

# EUROFI

# REGULATORY UPDATE

SEPTEMBER 2021



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# **1**

## **MACRO-ECONOMIC PERSPECTIVE**

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# OVER PUBLIC INDEBTEDNESS: WHAT WAY FORWARD?

Note written by Didier Cahen, EUROFI

Even before the Covid crisis, global debt was at an all-peacetime record due to over accommodative monetary policies in advanced countries over the past 20 years. The debt situation has been worsening with the Covid crisis. The continuation of a monetary policy of very low interest rates would intensify its negative consequences on growth, employment and financial stability. The increase in public debt and unlimited money creation are a dangerous spiral for our economies. Increasing public spending and debt in over-indebted European economies inevitably leads to economic underperformance and to the questioning of the existence of the euro. Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. Structural issues can only be resolved by structural policies: it is economic growth that eventually solves indebtedness issues.

## **Even before the Covid crisis, global debt was at an all-peacetime record due to over accommodative monetary policies in advanced countries over the past 20 years**

Global debt has reached record high levels. The continuation of very low interest rates during the past two decades has pushed many countries to implement active fiscal policies and economics agents to borrow more. This has driven global debt to records in peace time, even before the Covid crisis. According to statistics issued by the IIF, global debt reached a record high of 335% of GDP at the end of March 2020, up from 320% in 2019 and 200% in 2011. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within five years (2015-2020).

The very accommodative monetary policy in the EU over the last 20 years explains to a large extent this public debt overhang. In fact, with lasting interest rates at ultra-low levels, debt service costs are at post war troughs. The debt burden has never felt so light. Thus, governments are under no pressure to reduce their debts. Negative interest rates encourage them to borrow more and disincentivized fiscal discipline.

## **In Europe, except for very few countries, the fiscal rules of the Stability and Growth Pact have not been obeyed, which has also contributed to the over indebtedness of some EU countries**

Furthermore, in the EU, the rules of the Stability and Growth Pact have, most of the time, not been respected by most of the Member States (e.g France, Spain, Italy, Belgium) since their implementation in 2002. In those countries, gross public debt has continued to rise since the EU sovereign debt crisis (2011-2012). Such dynamic is due to the accumulation of yearly large public

deficits. Indeed, between 2014 and 2019, their average public deficit amounted to 3.2% of GDP (France), 2.3% (Italy) and 3.9% (Spain). Moreover, France, Italy and Spain entered the crisis with debt-to-GDP close or above 100%.

By contrast, Germany and the Netherlands entered the Covid crisis with healthy public finances, ensuring an average surplus of 1.2% and 0.04% of their GDP over the same period. Such fiscal efforts over 2014-2019 allowed them to gradually reduce and stabilize their public debt at respectively 60% and 48% of their GDP in 2019, to be in line with the EU fiscal rules.

## **The debt situation has been worsening with the Covid crisis**

Following the Covid crisis, monetary and fiscal policies have been more active than before, widely contributing to the shock absorption. Central Banks substantially eased the monetary policy stance over the course of 2020 to counter the negative impact of the Covid-19 pandemic on economies.

According to the IMF, between March 2020 and July 2021 global Central Banks have increased their balance sheets by a combined \$7.5 trillion and governments have spent \$16 trillion providing fiscal support amid the pandemic. Public deficits are the highest they have been since World War II and Central Banks have provided more liquidity in the past year than in the past 10 years combined.

## **Can such persistent accommodating monetary and fiscal policies continue in Europe in particular?**

The Annual Economic Report of the BIS (June 2021) states that “no well-functioning economy should operate with real interest rates that remain negative for too long: capital is misallocated and growth impaired” and adds that once the Covid pandemic is left behind and the economy has recovered, policy makers need to rebuild safety margins for both monetary and fiscal policy. “An economy that operates with thin safety margins is vulnerable to both unexpected events and future recessions which inevitably come. These margins have been narrowing over time. Rebuilding them means re-normalizing policy”.

## **The continuation of a monetary policy of very low interest rates would intensify its negative consequences on growth, employment and financial stability**

It is simplistic to believe that monetary financing and low interest rates will fundamentally take care of debt

problems. As we have learned over the last years' experience, abundant liquidity and low rates do not result in higher productive investment but in liquidity hoarding. Since 2008, M0 in major advanced countries (i.e., banknotes in circulation and bank reserves held at the central banks) has increased by 13,50% per year, which is 4 times faster than nominal growth in the real economy. In the euro area, during the same period, M3 that includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately (3,50% per year), showing that central money creation had not seeped into the economy. These figures show that the excess of liquidity has not been passed on to the real economy.

