and size of the pool of obliged entities: the EBA estimates that 160,000 financial institutions are subject to AML regulation in the European Union, which means this is a very large and diverse universe. It is also important to consider harmonising supervision because there is also diversity in terms of the regulatory authorities. For example, there are 57 AML/CFT supervisors from across the European Union represented on the EBA's AML supervisory committee. There must be collaboration across regulatory institutions within and between member countries.

2.3 An effective AML policy requires combining various essential elements: an EU AML authority, facilitated information sharing, extensive use of technology, further harmonised regulation, …

An official pointed out three key areas of focus: the need for a well-designed European AML supervisory authority; further harmonisation of substantive law; and a low threshold exchange of information between all relevant parties.

The UK has a model called the Joint Money Laundering Intelligence Taskforce. The UK has torn down the barriers to information sharing between banks, regulators, and law enforcement authorities. Nordea has been involved in pilots of this model in Sweden. The model would enable an EU level approach with better resourced FIUs, more information sharing and targeted data intelligence led efforts, for example on human trafficking.

An official reiterated the importance of harmonisation, considering it essential to transfer parts of the directive to a regulation in order to reduce national divergence. A regulator agreed on the need for a more harmonised regulatory framework in certain areas, as the EBA had outlined in its response to the call for advice on the Commission's proposals to enhance the regulatory framework. The EBA's key areas of focus included customer due diligence, the list of obliged entities, the determination of beneficial ownership, and increased powers and a harmonised regime for sanctions.

2.4 Permanent technology investments are required

An industry representative stressed the need for public authorities to be better resourced and better coordinated in order to combat fragmentation, which argued in favour of the Commission's proposal for the establishment of an AML authority and further assistance for FIUs.

The industry representative considered that the mere existence of an EU authority would not be enough, however. One other necessary measure would be a better use of technology and data. It is vital to ensure better public private collaboration between banks and public authorities, and the area of transaction monitoring is a useful case study here.

A regulator considered the impact of technology an important challenge. Technology could be better utilised to facilitate AML/CFT, but it also provides new means for criminals to commit crimes. This means the industry must enhance the range of obliged entities and ensure it remains up to date with technological developments. As the regulation is reformed, the industry must enhance the coordination between parts of its regulatory framework. It is vital to ensure that AML is an important part of any new regulation, technology or finance structure. From this perspective, AML is also relevant to the prudential framework for banks.

2.5 Europe requires a single formal KYC process delivering quality assured data

An industry representative considered that KYC processes are very formulistic and negatively impact clients, highlighting the example of Austria, which has built an environment where clients upload KYC relevant information to an appropriate system through their tax or legal advisers or full year auditors. This enables the entire industry to know that the information is quality-assured while only having one formal KYC process. Currently, if a client interacts with five or 10 banks, the KYC process must be carried out five or 10 times.

An official suggested that Know Your Customer (KYC) standards are one area in need of harmonisation. There is a need to regulate for standardised data sets for national and legal persons as well as for identification processes, including the means for remote identification. To enable the more effective prevention of money laundering, Europe should consider creating a KYC utility for onboarding, i.e., a database from which obliged entities could quickly and inexpensively retrieve identification data in compliance with data protection law. However, there must be high standards and a certain degree of flexibility because it is important to enable the application of a risk based approach here.

3. There is a need for a single supervisory authority with oversight of the full string of payments

A policymaker informed them that the Commission will write a report on the possibility of public private partnership on AML in the current year. This might not be part of the package currently being prepared, but it will set the scene and consider what more can be done in this area. In any case, the policy maker agreed on the importance of information sharing, which the previous speakers had stressed.

A policy maker noted that an industry representative had commented on the need for European supervisory initiatives to focus more on managing AML risks in partnership with banks. The industry representative described how there is a string of payments involved in money laundering. The only way to tackle money laundering is to make this full string of payments available to a single authority. The industry representative suggested that therefore their institution supports the introduction of a supervisory authority.

The two most important aspects here are to make AML comprehensive and to have a single supervisory body with oversight of the full string of payments, enabling a network analysis of the patterns involved in money laundering. If there is a faulty payment, the authorities must provide feedback on it. This is the only way to enhance the industry's ability to attack different patterns. In order to do this, it will also be essential to calibrate the industry's models. An industry representative echoed the importance of cross border cooperation and collaboration. The speaker's institution is ready to contribute and collaborate; the industry will find the means to achieve this.

A regulator stated that, as the private sector representatives outlined, the authorities' collaboration with the private sector is also weak and must be enhanced. It is important to create new ways to enhance this collaboration. As one small example, in the last year the EBA established AML colleges for the largest financial institutions, which is a concept borrowed from the prudential supervisory framework. The AML/CFT authorities sit down together and discuss the AML behaviour of a single institution operating across different countries.

4. The main priorities for progress

A policymaker invited the panellists to outline their number one priority for the Commission's package on AML. A public representative stressed the need for a regulation to limit the arbitrage between member states. An official suggested Europe should create an AML supervisory body based on a harmonised law. An industry representative considered that Europe could create a gateway to facilitate better information sharing and strike the balance between the General Data Protection Regulation (GDPR) and financial crime, which would facilitate more collaboration between the public and private sectors. An industry representative stated that the most pressing need is to equip EU supervisors with the ability to access the full string or network of payments. A regulator agreed with these priorities and added that, from the EBA's perspective, the industry will only ever be as strong as its weakest link, which demonstrates the need for a high minimum common denominator.

SESSION SUMMARIES

VI

GLOBAL COORDINATION CHALLENGES

GLOBAL FINANCIAL FRAGMENTATION: CAN PROGRESS BE MADE?

The Covid crisis has not led to a financial fragmentation at the global level so far, but challenges and concerns for international cooperation remain. Multilateralism is the most efficient way to solve common issues.

1. The global financial system has not fragmented in the Covid crisis

1.1 Rapid and coordinated policy responses to the Covid crisis prevented fragmentation

An official is cautiously optimistic, as the financial system was not at the centre of the crisis. After a shaky start in March 2020, it stabilised due to international coordination and swift public policy action to support the economy. Since then, supervisors and regulators have monitored the evolution of the crisis and provided flexibility where needed, while markets have generally responded positively to the strong public support given to the real economy. This resulted in unexpectedly high asset prices in such a severe crisis.

1.2 A great deal of progress has been made

A regulator noted that this is still an all-male panel, which shows that one area of fragmentation still exists within the financial services system. However, compared to the 2008 financial crisis, much distance has been travelled. Common rules were set up to strengthen the capital, liquidity or shock absorption capacity of the financial systems and global fragmentation decreased. Cooperation amongst regulators is as good as ever. Issues are discussed with standard setters and taken seriously. Progress has been achieved. However, there is still fragmentation, and the potential for additional fragmentation.

An industry representative stated the 2008 crisis did not go to waste as infrastructure was built, and so it would be great if this became a catalyst to get people around the table to work towards the next point. One problem is that the 2008 crisis was specific and clear, whereas this one had different vectors.

1.3 International regulatory reforms introduced after the Global Financial Crisis (GFC) have built up resilience

An industry representative said the intersection between Brexit and Covid is interesting. If Covid had happened in 2008 the impact would have been much worse and that is in large part due to support from the public side and the lessons learnt during the post-financial crisis, which have helped the financial system and the global economy. Congratulations are due to the public side on global coordination. The amount of work in coordination has been a positive.

1.4 Deference between regulators has increased

A regulator stated that IOSCO has 125 members globally, regulating more than 95% of the world's capital markets. A 2020 report on deference and fragmentation found an increased use of deference[1]. It might be counterintuitive, but deference between regulators significantly increased with enhanced cross-border capital flows. It is not that there are increasing signs of fragmentation, but there is the context of the pandemic. IOSCO ramped up its internal board meetings and made a public commitment to keep markets open, as the functioning of equity, credit and funding markets was vital for the real economy. That announcement ensured that markets did not close down and tried to address potential fragmentation.

1.5 International standard setters (IOSCO, FSB, Basel Committee) help with market fragmentation

A regulator noted that on pandemic and non-pandemic-related issues, the work done by international bodies helps with market fragmentation. It may not be perfect, but it has been shown to help. Important work with other standard-setting bodies like the Basel Committee helped to put the final implementation phases of the margin requirements for non-cleared derivatives in place and ensured that fragmentation did not happen. Guidance was made available on the application of IFRS 9, as that would have resulted in more fragmentation. Less glamorously, the setup was announced. Depository fund members float in real time, so encounter measures in their jurisdictions, and the measures taken meant that a depository could be populated for other members to see, which helped in not fragmenting markets and aligning standards, even without producing standards. That gave flexibility in areas like annual general meetings (AGM), disclosure options and on-site inspections, but also for voluntary control mechanisms.

1.6 Reasons for optimism

A Central Bank official thought there is good news, but also development areas. Structures established 10 years ago for global cooperation and coordination in the financial sector came through Covid well. Information on experience sharing was key when the situation was unprecedented and trying to reach a common view was vital, as was collective risk assessment and action and the substantive coordination of regulatory flexibility and forbearance. Standard setters and the FSB agreed on principles for regulatory action, either delaying regulatory changes such as IFRS 9 or allowing temporary forbearance where it did not weaken the system. Putting back those measures should be coordinated and collectively discussed.

1. At the St. Petersburg Summit in September 2013, the G20 Leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulatory regimes."

These structures work because they recognise the inevitable heterogeneity of different structures, and that different legal systems make the rules, while bodies like the FSB and the Basel Committee cannot. Maybe one day the United Nations will be the global financial regulator. However, until then the system has to accommodate different structures and stresses, but that those actions were coordinated made a huge difference in contrast to 10 years ago. The test of that will come as the recovery phase is entered, public support schemes are withdrawn and the long-term damage to the economy and financial sector losses emerge. A collectively coordinated approach will be essential.

On the importance of the joint risk assessment and actions to address it, there has been market turmoil and stress, with disruptive call markets in March, as the financial markets adjusted to the pandemic and the likely economic impact. International structures were quick to assess risks, producing assessments and formulating a programme of work to address fragilities. That is now moving forward. It will be a test of the system whether a risk assessment can be agreed upon, with the necessary policy items to deal with vulnerabilities in non-bank finance and implement them consistently across jurisdictions. However, the situation is so far so good.

The other good is how the technology side is dealing with payments issues. The G20 and FSB have a great deal of work to do on the roadmap for improving cross-border payments, and on standards for systemic stablecoins, which raise fundamental questions, and those which deal with the role of money in jurisdictions. It is vital to avoid 'Uber-isation', where something takes hold quickly and is used at scale before regulators catch up.

An industry representative raised the issue of non-performing loans (NPLs), which are considered benign and under control; there will be some, but less than expected. They are not as worrysome now as in 2008. Meetings were held in Brussels and the UK about progressing the securitisation market so that banks can move back books into the market and free up balance sheets to lend to the real economy. The opportunity is known, and there is room for optimism.

1.7 Basel and LIBOR reforms are good examples of international coordination

An industry representative stated that global coordination on LIBOR, a major financial services project for firms, has been significant. The UK will meet Andrew Bailey's deadline at the end of 2021 and is in execution mode. The UK's leadership o LIBOR globally, has been top class.

Basel is a good example of coordination. The Basel Committee jointly decided to postpone implementation by one year. There has been no decision to postpone it further, and so it should be done according to the timelines indicated. The EU will put forward a proposal in the middle of 2021. Covid has caused a timetable blockage in the College of Commissioners, but that is the proposed schedule, and it will be followed. The average time to pass such a proposal through the Union machine is two years minimum, which shows the timing for adoption. Then there will be a period for implementation. These timelines have been made known to the Basel Committee and will not be changed.

A regulator indicated that the key sense for recovery is optimism, but not complacency. Existing international infrastructures must be appropriate, such as IOSCO, CPMI and the FSB, as it matters for producing standards, information sharing, agreeing to disagree or addressing issues. Action may be required globally in non-finance areas like data localisation technology, and others in policymakers' broader remit. Examples from the financial space allow for learning.

2. Future challenges for international cooperation

2.1 The Covid crisis shows potential for ongoing fragmentation

A regulator noted that the position of the economic cycle can add to fragmentation. With the market turmoil in March, regulators were quick to speak of forbearance and a great deal of it happened. There have been many different measures, small and large, and some could have been better coordinated. Everyone mentioned that buffers are there to be used, but people understood different issues by that. Some thought that banks needed to support the real economy and ensure credit flows no matter what. Others said that buffers are cushions to be used for banks in trouble. These are two different issues. If the economic cycle is at the moment when things turn sour, national jurisdictions, regulators and economies tend to look after themselves. The Covid crisis showed the potential for continued and ongoing fragmentation.

2.2 Brexit is fragmentation

An industry representative stated that whether it is the cost of doing business or more permanent fragmentation is often discussed internally. Many are dealing with Covid issues, but Brexit is troubling others. People are adapting. Some of it is the cost of business, but some is real fragmentation in financial services and the real economy. National tensions may harden attitudes in dealing with cross-border equivalence and finding compromises, as there have been some disagreements in dealing with Covid and that is a worry.

An industry representative observed that competitiveness in European financial markets is deteriorating compared to other major financial centres, due to Brexit and the lack of harmonising regulations. The cost/income ratio of European banks is higher than in the US and for Asian banks. EU/Japan economic partnership agreements have been successful at bringing consultation before implementing new regulations. This coordination should be expanded globally, with policymakers moving towards global regulatory harmonisation, to achieve economic recovery, a carbon-neutral society and financial stability.

2.3 Financial fragmentation could arise if exit strategies are not coordinated

A regulator considered that problems with regulatory coordination could arise if the post-Covid recovery is characterised by wide divergences across the world economy. Pressure can build on regulators to keep support measures too long, in a way that is not prudent, or to postpone the necessary structural reforms to support the underlying resilience of the system. There may be differently perceived trade-offs between short-term supply measures and longer-term reforms in different regions that could result in pressure for regulatory deference and fragmentation, so it is vital to ensure that the right choices are made.

As to whether a tapering of public measures could result in tensions between states, coordination was deemed good going into the crisis especially in the financial sector. Exiting the crisis will entail asymmetrical impacts and so there will be different pressures and pacing from the withdrawal of support measures. An industry representative considered that efforts should be made to ensure that does not happen, as if it is not focused on, it will.

2.4 Different sources of concerns

2.4.1 A tricky political environment

A policymaker stated that the political context is not great. Trust between countries across the world took a hit following the global financial crisis and has not yet fully recovered. The reaction to Covid has shown that trust has reduced significantly. It is not an ideal environment, but it has been like this for a while. The financial sector will have to work to identify the benefits of common responses and convince politicians that common responses are best. There are limits to that and it is important not to be naïve, but to be realistic with the private sector and not overpromise on delivery or under-promise either. It is a tricky environment, but the EU has tight coordination methods in place, even at local level, which can work to mitigate risks.

2.4.2 Increasing protection needs and different mindsets of national populations

A Central Bank official noted that the pandemic has focused governments on risks imported across borders and the protection of national populations, and on the balance between localisation and overseas procurement in supply chains. This is obviously most notably in health but not exclusive to it. Some of the political sentiment which has been generated around that, which is as powerful as government's first priority is to protect citizens' lives, may spill over into other areas, and that is something to watch.

An industry representative stated that these comments are striking. The mood in the UK is different to that in Ireland. People's mindsets coming out of Covid will be different in terms of how they tackle the future. There are worries about whether it is the end of the beginning or the beginning of the end, and false optimism where people feel Covid is behind us. Ultimately, there will be the recovery and the bill to pay, which is not being talked about yet. Paying for the financing of the crisis will strain politicians and smaller economies.

Three countries are doing well in vaccine rollout: the US, the UK and Israel. Everyone else is playing catch up and there will be spikes. There are questions of the next variant or what winter brings, so there is still a way to go, and it is important not to be complacent about financial preparedness, given that institutions still struggle with growth and low interest rates. There are good things in place, but there are many worries about the future in terms of shocks to the system, geopolitical considerations and more.

2.4.3 The international banking crisis management evolution highlights a trend of ring-fencing issues

Additional requirements on loss-absorbing capacity were agreed on to make systemically global banks resolvable. The international framework also focused on stronger standards with territorial approaches to prudential supervision and crisis management, resulting in a duplication of supervisory and reporting requirements.

An industry representative stressed that it is not a contradiction if the public side thinks global coordination is improving and the private side thinks it is deteriorating, as much has been achieved, especially with prudential regulation in Basel III and capital liquidity. But following a decade of perceived global financial integration, there is a trend of localisation in a number of areas, be it as a consequence of Brexit or in the area of crisis management framework due to frictions between home /host countries. Loss-absorbing capacity has to be localised to a significant extent at each subsidiary. Considering the last mile and prepositioning of resources, an internationally consistent approach to lenders of last resort functions would help enhance the banks' resolution planning. The public side must agree that plans are credible and can be executed, maybe going beyond recovery and resolution planning into operational resilience, which is new and broad and important to have a common understanding of. The scope of what supranational bodies focus on should expand, because supranational regulators, together with national bodies, have responded to the crisis excellently, as with the overall response to the financial crisis, and these practices should be carried forward.

2.4.4 The size of Central Banks balance sheets

An industry representative considered that another question is the expansion of central bank balance sheets, which many economists see as taking central banks close to governments, in terms of governmental funding and what that means. The issues are in different vectors. Taking advantage of this crisis will be difficult to do or will require an additional amount of imagination.

The Chair asked if the build-up of debt in many European countries is a worry. An industry representative stated that the size of central bank balance sheets is, as is the misallocation of capital. If there is credibility and the ability to print money, that may go away. Having access to domestic savings, as in Japan, may make it possible to have a debt to GDP ratio of over 200%. Over the last 15/20 years, 60/70% of global GDP growth has been in emerging market countries. Many of the Basel and other rules have made it more difficult for emerging markets to access capital, and developed markets need economies like Brazil, China and India to grow rapidly. When they do not, global growth is anaemic. The question is if the price mechanism functions when there are negative yields of minus-30, high-growth emerging market countries borrowing at 9% and excess savings going into different parts. Smart economists can figure that out.

2.5 New areas and pending issues where more global coordination is required

2.5.1 The future will be driven by new topics

An industry representative stated that emerging issues and technologies need to be appropriately considered to avoid further fragmentation. Next to operational and cyber resiliency and digital assets, there is a need to focus on sustainable finance and to help investors to understand the relevant context and details. A further focus has to be on the growing importance of Non-Bank Financial Institutions, on market conduct and financial crime. These themes must be identified, and work agreed to respect national interests within a global system.

2.5.2 Sustainable finance: global convergence on ESG standards is challenging

A Central Bank official noted that climate is an issue where, probably for political reasons, the structures are behind where they should be. The Task Force on Climate-Related Financial Disclosures (TCFD) is there for disclosure, but the standards need more to enable the cross-border financial sector to price risk and assess reward as governments tackle climate change. The International Financial Reporting Standards (IFRS) proposal for an international body to coordinate sustainability standards is a step forward.

An industry representative expressed his concern for the future on Environmental, Social and Corporate Governance (ESG). Addressing climate change and directing capital towards facilitating the transition to net zero carbon emissions calls for ambitious international solutions. ESG and fragmentation are related to each other as governments encourage ESG-related investments in response to the pandemic and fiscal stimulus packages are implemented on a national discretion basis. There is a huge challenge globally in reducing greenhouse gases and transforming to carbon neutral. There are uncertainties, such as how and in what time horizon this can be achieved. Short-sighted aggressive campaigns like greenwashing in finance could harm the transition, for which most corporates are thinking of initiatives and investment in renewable energy, together with public investment.

Economic recovery from COVID-19, which is the original purpose of the fiscal package, could be an opportunity. Banks and policymakers must support sustainable transition pathways with appropriate liquidity provision. Europe is a world leader in ESG, with the EU's sustainable finance strategy. Regulations for promoting this should be harmonised globally. Regulatory harmonisation is critical for a common understanding of the rules and for categorising activities from an ESG perspective. Different global economic substances and features may cause understandable confrontations or disagreement in coordination amongst countries. Reaching realistic agreement requires focus on high-level global standards, rather than detailed prescriptive rules. The EU's international platform for sustainable finance will have a key coordination role.

2.5.3 Data and technology: For a G7 digital and technology forum?

A Central Bank official noted that there are areas of data and technology which are not the responsibility of financial sector regulators, but where what is decided will go to fragmentation and localisation. A cross-sector group of international corporates have suggested to the G7 that something like the FSB be established as a technology and data forum to coordinate emerging convergence. On cloud and AI, data will create financial sector fragmentation if authorities cannot be brought in or do not work together.

An industry representative stated that an issue in the US is the democratisation of data allowing retail players to play in the markets, blurring the lines between trading, investing and video gaming.

The Chair asked about support for a type of technology G7. A Central Bank official stated that a proposal had been made to the G7, but it could be the G20. FSB experience suggests a forum in which standard setters and regulators work under a broad political umbrella to try and line up and discuss areas where they cannot. There may be places where trade-offs cannot be made but trying to line up on standards where future fragmentation is likely and the financial sector will be affected by what is useful.

2.5.4 Deference and CCPs

A Central Bank official stated that it is not clear that much progress has been made on deference and CCPs. All possible progress may have been made due to political blockages as well as technical ones, but it is a balance and a trade-off, and jurisdictions will put the trade-off in a different place.

2.5.5 Recovery and resolution of failing banks at the global level

A regulator noted the reference to prepositioning. Even if Total loss-absorbing capacity (TLAC) standards try to tackle the issue, there is an inherent conflict. It must ensure where capital is held, so there is thus a fair share for all the jurisdictions for global international banks and also ensure the free fungibility of the capital and liquidity in case it is needed in an area of these banks. This issue has not been solved and there is still fragmentation.

An industry representative thought that a reliable, internationally consistent approach to central banks' lender of last resort role will be crucial as a key enabler of an effective and credible bail-in tool. This should encourage host authorities to limit excessive pre-positioning requirements, as intended by the FSB in designing the TLAC framework. Consequently, the increase in costs for banks, which would over time feed through to the economy, would be limited. Clearly this is important for supporting the recovery.

3. Multilaterism remains the most efficient way to find solutions for common issues

3.1 Fragmentation will always exist for structural reasons

There will always be fragmentation, for various reasons, according to a regulator. With a global supervisor, a global tax base and global government, it might be possible to dream of fully integrated global financial systems, but that is not there. The importance of integrated global financial markets should not be underestimated, but they are not the most important consideration in the governance of the global system. The system is characterised by different national boundaries, reflecting different legal and tax frameworks, different governments, and different accountability frameworks, so there will always be a trade-off between efficiency gains achieved by integrating markets across borders, and possible strategic or financial risks created by the provision of services by entities supervised in other jurisdictions. In that trade-off fragmentation is to be found.

The IOSCO report which fed into the FSB work concluded that such fragmentation is almost inevitable in the system and is not down to protectionism in the narrowest sense but to the fact that as long as there are different jurisdictions frictions will exist. Regulators must optimise the benefits of integration, subject to the natural constraints on process. The public side has seen more coordination not less. If the private sector sees it, it is due to market behaviour and not because of a failure of regulators to work together.

3.2 Fragmentation can have detrimental effects

Financial market fragmentation is seen as a significant challenge for regulatory authorities and policymakers because it might entail less competition, higher costs of capital and reduced availability of services.

An industry representative stated that the private sector would love to see consistent global implementation for international regulatory reforms. For global institutions with entities in different jurisdictions, running different processes and implementing different rules at different times brings fragmentation to the institution and a real cost. It seems like a small point in terms of rollout consistency and implementation timetables, but when not adhered to it is a huge cost.

An industry representative stressed the importance of further developing the financial system, banking and non-banking, to the benefit of customers, and agreeing on global topics to support open markets. Implementation must be completed where not yet fully done, including on internal TLAC/MREL prepositioning, and clarity has to be established on open issues such as lender of last resort capabilities, to ensure that the work done is credible. The hope is that this resolution planning is never used but working towards a common goal will develop the financial system going forward.

An industry representative hoped that language can be found to remind people of the benefits of financial services. There tends to be a defensive tone but articulating how it can be a driver for global growth will help. That has been difficult to do since the financial crisis.

An industry representative appreciated how financial regulators' global coordination has helped with the unprecedented problems of COVID-19. Society is now tackling ESG issues, which require new global coordination. Further regulatory divergence may affect the competitiveness of the European financial market, with European banks' average higher cost/income ratio crucially affecting third country banks operating in Europe, who may look to allocate capital elsewhere if their EMEA business is not sufficient to maintain sustainable growth. That will have a consequent impact on clients through direct cost increases, poorer service quality and more limited choice.

The Chair noted that making European capital markets deeper, bigger and more liquid would have an effect on growth. If the EU can deliver its projects, it will create a dynamic which will be beneficial to everybody.

3.3 Switching from looking back to looking forward and fostering international cooperation

An industry representative considered this an opportunity to switch from looking back, as a great deal has proven to be effective, to looking forward and enabling the financial system on digitalisation, cyber, digital assets, the increasing use of AI and consumer protection. National self-sufficiency can be balanced in a globally consistent regulatory framework so there is a level playing field and common standards. With different legal regimes, it can be impossible to have one standard, so the equivalence regime should be outcome-based to avoid a struggle over line-by-line equivalence; instead, it should focus on the outcome in achieving an overarching goal.

It is important to be pragmatic and forward-looking. This is owed to the next generation. The last decade was mainly about recovery from the financial crisis. The financial system must be made robust and stable enough to help the recovery from this crisis and to accommodate changes from the technological revolution, the new needs of investors and borrowers, and the overall economy. There is too much focus on looking back while being overwhelmed by the future. Prioritising how to create the new environment is vital.

A regulator agreed that it is vital to be forward looking, while finishing what was started. Basel III's too big to fail regulations still lack full efficiency and effectiveness. Areas such as non-bank financial intermediation, hedge fund leverage and money market funds are still on the table. The industry should take on new things but finish tackling the proven inefficiencies and vulnerabilities that were identified.

An industry representative agreed that there are actions which could foster further international integration to the benefit of each country, given the global financial system remains highly interconnected, reflecting both supply and demand needs across jurisdictions.

Authorities must follow through consistently on the reforms already begun, such as the completion of the Banking Union, the TBTF reforms and a consistent implementation of Basel III. Stepping up efforts to remove existing impediments to cross-border consolidation is the best route to attain financial integration.

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

NEARLY 4 MONTHS AFTER BREXIT: WHERE DO WE STAND AND FUTURE PROSPECTS

1. Current situation in the financial sector 4 months after Brexit

1.1 A smooth transition thanks to adequate preparation

An official explained that there have already been some visible changes in the financial sector since the end of the transition period (end of 2020). There was a relatively smooth exit thanks to the preparation of market participants over the last few years and to extensive work from the regulatory and supervisory authorities on both sides. It was important that the Trade and Co-operation Agreement was agreed beforehand, and it is equally important for it to be fully implemented.

A second official agreed that the transition has been relatively smooth, stressing that the industry has now adopted a way of working that bifurcates business between the EU and UK, given that equivalence is not in place in most financial areas. That is not where the UK had hoped to end up; nonetheless, the industry has successfully adapted to that reality, and there is a need to move on.

A regulator noted that there have been some shifts in business, but overall no major disruption or significant volatility has been observed. This means that the correct judgments were made on where there could be potential financial stability risks and how they could be tackled. For example the temporary equivalence granted to UK-based CCPs was an appropriate decision and the EMIR 2.2 regime helped to assess the risks posed by systemically important entities for the EU in a far better way than previously.

An industry representative confirmed that the main structural changes had taken place for global banks with a significant presence in the UK in advance of January 1st 2021. Global banks have opened EU entities to continue servicing EU clients and have transferred account opening to the EU for new European clients. Since Brexit, many banks have also enhanced their staff resourcing and regulatory permissions in their EU entities.

Another industry representative commended the authorities for appropriately flagging their requirements and demands, which allowed industry players to make the necessary changes to ensure that they could continue to serve customers. Putting customers at the centre of decisions is a good place to start both for the industry and the authorities, especially with the need to fund the growth and recovery of the EU economy in the Covid-19 context. The industry speaker agreed with previous comments that Brexit events and the volatility triggered by Covid-19 had been adequately handled by the industry and the authorities. The fact that most asset management products and services held up very well during March-April 2020 also shows the effectiveness of asset management regulation such as the UCITS directive, which provided the private sector with a high degree of visibility. UCITS has now become a gold standard and has also been adopted by many non-European investors such as pension funds. There must therefore be caution about any changes to this regulation, in particular in the context of potential divergence between the EU and UK.

1.2 Ongoing changes in the European financial landscape

A regulator stressed that a significant shift of share trading from UK trading venues to EU trading venues, representing around €6 billion of trades has been observed since January 1st 2021, while on the derivatives side some trading has shifted to the US. No major issues have disrupted trading activity or market operations. Further adjustments of business practices are expected and will continue to be monitored by the European Supervisory Authorities (ESAs) and the National Competent Authorities (NCAs). One key focus of this monitoring are the activities of relocating entities in order to ensure that they adhere to the agreed establishment plans. The risk of unauthorised business being provided by UK-based firms in the EU is also being assessed, with so far mostly minor indications of such activity.

A market observer stated that with Brexit the European financial sector has evolved towards a more fragmented landscape around a certain number of specialised hubs, which is closer to the situation that existed before the single market and the euro. Amsterdam attracted equity trading flows from the UK; Dublin attracted some commercial banking and asset management; Luxembourg mostly gained back office for asset management; Frankfurt has a number of commercial banks; Paris has a variety of areas and is probably the only place where parts of the full financial ecosystem can be found, including a concentration of broker-dealer activities. A greater transfer of activities to the EU has not yet been seen, simply because it takes time and was delayed by the pandemic. The Single Supervisory Mechanism (SSM) has given banks more time to adapt. There will probably be a more definitive outcome in the movement of activities to the EU by the end of 2021.

The trading of derivatives however poses a problem both for the EU and UK, the market observer emphasized. There has been a significant relocation of activity to the US, mainly resulting from the duplication of differing EU and UK derivatives trading obligations (DTO), both derived from MiFIR: the UK applies its DTO on a territorial basis and the EU applies it on a legal entity basis, which creates conflicting requirements. At present, about 70% of international exchanges between brokers and clients have moved to the US and 30% have stayed in London. European banks operate via branches and the share of business remaining in Europe cannot be accessed by European actors. It is urgent therefore that the EU should apply its DTO also on a territorial basis.

1.3. Policy work underway in the UK

An official explained that the UK is currently establishing its direction and approach to financial services legislation in order to create the proper environment for financial services, as it moves out of the EU. In the summer of 2020, a statement was made in Parliament about the UK's approach to what it described as "in-flight" European legislation and how the UK would complete the delivery of the acquis and possibly amend it. In importing the acquis into UK legislation, the UK has been confronted in particular with a challenge about defining where responsibility and accountability lie between UK policy-makers and regulators and the Parliament for setting and implementing policy. Through the Future Regulatory Framework Review, the UK is considering those constitutional arrangements.

The major area of reform identified by the UK authorities is Solvency II, which has been a longstanding concern for the UK, for example regarding the matching adjustment, the official added. The UK has also conducted a review of the listings regime, to which some changes will be made and will now embark on a process of consultation with the industry regarding possible adjustments to the regime for wholesale and capital markets. This review will be conducted in parallel with the Commission's review of the MiFID II directive. Different conclusions may be reached in the UK and the EU that may be discussed in the context of the upcoming EU-UK regulatory dialogue. This is however expected to be a process of adjustment rather than a radical reform.

2. Challenges associated with Brexit in the financial sector

2.1 The risk of legislative divergence between the EU and UK

An industry representative noted that beyond the area of derivatives clearing, which requires some form of cooperation, the 'new reality' is that either the UK becomes a regulation-taker, in order to continue accessing the single market of financial services, or it diverges to build a competing 'Global Britain', and in this case no one would have a political mandate in the EU to give the UK access to the single market of financial services. There may be shared views or ambitions between the EU and UK in certain areas e.g. concerning the green economy or technology, but converging on rules is needed to create a single market.

An official emphasised that there being divergence or not from EU policy thinking is not an end in itself for the UK. It is a possible consequence of the UK's thinking about what it needs to do to make its financial services safe, transparent and competitive. The UK was very closely engaged in the development of the European acquis for financial services, so there is no intention to 'throw it all out'. The UK is not expecting either to be able to continue operating in the single market post-Brexit. The question is rather to evaluate and manage the risk of divergence between the EU and UK as two autonomous third-party jurisdictions. The Memorandum of Understanding (MOU) recently agreed between the EU and UK sets in place a framework through which those conversations can take place.

Another official emphasized that while the UK does not want to be a rule-taker nor does the EU. A way of working together has to be found that allows autonomy to be retained on both sides.

An industry representative mentioned that although the UK government has made some statements to indicate that UK rules would diverge in certain areas, the extent of this divergence has so far been quite limited. In addition there may be some constraining factors on divergence in the longer term. For example, a significant number of financial services rules in the EU and the UK are derived from globally agreed standards e.g. at G20 level, which generally ensure some degree of alignment between jurisdictions regarding core rules. There are also global supervisory coordination frameworks in place, such as supervisory colleges and crisis management arrangements that may ensure a certain degree of convergence as well as a level playing field for market participants.

The market also has a role to play in ensuring that broadly common rules and standards can be maintained, the industry speaker believed. Global financial institutions normally have global matrix-organisational structures in place, with local reporting lines and governance structures as well as a global or regional coordination framework. Under such a matrix structure, some businesses are managed regionally or globally and internal insourcing and outsourcing arrangements are put in place, which makes sense from an efficiency and risk management perspective and is critical for managing business effectively. This is possible to the extent that financial services rules are broadly consistent at the international level, being derived from globally agreed standards.

2.2 Issues related to delegation arrangements in the Brexit context

A regulator stated that delegation arrangements could raise potential issues in the Brexit context. The delegation or outsourcing of services to other firms based outside the EU requires a continued monitoring to ensure that there is sufficient substance, control and risk management in place in the EU to achieve an adequate level of investor protection and stability. This is one of the focus points of the investment fund regime in particular, given the importance of delegation in the global business model of asset management, in order to ensure that the management companies of EU UCITS or AIF funds are taking the key decisions and properly managing risks in a context of delegation. The Single Supervisory Mechanism (SSM) is also monitoring the delegation and outsourcing arrangements of banks and the way their activities are organised, for example their trading book.

An industry representative stressed that delegation is a global supply chain model in the investment fund sector that improves the quality of services for customers, increases choice and helps to drive prices down. Having a framework that allows EU savers to invest in companies, technology and infrastructure around the world is something that requires continued support as it will benefit EU citizens. A clear and consistent regulation concerning delegation is needed in that perspective.

Responding to a question of the Chair about whether the responsibilities between e.g. the management company based in the EU and the trading arm possibly based in the UK are clearly defined at present, the industry representative confirmed that the rules are very clear. European fund management companies that have a delegated model have very strong safeguards and investor protections in place, and sufficient substance in the management companies onshore to ensure this. The continued focus of supervisory authorities on this issue is welcome. Delegation is indeed a key component of the UCITS model and essential for its reputation and sustainability.

A market observer agreed that delegation is part of the global business model of financial institutions, but there is a clear intention of the European authorities to have a critical mass of activities in the EU so that they can assess how the overall financial system is functioning and whether control and risk activities are appropriately conducted.

3. Possible post-Brexit evolution scenarios for the EU and UK financial sectors

3.1 The challenges posed by Brexit for the EU and UK financial sectors

An official stated that for the financial sector Brexit is a fragmenting event, since a jurisdiction is being broken into two. When a member leaves the EU it leaves the single market and the previous level of integration cannot be replicated, even with equivalence. Indeed, the financial sector arrangements cannot be insulated from the overall political context. However it is important now to strive for the best possible cooperation arrangements. Before Brexit, the City of London was not only a global financial centre but also an EU financial centre. London will remain a very important financial centre on the EU's doorstep. This is not a problem for the EU, since there is already a very significant level of interconnectedness between the EU and the UK and many areas of common interest in regulation. On the other hand, the fact that a significant part of the EU's domestic financial system may remain located in London and so outside of the jurisdiction, puts the EU at risk of being a rule-taker. The EU is indeed rather unusual in the extent to which its domestic financial system is relatively underdeveloped compared to the size of its economy. Longer-term risks of financial stability or loss of autonomy will need to be addressed by the EU, even if this raises costs and reduces efficiencies in the short term. Integration with the UK has tended to be an organic process built over several decades thanks to EU membership, so the process for reverting it will require time.

An industry representative added that EU clients will be increasingly serviced by EU entities, but the UK still has capabilities to continue to be a major hub for European clients, which can be aided by regulatory alignment between the EU and the UK.

Another industry representative agreed that there has to be acceptance that Brexit is a meta-fragmentation decision that will significantly impact the financial sector and that there is no way to insulate financial services from that fundamental force. Trying to replicate the pre-Brexit integration with equivalence does not seem possible, therefore the best way forward for the EU is to organise and build its own integrated and interconnected financial centres.

An official observed that the financial services sector is already adapting to a 'no-equivalence world' with a bifurcation of business between the EU and the UK that has now taken place. The official suggested that Brexit may be generating even more strategic policy questions for the EU than for the UK, because the UK continues to have its own financial centre, whereas the EU now has to determine how its own financial system is going to evolve. The UK moreover has means other than equivalence to manage access to its financial sector and a number of routes or options that it can use to manage its relationship with third countries and that it is currently exploring e.g. mutual recognition agreements or exclusions for overseas persons.

Answering a question from the Chair about whether the UK's approach includes ramping up its policy efforts at the international level, the official confirmed that the UK has always engaged very closely with international standard-setters, because it is in the UK's interest to do so. The UK moreover thinks that the transition to net zero (i.e. eliminating CO2 emissions) and the increasing use of technology in particular are going to require cross-border and convergent approaches at the international level. Common discussions will also be needed in the near-term about how to exit some of the measures used in the regulatory sphere to address the challenges of the pandemic. These are areas of shared interest between the EU and UK, where there are significant challenges in terms of efficient allocation of capital, the official emphasized. Europe as a geography needs to think about how it can operate together to establish a market that enables the allocation of the capital needed for addressing these challenges in a cost effective and safe way, which is a process that will be worked on by the authorities and market participants for several decades. There are serious challenges and imperatives in this area that require cooperation and collaboration and that go beyond the notion of equivalence.

3.2 Likely evolutions of the EU financial sector post-Brexit

A market observer suggested that the most likely long term scenario for the EU financial services sector is a concentration around one or two main financial centres where talent can be most easily attracted, together with a few other more specialised hubs.

An industry representative considered that the EU has the potential to build and operate the financial infrastructure that is needed for funding its economy and that is currently mainly based in London. With 450 million potential customers, one of the highest saving powers on the planet, hundreds of blue-chip companies and tens of thousands of small and medium-sized enterprises (SMEs) in the EU this is quite possible. This requires the development of interconnected financial centres across the EU, building on more integrated trading venues and market infrastructures. Accelerating and deepening the Capital Markets Union (CMU) is also essential, which may necessitate a big bang approach notably in terms of convergence of corporate and insolvency laws. Europe indeed must not be a territory of 'finance-takers', but a continent of 'finance-makers' in order to transform the high saving levels of EU citizens into high investment in successful companies. The focus of all EU institutions, regulators and supervisors should be on achieving that objective in a competitive and innovative manner, open to the rest of the world.

Another industry representative considered that there is reason for optimism about the future of investment and savings in the EU particularly when considering the area of sustainable investment and climate change, where Europe is in a leading position. The Sustainable Finance Disclosure Regulation (SFDR) is very pragmatic and allows the directing of savings to industries that will align with these values.

An official stressed that the EU is approaching the future as an open financial jurisdiction that wants to remain engaged with the rest of the world, including the UK, while at the same time developing a resilient domestic financial system and solid market infrastructures. Work around Banking Union and CMU will need to be accelerated in that perspective. Dependency on other jurisdictions may translate into insufficient autonomy or financial stability risks that also need reducing. This is a strategic approach that the EU needs to have for ensuring its economic future and should not be considered as protectionism.

The Chair stressed that trust between the EU and UK is crucial in this approach. The hope is that common ground can be found more broadly, because there is a big dividend on both sides to getting the relationship right and tackling the challenges that are at stake in the post-Covid environment.

4. Possible regulatory and supervisory framework for managing future EU-UK financial relations

4.1 Framework needed for EU-UK regulatory and supervisory cooperation

An official explained that the Joint Declaration on Financial Services Regulatory Cooperation between the EU and UK committed to establishing a framework for regulatory cooperation by March 2021. A Memorandum of Understanding (MOU) has been agreed with the UK at a technical level and its formal approval by the EU is expected soon. The MOU is not a framework for making decisions and is an important element of the EU-UK relationship on financial services going forward. It is based on the model used for the EU-US regulatory dialogue and should also work for the UK, although this dialogue could be more intensive, due to the higher degree of inter-connection. Both sides will retain their regulatory autonomy and independence, thus the dialogue going forward will be about cooperation and not a co-management of processes.

Another official added that the MOU is not a policy tool but closer to an 'administrative vehicle', establishing the norms of the new relationship and helping stakeholders to understand the nature of the engagement between the EU and the UK in the future. Eventually, it should become a way to progress policy with no reference to Brexit, allowing the EU and UK to cooperate in areas such as the transition of economies to net zero or enhancing the digitalisation of the financial sector.

A regulator agreed that there needs to be discussions between the EU and the UK to ensure a shared understanding about the direction of travel and that the MOU is an appropriate framework in that respect. The European Supervisory Authorities (ESAs) and ESMA in particular will fully participate in that regulatory and supervisory dialogue with the UK, which is already occurring on the ground. ESMA, which is directly supervising certain entities in Europe will indeed need effective and close cooperation with the UK authorities. The ESAs have other challenges at the European level in this new context. One is the ability to be sufficiently fast and adaptive in rule-making. The other is addressing the far more fragmented financial-services sector that is now developing within the EU around different financial centres, which will require more consistency and convergence in the supervisory and regulatory approach within the EU. The Chair added that if the objective is to achieve a truly integrated capital market in Europe, then the necessary supervisory powers have to be devolved to ESMA including stronger enforcement powers in the cross-border and systemic areas.

4.2 Possible EU-UK equivalence arrangements

An official stated that there will be no blanket decisions regarding equivalence and that equivalence decisions will be assessed on a case-by-case basis. The equivalence assessment phase may begin when the MOU has been formally adopted and the regulatory cooperation is in place. A 100% alignment is not required for equivalence, but divergence cannot be too strong either. There are tolerable levels of divergence and there are levels of divergence that are less tolerable for equivalence arrangements to be possible. The regulatory cooperation framework that the MOU creates will be very important for having additional clarity on this aspect.

A market observer stated that equivalence decisions also have different implications depending on the activities and currencies concerned e.g. for securities and derivatives trading, clearing and settlement. When equivalence concerns contracts in a given jurisdiction's own currency, which are highly systemic for this jurisdiction, there may be a risk to financial stability if an excessive amount of this activity is allowed to happen outside that jurisdiction. This may apply to the UK as well as to other third countries.

The Chair noted that the UK's own policy reviews are just commencing with a large consultation exercise and that demand for equivalence seems to be decreasing in the UK. An official confirmed that there is now a less broad-based pressure in the UK for reaching equivalence with the EU, although interests may vary across firms. Many financial firms have indeed adjusted to a world without equivalence and have invested in new legal entities in order to be able to sustain services to clients on the continent. To a certain extent the industry has moved on from the question of equivalence with the EU to broader questions about future UK policymaking and the harmonisation of standards. Multinational firms however remain interested in maintaining convergent regulatory standards with the EU.

SPEECHES

João Leão

Minister of Finance, Portugal

Keynote speech

Thank you. First let me congratulate Eurofi for organising this very interesting event. Thank you for inviting me to say a few words today.

I would like to look back at the last 14 months and to share some thoughts about how we got here today and about the road ahead of us. I am sure everyone will agree that it has been quite a challenging journey, but now we see finally light at the end of the tunnel. Around 14 months ago the COVID-19 outbreak hit Europe and we faced the difficult decision to close our economies. At the time, no one really knew what the consequences would be for our economies and firms. However, it was clear that our priority had to be the safety of our people.

Europe was truly tested. And now, although the fight is not over, looking back we can say that Europe's people, workers, firms and financial sector… they all showed an incredible resilience and capacity to adapt. The European Union also did not fall short of its obligations. The coordinated, bold and timely action at EU level was exemplary and showed a unified and strong front. The flexibility embedded in our fiscal, financial and state aid frameworks allowed us to agree on safety nets that provided an important relief for workers, businesses and sovereigns. The EU was able to agree on the largest stimulus package ever financed through the EU budget.

We must acknowledge that the response to this crisis has been very different from the one during the previous crisis. Different in terms of: (i)the speed of the agreements, (ii) in the willingness to find an appropriate solution to face a significant common challenge, (iii) in the way European policies have been complementing the national ones, and (iv) in the way monetary and fiscal policy have been working hand in hand for the first time, reinforcing their efficiency, and also in the role of the financial sector.

Let me say a few words about our fiscal instruments. Fiscal policy has been a crucial instrument to support families and keep firms alive. The agreement on the activation of the general escape clause in 2020 and 2021 allowed member states to fight against the economic and social effects of the pandemic crisis. Despite the incredible tumble, the economy fell much less than anticipated and especially unemployment rates increased much less than previously expected.

Although many countries are still being challenged by new waves of the virus, our firms and economies have shown the capacity to adapt, and the impact of these last lockdowns have been much less severe than the first one in 2020. These are only some signs of the success of our coordinated actions.

With regard to the financial sector, the banking system has also been able to deliver, guaranteeing the flow of credit to the economy. Indeed, banks went from being a shock amplifier in the sovereign debt crisis 10 years ago to becoming a shock absorber in this crisis. Put differently, banks went from being part of the problem to being part of the solution. Banks entered this crisis better capitalised and in a better liquidity position. Banks also benefited from the significant support provided by governments and authorities to households and non-financial companies. We are reaping the benefits of the good work done in the last decade.

Nevertheless, some of the pre-existing vulnerabilities persist. We must address them in a timely manner. The work on NPLs must continue. It is an ongoing priority for many banks. It is paramount to be prepared for the incoming rise of NPLs in the aftermath of the crisis. Here, special attention must be paid to the unwinding of support measures and to the impact on bank balance sheets and, in turn, on the lending capacity. Also, we need to assess if we have the tools we need and if they are fit for purpose. Banks' capacity to maintain the financing of the economy is crucial to support the economic recovery.

Now, looking forward…

As the vaccination campaign unfolds, we anticipate a strong economic recovery in the second half of this year and in 2022. However, uncertainty remains high, and we should not stop supporting our economies now as we risk intensifying the long-term scarring effects. Keeping the complementarity between fiscal and monetary policies is of the utmost importance. Fiscal policy should stay flexible. Support measures should be kept in place for as long as necessary. Also, we must stay vigilant as the speed of recovery is uneven across countries and sectors. At ECOFIN council we have agreed that fiscal policy must remain supportive of growth next year. I expect ECOFIN to confirm next month that the general escape clause remains activated in 2022.

Both workers and vulnerable but viable firms should be protected without preventing an efficient reallocation of resources across the economy. With recovery in sight, it is time to start planning the transition from broad emergency measures to measures that kickstart and support a strong economic recovery. At the same time, we cannot lose sight of the medium-term fiscal sustainability concerns.

After two large economic recessions in less than a decade, member states' debt levels have amplified. It is now time to reflect whether the current fiscal surveillance framework is still the most adequate to address the challenges of tomorrow. This crisis showed us the need to strengthen the EU architecture in order to guarantee some public finances, but as well necessary conditions to promote investment and growth. The Recovery and Resilience Facility will be a game changer, a key instrument that will allow us to kickstart the economy and to prepare the ground for a sustainable recovery without further burdening public finances. The national recovery plans represent a unique opportunity for member states to pursue high levels of investments that will create jobs, promote growth and support the green and digital transitions. Here a smooth and speedy approval of those plans brings our recovery effort one step closer to reaching the real economy. It is of utmost importance that the money starts flowing through the economy now when it is most needed.