Furthermore, lasting ultra-loose monetary conditions are reducing economic dynamism. The facts are undisputable: non-residential productive investment in advanced economies has significantly declined over the past ten years of zero interest rates (from 14,4% in 2000 to 12% in 2018 of global GDP). Indeed, interest rates that remain at zero for an indefinite period discourage investors from investing in risky projects and instead move into yielding and speculative assets. Household savings have shifted to liquid and non-risky assets, as investments no longer yield any return, in Europe in particular. In addition, low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what John Maynard Keynes<sup>1</sup> called the 'liquidity trap', investors play safe by placing savings in very short-term instruments rather than deploying them longer term, where low interest rates bring them inadequate returns for higher risks.

'Too low for too long' policies have also fueled the survival of weak firms, increasing a misallocation of capital. Indeed, such prolonged monetary policy easing contributes to consolidate zombie firms (over indebted and uncompetitive) that are only surviving because of the interest rate subsidy provided to them by monetary policy and incentivize companies to take on cheap debt rather than invest in long term projects.

The pursuit of such a loose monetary policy – "as if nothing had changed" – would be likely to trigger eventually a financial crisis with all its negative economic and social consequences. Indeed, the persistence of very low interest rates has led to overleverage and search for yield which has fueled asset bubbles and contributed to a weak profitability of the EU banking and life insurance sectors<sup>2</sup>.

**The increase in public debt and unlimited money creation are a dangerous spiral for our economies. Increasing public spending and debt in over-indebted European economies inevitably**

## **leads to economic underperformance and to the questioning of the existence of the euro**

Large deficits and high levels of debt and deficit have not been conducive to growth, especially in Europe. Indeed, the most indebted countries, (e.g France, Italy, Spain) have achieved the lowest growth performance of the eurozone since 2013<sup>3</sup>. The most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020. Likewise, the most indebted EU Members have experienced close to double-digit level of unemployment rate since 2007, as Spain (14,5% in 2019), Italy (9,9%) and France (8,5%). Despite their significant deficit, the three countries are among those with the highest share of long-term and young unemployment rate.

By contrast, the EU countries that have best managed their public finances after the Global financial Crisis and the EU Sovereign crisis (e.g. Germany, Netherlands, Austria) are those that have suffered the least from the Covid-19 shock. At 4,2% of GDP (Germany) and 4,3% (the Netherlands), their 2020 public deficit has remained mainly below the Eurozone average of 7,2%. Those countries also record among the lowest unemployment rate within the euro area, with 3.2% for the Netherlands and 5.9% Germany as of June 2021<sup>4</sup>.

As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate.

The economic consequences of the current Covid-19 crisis are worsening the situation. They are increasing the heterogeneity of fiscal performance across euro area member states. The aggregate government debt-to-GDP ratio rose by around 15% in 2020, reaching respectively 95% and 102% in the EU/EA. Italian, Spanish and French public debts are going to jump by more than 20% of GDP in 2020 to reach respectively 160% (Italy), 120% (Spain) and 116% of GDP in 2020 (France). Several factors drive these divergences: the relative size and economic importance of contact-intensive sectors and the differences in fiscal space available. These differences might impact confidence, investments, and growth prospects.

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the Union European is not a state and that negative externalities - stemming from questionable national policies - should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination. Some may think that fiscal discipline

1. Keynes 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. A European study from the prior year that showed over the last 10 years a massive and spectacular increase.

2. See the Eurofi Monetary Scoreboard – September 2021.

3. See the Eurofi Macroeconomic scoreboard – September 2021.

4. According to Moody's Analytics.



is no more indispensable because of the persistence of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

Furthermore, if this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

### Thinking that monetary creation can solve the problems arising from excessive debt is an illusion

Since March 2020, Central Banks have been carrying a primary role in public debt monetization, as they purchase a large share of new public debt issuances<sup>5</sup>. In sight of the massive debt purchases, Central Banks de facto, have become the agents of fiscal policies. This “fiscal dominance” that is presently taking place puts in question the independence of Central Banks and is a major disincentive for governments to engage in the structural reforms.