The issuance of high-quality euro-denominated bonds under the RRF will add significant depth and liquidity to the EU capital markets. This is also a milestone for the EU and a vital step to European economic policy integration as it is the first time that such a joint funding model is agreed on to support economic growth. The issuance of green bonds under this facility can also reinforce the international role of the euro and the EU leadership in the fight against climate change. We must spare no effort until we achieve a sustainable and inclusive recovery.

That is why the Portuguese Presidency has been working towards: (i) promoting a recovery leveraged by the climate and digital transitions, (ii) implementing the European pillar of social rights as a distinctive element to ensure a fair and inclusive transition and (iii) strengthening Europe's autonomy by taking a leading role in climate action and promoting a digital transformation at people's service.

We shall walk out of this crisis as a more integrated Europe, better prepared for the challenges of tomorrow.

Andrej Šircelj

Minister of Finance, Slovenia

Closing speech

Thank you, Mr President. First, I would like to thank you and the organiser for the invitation to this conference. I am honoured to be with you today.

Ladies and gentlemen, I regret that the unfavourable pandemic conditions still do not allow us to hold physical meetings and conferences, but I am very glad that there are signs of hope that the situation might soon improve. We have efficient vaccines and vaccinations are underway around the world. I am convinced that when a high enough vaccination rate is achieved, life will return back to normal. This can fill us with hope and give us strength to push through the final stages of this battle. I believe that before long, things will improve for all of us and that we will be able to meet at the next Eurofi conference in person.

Now, I would like to share a few thoughts on the post-Covid priorities. We have been dealing with this pandemic for more than a year. As burdensome as these hard times are, they have provided us with opportunities to rethink the world we live in. The rapid spreading of the virus pointed out the weaknesses of health systems in many countries. The restraining measures and lockdowns to reduce the spreading of the virus affected our businesses and economies. The radical changes that hit us overnight transformed our mindset. Due to the pandemic, we started thinking more carefully on one side and more visionary on the other. We became more diligent in regard to our health systems and our environment. We came to the conclusion that we should focus on exploring, finding, and using new solutions that are based on innovative technologies of the future.

I would like to emphasise that the recovery remains the paramount post-Covid priority. It will be a lasting and complex process. However, the main part of the recovery is the implementation of the investments and reforms envisaged in the recovery and resilience plans. The support measures that we have taken proved to be efficient. Many insolvencies and bankruptcies were prevented by the support measures. People were able to keep their jobs because employers enabled work from home and engaged in short-time working schemes by using stimulations. Income support measures for different vulnerable groups and people who could not work are also an important part of packages. With that in mind, I would like to point out that we should still be careful about not withdrawing the support too soon, as this would jeopardise a comprehensive recovery. We all know that sooner or later we will have to switch from the blanket approach and concentrate on focused and efficient recovery measures – but before the transition the recovery measures must be prepared.

So, at the moment, we are facing the challenge of finding the right timing to loosen the support measures. Knowing this, we also have to be aware that once the support measures are no longer provided, some companies might not survive and could disappear from the market. That is why we need to start the discussion on how and when to make the cut. We have to figure out how to help the companies that will not survive the transition from support to recovery measures and the employees of these companies. On the other hand, we need to support the viable and prospective enterprises. The companies with comparative advantages should be supported. This includes facilitated access to continuing education and insights that could advance current practices, upgrading employee skills, and retraining.

Unprecedented responses to the crisis on the national levels established the basis for the recovery. The historical agreement on the EU level, the EU fiscal stimulus, provides the starting position of the recovery. We should use this opportunity wisely. That is why we should try hard for the recovery and resilience plans to be ready for implementation as soon as possible. The disbursement of funds should follow soon after. The reforms that we set out in the recovery plans need to be implemented efficiently. This will guarantee a successful recovery that will provide the best ground for further discussions on the fiscal stance and the deepening of the economic and monetary union. The recovery, as we decided, needs to be based on innovations and improvements. It needs to take into account the green and digital components and also to follow the 'do no significant harm' principle.

These guidelines that we agreed upon offer us a chance of restructuring the economy and society for the better, but in creating a better environment, we must not leave people behind. We have to establish effective, active labour market policies and encourage the restructuring, reskilling, and strengthening of the development of knowledge and skills for jobs of the future.

The transition to a greener way of life is essential, as the current way of life is not sustainable. We all know that it is not going to be easy, but the bottom line is that it has to be done. It has to be done to ensure clean air and clean water, which are the fundamentals of quality living conditions in the long term. The change might not seem imperative now, but we must think of the future generations and the world they will inhabit. By taking the first step now, we provide for their future. The funds under the Recovery and Resilience Facility offer a great opportunity to invest in renewable energy, sustainable buildings and mobility, and cleaner environment. It is expected that banks will support the trend by providing better conditions for green loans. Green bonds are also becoming the asset class that are the subject of strategies and requirements of investors.

We must focus on ensuring the path for future investment as well. The investments, in line with green and digital requirements, must be directed to the sectors that need them the most. This will compensate the effects of the pandemic, support the recovery of the sector in question, and strengthen its resilience. The investments should also encourage cooperation between the public and private sectors.

I believe that our plans for the recovery are a welcome and much needed step in the right direction. We have to follow our goals and be motivated by the improvement that we can achieve in the Covid-affected economy and society. The ambitions must have a grasp of reality and first focus on the most urgent issues. The recovery of the most affected sectors will provide leeway for an upgrade where need is the greatest. We must gain experience, constantly exchange best practices, and wait for the recovery to be well underway.

After the recovery is entrenched, we can focus on major restructuring while keeping in mind that the social aspect of the recovery still has to guarantee support for the people who are employed in non-viable companies or even sectors.

Ladies and gentlemen, let me conclude by saying that the COVID-19 pandemic is most likely the greatest challenge that we have ever faced. In these times, the most difficult times that all of us have encountered, we have learned how to work together, and we have cooperated. From here onwards, things will only get better. They will not be easy, but we have to keep in mind that the hardest part is over. Now, we have to make sure that we keep on working together and take advantage of the opportunities that we have created. Hence, I encourage you to continue with the coordinated political reaction that enhances the EU added value. We also must not forget about the solidarity and inclusivity that we have practised so well during the past year. I am firmly convinced that a wholesome recovery and a prosperous future lie in the strength of unity, and the opportunity that lies ahead is an opportunity that we must not miss. Thank you very much.

Pierre Gramegna

Minister of Finance, Luxembourg

How to reconcile economic growth and debt sustainability in the EU over time?

Thank you, Didier. You have made my day this morning by starting the introduction in Luxembourgish. This is quite rare and really a treat. Congratulations, because it was perfect in terms of grammar and pronunciation, so I think you can easily become an honorary citizen of Luxembourg. I know you come often and with pleasure to our country. I hope that you, I and all our listeners, who are normally participants in the Eurofi meetings, can all soon meet again for real.

Today is 16 April 2021. It was one year and one week ago, on 9 April 2020, that the Eurogroup and Ecofin Ministers decided the emergency measures to cope with the consequences of the pandemic. I remember what happened on that night very well. There were long negotiations and there was the three-pronged response to the pandemic, which triggered a symmetric economic shock that sent waves through all the countries in Europe and the world. We were able to show solidarity, take measures together and even seized the opportunity to have a Hamiltonian moment, as it has been described, by giving the Commission the possibility to take up debt on behalf of the European Union. Luxembourg was the signatory of a letter by nine Prime Ministers, saying that we should act in such a direction. We were the only triple-A country to do and I am glad we did so. Europe has, thanks to that, been able to give a credible response to the challenges ahead.

If I look at the three measures we took, there was the European Stability Mechanism (ESM) facility, which just by its existence has reassured markets and has allowed all countries to find on the capital markets the necessary bond facilities that they needed. The European Investment Bank programme with guarantees for companies is running, and the Support to mitigate Unemployment Risks in an Emergency (SURE) programme has been a total success in financing labour systems in many countries.

As the longest serving Finance Minister in the Eurogroup, I am very pleased about what happened. We can also be a little proud of what we achieved, but nevertheless let us be realistic: we still have a lot of challenges in front of us. What I have just described is what we did, in a nutshell, in a couple of weeks, just at the moment where the first wave happened. The theme of today is how to combine higher debt with good growth. Maybe because I have been in the Eurogroup for nine years, in order to understand how to deal with it, the best thing to do is to distinguish between the short, medium and long term. What did we do in the short term? Part of this has already passed behind us, in 2020 and the beginning of 2021. The short term, for me, continues in the months to come, probably for the whole of 2021 and part of 2022. The medium terms is five years from now, and then it is the long term.

What can I say about the short term? What we did in the aftermath of the immediate lockdown and the three emergency measures that I described was that we had an attitude that we should do whatever it takes to support the economy and save jobs and livelihoods. Obviously such a ‘whatever it takes’ approach costs a lot of money. Over the months we have learnt to live with the pandemic, waiting for the vaccines. Now the vaccines are here and we realise that we still need to support the economy, but I think that we have shifted from a ‘whatever it takes’ approach to a more targeted support of the economy. What do I mean by ‘targeted’? I mean that we have to support those sectors that are still suffering from a partial lockdown, on the one hand; secondly, we must help those who have lost their job or are about to lose their job, through upskilling or reskilling so that they can find a new job. The second phase of more targeted support is obviously slightly less expensive but it is still very costly.

In the short-term, in which I count 2020, 2021 and 2022, we have realised that all countries have increased their debt considerably. If I take my country, we have gone from a debt-to-GDP ratio of 21% or 22% up to 28%. In my country, this is considered an enormous jump. If I compare that with other countries, our increase is still less, even in percentage terms, than other countries. In some member countries, the jump is a double-digit figure; sometimes it is as large as a 20% increase of debt compared to GDP. For that reason, and also because the national deficits have grown considerably and are far beyond the 3% limit, the European Commission and the member states decided to use the escape clause that is foreseen in the treaty, and so, for 2020 and 2021, the escape clause has allowed us to increase spending, which in consequence led to higher debt and deficits. For 2022, the decision has not formally been taken, but as the pandemic is lasting for longer than anticipated, despite the vaccine, it is close to inevitable that we will need the escape clause in 2022. In my opinion, that should be the last time we will use it, but it is inevitable that we will use it in 2022. That is for the short term.

For the medium term, the catchphrase here is, 'Quality before quantity'. Let me explain what I mean by that. The 27 countries decided last year to rebuild and restart the economy by setting up a recovery and resilience fund, and there you can already see the road that is being designed for this recovery, and that is that the priorities lie with the double transition: the green and climate transition on the one hand, and the digital transition on the other. 37% of the investments that should be triggered through that fund should be in the field of environment and climate, and 20% should be in the field of digital. That highlights what the key is. The key is to have a qualitative recovery, and we should learn from the crisis of 2008, when we really altogether made a mistake by putting too much emphasis on budgetary discipline without looking in parallel at the need for innovation and investment. We do not want to repeat that mistake and we are in the process of not repeating that mistake.

In other words, we should switch from a stability and growth pact to a growth and stability pact. It is just an inversion of the two initials, but I think the accent should lie on the word 'growth', though stability is necessary at the same time. How does that translate? After 2022 we should revamp our stability and growth pact with one key idea in mind, and that is that qualitative investment needs to be treated differently from current expenditure. We need to encourage countries to do their utmost to innovate and to invest, both at a public level and also by creating a framework in which private investment can thrive. This qualitative investment should obviously partly or to a large extent be in the same direction as the recovery fund. That means helping in the two transitions, the green one and the digital one.

In my own country, we have taken that very seriously. In fact, we have not waited for the recovery fund to put a lot of emphasis on sustainable finance, because, if we want to ensure the green transition, we must make sure, especially as Finance Ministers, that the private sector helps us organise and finance the transition. The European Union has given itself what we call a framework of taxonomy to describe what is sustainable financing of the economy. We have in Luxembourg issued a sustainable bond last year, thanks to a new framework that contains also the taxonomy of the European Union, and it is the first such sustainability bond issued by a European country and it was oversubscribed, showing that the private sector is also expecting governments to go in that direction. Another example is the Luxembourg Green Exchange, where more than half of all the green bonds worldwide are listed. This stock exchange exclusively lists green bonds, but the number of green bonds is still far too limited. They are only 2% to 3% of all the bonds issued worldwide, so we still have a long way to go.

In the medium term, in order to make debt compatible with growth, we need to be sure that we favour investment innovation and do not continue to just spend a great deal on running costs. This is key, because if we do not manage that, not only will the debt level be too high but our economies are not going to be productive and competitive. That is also the upper limit for the debt that we must see at the horizon. What is the magical number of how high or low debt should be? Nobody has that answer. It is clear that in the medium term, if we just let all countries spend as much as they want to support their economy, without insisting on quality, Europe will make itself uncompetitive.

I then come to the very last point, which is about the long term. There is one country in the world that has experienced low interest rates, which we now have. I have not talked about low interest rates yet. I would like to underline that the European Central Bank (ECB) decision to have a very accommodative monetary policy has been key to offsetting the consequences of the pandemic, with this sudden fall of the economy. Secondly, the low interest rate policy has helped all the countries to take up capital on the market at a very low cost. I also suppose that we are going to have that for quite a few years, as the ECB has already said it will do, which gives you a medium-term horizon where you can count on low interest rates, but can we keep that for the long term?

We have only one example in the world where we have seen that for the long term, and that is Japan. I have lived in that country as ambassador for six years, from 1996 until 2002. At that time, Japan already had a decade of low interest rates. Today, as we speak, Japan still has very low interest rates, so it has been there for more than a generation, for 30 years. What do we see? The growth of Japan has been far lower than the rest of the developed world, and obviously far lower than China, but that is true for all the other countries. In the very long term, low interest rates or ultra-low interest rates create other issues like an overvaluation of assets on the one hand, and it also pushes towards a poverty gap in the population in the country. In the long term, we need to take into consideration that you cannot or must not guarantee ultra-low interest rates because you have the risk of making your economy unproductive.

I have tried to answer the question that was asked. It is not an easy one, as you obviously guessed, Didier. I hope I have been as outspoken and clear as possible. In a nutshell, in the short term we have the escape clause and that helps to offset. In the medium term, we need to put the accent on qualitative investment, and in the long term we must strive to reduce again the debt burden. I will conclude by saying we should not forget that it takes one or two years to add 20% of GDP's worth of additional debt; it takes one generation to go back to the previous level, so let us not forget the long term. Thank you.

Pablo Hernández de Cos

Chair, Basel Committee on Banking Supervision
and Governor, Bank of Spain[1]

Crossing the Basel III implementation line

Introduction

Good afternoon, and thank you for inviting me to speak at the Eurofi High-Level Virtual Seminar, in association with the Portuguese EU Council Presidency.

It is now well over a year since the start of the Covid-19 pandemic, which is first and foremost a health crisis, with a devastating impact on lives, livelihoods and our longer-term well-being. We have also seen the devastating economic impact resulting from this crisis. To give just one example: by the end of 2022, global GDP is forecast to be up to 4% lower than pre-pandemic projections *(Graph 1)*.[2]

So recent positive health-related developments bring some much-needed rays of hope. These include those regarding vaccines and further advances in diagnostics and medical treatments. There is light at the end of the tunnel.

But there continues to be a high degree of uncertainty related to the outlook, and with it a range of downside risks. These range from the creeping emergence of new variants to bottlenecks in the production, distribution and authorisation of vaccines. Health-related restrictions may continue to be with us for some time, which in turn will continue to impact economic activity. Talk of sharp economic bouncebacks and a revival of the Roaring Twenties may therefore prove to be somewhat premature. Put differently, the tunnel may well lengthen, with the light at its end becoming dimmer.

What are the implications of this backdrop for the global banking system? And how best can banks be “part of the solution” in contributing to a sustainable economic recovery? I will try to provide some answers to these questions in my talk today, focusing primarily on the crucial importance of implementing the Basel III Framework in a full, timely and consistent manner.

The benefits of a resilient banking system are now clear

Covid-19 is the first system-wide stress test of the global banking system since the advent of Basel III. Much has been said about how the banking system has remained broadly resilient to date, and how banks have not been part of “the problem” in exacerbating the economic crisis.[3]

This is in no small part due to fact that banks entered the pandemic on a much more resilient footing than during the Great Financial Crisis (GFC), thanks to the initial set of Basel III reforms.[4] In addition, the ongoing cooperation among Basel Committee members during the Covid-19 crisis was key to ensuring a global, timely and comprehensive response by the Committee during the initial phase of the crisis to address some of the short-term financial stability issues. And the unprecedented range of fiscal and monetary measures taken by all jurisdictions to support the real economy have largely shielded banks to date from losses and the crystallisation of risks.

These initial Basel III reforms were focused primarily on enhancing the quality and quantity of loss-absorbing capital, introducing international standards to mitigate liquidity risk, and incorporating a macroprudential dimension to capture system-wide risks. They have clearly increased the safety and soundness of banks worldwide.[5] For example, banks’ Common Equity Tier 1 (CET1) risk-weighted capital ratios have more than doubled over the past decade, reaching over 14% by the end of 2019 *(Graph 2)*. Tier 1 leverage ratios stood at over 6% at the end of 2019, an increase of almost 80% since 2011. And banks’ holdings of high-quality liquid assets grew by more than 50% during this period, totalling €10.7 trillion by the end of 2019.

1. In relation to the content of this address, as a member of the Governing Council of the European Central Bank, I am required to observe the so-called “quiet period” preceding meetings at which monetary policy decisions are to be taken. Accordingly, my reflections are related to my role as BCBS Chair and should not be interpreted as indicating the monetary or economic outlook.
2. OECD (2021).
3. Hernández de Cos (2020).
4. BCBS (2011, 2013a, 2014).
5. See eg Borio et al (2020) for a primer on post-GFC regulatory reforms.

Importantly, this enhanced resilience did not come at an expense to the real economy. Contrary to some of the assertions made by some stakeholders when the initial Basel III reforms were being developed, we did not see any sharp pullback in bank lending at the global level. In fact, banks' balance sheets grew by over 25% over the past decade *(Graph 3)*.

During the Covid-19 crisis, the Basel Committee took several prompt measures to safeguard the resilience of the banking system, ensure that banks continue to lend to creditworthy households and businesses and provide sufficient operational capacity to authorities and banks. These include technical guidance on the prudential treatment of the risk-reducing measures taken by governments in many jurisdictions to ensure that they are reflected in banks' regulatory requirements. The Committee also reminded banks that expected credit loss accounting frameworks should not be applied mechanistically in order to avoid excessively procyclical outcomes. We also reiterated and elaborated our supervisory guidance on the role of the Basel III capital and liquidity buffers to absorb shocks and maintain lending to the real economy. And in order to ensure that both regulators and banks have sufficient resources in place to address the short-term financial stability priorities related to Covid-19, the Committee deferred the implementation timeline of the outstanding Basel standards by one year from 1 January 2022 to 2023.

Together with the extraordinary support measures taken by public authorities across jurisdictions to contain the effects of the pandemic, the Basel III reforms and the Committee's Covid-19 measures have helped ensure that bank lending remained resilient during the initial phase of the pandemic: bank lending increased in the first half of last year, a far cry from the stark deleveraging that occurred during the GFC *(Graph 4)*.

We have also seen the broader and tangible benefits from having well capitalised banking systems. For example, jurisdictions with banks that had the largest capital buffers experienced a less severe impact on their expected GDP growth, as measured by the IMF's growth-at-risk (GaR) framework.[6] In a similar vein, better-capitalised banks increased their lending during the pandemic relative to their peers.[7] And the uptake of public support measures, such as loan guarantee programmes, was higher for better-capitalised banks.[8]

These facts support the growing empirical literature pointing to the net benefits of higher capital and liquidity requirements.[9] A reminder that it is strong and healthy banks that are able to support the real economy and lend to households and businesses.

Covid-19 has also further underlined the importance of global cooperation to safeguard the financial stability of banks. The cross-border spillovers of financial distress can result in an under-investment in financial stability by individual jurisdictions.[10] An open global financial system therefore requires global prudential standards and ongoing supervisory cooperation.[11] Unlike with global pandemics, self-isolation is not an option for effective policymaking and supervision.[12]

Despite all these positive developments, we are far from declaring, "mission accomplished" when it comes to the safety and soundness of the global banking system. There continues to be no shortage of risks to the banking system as the pandemic continues to unfold. As I discussed in an earlier speech, it is a question of when, not if, bank losses will start to crystallise.[13] The potential permanent economic "scarring" from the crisis, alongside rising debt levels, could increase the longer-term structural fragilities of banks' balance sheets. Moreover, we cannot understate the stabilising effect of the extraordinary public support measures on the banking system during the current crisis.[14] But such measures will eventually be unwound, leaving the banking system to rely on its own prudential safeguards.

Against this backdrop, banks and supervisors must continue to vigilantly monitor, assess and mitigate emerging risks as we go through the next phases of the crisis, and ensure that banks contribute to the subsequent recovery in a sustainable way. This is why the Committee has set up a structured approach to monitoring of the resilience of the global banking system as the Covid-19 pandemic continues to unfold, which is a key part of our current work priorities.

Implementing Basel III: a little less conversation, a little more action, please

In addition to monitoring current risks and vulnerabilities, we must ensure that we adopt an increasingly forward-looking supervisory approach by identifying, assessing and mitigating emerging risks and structural trends impacting the global banking system. Some of these risks and trends – including the digitalisation of finance, climate-related financial risks, and banks' business models – were already identified before the pandemic. Covid-19 has further underlined the importance of addressing them.

6. Galán (2020). GaR links macro-financial conditions to the probability distribution of future real GDP growth.

7. Hardy (2021).

8. Bank of Spain mimeo.

9. BCBS (2019).

10. Eichengreen (2006).

11. Hernández de Cos (2019).

12. Rogers (2020).

13. Hernández de Cos (2020).

14. As an illustration of the significance of these measures, recent stress test results by the IMF suggest that, under a severe adverse macroeconomic scenario, more than 90 percent of banks by assets across 29 systemically important jurisdictions would remain above statutory minimum capital levels through 2022. These results reflect the impact of the extraordinary monetary and fiscal policy support and important bank-specific mitigation policies. Without such policies, the IMF estimates that the proportion of capital-deficient bank assets would have roughly doubled. See IMF (2020) for more.

Yet an important prerequisite is the need to lock-in the financial stability benefits of the outstanding Basel III reforms by implementing them in a full, timely and consistent manner. Doing so would ensure that the regulatory fault lines of the global banking system – the gravity of which remain as important today as it was pre-pandemic – are adequately fixed. This is why a key priority for the Committee over the coming years is the implementation of previously agreed reforms.

Let me provide a brief recap of the nature of these outstanding reforms, which were finalised in 2017.[15] While the initial set of Basel III reforms fixed a number of fault lines in the pre-GFC regulatory framework, the way in which banks calculated risk-weighted assets (RWAs) – the denominator of banks' risk-weighted capital ratios – remained largely unchanged. Yet the GFC painfully demonstrated the excessive degree of variability in banks' modelled capital requirements. For example, when banks were asked to model their credit risk capital requirements for the same hypothetical portfolio, the reported capital ratios varied by 400 basis points *(Graph 6)*. Similarly worrying levels of variability could also be seen in other modelled risk categories, including market and counterparty credit risk.[16] And the GFC highlighted shortcomings with the operational risk framework, where banks' modelled capital requirements were insufficiently robust to cover losses stemming from misconduct and inadequate systems and controls.

This excessive degree of RWA variability threatened the credibility of banks' reported capital ratios. At the peak of the GFC, investors lost faith in banks' published ratios and placed more weight on other indicators of bank solvency *(Graph 5)*. Whether due to a lack of robustness in banks' models or an excessive degree of discretion in determining key regulatory inputs, the shortcomings in the RWA framework underlined the need for a complete overhaul.