Moreover, the idea that States can compensate for everything by exposing their balance sheets is unfortunately a fantasy. Indeed, it is not because budget deficits are monetised that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer’s “signature” and a key factor in the decision to buy securities by private investors, especially non-residents. As they are very sensitive to the rating, they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgments voiced by the markets actually do not matter, because the Central Bank will always be there to buy, is doubly inaccurate: the Central Bank will not always be able to buy everything, as we shall see below, and the quality of a State’s signature is an essential element of confidence that must be preserved at all costs for the country’s future.

The continuation of the monetisation of an increasing share of public debt stock and new issues would eventually promote financial instabilities and lead to a loss of confidence in the currency. The ECB cannot absorb all public debt forever. If some national Central Banks are theoretically free to monetise the entirety of their States’ public debt, the same cannot be said of the ECB, which is governed by an international treaty that prohibits the monetisation of public debt. Similarly, the

idea that Central Banks purchasing public securities could cancel their assets in order to reduce their States’ debt to zero is, in the European case, legally impossible. The subsidy to the States that would be implied by the cancellation of public debts is not compatible with the Maastricht Treaty, which prohibits the monetary financing of Treasuries.

We cannot pretend that money creation can exempt our societies indefinitely from having to face the question: “who will pay?” Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States?



### It is economic growth that eventually solves indebtedness issues

Adequate remuneration of risk, implementation of structural, supply side-oriented reforms and sustainable fiscal policies are essential to promote a return to healthy growth in overindebted countries.

The world should move gradually and cautiously towards monetary normalization, in order to avoid cliff effect. Preparing for European interest rates to return to more normal levels would also be the first step to a more productive post-pandemic period of higher growth and investment. A key condition will be ample cooperation between the monetary authorities in the leading countries, in line with standard practice not just in the 1980s and 1990s but also during the 2008 crisis.

Fostering a sustainable path to stronger growth is essential. Raising long term potential growth is of the essence to solve the indebtedness issue. This requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries in particular has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything: only domestic structural reforms can resolve structural issues and increase productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

In over indebted countries, governments must take corrective actions to ensure a path to primary fiscal balances and reduce unproductive and inefficient public spending. In Europe, reforming the Stability and Growth Pact is an urgent necessity<sup>6</sup>. It would be rational to propose that each member country should outline a specific path for reducing its public debt which would take account of specific local parameters.

5. Refer to the Eurofi Monetary Scoreboard: 72.8% of French debt issuances have been bought by the ECB in 2020. The figure reaches 90% in Germany, 78.9% in Spain, 84.1% in Austria, 112.4% in Italy, 113.9% in the Netherlands.

6. Larosi re, J., “A framework for a successor to the Stability and Growth Pact” – June 2021 (available in the Eurofi Regulatory Update - September 2021)

# A FRAMEWORK FOR A SUCCESSOR TO THE STABILITY AND GROWTH PACT

Note written by Jacques de Larosière

The issue of the rules of the European fiscal framework has been put on hold because of Covid.

This subject is far from simple. The rules of the Stability and Growth Pact have become difficult to interpret let alone implement.

Behind this difficulty, it must be understood that the subject is complex, not least because of the heterogeneity of the economic and financial situations of the Member States which has been increased by the Covid crisis<sup>1</sup>.

## Why do we need fiscal discipline in a Monetary Union?

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the Union European is not a state and that negative externalities - stemming from questionable national policies - should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

Must we abolish the numerical rules of the Stability and Growth Pact? The deficit (3% of GDP) is a hard-to-challenge safeguard in "Normal" periods". On the other hand, the limit of 60% of GDP for public debt seems both outdated and of questionable logic. This ratio varies greatly from one Member State to another and should be "personalised" on a case-by-case basis, depending on available margins and debt sustainability.

In the spirit of the recent proposal by the French Economic Analysis Council, we believe that a common framework should be maintained at European level.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

## The objectives of the fiscal framework

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 several objectives that one tries to reach. One is debt sustainability, but also many want to use fiscal policy to promote growth or the green economy. Some want to prevent or correct divergences in the monetary union, and some want to create space for cyclical stabilisation. These are all serious objectives, and it is difficult to disagree with all of 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 notably for the small countries. The EU budget provides permanent 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.

A rule adapted to certain circumstances may not make sense in another context. Over the years, attempts to pre-program all possible contingencies have led to excessive complexity while Member States have not wished to give the Commission effective powers to adapt the rules to specific situations.

## Distinguish between legitimate and abnormal fiscal heterogeneity

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 thus 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 gradually on that element.