The outstanding Basel III reforms seek to help restore the credibility in the calculation of banks' RWAs in four ways:

- First, they will enhance the robustness and risk sensitivity of the standardised approaches for credit risk, market risk and operational risk, which will facilitate the comparability of banks' capital ratios. For example, the Basel II standardised approach assigns a flat risk weight to all residential mortgages. In the revised standardised approach, mortgage risk weights depend on the loan-to-value ratio of the mortgage. The revised standardised approaches also reduce mechanistic reliance on external credit ratings by requiring banks to conduct sufficient due diligence and by developing granular non-ratings-based approaches.
- Second, they will constrain the use of internally modelled approaches. The GFC highlighted a number of shortcomings related to the use of the internal ratings-based (IRB) approaches to credit risk, including excessive complexity, lack of comparability and lack of robustness in modelling certain asset classes and key risk parameters. Accordingly, the use of the most "advanced" IRB approach has been removed for certain asset classes, and "input floors" have been put in place for certain risk metrics to ensure a minimum level of conservatism. In a similar vein, Basel III removes the use of internal model approaches for credit valuation adjustment (CVA) risk, as CVA is a complex risk that cannot be modelled in a robust and prudent manner. Finally, Basel III streamlined the operational risk framework, replacing the internally modelled approach and existing standardised approaches with a single risk-sensitive standardised approach to be used by all banks. These changes are aimed at overcoming two major flaws in the operational risk framework. First, capital requirements for operational risk proved insufficient to cover operational risk losses incurred by some banks. Second, the nature of these losses – covering events such as misconduct and inadequate systems and controls – highlighted the difficulty associated with using internal models to estimate capital requirements for operational risk;
- Third, the Basel III reforms will introduce a robust risk-sensitive output floor. The output floor provides a risk-based backstop that limits the extent to which banks can lower their capital requirements relative to the standardised approaches. This helps to maintain a level playing field between banks using internal models and those on the standardised approaches. It also supports the credibility and comparability of banks' risk-weighted calculations thanks to the accompanying public disclosure requirements, as banks will be required to publish their total RWA that constitute the denominator of their risk-weighted capital requirements, including with the output floor adjustment.[17]
- And fourth, the reforms will complement the risk-weighted framework with a finalised leverage ratio. The leverage ratio provides a safeguard against unsustainable levels of leverage and mitigates gaming and model risk across both internal models and standardised risk measurement approaches.

These reforms benefited from an extensive consultation process with a wide range of stakeholders. As you know, the Committee actively encourages and seeks input from stakeholders when developing our standards. Indeed, this approach was recently described as "one of the most procedurally sophisticated" processes.[18]

Accordingly, the Committee issued no fewer than 10 consultation papers as part of these reforms, with an accompanying consultation period that spanned the equivalent of almost three years! The finalised standards took on board many of the comments received from stakeholders and reflect the differences

15. BCBS (2017).
16. BCBS (2013b, 2015).
17. BCBS (2018).
18. Viterbo (2019)

in views among our members. They are a compromise by their very nature. A back-of-the-envelope estimate suggests that over 35 key adjustments were made to the reforms as they were finalised relative to the original proposals. Since I am speaking to a mostly European audience today, I should note that the majority of these adjustments were made to reflect the views of different European stakeholders.

The Basel III reforms were also guided by rigorous quantitative analyses. These studies clearly show that the Committee met its objective of not significantly increasing overall capital requirements at the global level. Under very conservative assumptions, these reforms are estimated to increase banks' Tier 1 capital requirements by only 2% if implemented immediately.[19] Of course, some "outlier" banks may face higher requirements, for example as a result of aggressive modelling practices. This is an intended outcome of our standards, which are precisely targeted at reducing excessive RWA variability. Even in those instances, the actual capital impact is likely to be much lower than is asserted by some stakeholders, not least because of the sufficiently long transitional arrangements: starting in 2023, the final elements of these reforms will be implemented by 2028, fully 20 years since the GFC.

And it is increasingly clear that the outstanding Basel III reforms will complement the previous ones in having a positive net impact on the economy. For example, a forthcoming analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks.[20] It also finds that potential deviations from the globally agreed Basel III reforms – for example, with regard to the output floor – would significantly dilute the benefits to the real economy.

Conclusion

Covid-19 has underscored how a functioning banking system is one that is resilient and capable of absorbing shocks instead of amplifying them. Yet the importance of addressing the remaining structural flaws and frailties in the global banking system remains as high today as it was pre-pandemic. These fault-lines could be brutally exposed once again in future financial crises. And they would remain unaddressed if some jurisdictions do not implement all aspects of the Basel III framework.

It is therefore in our collective and global interest to move on towards implementing Basel III. Combating infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. The Covid-19 pandemic will not end until everyone is safe. Similarly, the global benefits of Basel III will not be achieved unless all Basel Committee jurisdictions implement the outstanding reforms in a full, timely and consistent manner, as repeatedly agreed by G20 Leaders and the Group of Governors and Heads of Supervision.[21] Failure to do so could potentially trigger a harmful "race to the bottom" in bank prudential standards, which would ultimately threaten global financial stability. More than a decade after the GFC, we owe it to the citizens across our jurisdictions to demonstrate our commitment to global cooperation and strengthening the resilience of our banks.

Looking ahead, we must cross the Basel III finish line and devote our attention and resources to emerging risks and trends impacting the global banking system, including the ongoing digitalisation of finance and climate-related financial risks. Indeed, these are some of the main elements of our work programme for the coming year, which we will be publishing shortly. Yet delays or inconsistencies in the implementation of Basel III would undermine our ability to move forward with equipping banks and supervisors with the necessary tools to meet these future challenges. So my final message to you is simple: a little less conversation, a little more Basel III implementation action, please!

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19 BCBS (2019).

20 ECB (2021).

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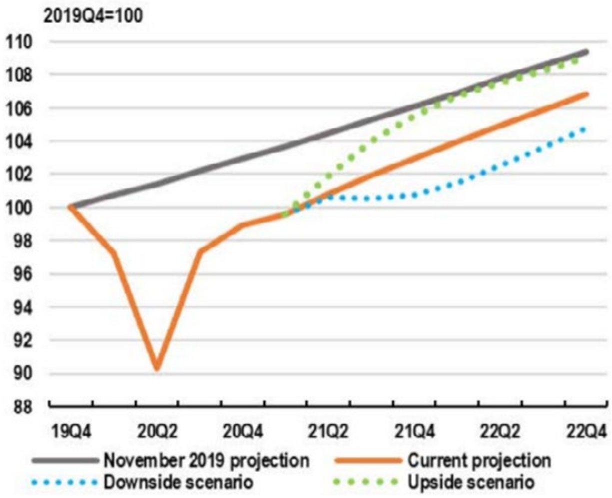
GRAPHS

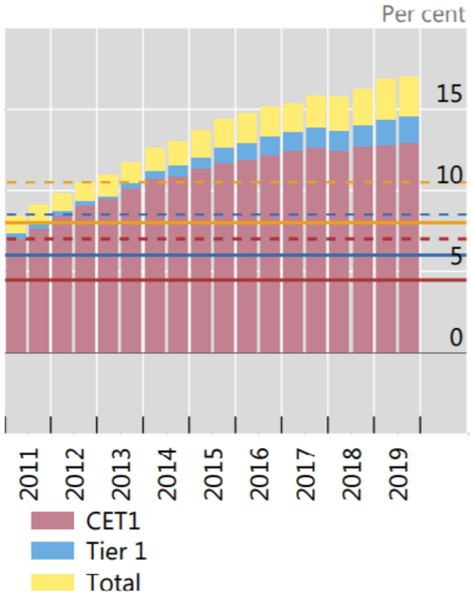
Graph 1 World GDP index[1]



Source: OECD (2021).

[1] The November 2019 OECD Economic Outlook projections are extended into 2022 using the November 2019 estimates of the potential output growth rate for each economy in 2021.

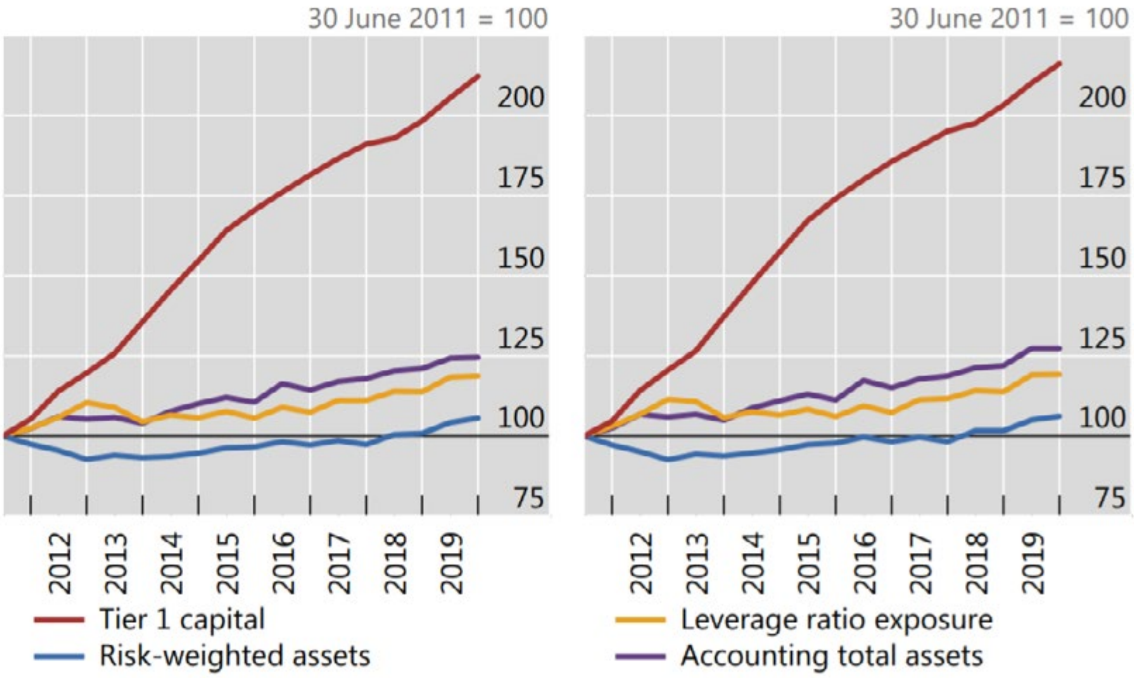
Graph 2 Evolution of banks' risk-weighted capital ratios[1]



Source: BCBS (2020b).

[1] For a consistent sample of 105 large internationally active banks. The solid lines depict the relevant minima; the dotted lines the minima plus the capital conservation buffer.

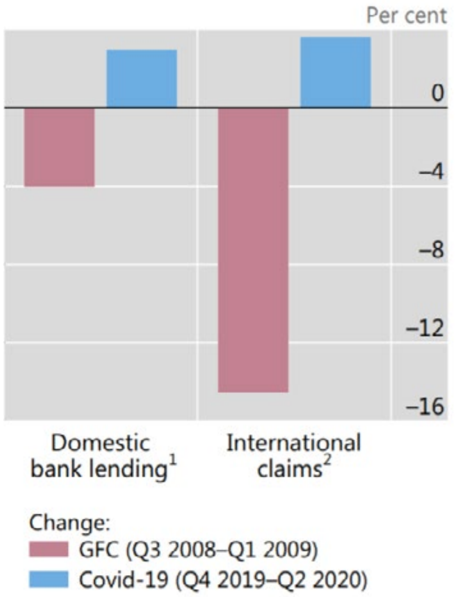
Graph 3 Evolution of key regulatory and balance sheet variables[1]



Source: BCBS (2020b).

[1] For a consistent sample of 105 large internationally active banks. Tier 1 capital, RWA and leverage ratio exposure assume full implementation of Basel III. Data points from H1 2010 to H2 2012 use the original definition of the leverage ratio. Data points from H1 2013 to H1 2017 use the definition of the leverage ratio set out in the 2014 version of the framework. Note that the data points for H1 2013 use an approximation for the initial definition of the Basel III leverage ratio exposure where gross instead of adjusted gross securities financing transaction values are used. Data points from H2 2017 onwards use the final definition of the leverage ratio to the extent data are available.

Graph 4 Bank lending during the GFC and Covid-19

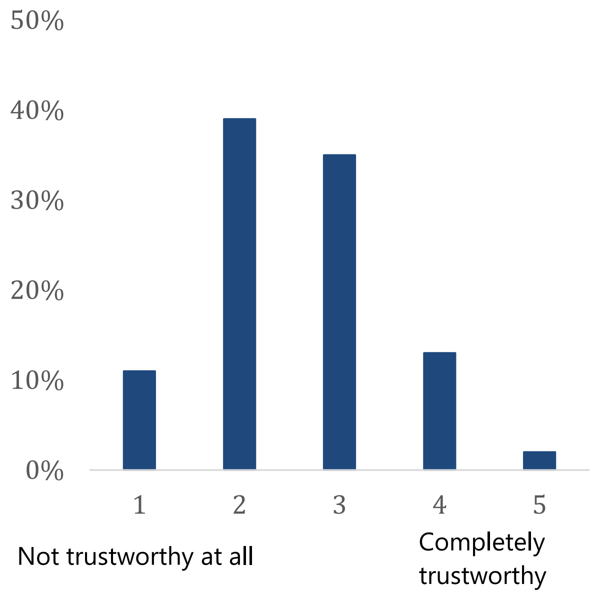


Sources: Datastream; SNL; BIS; BIS calculations.

[1] *Bank credit to the private non-financial sector (based on 44 reporting countries).*

[2] *Immediate counterparty basis, for all reporting countries, all counterparty sectors and all maturities.*

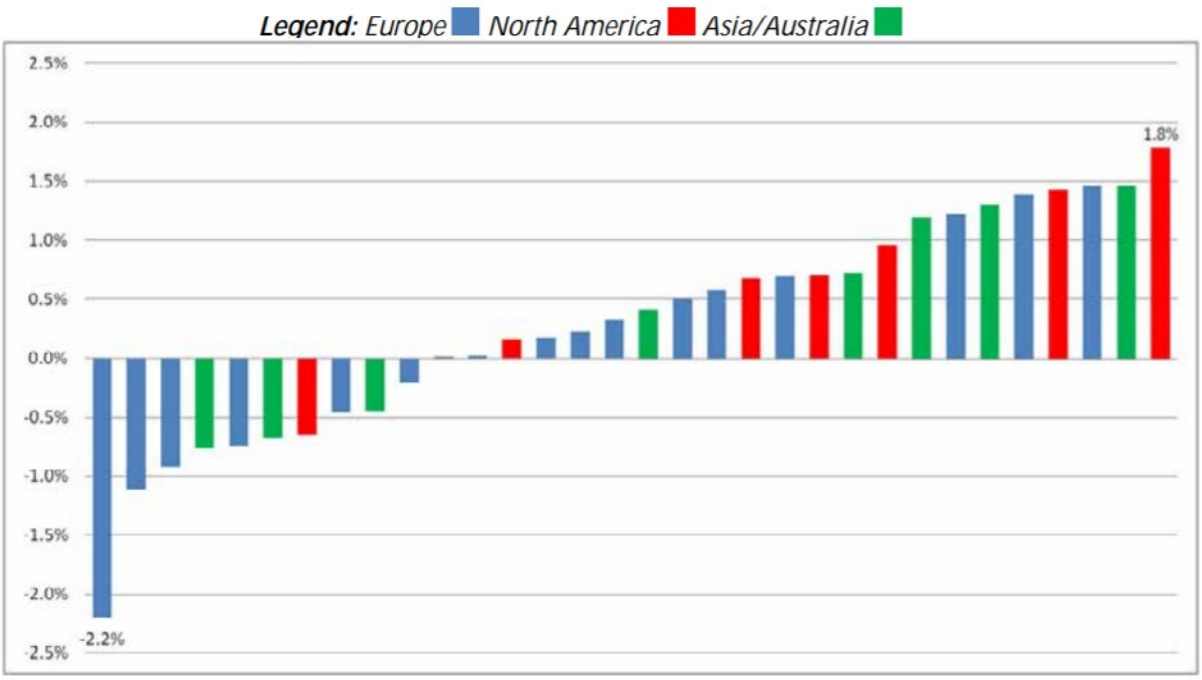
Graph 5 Responses to question, "How much do you trust risk weightings?"[1]



Source: Barclays Capital (2012).

[1] *Survey of 130 Asian, European and US equity investors, representing 100 institutions with approximately $6 trillion of equities under management.*

Graph 6 Difference in reported capital ratios for hypothetical portfolio[1]



Source: BCBS (2013c).

[1] *Graph shows the change from a hypothetical 10% capital ratio if individual bank risk weights from the hypothetical portfolio exercise are adjusted to the median from the sample. Each bar represents one bank. The chart is based on the assumption that variations observed at each bank for the hypothetical portfolios are representative for the entire sovereign, bank and corporate portfolios of the bank and are adjusted accordingly. No other adjustments are made to RWA or capital.*

Klaas Knot

President, Netherlands Bank

From intensive care to full recovery - finding the way out of the Covid crisis

Thank you for having me. Eurofi is an important forum for high-quality discussion between policymakers, regulators and representatives from all parts of the financial world. As all these stakeholders hold a piece of the Covid recovery puzzle, it's good Eurofi was able to go ahead with this event. Even if we can't be physically together in the same room.

Today I want to make some observations relating to the exit path from the Covid-related economic crisis. Where do we stand? What can we expect this year? And how should policy-makers proceed, as the European economy gradually recovers?

We could compare the European economy with a patient recovering from a severe accident. So far, our efforts have been directed at stabilizing the patient. I would call this the emergency phase. With the vaccine roll-out underway, I think we can say we are approaching the end of this phase.

This means we can now gradually begin to focus on the second phase, which I would call the recovery phase. The patient is stable, but is still dependent on life-support systems and medicine. As the doctors consider the rehabilitation program, their task is to slowly reactivate the patient, closely monitor progress, and make sure medical care is not scaled down prematurely.

Only when recovery is clearly underway can we start focusing on allowing the patient to leave the hospital, and to build up resilience to possible future adversities. This is the third phase, which we might call 'rebuilding resilience'.

Let's first see how the patient is doing, now that we are approaching the end of the emergency phase. The euro area economy is forecast to rebound by more than 4% this year, after contracting by over 6% in 2020. Insolvencies and unemployment have been relatively subdued until now. Strange as it may sound during the worst economic downturn since World War II, the economy has done consistently better than we anticipated about a year ago. Of course, massive fiscal, monetary and prudential support made all the difference here. For example, some studies suggest Covid-related failure rates of SMEs in Europe would have been between 9% and 18% in the absence of government support.

Nevertheless, the European corporate sector has been hit hard. Particularly those sectors that rely on physical proximity, such as retail, hospitality, entertainment, and travel. Or sectors exposed to natural resources and global supply chains, or those where public support measures are absent. For some of these industries the shocks are temporary, such as for hospitality. Or they will recover if they manage to adjust their business models. In other industries, shocks may have more permanent effects. Business travel, for instance. Similarly, the long-term shift to online retail has likely accelerated. In such cases, a temporary shock may spur developments which become permanent.

The banks have been the bright spot in this story so far. They have generally remained resilient and continued to provide credit to the real economy. Their good position is in part thanks to the post-financial-crisis reform agenda including the build-up of more robust buffers. But also because banks have been shielded from large losses due to low insolvency rates. And low insolvency rates, as we have seen, are in turn induced by support measures, such as government guarantees on bank lending. As a result, the policy response to the crisis has increased the dependency of governments, banks and business on one another.

At the moment, this sovereign-corporate-bank nexus – as some have named it – is vital in supporting the economy. But the nexus also means sovereigns are increasingly exposed to corporate risk, and vice versa. This might become an issue if many businesses suddenly were to go bankrupt. Rising credit losses for banks may require governments to provide more support and pay out on guarantees. That would further increase pressure on public finances. Conversely, rising sovereign risk premia could also affect banks through their domestic bond holdings. In the euro area debt crisis only a decade ago we experienced how a vicious circle between governments and banks may lead to financial instability.

Luckily, the risk of such a doom loop has diminished with the vaccines and the prospect of economic recovery. But at the same time, it is clear that the virus will continue to linger for quite some time to come. So obviously, governments will be looking for ways to lift restrictions on the economy where possible.

Apart from external factors, the corporate-sovereign-banking nexus raises the stakes for finding the right exit path from the economic crisis. Finding this path involves striking a balance between two risks. On the one hand, policy support involves costs. The fiscal costs are most visible. But there are other, more indirect, costs as well. The lockdown and indiscriminate government support prevent market forces from doing their job. A dynamic economy needs to constantly renovate itself through creative destruction, a process which is now impeded. And if we keep the patient on medicine for too long, withdrawal symptoms will increase. On the other hand, if we retract policy support too quickly, there is a good chance that the patient will stumble and fall, putting a healthy recovery back for many months. So policymakers will have to be constantly mindful of this trade-off, observe the patient very closely, and adjust the pace and sequence of tapering measures accordingly.

In terms of the European economy – once we approach the recovery phase, we could start discussing the withdrawal of emergency support measures, which would also mean gradually allowing market forces back in. However, we should tread carefully in all scenarios, because the risk of retracting policy support too quickly will likely continue to outweigh the risk of unwinding it too slowly for some time to come.

This is especially true for fiscal policy. It's important that governments do not withdraw their fiscal stimulus until we have made a good start with the recovery. This may well take us to year-end at least. Once the worst is over, fiscal spending can slowly shift from emergency to recovery. This means gradually replacing general blanketed support with more targeted support, and income support with public investment. The Next Generation EU Recovery Fund will be a key building block to get this investment going. This helps meeting the challenge of the much-needed energy transition, and raises the growth potential of our economies. And growth is something that we will also need very badly to bring down sovereign debt levels.

Monetary policy in the Eurozone will have to continue to support the recovery. As we are in the silent period today, all I can do is repeat that generic statement we have been making numerous times.

Next to fiscal and monetary policy, an important question is how to deal with the rise in corporate debt levels. Under the warm blanket of government support programs, the financial position of corporates has deteriorated. As policymakers start to withdraw support, even if they do so gradually, we will likely see a rise in the number of business that are not going to survive. To some extent this is inevitable. For example in the case of firms that were already vulnerable before the crisis. Or firms whose business models are no longer viable due to post-Covid changes in consumer preferences. But Covid-related legacy debt should not be a reason for firms that are intrinsically viable to go out of business. In a market economy, normally bankruptcy is an important agent for renewal, but it is also a costly one. If applied indiscriminately and unnecessarily, it is bad for employment, bad for creditors, and bad for the economy. So under the current circumstances, we should look for more targeted and less costly solutions where possible. That might involve corporate debt restructuring where banks and other private creditors, and also tax authorities agree to provide some relief. This could help stem the build-up of non-performing loans.

That is why I welcome the Commission's NPL Action Plan. What I like about the plan is that in addition to cushioning the blow for corporates and banks, it supports a European market for bad debt. It is good to see the progress that's being made in several places and it's important to take further steps here.

This is a good moment to say something more specific about the banking sector. As insolvencies are expected to rise, banks will see their non-performing loans increase. Fortunately, banks have strengthened their buffers in the preceding years and have taken provisions against the incoming Covid impact. These now constitute two solid lines of defense. But still banks are bracing for impact.

Under these circumstances prudential authorities should monitor developments closely. There is a myriad of non-fiscal support measures in place at the moment, that enable the financial sector in continuing to provide credit to the real economy. A careful exit requires that we first get a clear view of what individual measures are in place and what the impact, both individually and in combination, would be if they were lifted. In other words, we should be able to look through the various kind of support measures, and be able to see what is going on below the surface of banks' balance sheets. For instance, what is the effect of the IFRS9 transitional arrangement on capital ratios? Mapping the impact of non-fiscal support measures will help to design a smart exit path without material cliff effects, and should support authorities to provide clear guidance to financial institutions.

Only when the recovery is clearly underway is it time to start restoring the buffers in the economy that have been used to absorb the Covid shock. This is the third phase, which I called 'rebuilding resilience'. In this phase, which I am happy to discuss in more detail at some later Eurofi event, we will have to focus on further improving the growth potential of the European economy. We will have to bring government debt on a path to more sustainable levels. We will have to repair the resilience of the financial system, by restoring buffers in the banking sector, including the build-up of more releasable buffers. And we will also have to address weaknesses in non-bank financial markets. In short: getting the patient back into a healthy condition and resilient against future adversities. Although this phase is essential, it is important not to rush things. At the risk of repeating myself: we first need to have a robust recovery in place.

Dear friends, Europe will get through this crisis, both in terms of health and economically. We rushed to the emergency and threw everything we had at the patient. And now our aim is, and should be, full recovery. That requires time and careful treatment. So let's continue the good work in close cooperation and get the European economy back on her feet again.

Thank you.

François Villeroy de Galhau

Governor, Banque de France

What fiscal policies beyond monetary policy support?

Ladies and Gentlemen,

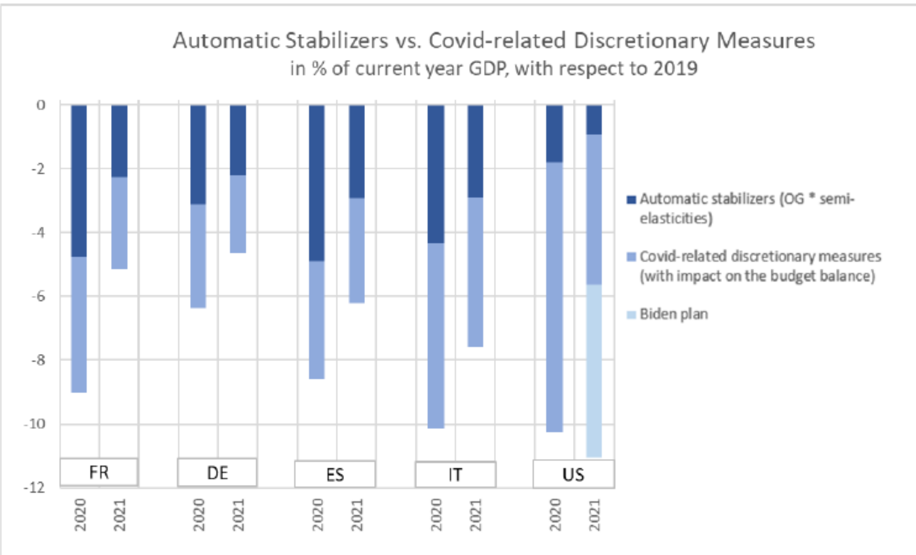
I am very happy to join you today. I would like to extend my warmest thanks to Didier Cahen and David Wright for fostering the fruitful European spirit that we all cherish, despite the difficulties of the moment. As you know, the ECB silent period has already started, so I won't say a word on monetary policy. However, this will give me the opportunity to tackle a core issue of our incomplete Economic Union besides our successful Monetary Union: fiscal policy. Monetary policy cannot be – and fortunately no longer is – the only countercyclical tool available in the euro area. There are two other links between monetary and fiscal policy to which I would like to draw attention: an accommodative monetary policy, as we have today, supports an active fiscal policy. The second is the risk of a bank-sovereign loop, which as supervisors we are keen to avoid. Let me nevertheless stress that I have no such fear for the country I know best: French banks since 2014 have decreased their exposures vis-à-vis public debt in absolute terms and have done so dramatically as a proportion of their balance sheet.

I will first talk about the "fiscal" lessons we can draw from the Covid crisis for Europe (I). I will then turn to the national level and illustrate these principles with reference to the French situation (II).

I. Improving Europe's future fiscal rules

The EU and its member states have reacted vigorously in 2020. The ECB's balance sheet is now double the size of the Fed's as a percentage of GDP. And active fiscal policy was of the essence. In 2020, Covid-related discretionary measures were stronger in the United States than in the main euro area countries. However thanks to our social model and its higher automatic stabilizers, the overall 2020 fiscal stimulus in the euro area was almost as strong as in the United States:

Having said that, what can explain the larger loss of GDP in 2020 in the euro area compared to the United States? According to the Banque de France's work, much [80%] of the difference in losses is due to something other than public support. In southern Europe, about 40% is explained through effective constraints on economic activity, and 40% through sectorial specialisation – the higher dependence of European countries on tourism, and the technological lead of the United States (development of teleworking before the crisis, weight of new information technology, share of e-commerce...).



Sources: For Euro area countries, Eurosystem data as of 26/01/2021 for discretionary measures, and March MPE for the GDP and the output gap. For the US, BDF estimates as of 12/03/2021 for discretionary measures, and CBO (February projections) for the GDP and output gap. Calculations: For discretionary measures, budgeted envelopes, measures affecting the government balance. For the automatic stabilizer, product of the change in output gap by the semi-elasticity estimated by Girouard and André (2005). In deviation from 2019, cumulative impact. The sum of the two elements may differ from the variation in the primary deficit due to discretionary measures not related to Covid measures, compositional effects of GDP growth and disaggregated semi-elasticities that may diverge from the past estimations. For US estimates, GDP and output gap projections do not include the effect of the Biden plan since no official macroeconomic estimates have been published yet.

Three major crises in the past ten years – 2008-2009, 2011, 2020 – have nevertheless shown the need to complete the Economic Union in addition to the successful Monetary Union, starting with a **permanent fiscal capacity**. Yes, a big step forward has been made thanks to Next Generation EU, financed by a shared debt instrument. Before thinking of possibly increasing its size, we should accelerate its implementation: speed, even more than weight, is what is currently lacking in Europe. But our real leap forward will come when the existence of a permanent common fiscal capacity, – although less limited in amount, although different from a standing budget because not systematically activated, – allows genuine countercyclical action to be taken.

Conversely – and not contradictorily –, adequate fiscal discipline is key to cope with economic reversals. Look at Germany, which fixed the roof while the sun was shining, and made appropriate use of its financial leeway during the crisis. There will be a debate, to be concluded most likely next year after the German and French elections, on the Stability and Growth Pact, following three years of warranted suspension between 2020 and 2022. We should avoid a fruitless confrontation between "illusionists" – who plead for debt cancellation, which is completely out of the question – and "traditionalists" – who want to keep the same old rules as if nothing had changed, including on the level of interest rates. We do still need rules, but revised and simplified ones. Indeed, the current low interest rate environment (with $r<g$) does not mean that public debt sustainability issues have become irrelevant: it only implies that governments have more time to ensure debt sustainability. Contrary to some recent proposals[1], we shouldn't, according to me, get rid of the numerical targets which are in the Treaty: they are useful anchors, including the 3% deficit which is – in the case of France – more or less the threshold that would stabilize the public debt ratio at its pre-covid level. But the revised rules, without changing the Treaty, should be based on a long-term debt trajectory and on a single operational target, namely a ceiling on the growth rate of public expenditure as proposed by the European Fiscal Board (EFB), chaired by the Danish economist Pr. Niels Thygesen.

First, we can keep the 60% long-term debt anchor. But the 1/20 linear rule of yearly adjustment towards it is too demanding and should be made more country-specific.

Second, for the operational target, relying only on the current interest burden, as suggested by some, would be at the same time short-termist and too partial: the levels of the total public deficit and of public debt remains key to assess the sustainability of public debt in the face of unexpected shocks. But interest payments could be included in a net expenditure rule, unlike the EFB proposal which excludes them. At constant taxation rate, a rule based on total government expenditure growth would make it possible to control both the public deficit and the public debt, since, implicitly, it incorporates a fiscal response to changes in the interest burden. For example, if interest rates decline (as in an economic downturn), leading to a reduction in the government interest burden, primary expenditure can be adjusted upwards and amplify the countercyclical effects of the monetary policy decision. However, if rates rise, as in an economic recovery, governments would have to make more of an effort on primary expenditure. How could we set the target for the expenditure rule? It could be country specific, if – and only if – (i) it seriously takes into account the initial level of debt and its sustainability but also the overall growth potential of the economy, and (ii) is explicitly agreed by a European authority.

Another possibility worth exploring to improve our fiscal governance is to set up an adjustment account mechanism. A deviation from the expenditure rule over any year (i.e. a too rapid increase in public expenditure – if limited and occasional – or, on the contrary, a level of public expenditure below the predefined target) could be earmarked for compensation over the course of the subsequent years.

The bottom line is that the long-term sustainability of public debt should be ensured by credible but flexible fiscal rules.

Sound fiscal rules are also crucial to improve the quality of public expenditure: spending on the future – education, research, the ecological transition, investment – must take priority over spending on the day-to-day operation of public services, or on some of the social transfers. In advanced economies, fiscal multipliers[2] are particularly high for public investment:

IMPACT ON THE LEVEL OF GDP OF A 1% STIMULUS IN THE ITEM CONCERNED

	1 Y	2 Y	3 Y	4 Y
Public investment	**0.74**	**0.85**	**0.81**	**0.72**
Public wages	0.10	0.25	0.37	0.43
Social benefits	0.09	0.26	0.37	0.43
Tax	0.09	0.23	0.34	0.40
VAT	0.05	0.17	0.29	0.39

Strongest impact on activity for public investment stimulus
More limited effect on activity for income stimulus (public wages, social benefits) due to the adjustment of the saving rate

Source : Banque de France

1. Les notes du Conseil d'analyse économique, Pour une refonte du cadre budgétaire européen, Avril 2021

2. Abiad A., Furceri D., Topalova P., The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies, IMF Working Paper, May 2015.

In this respect, this harsh crisis can also be an opportunity to bridge the skills and innovation gaps thanks to productive investment. But unfortunately, this key debate over the quality of spending is the blind spot in our European democracies.

II. Public finance in France

Now, allow me to illustrate these principles with reference to the country I know best. In France, we sometimes have a strange relationship with austerity: we are the country that fears it the most but one of those that practises it the least. This unfounded fear distracts us from our real problem: the weakness of our growth and the excessive cost of our public services even though we have the same social model as our neighbours. I strongly believe in our European social model, which is not a handicap but one of our strongest common European assets. And let me be clear: I am not promoting austerity – with cuts in public expenditure – but moving gradually towards a stabilisation of public expenditure in real terms. Our challenge is the 10 percentage-point differential between our government spending-to-GDP ratio and that of the rest of the euro area:

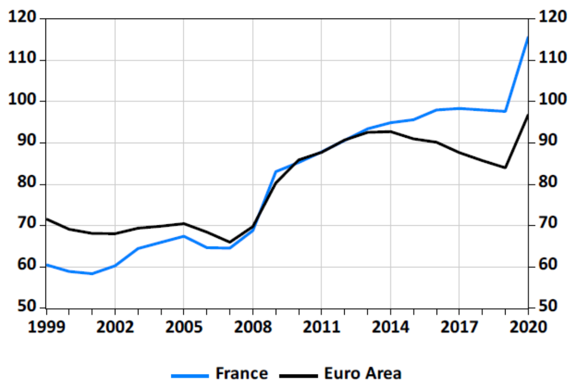
PUBLIC SPENDING (% OF GDP AND % GROWTH)

	1999*	2019*	Real average growth 2009-2019**
France	52.6	55.6	1.1
Germany	48.2	45.2	1.3
Italy	47.2	48.6	-0.2
Spain	39.9	42.1	0.1
Euro area	47.7	47.1	0.6
Euro area (exc. France)	46.4	44.8	0.4

Source: Insee, Eurostat, Banque de France's calculations, real expenditures deflated by the GDP deflator

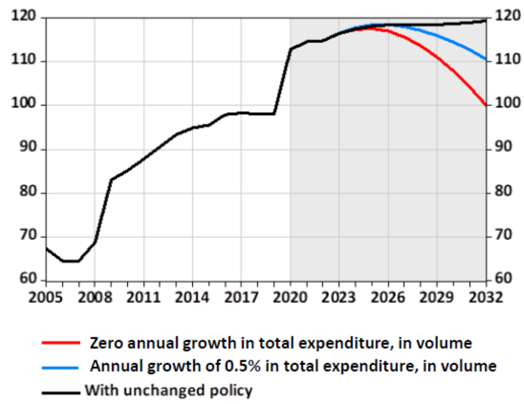
Since 2008, the pace of growth rate in our public expenditure has diverged significantly from that of GDP growth, in contrast to Germany or the rest of the euro area.

We are starting with a public debt of 115.7% of GDP at the end of 2020, which is almost twice as high as 20 years ago:



Source: Insee, Eurostat, for 2020: INSEE for France, Eurosystem (March MPE) for Euro Area

Under a no-policy-change assumption, with potential growth of around 1.1% and a rate of public spending growth in real terms of around 1.1%, which is close to the trend over the last ten years, we will only succeed in stabilising our public debt at this high level over the next decade; this would be a dangerous strategy given the risk of a new exogenous economic crisis or an interest rate shock. But we can write a more positive script to avoid this trend-based scenario. It involves a combination of three ingredients: time - only start to reduce our debt ratio once we are economically out of the Covid crisis, hence after 2022, and adopt a ten-year strategy; growth – which will generate revenue but not miracles; and more controlled and efficient public spending:



Source: INSEE until 2019, March MPE for 2020-2022; Banque de France - DSA simulations until 2023

Zero growth – i.e. stabilisation – of total public expenditure in real terms at constant taxation rate would reduce the debt to around 100% of GDP in 2032. Real expenditure growth of 0.5% per year would reduce the debt to around 110% of GDP. The government's update of the stability programme published this week rightly provides for such a control of public expenditure once the recovery is firmly established (0.7% growth per year from 2023 on average), although this is somewhat higher than 0.5% per year, and incorporates a more optimistic view on potential growth than our own forecast (1.35% vs. 1.1%). What is more important in this regard however is not the exact number but that the established targets are effectively met. The level to be fixed – and then respected –, is a matter for democratic debate, not for central banks. This is a demanding but attainable goal: many of our European neighbours have achieved it.

In conclusion, the Covid crisis has completely warranted a very supportive fiscal policy. But the gradual exit from this crisis should be a crucial opportunity for us Europeans to respond to one core question: how to maintain the right use of the fiscal tool while ensuring the sustainability of our debt, in order to be able to finance our common social model for coming generations. Accommodative monetary policy obviously helps, but it cannot be taken for granted eternally. To draw an analogy from the sphere of climate change, we should avoid a «tragedy on the horizon». Thomas Paine, an English-born political philosopher and citizen of the world, once said: "If there must be trouble, let it be in my day that my child may have peace.[3]" This is exactly what we should aim at in the next decade. Thank you for your attention.

3. *The American Crisis* (circa 1776)

Mairead McGuinness

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

Keynote speech

Introduction

Ladies and gentlemen,

Thank you for the invitation to speak to Eurofi today on two of the Commission's flagship projects: the Banking Union and the Capital Markets Union.

You could be forgiven for asking if yet another speech on the completing the Banking Union and advancing the Capital Markets Union will make a difference. And certainly I've made a number of speeches on these topics in six months in the job! These two projects are very different, yet they have one big thing in common: matching ambitious goals with tangible progress. We want to show that Europe can deliver.

The current political climate is tense: COVID-19, restrictions on social interactions, frustration with delays in vaccination. We risk fatigue and an erosion of trust. But as much as a crisis is a problem, it can present an opportunity.

A big crisis needs a bold response.

A crisis is a chance to reinvigorate old possibilities and take up new ones. We can show that Europe brings results.

It is a time to be audacious, in finance as well.

At the Euro Summit in December, Eurozone leaders gave renewed political backing to the Banking Union and the Capital Markets Union. In June, the Euro Summit needs to translate that into concrete action.

Banking Union

As you will recall, the Eurozone debt crisis demonstrated very clearly that Euro-area national banking sectors were too closely linked with national governments.

Fragile banks and bank bailouts can impact national finances. In turn, if governments have high debt levels, the exposure of banks to sovereign bonds becomes riskier. And fragile banks lend less, which slows down economic activity and reduces government revenue. That's the doom-loop that we saw in the Eurozone debt crisis.

The Banking Union aims to break this vicious cycle.

It's about ensuring greater financial stability and strengthening the single currency by integrating the euro-area banking system more deeply. It is an essential part of a genuine Economic and Monetary Union.

Since starting work on the Banking Union, we managed to establish a Single Supervisory Mechanism and a Single Resolution Mechanism – the first two pillars. But we didn't get any further. Unfortunately, we stopped half way through. Difficult but necessary decisions and compromises became ever harder to make as memories of the crisis faded.

Right now, we have reached a new crisis. But banks have proved resilient, thanks in no small part to our post-crisis reforms. Despite the economic shock resulting from COVID-19, we have – so far – avoided a financial shock. But this crisis is a reminder that our work is incomplete.

We are still missing the third pillar of the Banking Union, a European Deposit Insurance Scheme and a solution for liquidity in resolution.

A common European deposit insurance scheme would increase financial stability and depositor confidence by pooling funds at the European level. It would also reduce the vulnerability of national deposit guarantee schemes to local shocks. Our ambition has not changed.

The Commission continues to believe that the Banking Union will only be complete when EDIS is in place and that in the end we will need a set-up involving loss mutualisation. Work on a hybrid model is a first step.

On liquidity in resolution, we need to make progress on a robust public mechanism, as exists in other jurisdictions.

In June, the Eurozone leaders will meet to translate their December commitments into action. Now I don't underestimate the challenges that we face. We will not agree on everything in June. But we need to set things in motion.

We need a comprehensive plan with enough political consensus so we can make progress on the individual pieces of the puzzle afterwards. I hope we will have the courage to do that.

The global financial crisis started almost 15 years ago. It's time we complete the post-crisis reforms, put that era behind us, and focus on the challenges of the post-COVID world.

Capital Markets Union

The EU's top priority is to overcome the pandemic and the resulting economic crisis. The Capital Markets Union can contribute to the recovery by providing deep, liquid, integrated capital markets. COVID-19 has exposed weaknesses in the EU economy. We've seen that we need to widen access to alternative sources of funding for our companies, beyond bank loans. Efforts towards a genuine single market for capital are not new.

They started with the Treaty of Rome more than sixty years ago. The Treaty set out a vision for the common market, based on the principle of four freedoms of movement: for goods, people, services – and for capital.

We renewed that commitment to a genuine single market for capital in Europe in 2015 with our first CMU Action Plan.

In the Commission we've completed all the actions announced in that plan. But we're not finished yet.

Progress has been especially slow in areas governed largely by national laws, such as non-bank insolvency and company law. Wide divergence in these areas gets in the way of cross-border investment. Making progress will not be easy. But large, integrated capital markets are essential to deliver our key economic policy objectives.

The benefits are not limited to financial market participants. The CMU is closely linked to:

- the post-COVID recovery,
- an inclusive and resilient economy;
- the twin transitions towards a more digital and sustainable Europe; and
- Europe's global competitiveness and open strategic autonomy.

The new CMU Action Plan adopted last autumn aims to help us overcome the remaining barriers. And it has three core aims:

Making funding more accessible to European companies and supporting more long-term equity financing;

- Making the EU an even safer place for individuals to save and invest long-term; and
- Integrating national capital markets into a genuine single market, ensuring that access to financing is not limited by national borders.

To that end, in the coming months we will review the Solvency II framework to facilitate long-term and equity investments by insurers.

We'll propose a Single Access Point to provide investors with seamless access to company information across the EU. We'll review the framework of European long term investments to enable retail investor participation and encourage investment in digital and green projects. And we'll propose the long-awaited consolidated tape.

In parallel, we are doing the spadework on structural issues like non-bank insolvency and cross-border taxation procedures.

They are politically sensitive areas – but will be key for making progress in the medium to long term.

I'm glad that everyone agrees about the political objectives of the CMU. I'm hopeful that means we can reach swift agreement when the legislative proposals are published.

The new measures will require strong political commitment from all involved, during negotiations and when it comes to putting measures into force.

We need support from everyone to make sure that proposals bring tangible results towards deeper capital markets to increase the EU's financial firepower.

Closing

We should make progress on both the Banking Union and the Capital Markets Union, at the same time. Of course, they are different: the Capital Markets Union does not need public risk sharing, it does not need an institutional overhaul and it is an incremental project without a single vision of the end point. But these two projects can reinforce each other.

The Banking Union addresses weaknesses in the banking system. Meanwhile, the Capital Markets Union will reduce the reliance of the EU economy on bank funding. The Banking Union aims to increase the resilience of our banks. That will in turn support the development of EU capital markets, as banks are big players on financial markets, providing services to both issuers and investors. A well-capitalised banking system is more likely to support the smooth functioning of capital markets in times of crisis, for example by avoiding fire sales of assets or extreme price movements.

The CMU will strengthen the resilience of the banking sector, by increasing private sector risk-sharing across the EU, through cross-border holdings of financial assets. That will allow for greater shock absorption by markets in times of crisis.

In short, the Capital Markets Union and the Banking Union complement each other.

I am determined to make decisive progress on both in the coming months. The financial sector underpins the real economy.

So this work is important not only for financial market participants but also for citizens and businesses in the wider economy.

Keeping credit flowing to households and companies, making more financing options available for start-ups, giving people more options to save and invest for their future.

Integrated capital markets and a strong banking sector will help us recover from the current crisis and facilitate the transition towards a greener, more digital economy.

I look forward to working together to finally deliver on our ambitious promises.

Thank you.

Valdis Dombrovskis

Executive Vice President, An Economy that Works for People, European Commission

Implementation of the EU Next Generation package, what next?

Ladies and gentlemen,

First of all, thank you for inviting me to speak to you at Eurofi's seminar today. I hope next time we can meet in person.

When I addressed the Eurofi conference last September, I introduced the Next Generation EU recovery package and its main funding instrument, the Recovery and Resilience Facility.

Although we still face a great deal of uncertainty and risk, the economic outlook now looks more optimistic – with a few caveats, of course. A lot will depend on the evolution of the pandemic and progress in national vaccination campaigns. This should allow containment measures to ease gradually over the coming weeks and months. We can expect a recovery to take hold during the second half of this year.

Both the EU and euro area should return to their pre-pandemic output levels in mid-2022. However, the recovery is going to be uneven across EU countries.

Europe has demonstrated strong solidarity through this crisis. We managed to coordinate quickly and decisively across 27 Member States with emergency measures to keep economies and societies going. This is about many livelihoods saved, jobs protected, businesses kept afloat, both large and small.

Europe is now coming out of this crisis. And its impact would have been much worse without the unprecedented efforts made by the EU's institutions and Member States.

National fiscal measures, together with automatic stabilisers, amounted to some 7% of GDP in 2020.

Liquidity support, mostly in the form of guarantees, added up to some 19% of GDP. This was facilitated by activating the general escape clause of the Stability and Growth Pact early on, and applying the full flexibility of state aid rules.

In addition, the powerful European Investment Bank instruments - including the Pan European Guarantee Fund – have provided sizeable support, particularly for smaller businesses.

The SURE short-term work scheme has helped to support millions of workers and companies.

Altogether, support measures are estimated to have cushioned the GDP contraction in 2020 by around 4.5 percentage points.

It is clear that we need to continue supporting the economy both this year and next – and not withdraw support prematurely. Support measures should continue for as long as needed. They must remain temporary, targeted and agile: to avoid creating a permanent burden on public finances.

The decision on whether or not to keep the general escape clause activated will depend on the overall state of the economy. And it will be based on quantitative criteria - in particular, economic output reaching its pre-crisis level.

Our current forecast points to the clause staying active in 2022 and no longer in 2023. A final decision will be taken in the European Semester spring package. The post-pandemic world will probably bring new vulnerabilities, such as greater structural inequalities and higher debt burdens.

Latest data from the European Central Bank shows that banks' ratio of non-performing loans is continuing to fall, despite the crisis. For the last quarter of 2020, the NPL ratio fell to 2.63%.

Still, we will need to watch out for increased risks of insolvencies and their fall-out in terms of unemployment and non-performing loans. And we will need to make sure that financing of the economy can continue. For that, we need deep and integrated capital markets. And we need strong and solid banks to provide financing to household and companies. This is why we want to make good on completing the Banking Union and advance towards completion of the Capital Markets Union. This includes making the most of digitalisation to boost our economy.

Yesterday, the European Central Bank published a report on the outcome of its public consultation for a digital euro. It shows a clear desire by respondents – people, businesses and payment industry professionals - for integrating a digital euro into existing banking and payment systems. They saw privacy as its most important feature, along with security and useability throughout the euro area.

A digital euro can only be successful if it meets the needs and expectations of those who are going to use it.

Ladies and gentlemen,

On fiscal policy, we know that this support cannot stay in place forever. When the time is right, Member States will need to refocus their budgets towards achieving prudent fiscal positions in the medium term.