## Better internalize the European framework in domestic systems

The framework seems more important than the precise rules, if 'rules' means a set of numbers. A set of

1. According to the EU Commission (May 2021), seven EU Member States would have their public debt exceeding 110% of GDP in 2021: Greece (208,8%), Italy (156,6%), Portugal (127,2% of GDP), Spain (116,9%), France (116,4%), Belgium (115,3%) and Cyprus (112,2%). By contrast, sixteen EU countries will keep their ratio at or below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland will see their public debt compared to GDP hovering respectively at 72,1% of GDP, 56,8% and 71% in 2021.



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.

### An adapted framework for a common discipline

As Tuomas Saarenheimo, President of the EU's Economic and Financial Committee, pointed out during an exchange of views at a Eurofi Seminar in April 2021, it would not make much sense to go back to a disciplinary system based on sanctions. The purpose should be to introduce into the European mechanisms an intelligent view of the priorities to be implemented on a State-by-State basis. That is the real challenge.

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.

### The gist of a common framework

This revised common framework should, if it is to be useful and realistic, define, on a State-by-State basis and in a medium-term perspective, the budgetary guidelines which best reflect the particular national and Community interests.

Each state would have to explain its orientation by focusing on its own priorities. The European authorities (European Commission, ESM) should regularly monitor the implementation of what would reflect the common understanding on these issues.

It should be suggested, for example, that countries with excessive government spending compared with average of the euro area, will need to focus on significantly reducing this particularity (with a well-established and monitored nominal spending standard).

Other countries will have to focus more on reducing their public debt if such reduction appears to be useful in addressing the sustainability problems of the countries concerned (debt target and primary surplus). This is important because the markets are guided more by dynamics than by absolute numbers in determining country spreads. If we accept that monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalization policy. From this point of view, the updated fiscal rules should include special monitoring of the primary balance by prohibiting primary deficits.

More generally, the quality of public spending must be given more importance than its quantity. We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – nonproductive expenditure – represent almost all public expenditure.

In this respect, a country like France, which holds all records of public spending relative to GDP, devotes only a small amount of resources to productive public investment. Absorbing 55% of GDP to finance the “end of the month” is much more serious in itself than if much of it were spent on public investment. The new European mechanism will have to take this into account. In this perspective, putting in place early warning mechanisms to prevent unsustainable public finance trajectories would be also required. Indeed, a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline. It is more serious to reach 55% of public expenditure on GDP (before Covid) when the European average is 8 to 10 percentage points lower, than to have public debt above 60%.

As Commissioner Gentiloni pointed out: “Fiscal policy should ensure a composition of public finances that is both growth-friendly and sustainable. A special treatment for growth-enhancing expenditure would be helpful.... Or to put it another way, our fiscal rules should be adapted to improve the composition of public finances and make sure that any new debt is good debt”.

The idea would be to achieve a mechanism that is sufficiently adapted to the problems – by definition different – of each of the Member States, by establishing common standards under European supervision.

The proposals to entrust an independent European Budget Committee with responsibility for defining the concept of sustainability as well as the debt target and growth assumptions seem excellent.

### Transitional aspects

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 framework 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.



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

Experience has shown that many States had not complied with the Pact. The following lessons must be learned:

- Rules are needed;
- They must be “personalized” (country by country);
- The methodology used must be indisputable.

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

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

# MACROECONOMIC SCOREBOARD: REVIEW OF THE ECONOMIC PERFORMANCE AND FISCAL POLICIES OF EU MEMBER STATES

Note written by Jacques de Larosière and Didier Cahen  
with the support of Elias Krief and Lea De Greef

This Eurofi Scoreboard highlights four key economic issues faced by EU Members States:

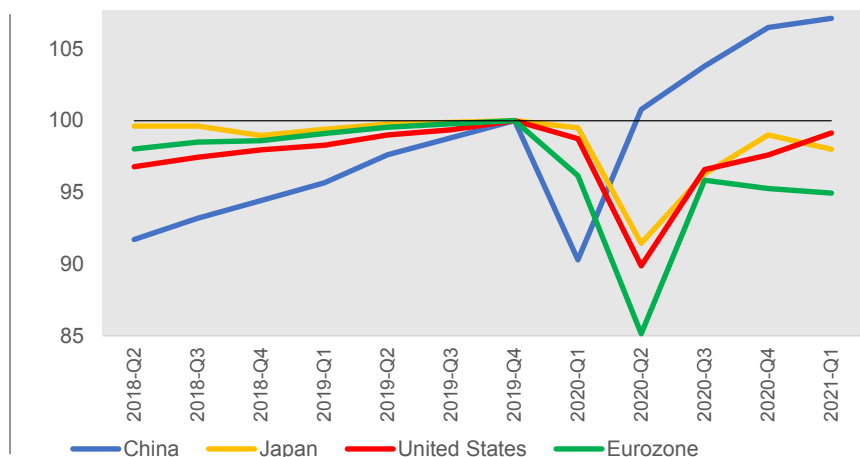
- First, the Covid-19 crisis has widened the economic gap between the euro area and its main international competitors;
- Second, the Covid crisis has exacerbated the existing economic and fiscal heterogeneities across EU Member States;
- Third, EU countries with the highest level of government expenditure as a percentage of GDP are those with the least competitive firms;
- Fourth, excessive public debt does not boost growth and employment.