Once the recovery takes hold, we will relaunch the debate on the future of our economic governance, when we can reflect on these developments, and take our experiences from the COVID crisis into account. As I understand, in the previous panel, you were discussing this topic.

Building political consensus for this will be crucial. A fiscal framework can only be effective if there is strong political commitment to adhere to it.

I see two main areas where we will need to reflect:

- how to make sure the rules bring about sustainable fiscal positions in all EU countries;
- how to simplify what has become a complex framework.

I know that this is not going to be an easy discussion – there are many longstanding views and differences. For now though, the immediate priority is to tackle the pandemic and its socio-economic fallout.

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

I see this next phase, when it happens, as a dual opportunity.

- to stage a lasting and inclusive recovery;
- to make our economies stronger and more resilient for the future, making the most of the possibilities offered by the green and digital transitions.

Both are areas of high potential growth and will be vital for the recovery. This is a unique chance to reduce social divergences and modernise in a green and inclusive recovery.

The Next Generation EU recovery package worth €750 billion gives us a powerful tool to make this happen.

In the longer term, it will allow EU countries to:

- address long-standing challenges;
- better position for the green and digital transitions;
- increase growth and jobs through investment;
- and invest in people.

This brings me to the Recovery and Resilience Facility, or RRF: the centerpiece of our recovery package.

Putting it into proper effect should provide a strong impulse to the economy, especially if the funds are well spent and accompanied by effective reforms. We estimate that real GDP in the EU will be boosted by up to 2% over the RRF years.

This is why the Commission is engaging intensively with national authorities to make sure that their recovery and resilience plans are of high quality and submitted as soon as possible.

The plans should contain a high level of ambition, with the right balance between investments and reforms. They need to address at least a significant subset of challenges in the country-specific recommendations within the European Semester.

So, they must have a long-lasting impact, not just bring about a short-lived surge in GDP growth. They must support our growth potential for years to come. So, the RRF funding needs to be wisely spent.

We have received information from the vast majority of countries about what they intend to include. And many Member States will be submitting their plans by the end of the month.

For the months ahead, our watchword will be implementation: making the best use of the RRF's substantial funding to help each country's long-term recovery.

While it will be central governments that will receive the funding, the recovery will only succeed if an entire country takes responsibility for putting a national plan into full and proper effect.

That means strong regional and local ownership, together with support from social partners and civil society. The Commission encourages their involvement at every stage of the process.

We have achieved a great deal in a short time – and it is absolutely crucial to get these plans right, with the right reforms and the right investments.

We chose the name NextGenerationEU for a good reason.

It reflects the fact that our recovery plan is not only about getting through the crisis but also about the future of young people.

We need a recovery that provides many things to people.

It must provide quality jobs and decent incomes.

It must allow us to make the most of opportunities offered by the green and digital transitions. And it must leave nobody behind.

Ladies and gentlemen,

I would like to conclude by thanking Eurofi and its members for their constant support throughout this extremely difficult time.

It has been essential to provide the real economy with adequate funding and to shore up the resilience of the financial sector.

Together, we have achieved this - and, I hope, got through the worst of this crisis.

And I know that we can also rely on your support as we enter the next phase. Thank you.

Sir Jon Cunliffe

Deputy Governor, Financial Stability, Bank of England
and Chair of the CPMI

Concluding remarks

Thank you very much, David. Thank you for inviting me to speak today. I certainly hope I will be able to attend Eurofi in person physically soon. I will say a word about Brexit but it will just be a word.

I wanted to talk this evening about three particular questions. The first one is: what have we learned about cooperation and fragmentation in the financial system over the stresses of the last year? The second question is: what lessons might other non-financial sectors draw from the post-financial crisis performance of financial regulators and supervisors who have been implementing it over the last 10 years? The third question is: what might be the impact on the financial sector of some of the fragmentation dynamics which have been generated by the Covid crisis?

Looking first at the financial system under Covid, my high-level conclusion is that where we have put in place robust global frameworks the financial system has, so far, proved resilient to an extreme tail event. What I have in mind here is primarily the banking system that was at the epicentre of the financial crisis 10 years ago. Internationally agreed standards for capital and liquidity have enabled the banking system to meet the initial surge of borrowing as the implications of the pandemic became clear a year ago, then to maintain lending - supported in most jurisdictions by government schemes - and finally also to weather the prospect of material losses as a result of the economic impact of the pandemic.

We are not out of the woods yet. Huge fiscal support to corporates and households in many countries has meant that the losses from the crisis have not yet crystallised. We will only really see the true extent as the pandemic recedes, as public support is withdrawn and as the scale of the economic damage is revealed. There are longer-term questions about the usability of capital and liquidity buffers in the recovery and perhaps the biggest test may yet be to come. However, solvency itself has not been a worry. 10 years ago the very prospect of losses from an economic hit of this magnitude would have meant failing banks and a financial crisis. By contrast, as a result of the post-crisis reforms, confidence in the core banking system has been maintained.

The same, unfortunately, is less true of non-bank finance where the prospect of economic damage from the pandemic led in March to a dash for cash that disrupted core financial markets and tightened financial conditions at exactly the wrong time. It required massive intervention by central banks to restore order and to stabilise non-bank finance. It is of course to be expected that the sudden arrival of a pandemic will cause financial sector stress and a very sharp adjustment in financial markets.

However, there also appears to have been a number of factors that amplified that stress and created a self-reinforcing liquidity crisis that could only be stopped by central bank intervention. With one notable exception, namely the run-on money market funds, these dynamics were quite different from those that we saw in the financial crisis 10 years ago. This may have been the result of reinforcing the resilience of some core parts of the system, wholesale banking and central clearing, for example, perhaps without sufficient attention to the resilience of the non-bank entities that interact with the core. The international regulatory community, through the Financial Stability Board and the standard-setting bodies, now have a major programme and will work hand-in-hand to investigate those dynamics and vulnerabilities and to develop policy responses where justified.

That brings me to another very important takeaway from the very real stress test that the financial system has experienced over the past year: the way in which the machinery for international regulatory cooperation has functioned. Strengthening this machinery with the creation of the FSB was one of the key reforms of the global financial crisis. Over the past year the FSB and the standard-setting bodies have worked extensively and effectively to assess risk, share experience and coordinate action. Individual jurisdictions, of course, have tailored their regulatory actions in the fact of the pandemic to meet individual circumstances, but there has been broad agreement of consistency in the approach to temporary regulatory flexibility and forbearance. That has been underpinned throughout by the principles agreed at the beginning of the crisis by the FSB to enable a coordinated response while minimising the risk of market or regulatory fragmentation.

Unlike many of the structures for international cooperation and coordination in other sectors, structures that have been weakened in recent years, in the financial sector the machinery put in place 10 years ago has so far responded well to its first major stress. However, again, we have not come to the end of the story. One important next test will be whether we can come to an agreement internationally on how - and how far - to reinforce the resilience of non-bank finance and whether we can implement any changes.

That brings me to my second question: is there anything that other, non-financial, sectors could learn from the experience of the financial system over the past year? I should stress here that I am not claiming some higher wisdom or nobler purpose on the part of financial sector regulators and central bankers. The reforms have made the financial sector more robust and have enabled the authorities to work together with the result of a searing global and financial economic crisis that may have done longer lasting damage to the world economy than Covid is likely to do. It is rather that lessons learned very painfully in one area may offer some pointers to those dealing with similar issues in other areas. The overarching lesson is that, 10 years ago, we came through crisis to what appears to be a similar fork in the road. Financial globalisation had been one of the drivers of growth in the global economy and the lifting of hundreds of millions out of poverty but it also contributed to a series of crises, first regional and finally global, amplifying adverse risks and shocks and transmitting them between jurisdictions.

The choice, put very starkly, was between fragmentation - putting up barriers to cross-border flows of capital and financial services generally with all costs in terms of reduced risk sharing and lost efficiency that brings - and governance - putting those global flows onto a safer, more resilient, more managed and internationally agreed and trusted footing. The consensus was in very large part for the governance approach. The international regulatory community, with powerful political support from the G20, launched an unprecedented programme overseen by a new institution to put in place the necessary international standards and cooperation mechanisms. Some have portrayed this as a way of resolving the tension between the economic benefits of financial globalisation on the one hand and the danger of that globalisation posed for individual jurisdictions through the importing of risks to their financial stability on the other hand. That logic was certainly one of the drivers of what I have called the international governance approach. However, it is only part of the picture. An equally important point was the recognition that financial globalisation enabled risk sharing between jurisdictions. Put another way, global flows of capital and financial services mean not only that one jurisdiction may be importing risks from elsewhere. It also means that a jurisdiction can diversify its risks among others. Although there were occasions when openness transmitted shocks, sometimes the transmission of shocks actually helped to diminish stress and avoid crises. These were in fact two faces of the same coin.

In turn, the assessment of whether it is better to restrict the import of risk from elsewhere or to maximise the ability to diversify one's own risk turns essentially on the confidence that one can have in others. The governance approach is intended to create the high standards and the machinery to provide that confidence. The current pandemic has generated very similar questions about the resilience of risk in the context of global supply chains, particularly – though not exclusively – in health-related areas. The empirical and theoretical evidence suggests that the global value chains are associated with better average economic performance. The evidence does not, however, suggest that that is necessarily associated with a greater degree of economic volatility. Risk diversification may be one of the reasons for this finding. As has been observed, "putting all your eggs in one basket does not diversify risk, even if the basket is at home".

As these familiar questions of local versus global are considered in the aftermath of the pandemic, I would single out three particular pointers on what in the financial sector has worked in the global governance approach. First, the importance of structures that are not political in themselves but have political legitimacy. These need to recognise both that their role is not to supplant domestic legislatures and that the common approach needs to have the flexibility to reflect domestic heterogeneity. The FSB, reporting to the G20 and working with technical standard setters has, by and large, achieved this balance.

The second pointer is the value of stress-testing which has become standard in financial regulation as a way of assessing and of providing confidence about the resilience of cross-border supply chains in sensitive areas in which jurisdictions want to ensure supply beyond consideration of economic gain or cost. International cooperation in identifying critical sectors and stress-testing them to key risks and transmission channels can build confidence, and it helps to resolve the buffer versus resilience a point that I mentioned earlier.

The third pointer is the importance of data and transparency in building resilience and in assessing risks. The financial reforms were underpinned by substantial efforts to improve data availability and sharing, to improve our understanding of the risks and the resilience in the global financial system. This has actually been one of the hardest elements of the post-crisis reform programme to implement fully, and there surely remain gaps - as the experience in March a year ago and this March illustrate. However, the experience of the past year has also shown that we are now in a much better position to assess and manage risks than we were 10 years ago. I suspect that better, more timely and more granular data on critical global supply chains might be a very important element of building a governance approach.

Finally, I want to look very briefly at the question from the other direction. The pandemic has inevitably focussed governments on the protection of their own citizens, on risks that can be transmitted across borders and on dependence on overseas supply. Will this have an impact on the approach taken towards the international flow of capital and financial services? There is no obvious, direct reason why it should do so. The dash for cash last spring, it is true, highlighted again the interconnectedness of financial markets across jurisdictions and it also highlighted some of the risks facing emerging markets in particular in the management of capital flows. But the response in the international community, as I have suggested earlier, has been an increased and cooperative effort to tackle some of the vulnerabilities that were revealed rather than any immediate push towards localisation.

The financial system does not, however, exist in a vacuum. Its governance domestically and internationally can be affected by prevailing political winds. A greater emphasis on strategic autonomy in the political discourse, a shift in the perceived balance of risks and rewards between localisation and international supply may in turn spill over and affect the commitment to the governance approach to the international financial system that I identified earlier. And in Europe, of course, the aftermath of Brexit may well add to such dynamics.

It is by no means certain that such a spill over will occur. The commitment following the financial crisis 10 years ago to the governance approach was not, as I have said, much affected in recent years by the weakening of international cooperation in other areas. But it does perhaps put a premium on showing that we can, using the structures that we put in place 10 years ago, tackle the vulnerabilities that we have identified in the financial system last spring. It perhaps also underlines the needs for the international regulatory community to continue to maintain cool heads and cool judgements. Thank you very much.

Werner Hoyer

President, European Investment Bank (EIB)

Towards the digital future

The COVID-19 pandemic has had an immensely disruptive impact on our daily lives and on our European economies. It is now common to say that the pandemic has made digitalisation more important. European firms agree on the importance of the digital when we ask them about their investment needs. This pandemic has been an eye-opener for all of us, when it comes to innovation and digitalisation.

According to our latest EIB investment survey (EIBIS), many firms say not only that the pandemic will make digitalisation ever more important, but that it will also affect their supply chains and the products and services they offer. Firms need to step up investment to adapt to this fast-changing reality. However, firms are also telling us that they will invest less than initially planned. That is not surprising. The crisis has left many firms with severe balance sheet issues, in particular smaller firms and those active in the sectors most affected by the crisis.

As a consequence, many firms face a trade-off between short-term viability and long-term competitiveness. They can either try to reduce the threat of insolvency by deleveraging now, or they can invest in their longer-term competitiveness at the risk of becoming insolvent before these investments pay off. For many, the answer to this dilemma is, understandably, to prioritise short-term viability. However, not investing in the future can expose them to disruption.

Still, a weak recovery in corporate investment could not come at a worse time. Even before this crisis, we were not doing enough to meet the significant challenges we are facing, notably on climate and on digitalisation. Europe is not generating the biggest players in digital. Today, several Chinese companies are emerging as important players in the digital sectors alongside US companies. The EU has global leaders in the automotive sector but has fewer firms in the fast growing digital and technological sectors. This may explain the gap between the EU and the US in creating new, leading global R&D companies, especially in the digital sector, where economies of scale and winner-take-all dynamics dominate.

It is not only the top players that are missing. European firms are lagging in digitalisation more generally. By 2020, 37% of European firms had still not adopted any of the new wave of digital technologies, compared to 27% in the US. Encouragingly, the proportion of digital firms in the EU grew by nearly five percentage points over the 2019 period, but the US saw a comparable increase.

There is a divide between the US and the EU. But there is also a risk of polarisation within Europe too. We find that large firms tend to digitalise more quickly. The side effect is particularly pronounced among manufacturing firms: only 30% of EU firms with fewer than 10 employees adopted recent digital technologies, whereas this share increases to 80% for firms with more than 250 employees. The fact that EU firms are smaller on average than those in the US is likely to be a major disadvantage when fast-tracking the adoption of digital technologies.

It is not merely the corporate sector where change is not happening quickly enough. The European Investment Bank’s survey of municipalities highlights that infrastructure gaps remain prevalent in the EU, especially for digitalisation and climate change. More than one in two municipalities considered their infrastructure investment inadequate. This is likely to have long-lasting effects. We observed that the share of firms that are digitally advanced rises in countries with the largest share of municipalities that have better digital credentials.

In a word, the lag in digitalisation is worrisome. We all have seen that technology adoption could partly shield the economy from the impact of the pandemic. Having digital technologies in place that allow us to work remotely has been a prerequisite for business continuity, also for us at the European Investment Bank. What is more, digitalisation promises to be a game-changer for productivity. If firms invest less in the coming years, it would be a disaster. It would mean a further drain on Europe’s competitiveness and a setback in our ambition to close the digital gap vis-à-vis the US and other global players at a critical moment in time.

There are many fears around digitalisation, and particularly automation and the impact it might have on our societies. Indeed, the ongoing digital transformation is ushering in profound changes in EU labour markets. So far, digitalisation has had a positive impact on employment. Digital technologies are changing the content of jobs, but they have not so far led to job destruction, on balance. The available evidence does not corroborate fears of the end of work ushered in by digital technologies. Digitalisation has supported the creation of new employment in many firms directly by creating new jobs like data analysts or software developers and, indirectly, by raising productivity, reducing prices and stimulating demand. What is more, digital companies have been able to pay their employees higher wages than their non-digital peers.

However, we know job creation goes hand in hand with creative destruction, putting pressure on routine jobs which have little complexity. Recent advances in digital technologies have tended to benefit high-skilled workers and those in less routine occupations. Investments need to focus on people, if the digital transition is to be successful. A lack of appropriate skills limits the ability of individuals to respond to economic evolution and a changing job market. Reforms to adult-learning systems and broader participation is needed to deal with the risks of a growing gap in worker skills and further labour-markets polarisation.

Digitalisation is also having a tremendous effect on innovation. Just take the example of artificial intelligence, or AI. Before the COVID-19 pandemic, healthcare professionals were already driving up the adoption of AI technologies. The pandemic has accelerated this trend tremendously. Real-time contact-tracing apps are just one example of the many AI applications used to monitor the spread of the virus and to reinforce the public health response to it. AI and advanced robotics are also key for the development and manufacturing of vaccines against COVID-19. European biotech companies relying on AI have been strong partners in the global race to deliver a COVID-19 vaccine.

Digitalisation is important not only for the current health crisis. When thinking about the climate crisis, our innovation potential is crucial. This is a defining moment in our fight against climate change and environmental degradation. Investment in new technology is key, so we need to see the link between innovation, climate and development. If we want to maintain the global temperature increase below 1.5 degrees, we need a massive drop in greenhouse-gas emissions. It should be clear that this is not possible with our current technologies.

Luckily, Europe leads the way on green innovation and on combining the potential of green and digital technologies, despite its lag in digital innovation and adoption. At the intersection of digital and green domains, Europe has 76% more patents than the US, and four times as many as China has. If we build on that lead, not only do we have a chance against climate change, but we may also boost the global competitiveness of the European economy in the decades to come.

While the EU's position is encouraging, other countries threaten to overtake it. If policymakers want the EU to stay ahead in the development and uptake of digital and green technologies, they have to address some of the barriers that hold back innovation. So time is of the essence. It is essential that investments do not stall, in particular green investments. Given that the lifespan of factories, housing or power plants that we are building today stretches far beyond the 2050 target, it is important that investment in cleaner technology should take place today.

As the EU bank, we are already making a clear contribution to foster digitalisation. Over the past four years, the European Investment Bank has already invested over €10 billion, helping to provide 70 million households with high-speed internet. In addition, the Bank has just disbursed €150 million for AI projects in the EU, and much more is in the pipeline.

However, digital security is just as important as high-performance infrastructure, if Europe is to remain at the forefront of economic and technological developments. Increasingly frequent and successful cyberattacks over the past few years show just how crucial it is to invest in the security of networks and digital services. That is why the EU bank is supporting start-ups such as the Swedish company Clavister, whose range of security technology includes network protection for water and electricity providers – one of the very vulnerable parts of our set-up.

Europe needs to wake up to the potential of digital technologies. Our survey results suggest that the adoption of digital technologies can boost firm performance in terms of productivity, investment and innovation. At the same time, policymakers will need to pay attention to some of the social and market impacts of further digitalisation. These include a hollowing-out tendency of mid-level jobs, job-polarisation, risks of too-high market concentration and some cybersecurity threats. This issue needs to be addressed: whether Europe leads the digital transformation or just follows it.

The EU could prioritise helping firms reap performance benefits and competing successfully on the global stage. This might seem familiar to all of you, but it needs to be repeated again and again: we need to press ahead and accelerate the completion of the digital single market. This would allow many great European companies to reach the size where they stand a chance of competing with leading players from the US and elsewhere. We also need to accelerate the implementation of high-performance digital infrastructure, including 5G networks. This will make so much more innovation possible in new goods and services.

To be at the frontier of digital innovation, we need to have to have the digital infrastructure of the future, not of the past.

Ashley Alder

Chief Executive Officer of the Securities and Futures Commission of Hong Kong and Chair of the IOSCO Board

Corporate sustainability disclosure standards: The way forward

Environmental, social and governance (ESG), and especially climate, is now one of the dominant themes for global regulators and progress has accelerated at an astonishingly rapid pace this year.

There is a growing consensus that, amongst other things, climate change poses significant financial risks and that urgent, coordinated action is required to address them.

The EU's green finance agenda is ambitious, multi-faceted and increasingly sophisticated. But Europe only accounts for about 8.4% of global carbon emissions. It is evident that if climate considerations are to be properly taken into account throughout the investment chain, we will at the very least need globally consistent corporate-level reporting standards.

Although equivalence can be a technique to export some EU financial sector standards internationally, it cannot operate in the same way for non-financial corporations for the simple reason that they are not subject to the gamut of bank and market regulations where equivalence normally sits. So global standards have an inevitably vital role to play.

To advance this global consistency goal, the International Organization of Securities Commissions (IOSCO) has thrown its weight behind the proposal made late last year by the IFRS Foundation to establish a new global sustainability standard-setting board, the Sustainability Standards Board (SSB), which would fulfil a similar function to its existing International Accounting Standards Board.

The new board would create a comprehensive and harmonised corporate-level reporting framework, starting with climate, incorporating but also developing the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

However, concerns are emerging in the EU that the approach to climate reporting pursued by IOSCO and the IFRS Foundation and the different approaches in the EU could result in inconsistent or even conflicting standards, leading to confusion amongst the investor community and creating unnecessary burdens for reporting companies.

The European Financial Advisory Group (EFRAG) issued a paper in February 2021 setting out its own recommendations for EU non-financial sustainability reporting standards.

Parallels have been drawn with the well-known divergence between IFRS accounting standards and US Generally Accepted Accounting Principles (GAAP) which, despite considerable effort, have never fully converged. As in that case, differing climate and broader sustainability reporting frameworks could inhibit the ability of investors to compare disclosures, thereby impairing their ability to allocate capital efficiently across the global investment universe.

My main message today is to assure you that this outcome can be avoided and to explain why I believe this can be done.

To begin with, the IFRS Foundation's proposal is now central to IOSCO's work in this area. And this goes back to the fact that Europe only accounts for about 8.4% of global carbon emissions. If we are to move the dial on climate finance, it is essential that we establish globally consistent corporate—or real economy—climate reporting standards as a matter of extreme urgency to deal with the remaining 91.6%. Failure to do so would harm all of us, including the EU—no matter how good its own proposals are.

To start with the basics, we have recognised for some time that further progress across the whole spectrum of climate finance depends on more reliable, consistent and comparable climate reporting by corporates. Without this, financial sector firms, including banks, insurers and asset managers, will not have the information needed to assess climate risks on their balance sheets or make credible disclosures to end investors.

Good progress has been made under the TCFD umbrella. But its status reports have highlighted that the content of disclosures about the impact of climate change on companies' financial prospects and strategies has been disappointing.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

On top of this, there are too many voluntary climate reporting standards for companies to choose from. And so greenwashing is also a major problem.

A major breakthrough

That is why the IOSCO Board decided to support the IFRS Foundation proposals to set up the new global sustainability standards board. Importantly, the IFRS Foundation and IOSCO are also collaborating on this project with the five major independent sustainability standard setters[1].

The IFRS Foundation is already responsible for global accounting standards. Our objective is for the new standards board to produce parallel sustainability reporting standards, starting with climate.

There are five reasons why we see this project as a major breakthrough.

First, content is critical. With IOSCO's strong encouragement, the five independent standard setters have already published a prototype financial disclosure standard which synthesises the TCFD recommendations as well as their own disclosure frameworks. As such, it provides a running start for the rapid development of an IFRS standard.

The prototype is based on the idea that climate reporting will sit alongside traditional financial statements reporting, with both operating as essential inputs for investors to determine enterprise value. The concept of enterprise value is critical.

The IFRS Foundation has already established a working group to evolve the prototype into the first corporate climate reporting standard. This standard will provide a global baseline, but it will be far from basic.

Second, good governance is assured. The new standards will be developed within the tried and tested IFRS standard-setting framework. IOSCO chairs the IFRS Monitoring Board which looks after the public interest dimension and will be closely involved in the institutional set up of the new standards board.

Third, this approach promises a pathway to eventual mandatory adoption. IOSCO has put together a technical expert group chaired by the US Securities and Exchange Commission and Monetary Authority of Singapore to look at whether IOSCO can endorse the developed prototype as the basis for a final reporting standard. Endorsement of the final standard would send a strong signal to IOSCO members to use it in their jurisdictions.

Fourth, speed is essential. With the running start we already have, the aim is to set up the SSB by November 2021 and for IOSCO to endorse the global climate standard as early as possible in 2022.

Finally, a global standard for climate reporting should be capable of being audited. For example, auditors should be able to challenge companies on links between climate reporting and conventional financial reporting.

In short, these standards will be positioned for adoption globally, will be scalable from the outset, will incorporate the materiality principle and will be adaptable across different economies and geographies.

Enterprise value

The concept of enterprise value is central to the prototype now being evaluated as the basis for an IFRS reporting standard.

This is against the background of concerns from the EU that this concept does not fit well with the "double materiality" idea at the heart of the EU approach.

Enterprise value focuses on information which is crucial for investors to assess the material financial implications of climate change for a company. It is about how climate and other sustainability issues can erode a company's worth, or how they present opportunities which can create value.

It also reflects the dynamic nature of sustainability-related issues which may become more or less material over time as the business environment changes and investors raise their expectations.

Clearly, this type of reporting is distinct from broader sustainability reporting, the purpose of which is to illuminate a company's most significant impact on the environment, people and the economy. But this does not mean that the IFRS proposals are inconsistent with double materiality. Far from it.

First, the five standard setters who drafted the prototype have stated their belief that sustainability reporting and sustainability-related financial disclosure must be seen as interrelated reporting concepts, with standard methodologies wherever appropriate.

Secondly, the prototype sets out a sophisticated "building blocks" approach to a more comprehensive corporate reporting system.

This starts with the information of most relevance to those with a specific interest in understanding enterprise value. It then scales up to include information relevant to users with various objectives who want to understand a company's positive and negative contributions to sustainable development.

With this approach, and the right level of ambition and cooperation, there should be no significant dislocations between the global and EU policies for sustainability disclosures.

In reality, enterprise value and double materiality are complementary concepts and will become even more so as investors demand more information about the material impact companies' activities have on the environment.

Compatibility

Current plans call for the new standards board to be set up before the 26th UN Climate Change Conference of the Parties and for a global climate standard

1. The Climate Disclosure Standards Board, Global Reporting Initiative, International Integrated Reporting Council, Sustainability Accounting Standards Board and CDP (formerly the Carbon Disclosure Project).

to be published in 2022 for wide adoption across jurisdictions.

The timeline reflects the urgency of this work and that speed is of the essence.

With the EFRAG proposals, the EU now also has a roadmap for the scope and structure of future sustainability reporting standards for companies. I was pleased to see that one of EFRAG's key conclusions is that there is "significant merit in promoting mutually reinforcing cooperation between EU standard-setting efforts and other international initiatives".

As I mentioned earlier, a concern is that the world will be divided into two standards along the lines of IFRS and GAAP. I believe this fate can be avoided and that our different approaches are in fact compatible and can work together.

As a practical matter, I will ensure that further measures are taken immediately to more closely connect IOSCO's sustainability finance group—extremely ably led by Erik Thedéen, Chair of Sweden's financial regulator—and the IFRS leadership with the EU authorities, especially EFRAG.

In fact, IOSCO has proposed a multi-stakeholder consultation committee to operate within the IFRS Foundation structure; part of its job will be to promote consistency and comparability with jurisdiction-specific reporting standards.

Our collective responsibility

In conclusion, I would also like to acknowledge that there are still some serious technical challenges to be overcome in the area of climate and broader sustainability reporting, and we are far better off working on these together.

I have mentioned the fairly disappointing status reports published by TCFD. It should be our collective responsibility to cure these shortfalls through the evolved standards we are now all pursuing.

This will require far greater understanding around the content of scenario analysis, which lies at the heart of reporting on transition and physical climate risks, and should include collaboration with our central banking colleagues in the Network for Greening the Financial System who have been working on scenarios as an aspect of the prudential supervision of banks and insurers.

We also need to do far more in the area of data and metrics relevant to different business sectors and activities. And investors are now asking for specific disclosures to judge the credibility of a company's commitment to net-zero targets.

This just scratches the surface. All of this will require close international cooperation, to which IOSCO, the IFRS Foundation, EFRAG, the EU Commission and the EU's own International Platform on Sustainable Finance are all well placed to contribute.

Thank you.

Anne Finucane

Vice Chairman, Bank of America
and Chairman, Bank of America Europe

Introductory remarks on global ESG standards

Hello. I am happy to be with all of you virtually to share my thoughts with you around ESG global metrics and the need for convergence. We have seen an exponential growth of the ESG market, with extensive research from our own research team and from others, indicating that you are not giving up returns when you subscribe to ESG behaviour. Research has found that companies that apply ESG – and I mean that broadly – are more profitable, less risky, have lower client attrition and have higher employee and customer satisfaction. Their profitability also seems to consistently be better. I would add that of the $100 trillion of assets that are professionally managed globally today, about 40% of those have some ESG quality.

There is an increasing expectation for companies to integrate ESG considerations and impact into their core purpose, strategy and operations. This is being driven by three big dynamics. One is the widespread understanding and agreement that there are large, systematic global issues that we must address urgently. Two: the growing belief, which we certainly share, that corporations have a role and a responsibility to address these issues, often referred to as stakeholder capitalism. Three: an increased understanding that companies that manage ESG well will perform better, prompting investors to shift their money to those ESG leaders. However, we need to make sure that we have a common language across the globe on ESG, that we can measure these ESG characteristics and the long-term value creation of business in a comparable way, and that we all talk about the same things using the same nomenclature.

That is why we are closely involved in the work on universal disclosure metrics that the World Economic Forum, along with the Big Four accounting firms, and in collaboration with all stakeholders, are leading to help drive a convergence among global non-financial ESG reporting standards. The International Business Council of the WEF, the IBC, chaired by our CEO, Brian Moynihan, has issued stakeholder capitalism metrics that provide a very useful contribution to this process. We are working with dozens of global companies, asset owners and asset managers, the standard-setters themselves, and regulators in the US and elsewhere to help spur convergence towards a single global standard for ESG reporting. This is an important body of work. The Big Four and IBC stakeholder capitalism metrics show that we can draw from existing, well-known standards to create a foundational set of existing metrics and disclosures deemed most critical for sustainable value creation, and with the purpose of demonstrating corporate leadership in areas our stakeholders want to see.

We also support the work that the International Financial Reporting Standards Foundation is doing to consolidate and reduce fragmentation in sustainability reporting standards. The work of the IBC has been recognised by the IFRS and others as an important contribution to the non-financial disclosure movement. Having one global sustainable reporting standard will allow comparison across companies, but will also increase transparency. While the E is quite developed, with the EU having written its taxonomy and other jurisdictions following the same lead, the S and the G are still in the making. It is critical that we should make progress on these items, and with transparency that will be the leading factor. Transparency is the key to governance. Over time it will make clear that those who govern effectively will succeed in the long run. That effectively means looking at your value creation and looking at how your business goals are aligned with the SDGs.

If progress is to be made on ESG, we need a fully-fledged universal transparency reporting framework. The EU is also in the process of introducing its own sustainability reporting, but to address the challenge of climate change we must reach ambitious international solutions and an internationally accepted common reporting framework, embedding non-financial and financial considerations. That will lead to a better allocation of capital. For any transparency framework to work, effective principles of governance should be set up to ensure companies are really integrating ESG into their operations. Stewardship and accountability are key.

As one of the world's largest financial institutions we are committed to working to address some of society's most critical ESG challenges using our scale, innovation, talent, and financial capabilities, but as you know, climate change requires collective responsibility. Making bold commitments to net zero requires actions and honesty. Sustainability and ESG reporting is the way to demonstrate actions. I am looking forward to hearing more from this panel on the prospects for global and EU ESG standards converging, and I believe the discussion will show not only how much we need converging standards, but also how big a challenge this really is.

EXCHANGES OF VIEWS

Is normalising EU monetary policy feasible? If so, how and when?

Jacques de Larosière - Honorary President, Eurofi

Andreas Dombret - Global Senior Advisor, Oliver Wyman

Andreas Dombret (Chair)

The Chair introduced himself, welcomed everyone to the discussion and wished Portugal a fruitful, productive and successful Presidency.

He noted that, as a former governor and former managing director of the International Monetary Fund (IMF), and as a founder of Eurofi, Jacques de Larosière needs no introduction, so they could jump into the first question. Despite 10 years of accommodative monetary policy, which has led to low-to-negative interest rates, growth in the eurozone is still subdued and investment is declining. He asked why this is the case.

Jacques de Larosière

Jacques de Larosière considered that today's world is made up of paradoxes. Global demand is weak, investment needs are enormous and not being realised, at least in Europe, and interest rates have been low for a number of years, although non-residential productive investment has been declining. Monetary policy has been particularly accommodative for more than 10 years, and interest rates have converged to zero or negative rates.

Looking at M0 – banknotes in circulation and bank reserves held at the central bank – shows that in advanced economies, during the last 10 years, the money base has grown almost four times more quickly than the nominal economy. This policy has been so accommodative because monetary policy has been geared to an overriding objective in terms of consumer price index (CPI) and to keep inflation at a level close to 2%. This objective poses a major problem, because structural factors have been at play for the last 10 to 15 years: ageing; opening of international trade and globalisation, which has allowed western countries to import massive amounts of goods and services that are made on low wages (approximatively 1/10th of those of industrialized countries); and consequences on prices stemming from technological innovation. These factors have put inflation at a lower rate than in the old days.

This moderation of inflation has to be understood not as the result of a weakness in demand but of structural changes. Monetary policy has made a serious mistake because policymakers seemed to believe that low inflation – and lower than the arbitrary target of 2% – was the manifestation of insufficient global demand. The Keynesian recipe of monetary stimulus was therefore justified, in their eyes, and so they decided to increase monetary creation, as long as inflation was lower than 2%. More analysis should have been required on the precise nature and causes of these disinflationary forces. To the extent that these forces are structural and therefore unavoidable, attempts should not be made to redress them by more money expansion.

Money creation, in fact did not create more demand nor more inflation but translated in less velocity. If monetary policy over the last 15 years or so had been geared to a more realistic inflation target of around 1.5% or 1%, instead of 2%, the world would have avoided the unnecessary expansionary monetary stance, as well as deflation.

This systematically loose monetary policy contributed to building the enormous credit bubble that nearly broke the financial system in 2008. All financial indicators were flashing, but, as the CPI was low, central banks were not worried. However, they should have been, because a financial bubble is the present manifestation of inflation in an environment of technological disinflation.

Strange as it can seem, the extreme magnitude of the excess leverage that was appearing in the financial cycle, did not attract the attention of Central Bankers, simply because CPI was stable. The financial house was burning, but no alarm bell was ringing; complacency was the name of the game and the fire became threatening.

Andreas Dombret

The Chair noted that the COVID-19 pandemic has clearly not made the situation better but worse in the past year or so. However, that is by no means able to explain by itself low growth and receding investment in the eurozone. He asked what have been the effects on growth of monetary policy over the last 10 years.

Jacques de Larosière

Jacques de Larosière stated that the question is at the heart of the problem. If aggregate demand remains weak, it is mainly due to structural factors such as ageing, etc, leading to an overall saving surplus. A common opinion is that, in the face of relatively sluggish global demand and excessive savings, fiscal and monetary policies are required to stimulate demand, so it is worth pausing to analyse this apparent obviousness.

In spite of the explosion of debt over the last 20 years and of very low interest rates, the stock of non-residential productive investment – not including intangibles – has fallen from 14.4% to 12% of gross domestic product (GDP) in advanced economies, which has been only partially offset by the rise in intangible investments which have risen from 4,3% to 4,9 % of GDP. This is a staggering figure. In a normal situation, the capital base should not fall but expand. It is surprising that this statistic, which is one of the most significant in terms of global demand, is not highlighted more. The collapse of productive investment has occurred despite historically low interest rates.

Jacques de Larosière stated that a strange hypothesis eventually emerged to him: is it possible that very low or negative interest rates contributed to lower investment? The answer would be that that is absurd. If the financial conditions are easy and inexpensive, it is not clear how investment could be penalised. This is where the liquidity trap comes in. Once again, Keynes was right. He was in favour of low interest rates, but he specified not too low interest rates. Indeed, when they are too low, they deter savers from investing in long-term bonds and encourage them to either keep their savings in liquid forms, which they are doing, or in assets remunerated only because they are risky. On the other hand, entrepreneurs, discouraged by the prospect of no growth emanating from zero interest rates for a long time, are turning away from productive investment in favour of things like share buybacks and speculative opportunities.

This is not an invention; it is based on a study from the prior year that showed over the last 10 years a massive and spectacular increase in the purely liquid part of household savings – notably, in overnight bank deposits – even before the Covid crisis. This research is European and may be less verifiable in the US, where investors are less risk-averse than they are in Europe, and more interested in the opportunities offered by Wall Street. This interpretation is not universal, but, if it is correct in Europe, serious thought should be given to the problems posed by monetary policy.

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

Andreas Dombret

The Chair proposed going from the analysis to the recipes. He asked whether a zero-to-negative-interest-rate policy on the one hand, and fiscal domination on the other, are the right recipes for reviving eurozone economies, as it is not possible to be satisfied with the paradigm of low growth going forward.

Jacques de Larosière

Jacques de Larosière stated that not only is he not convinced that a negative-interest-rate policy and fiscal domination are the right recipes, but he is convinced that they are the wrong recipes. Zero interest rates alone do not foster economic growth. They shift savings to liquidity holdings, discourage long-term and riskier investment, as they have no remuneration. They trigger financial bubbles and pave the way to the next crisis.

Andreas Dombret

The Chair noted that it would be possible to talk about this for much longer and asked for the three most important takeaways for the audience.

Jacques de Larosière

Jacques de Larosière considered that the time has come to start getting out of the present monetary trap, gradually and with the benefit of international consultation. He proposed three simple orientations: first, to allow long-term financial markets to express their inflationary expectations through higher yields. This would provide investors with a more normal remuneration and foster long-term investment. Adequate remuneration for risk is of the essence. Second is to have a more realistic view on price developments. A price slightly less than 2% is not one of instability; it is the contrary. Third, if yields tend to get somewhat higher, central banks should not consider that they should redress their tendency and provide member states with the unconditional benefit of a zero-rate guarantee. Fiscal domination, which is presently a fact of life, should not become the rule for the future.



The reform of the EU fiscal framework and the transition for its re-implementation

Klaus Regling - Managing Director, European Stability Mechanism (ESM)

Tuomas Saarenheimo - President of the Eurogroup Working Group and the Economic and Financial Committee, Council of the European Union

David Wright - President, Eurofi

David Wright (Chair)

The Chair welcomed participants to a debate on the reform of the EU fiscal framework and the transition for reimplementation and introduced the speakers. The discussion would consider the reform of the fiscal framework.

There are a few initial assumptions to consider: first, this is not in the context of treaty change, nor, hopefully, in a context of perpetual monetisation of public debt, and some form of coordination framework is needed. These are basic principles. He asked Tuomas to look at the outlook and how to move towards a firmer and more stable situation.

Tuomas Saarenheimo

Tuomas Saarenheimo considered that there is a recognition that something needs to be fixed and that colleagues are unanimous on this. Moving on from there gets more complicated. An issue is the increasing complexities that have been introduced into the rules over the years, much of which came with the Two Pack and, particularly, Six Pack reforms around 10 years ago. That has already started and there are all kinds of unmeasurable variables that the assessments are based on.

Behind this complexity lies the fact that fiscal policy is complicated, and situations vary. Rules set up sensibly in one set of circumstances might be completely nonsensical in another set. Over the years, attempts to pre-programme for all eventualities has led to complexity. There has not been the willingness to provide the Commission the discretionary powers to adapt its assessment to various situations, but rather member states have wanted to have clear rules for every situation. That has led to the current situation.

It is not about providing the EU tools to discipline misbehaving countries. The idea of creating a framework that forces fiscal discipline on countries through the use of sanctions is a fallacy. Rather, better ways have to be found to work with countries and to engrain the European fiscal framework in national budgetary practices, in a manner that facilitates intelligent discussion, increases transparency and honesty of budgetary policy and communication at the member-state level, and creates support for responsible fiscal policies. This is the challenge faced.

Klaus Regling

Klaus Regling noted that this is a clear explanation of why the framework that has been developed over the years needs to be reformed. It is clear from the introduction that there is an assumption that fiscal coordination is needed in a monetary union, which makes sense. In the end, monetary union is still unique in the sense that it centralises monetary policy completely, while fiscal responsibilities continue to be with national governments and parliaments, so it requires coordination.

First, it is important to be clear about the aim of fiscal surveillance, framework or governance, because there are many good reasons to have it. There are many objectives that people try to reach. One is debt sustainability, but also many want to use it to promote growth or the green economy. Some want to prevent divergences in the monetary union, and some want to create space for cyclical stabilisation. These are all good objectives, and it is difficult to disagree with them.

At the same time, it is not feasible to reach five objectives with one rule, so the discussion must be broadened, remembering that other instruments exist, like the EU budget. The EU budget provides permanent, continuous transfers from richer to poorer countries and can be used to prevent divergences among countries and to promote convergence. It can also be used to promote greening of the economy. The annual country specific recommendations could also be used. There are many instruments – not only the Stability and Growth Pact – to reach several objectives linked to budgetary and fiscal policies.

To make it even more complex, it is important to remember that assessing the value of a fiscal framework is a question not only of debt levels or deficits but also of quality of expenditures, of revenues, which can be growth-friendly or less so, and of the size of the public sector. Jacques noted in an article in the Eurofi magazine that the size of the public sector – if, say, expenditure to gross domestic product (GDP) is 10 percentage points higher in one country than in others – is more important than higher debt. It is a complex issue to find a system that ensures that the entire public finance is good and, in this broad sense, achieves all these objectives.

There is no silver bullet to achieve all of that and no model ready in the drawer that can be adopted and fix all the problems. It will not be that simple, but something is needed. Tuomas mentioned some principles that could be subscribed to, such as simpler rules and using observable variables. Expenditure rules should be used, as others such as the European Fiscal Board have proposed. The primary balance should maybe be used as an anchor for countries that have particularly high debt levels.

Then there is the difficult question of what debt target to aim for. The current world is different from when the Maastricht Treaty was negotiated. At that point, the 60% debt-to-GDP level was a reasonable target. It happened to be the average of the member states at that time and was also consistent with a nominal growth rate of around 5%. Interest rates were also much higher than today. In the future, interest rates will be lower than in the past. They will not remain as low as they are now, but on average they will be lower than 20 or 30 years ago. That indicates that higher debt-to-GDP ratios can be accepted as something to aim for. The 60% should be raised. This will be a controversial issue but there are good economic arguments for that.

In addition, a fiscal-stabilisation facility should be added to this new framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

That is one reason, but there is a second reason for thinking about a transition period. The general escape clause in the current year will also apply in the next. In 2023, when it will probably no longer apply, there will not be many countries with a deficit below 3%. Several will have deficits close to 10% and will need and should have a number of years, for economic reasons, to reduce them. A recent proposal from Jean Pisani-Ferry and his colleagues is to look at plans country by country for how to manage public finances in the future.

For the steady state it is preferable to have a new set of rules, but they cannot apply immediately, because the situation in 2022 23 will make that impossible. A transition period could be envisaged, where something like Jean Pisani-Ferry's recommendations is used: country-specific adjustment or consolidation plans proposed by the Commission, discussed in the Eurogroup and agreed in the Council, in order to bridge the time until a new common framework is reached, perhaps after three or four years, where some of the principles mentioned are reflected.

David Wright

The Chair noted that that is quite a long timeframe before any new rules would start to apply. It is a long transition period. He asked Jacques de Larosière to outline some of the thoughts mentioned in his paper on the elements that could be useful in the future fiscal framework in order to improve discipline.

Jacques de Larosière, Honorary President, Eurofi

Jacques de Larosière felt in harmony with the previous speakers' comments. First, the accepted rules of the stability pact are now so far away that it may be tempting to 'throw the baby out with the bathwater'. That would be a major mistake. It is precisely because of the turmoil of enormous deficits and massive debt ratios that rules to help countries normalise and better their position have been conceived. It is indispensable to work on this subject and not wait for the future to happen.

A second idea, which is close to what Klaus said, is that the situation is more complicated than it was 20 years ago. This complexity must be considered, as mentioned by the first speaker, who carefully explained the importance of this complexity. This is right.

It is vital to be intelligent and not get percentages and rules out of the blue. To work on this complexity, first it is critical to understand what could be called the legitimate heterogeneity. If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because of a 3% rule or a 60% rule. It is important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and abnormal heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working marginally on that element.

The third idea is that the amount and quality of public expenditure is probably more important than the level of debt to GDP. In many cases – and in the case of France, for instance – the abnormality of public expenditure related to GDP compared to other countries is such that it is practically impossible to regain, with that abnormality, a path of gradual normalisation and of industrial competitiveness. Proposals have been made in France to reduce a little more sharply this abnormality in order to be able to regain something more reasonable.

Public expenditure has to be worked on, both on the quality and whether it is to pay for the end of the month of current expenditures or to increase the capital base of the country through valuable investments. Attempts have to be made to move it towards valuable investments and to reduce the part of those public expenditures that are related to current expenditure, while acting on the quantity or the size.

It is possible to be agnostic on the number of years. Each country will probably have its own views on the duration of the process that will lead it towards an acceptable, reasonable path. This period has to be discussed as an essential part of the framework. Klaus is right that a specific, tailormade process must be done, especially in the first years, and then, when some normality in the primary budget has been regained, it will be time to think of a common framework for everybody. It is too early now, and it has to be done country by country. Jean Pisani-Ferry's study has made that point.

First, this is a necessary process that has to start quickly. There is no time to waste. Second, the complexities of nations have to be delved into. Third, that has to be done collectively. It cannot be a state-by-state or member-by-member thing. An element of agreement on the direction of movement and on the timeframe must be instilled in that nationally based process. These are not original ideas but are in line with what the two previous speakers have said. It is difficult work that needs a great deal of attention and dialogue with the country. It is not only the photograph of the country's views; it has to be negotiated.

David Wright

The Chair asked Tuomas Saarenheimo for comments about a transitional period, without being precise about timing, and whether peer pressure could be ratcheted up, with the Commission playing a bigger role.

Tuomas Saarenheimo

Tuomas Saarenheimo believed that rules are needed, although it would be more precise to say that a framework is needed. The framework is more important than the precise rules, if 'rules' means a set of numbers. A set of numbers is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems.

Regardless of the criticism that the framework has received, in general, quite a number of good examples have also been received. The best examples come precisely from countries where the European fiscal framework is an integral part of the domestic budgetary process and is present from the first domestic discussion. A situation where the European framework comes into play only when the draft budgetary plan is presented and then either accepted or rejected is too late. It has to be part of the domestic discussion.

The spirit of what Klaus and Jacques said is, essentially, the same. Jacques spoke about legitimate heterogeneity, which links to not focusing on rules and numbers but on frameworks, targets and goals. The question is one of where Europe wants to move towards and then of considering the situation in a country. It is vital to consider expenditure needs, the structure of the economy and ways to improve competitiveness. The most important thing is to get an honest, visible discussion on each country and then have the courage, if a country puts forward a set of bad policies, to 'call a spade a spade' and to say that these are bad policies, and to try to affect the domestic discussion. There are many ways to get there, but this is key.

David Wright

The Chair asked whether this could include public statements.

Tuomas Saarenheimo

Tuomas Saarenheimo agreed. The European framework primarily works through publicity and media attention, while hesitating to call it naming and shaming, but it ultimately is that. No country or government wants it known that it has bad budgetary policies. No country wants to read it in the Financial Times or domestic newspapers. Media and publicity are a key part of this. An important part of this endeavour is to find ways to open up the discussion. There is no need to be cagey or to soften blows so as not to trigger an escalation. Honesty must be a big call of this exercise.

David Wright

The Chair asked Klaus Regling for comment on Jacques' idea of some form of early warning mechanism.

Klaus Regling

Klaus Regling recalled the idea of the transition period. 2022 will start with a situation that is heterogeneous and difficult, and which will require time to adjust and return to a more common framework. That is unavoidable and can be done only country by country. Tuomas is right that disagreements should be discussed in the Eurogroup – that is the kind of peer pressure that leads to results – but it should also become public. The Commission has also done that in the past. There were sometimes statements at press conferences about the budgetary plans in certain countries. The European Semester provides a framework to talk early and before final decisions are taken in a country and the Commission can indicate early whether policies are good or need to be improved.

The European Fiscal Board has not been mentioned, but it has played a positive role and can also be helpful in giving input into the process, together with national, independent councils. In principle, every country should have one, and maybe they can be better used. From experience, when there is negative publicity, markets react. It is true that governments then react, as they see that it can be costly to ignore the advice or comments coming from the European Commission or the Eurogroup.

David Wright

The Chair thanked all the speakers for their interesting input into the discussion.

Exchange of views

Ana Botín - Executive Chair, Banco Santander

David Wright - President, Eurofi

David Wright (Chair)

David Wright welcomed and introduced Ana Botín, giving thanks for Banco Santander's support. Ana Botín has immense experience and knowledge of the challenges facing European banks, and as Chair of Banco Santander serves about 150 million customers worldwide. David Wright asked about the crucial role the banks have played in bridging the disruption of the pandemic and why it has been so different from the previous crisis.

Ana Botín

Ana Botín stated that this is a very different type of crisis. This is a health crisis which has created an economic shock; that is very different from 2008, which was a financial crisis. Back then banks were in large part the source of the instability but, this time, they have been a source of stability. If banks have been part of the solution this time, it is because they learned the lessons of that crisis. They now have strong balance sheets and are able to support people and business. For example, Santander lent €1 billion euros a day during 2020, and its peers did likewise.

The nature of the public health response created an urgent need for liquidity support for otherwise generally viable businesses, which is a very important point. This was a gap that banks could step into with state backing. Emergency lending has played a much bigger part in this crisis than in the 2008 crisis, in part because banks were deleveraging in 2009.

The third point, which is crucial, is that financial regulators and governments moved together, working with the banks, very quickly to support economies. From the point of view of the banks, the biggest difference compared to 2008 is the speed and scale of the response from authorities. Given that the last crisis was a financial crisis, in some cases authorities were reluctant to be seen to be rescuing banks and creating morale hazard, and they intervened only when there was no alternative. This time the response was almost immediate, with monetary and fiscal measures in Europe coming into place within days. The response was ahead of the problems, and banks were there to help, because they had strong balance sheets and were agile.

David Wright

David Wright asked whether Ana Botín is worried about corporate insolvencies and non-performing loans as there is now a transition to a more normal economy.

Ana Botín

Ana Botín believed the lesson is that when governments, regulators and banks work together at speed they can actually make a huge difference, and a once-in-a-century shock has been withstood. These plans require trade-offs. Loan moratorium programmes, for example, require banks and governments to work together. Commercial banks were used as a route for state-backed lending, and so, looking to the future, it is critically important that any consequent bad debt be dealt with constructively and in partnership, that contracts should be respected and that if direct aid is desired that it is not at the expense of changing the conditions of the loans that were given. This is really important, because it is going to be an issue in many countries.

There is still a health crisis. The best economic policy, the best thing for citizens, companies, banks, the economy and society is to deal with what is still here: a very severe health crisis that has not finished. Vaccination is the best economic policy for 2021.

Looking ahead in terms of how best to handle a rise in insolvencies, there is substantial capital and substantial loan reserves. Losses have not yet materialised, but this is a risk to profitability and not to solvency. For example, Santander's pre-provision profit, even after increasing its loan reserves by 50% last year, could still increase again by that same amount without getting to zero profit. Others doubtless have similar, albeit slightly different, numbers. Losses will come in 2021 and 2022, but there are provisions. If more provisions are eventually needed, it has to be added at a lower cost of risk. It is a risk to profitability, but not to solvency.

Where solvency rules have been temporarily relaxed, it is crucial that companies still need help, and that depends on the depth and the quality, as well as the speed, of the recovery. The vital message is that growth matters. Clear action on NPLs is needed, probably with a gradual approach, and a gradual approach to returning to prudential standards. Regulators must be worked with to ensure that the regulatory framework is not focusing on stability at the expense of growth, and that there is a capital framework which is not procyclical.

David Wright

David Wright queried whether there is concern about the implementation of Basel. Europeans are apparently concerned about the output floor and capital for non-rated SMEs, for example.

Ana Botín

Ana Botín confirmed that there are concerns. The biggest challenge is making sure that a cliff-edge effect is avoided, not just on the fiscal side but also on the banking side, and so banks need to be able to lend more to business. Banks need to be able to deploy more of the capital they have built up, which means being able to attract investors. That is a starting point. Without a good, profitable model it is going to be very difficult. Basel matters and their implementation is a very immediate challenge. There is a risk that the Basel implementation will restrain banks much further at a time when they need to be able to support recovery. Rules need to be simplified and properly calibrated to take into account European specificities.

Strong economies are powered by strong banks. In Europe, SMEs depend on banks for 70% of their external financing. There was a €400 billion financing gap for eurozone SMEs in 2019. That is 3% of gross domestic product (GDP). There is a need to calibrate capital to remain prudent and strong, but also to be able to support the economy and use balance sheets responsibly. Then there is the whole issue of the digital transformation and how to compete.

David Wright

David Wright noted that Ana Botín has been positioning Santander for the new digital and green world. Both trends are irreversible. David Wright asked whether Ana Botín is worried about the level playing field.

Ana Botín

Ana Botín stated that due to COVID-19 everyone has to become digital. Car companies are now saying that they have to be software companies. The financial sector is essentially dealing in a digital currency anyway. 80% of all Santander UK sales in 2020 were digital. Competition and innovation are positive, but it has to be fair competition. This has to be addressed, especially regarding data and payments. If data is opened up to other companies, those other companies should do the same, but that is not happening. The Revised Payment Services Directive (PSD2) is focused on banks opening up data on customers, but it is not reciprocal. A much better service and a much better price on risk can be offered if banks get data from other companies that are willing to share. In the European Banking Federation (EBF) and other fora, the principle of same services, same risks, same rules and same supervision is defended. Data access is crucial, but there are many other issues. For example, this relates to both the green and the digital issues.

Recently everything became software, and this is very good news. Previously, software was not treated as capital. Software is one of the biggest assets companies can have. American banks were able to treat it as capital. When European banks invested in software, it was deducted one-to-one immediately, so this is a major progress. More rules like this that are adapted to the reality of today are needed, and the reality is that most things are becoming digital. This is interesting for Europe, for the consumer, for the banks, and for growth; on green issues it is the same. Basel is looking at this. There should be awareness of the optimal level of capital. There are questions on how to calculate risk ratings on assets helping to green the economy and how to agree on a common set of data taxonomy standards. There is an alphabet soup of different standards and rules; common and hopefully global agreements must be reached.

David Wright

David Wright asked whether Europe has carved out intellectual leadership, particularly on green issues and on some of the digital issues, but with too slow decision-making.

Ana Botín

Ana Botín stated that Europe has a huge opportunity to become the standard setter for green, digital and data issues. The Digital Markets Act, and several other initiatives in the Commission, are very encouraging. Banks and companies should provide input for the Commission when they ask for consultation. Sometimes they are too shy. Specific cases should be chosen and evidence given to the Commission. There is a need to move faster, but it is also important to do it the right way, and it is not easy. Getting input, as the Commission is trying to from the private sector, is hugely important. To the broader question of Europe and the US, Europe is at a disadvantage. A common question asked is what the gap is between regulation, or why the financial market in Europe is so different from the US.

David Wright

David Wright asked why the valuations of European banks' profitability are much lower than those of the US. Many excuses have been given, such as securitisation, no banking union and no capital markets union.

Ana Botín

Ana Botín confirmed that the short answer is that it is the sum of all of those. There is not one answer. Santander was worth the same as JP Morgan 10 years ago, and today JP Morgan is eight times larger. Santander was the largest bank in the eurozone; it is still number one or two depending on the month or year. JP Morgan is 10 times more, and Santander has done well in terms of growth. One important factor is the macro context. The US rebounded very quickly after 2011, whereas Europe entered the euro crisis in 2011-12, with three years of very poor growth, ultra-loose monetary policy and negative growth. There is much debate about negative rates, but this is very important. The commodity is interest rates, so a small difference there has a huge impact on profitability.

It is not just a difference in interest rate. It is the construction of the financial system itself, the Fannie and the Freddie. Mortgages need to be kept in a balance sheet in Europe; in the US, they sell them off. Americans have enough space to support the economy much more. The regulatory regime is also much more constructive. There are fewer intrusive business limitations. In the US, there is a single market. There are economies of scale, which are hugely important on digital. In Europe, the capital markets union has been discussed for years. There is also the question of innovation. There is a long list that should be understood, because stronger banks are needed for a stronger economy.

David Wright

David Wright agreed and noted that the projected growth rate for the United States is at 6.5% according to the governor of the Fed, while Europe is at 3.5% or maybe 3.7%. Some think that the US growth rate could even be in double digits. David Wright asked what the position will be in 10 years' time.

Ana Botín

Ana Botín noted that the consequences of Covid-19 will only be seen after a couple of years but these will accelerate change, and in a direction that might not have happened without Covid-19. It is going to have a huge impact on the political side. Government intervention means that there is more debt. That is going to cause a great deal of rethinking of public policies, which is right. A new social contract is needed, and this is aligned with the green and digital issues. It also has huge implications for taxes, competition and many aspects of political, public and business life.

For Santander as a business, change is driven by consumers. Behaviour is going to be very different. There will be 5G. The Internet of Things (IoT) means people will be connected in a way unimaginable today. Again, speed is very important.

Europe is excellent on the economic and public sides. It has done a fantastic job on the monetary side through the European Central Bank (ECB), and also on the fiscal side. It could do better on health. It now has to shape its future correctly to allow businesses to be agile.

To create new jobs, we need to be agile. How SMEs are financed has to be reinvented, because they do not have a factory or a bar; they have talent and brains. There are questions of how to finance start-ups and incentivise banks. Different business models are needed. Santander calls it 'one Europe, one Santander'. The question is how to create a global platform, and how to do that at the European level for all industries. The future driven by the consumer is much more digital, with the likes of payments. Payments will not be measured; it is going to happen, so there will be a need to learn how to provide more value added for clients, and more help for succeeding on a personal basis or as a small company entrepreneur.

David Wright

David Wright thanked Ana Botín.

Exchange of views

Bernie Mensah - President of International, Bank of America

David Wright - President, Eurofi

David Wright (Chair)

The Chair welcomed everyone to the session and introduced Bernie Mensah, the President of International for Bank of America, a member of Bank of America's executive management team and CEO of Merrill Lynch International in London, to give us a broad account of how banking is evolving and what important issues are. The Chair began by asking how Bank of America as a major global institution sees the global situation and the basic trends for where banking will be in five or 10-years' time.

Bernie Mensah

Bernie Mensah said that he sees the present trends as similar to others. Fragmentation is one. Sustainable finance, environmental, social and governance (ESG) and green financing concerns is another, where there is a need to get a grip on the topic, and make sure that it is set up in the right way as it evolves and become more important. The management and handling of data and its impact on financial services and clients is something that everyone is having to 'get their arms around,' if possible. Perhaps one further area is Asia, with China having driven growth in many other sectors over recent years. Asia has always been a large exporter of savings and perhaps putting to use those savings within Asia itself, with initial public offerings (IPOs) etc, is something to come.

David Wright

The Chair agreed it is interesting and asked whether there is a level playing field with the new digital competitors that are entering, such as new fintechs, or whether that is a worry. He asked if regulation is sufficiently evenly balanced across the globe.

Bernie Mensah

Bernie Mensah said that it does not always feel like a level playing field, and in some areas regulation may be a little behind and in some areas ahead - although this is perhaps not intentional. In a way, it is right to let 1,000 flowers bloom and see what innovation comes. However digital competitors are playing in a space that is traditionally very highly regulated, and big banks might say that, as they are regulated, so everybody else should be. It is about getting that balance right. It is interesting that China recently released a set of regulations, driven by a large IPO there, which seemed intended to regulate some fintechs in the context of these financial institutions. That is not necessarily what would happen, but regulators are looking at that example, as they probably should.

David Wright

The Chair noted that Bank of America implements over time all the Basel standards. He asked whether the Basel process works well and if the standards are implemented in a consistent way across the globe.

Bernie Mensah

Bernie Mensah observed that looking back over 10 or 12 years they have been good on the whole. The standards certainly played a part in the response to the pandemic crisis of 2020. For the industry it was not a financial crisis; there were no systemic issues concerning banking and that is great. There are always unintended consequences and some adjustment is needed around that, mainly regarding the extension of deadlines and timing, etc. As a banker, one likes a little more flexibility, while expecting regulators to want to insist on making sure some of these things do come through. Interestingly, one of the things on the horizon is the Fundamental Review of the Trading Book (FRTB), which has been quite rightly kept back a couple of times. That highlights some of the flexibility that has been needed. What it is trying to achieve cannot be faulted, but some elements of cost benefits have been necessary when postponing the deadlines around that.

David Wright

The Chair asked Bernie Mensah for his views on Brexit, as an institution with large interests in the UK and across many European member states. He asked whether things are unfolding as expected or if there are surprises, and what he would like to see in the future.

Bernie Mensah

Bernie Mensah observed that Brexit has dominated attention for a while. The bank's reaction was set early on to deal with it as positively as possible and to take advantage as much as possible of the new dispensation. Like others, entities have been established on the continent, in Ireland and in France. This allows for as much full-service support of clients as possible, and we have senior people in place making that happen. The upside with that and the upside with Brexit, insofar as anyone is looking for one, is that it has brought the bank closer to clients on the continent, which has been positive in terms of the level of dialogue with clients in France, Germany and across the EU.

It allows for closer working with regulators across the region to understand the direction of travel on topics. Liquidity, however, remains a concern. There is a great deal of liquidity in London and a great deal of liquidity on the continent, and one concern would be where that liquidity would shift to, because that drives capital flows, capital allocation, profitability and it also drives finding the right solutions to existing market issues. As expected, it is a little bifurcated at the moment, so that will have to be kept under review.

Finally, on the horizon are discussions about clearing and where that ends up. There are probably not too many surprises in terms of the opportunities and challenges that are expected to emerge.

David Wright

The Chair asked if these are early days and whether the business that has moved is the beginning of major changes in structure between the EU and the UK, or if a steady state is being moved towards quite quickly.

Bernie Mensah

Bernie Mensah stated that there are different angles to that, and investments have been made. It is not necessarily a steady state, because things always evolve. Even in London and New York they are evolving.

Likewise, the relationship between the EU and the UK is clearly evolving. The recently-agreed memorandum of understanding (MOU) is part of that evolution. It is important for both centres to figure out what the new dispensation means, and that is just as applicable to the UK as it is the to EU. The EU would probably agree that their financial centre was in London and so the EU is in the process of building, investing in, coalescing – whatever word might be used – a financial centre within the EU. There are many thoughtful, smart people who are figuring out what that should look like. The UK, having dissolved its relationship with the EU, will also have to figure out the direction of travel for the City of London.

David Wright

The Chair asked whether Bernie Mensah would agree that if Europe can deliver a Banking Union and drive forward on a Capital Markets Union, sustainability and digital, the potential for growth for financial institutions, including large ones such as Bank of America, is quite important.

Bernie Mensah

Bernie Mensah agreed absolutely. It has often been quoted that if the EU is compared to the US, for example, a large amount of corporate funding in the US is done through the capital markets, more than 50% or 60%. In the EU, that similar percentage is on bank balance sheets. Senior EU policymakers have said that the balance is not right. It might not be desirable to get to 60% or 70%, but capital markets are an incredibly powerful and useful tool for driving economies, funding high yield investments, and providing an alternative source of capital. A thriving high-yield capital market can fund growth companies in an efficient way, with the losses borne by those prepared to take the risk, in a way that allows capital to be driven to where it needs to be. Perhaps with negative rates in the EU, a little more of that would be useful. That is perhaps the angle bankers would be expected to take, but it might be a benefit for institutions that were always in the EU, but who now have more people on the ground and are spending more time there, to add to that dialogue.

David Wright

The Chair thanked Bernie Mensah very much for his thoughts and much-needed optimism.


Exchange of views

Jean Lemierre - Chairman, BNP Paribas

David Wright - President, Eurofi

David Wright (Chair), President, Eurofi

The Chair introduced Jean Lemierre and noted that Eurofi had heard a great deal about the positive role that banks have played in the Covid crisis. He asked about the role of the banks in the recovery and whether there are concerns about a spike in non-performing loans (NPLs) that could have systematic consequences.

Jean Lemierre, Chairman, BNP Paribas

Jean Lemierre stated that 2020 was a challenging year and many have done well in these extraordinary and difficult times. Governments have done well. Supervisors and regulators have done well in taking decisions. Central banks have done extremely well, fuelling support to the economy. The EU Commission has done the job. The official sector was there with quick and ample positive reactions.

The private sector – and mostly the corporate sector – has done well at a difficult time. There may have been some difficulty in adapting, but, as a rule, they have done well. This needs to be said because it shows that economies everywhere are reactive and tend to adapt, and entrepreneurship has been high at a time of difficulties. Banks have done their job. Banks are there to be open, to be with clients, and to use balance sheets to support the economy. That has been done.

Banks have acted, first, alone, and then with governments. In March and April 2020 when markets were closed, there was a burst of support, mainly liquidity facilities, to the economy that had a big social impact. It has avoided massive disruption. Then governments joined with state guarantees in many countries to support the economy. Looking at the level of risk today shows that most of the provisions that were made at the end of 2020 are forward-looking, which is fine. There is a need to be careful about the future while being aware that, in this unique environment, banks were able to control risk with governmental support.

It is not over. Vaccination helps a great deal. The speed is different country by country and the recovery will hopefully be led by vaccination. The beginning of a strong recovery is visible, and International Monetary Fund (IMF) forecasts show that perhaps in a few months some economies will be moving, especially in the US. This is welcome. However, some sectors have been hurt massively and in Europe that is transport, tourism, hospitality, bars and hotels. They have suffered and will continue to suffer greatly. To a large extent, the loss of gross domestic product (GDP) is concentrated in these sectors, so these companies will suffer.

There is still much work to be done by banks, mainly in offering liquidity facilities to recover, grow and invest; and secondly, in these difficult sectors, company by company, to find solutions for how to manage the debt. Some cases may show a wall of debt that must be managed in order to give companies an opportunity to recover. Some of them will have real difficulties and, unfortunately, there is the fear that some of them will go bankrupt, although hopefully not too many. Hopefully, by working together, the job will be done.

This is a response to having listened carefully to the governor of the Bank of Spain. Banks were part of the solution last year by doing the job. It is essential to continue to do it and to have the capacity to do it. To a large extent, it is based on knowledge of clients. Hopefully, banks know their clients, and they showed this in 2020. Room for manoeuvre in terms of capital requirements is essential.

With this in mind, there are two points: stress tests and, further ahead, implementation of the Basel III review. Without going into detail, the point can be understood. Banks can do the job if there is the capacity to do it. This requires careful attention and implementation. Time is not a problem. The time can be taken to do it if there is a simple, honest and well discussed assessment of various aspects, and then the job is done for the people. The system is safe. If it was not, it would have collapsed in 2020. Now is the time to move step by step, carefully and openly. This is based on banks' commitment to clients and to the economy, and willingness to deliver and, hopefully, a continued understanding by the official sector of what banks do and letting them do it step by step, and carefully.

David Wright

The Chair asked if there is a feeling of increasing optimism around banking and if that optimism encompasses a sense that banking union could be completed reasonably soon. The Portuguese Presidency has hinted that it could be in the European Council in June with a roadmap. He asked if those hints have been heard and about the importance of this.

Jean Lemierre

Jean Lemierre considered that a great question. Not being a politician means not creating large headlines, but speaking about real life day in, day out. Banking union would be profoundly welcomed. It is essential. Good decisions have been made, with the main one being the creation of the Single Supervisory Mechanism (SSM) for the eurozone. It is a huge step forward. It works, it delivers, and it creates value for all.

At the same time, there is hesitation and setbacks. Banking union is a single market for banking activities to better finance the European economy. At present, the capacity to move liquidity freely and optimally, or to move capital or equity freely, does not exist. The debates behind this are well known by now, so it is time to do it.

Europe has built up a big institution in the resolution fund. It is often said that there are too many banks in Europe and some banks could disappear. This comes from the official community. The result is the accumulation of billions of euros, and even more each day, because of the current situation, in a resolution fund that is only used in a few cases. This could be used to improve the system.

Circumstances require a new system, which is the European Deposit Insurance Scheme (EDIS). EDIS guarantees national funds to guarantee deposits. There is no difficulty in guaranteeing deposits, but it raises the question of how these funds are used in a preventive way to avoid putting in place a deposit guarantee. In some countries, this money has been used at a national level to continue to support existing banks that normally should have disappeared. It is difficult to understand the rationale behind piling up a new fund to continue to do this, because the national funds are exhausted or close to exhaustion.

If banking union is a single market, opening flows of liquidity and equity, creating a more consolidated and better banking system, and getting rid of banks that are seen as useless by governments and the official sector, that is fine. However, if it is continuing to build up funds for banks that do not go to resolution or merger, that is a problem, because competition and state aid are at the core of Europe. If banking union is maintaining inefficient banks, it is a waste of money. If banking union is creating an efficient single market, it is welcomed. There is a commitment to the second one with a fear of having to pay for the first one.

David Wright

The Chair agreed completely and raised a common complaint that is heard from many banks, around the challenge of digitalisation. There are new players coming into the market challenging all sorts of business lines. He asked if there is an understanding among regulators that there should be a level playing field and that an elephant should be regulated as an elephant. He asked if there are worries about creating an unfair regulatory disadvantage for what might be called 'the classic banking sector.'

Jean Lemierre

Jean Lemierre agreed that there are and referred to what China is doing. Earlier discussions with the People's Bank of China (PBOC) were clear and speeches have been made that well explain the danger of non-regulated financial-services providers, so it is right to put this in order. Europe will see the same and it is a surprise to see the flow of money being invested in some of these competitors. Current catastrophes are not far from this, so supervisors and regulators need to know what is required. It is important to know if they want to continue to guarantee deposits and offer a safe environment for people and if they want institutions that are able to lend to the economy, knowing their clients over the cycle. 2020 showed that it is better to have it than not. Not paying attention not only to unfair competition but to the unsafe world is a problem.

Maybe the market is more aware of this. When looking at the valuation of some initial public offerings (IPOs), people begin to have doubts about this type of competition and to tell others to be careful as it cannot stand for too long. Monetisation is key and digital is paramount – and banks must do it – but there is a need to ensure that this type of new entity is used to put banks under pressure to move forward, not to simply kill them. When it is dead, it is dead, so fair competition is needed. The same is heard from China and from others. When the head of JP Morgan is making a speech about this, it is a warning. The problem is any opposition is responded to as if it is out of a fear of competition. Competition is fine. Competition should be fair, and about efficiency and the protection of people.

There are worries about this type of entity, but, going a step further, non-banking financial activities also need a careful review, because there is plenty of liquidity in the world. Money is cheap, which is exactly what is needed and decided by the central banks. They are right, but it does create unintended consequences. Banks, as well as regulators and supervisors, need to be careful around unintended consequences, because they may have a big impact on the banking industry and on people. There will be destruction of value and bad reputations and the blame will not fall on the non-banking financial industry but on the banks.

This is a strange world, but it cannot be reasonable to see highly leveraged – to the point of tens of billions – non-transparent institutions that have not done the job, not from a legal but a moral point of view. There are serious questions about this. There is a lot to do, and it needs to be done together, so Eurofi is helpful in sharing views. Banks have to take part of the blame. Action is needed, while being careful, notably on risk management. Regulators should also be careful about non-banking entities, which, in some cases, are based on the new technologies mentioned. There is a lot to do, and more discussions on this are welcome.

David Wright

The Chair noted that it is always stimulating to talk to Jean and there is never enough time. Sir Jon Cunliffe participates in the Financial Stability Board (FSB), which, as is well-known, is now looking carefully at non-bank financing, because some of the problems that have arisen have come in that sector. In a way, the global regulators are on the job. He thanked Jean Lemierre and looked forward to the next conversation.

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ABOUT EUROFI

The European think tank dedicated to financial services

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

OUR OBJECTIVES

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

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

OUR APPROACH

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

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

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

OUR ORGANISATION AND MEMBERSHIP

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

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

OUR EVENTS AND MEETINGS

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

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

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

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

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

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

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