## 1. The Covid-19 crisis has widened the economic gap between the Euro Area and its main global competitors

### 1.1 The economic crisis has been more severe in Europe than in the US, China and Japan

In 2020 the eurozone GDP fell by 6,8 percent, nearly twice as much as the US (-3,4 percent). Japan (-4,8%) and China (+2,5%) have also experienced a lower output fall.

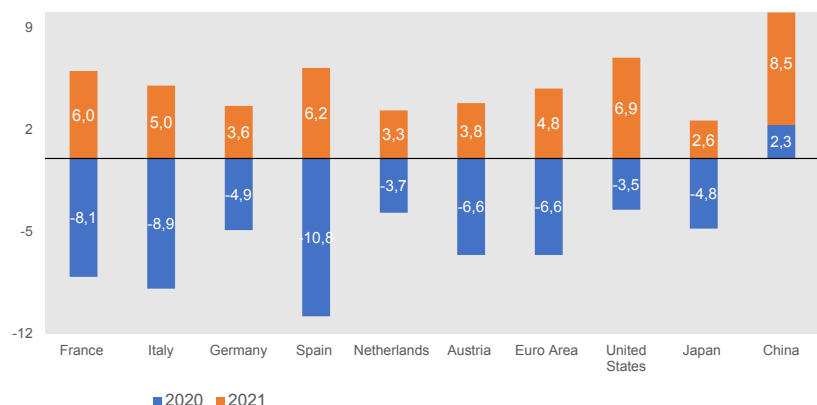
**CHART 1.**  
**Real GDP Growth**  
**Q4 2019=100, Percentage**  
**Change from previous quarter**  
  
*Source: OECD*



### 1.2 Europe will be slower to recover than the United States

The rebound in growth of the Eurozone in 2021 is forecast to be only 4,8% against 8,5% in China and 6,3% in the United States according to the European Commission and the OECD.

**CHART 2.**  
**Real GDP Growth,**  
**% Annual Change**  
  
*Sources: AMECO Summer*  
*Forecasts, OECD*  
  
*Note : 2021 Forecasts for Japan,*  
*the US and China are taken*  
*from the OECD Economic*  
*Outlook of May 2021*



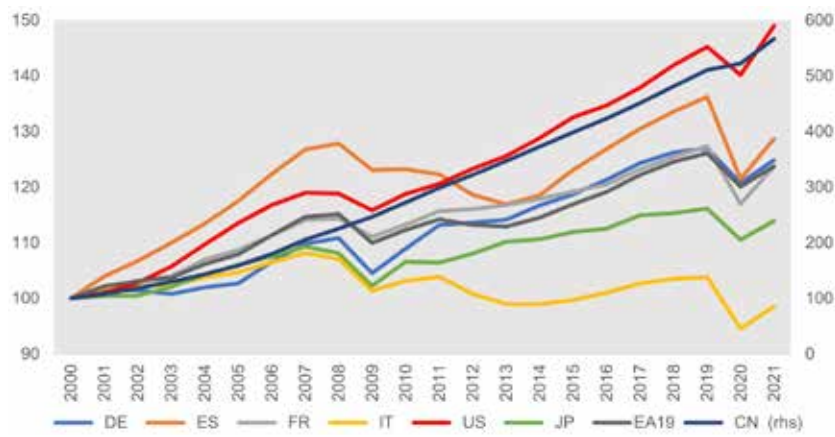
In July 2021, the European Commission revised upwards its growth forecasts for 2021 and 2022: Eurozone GDP is expected to grow by 4,8% this year, up from 4,3% in May 2021, and by 4,5% in 2022, up from 4,4% in May.

### 1.3 Over the last few decades, real GDP growth in the Euro Area has failed to catch up with the US and China

From 2000 to 2007, the EU economy (excluding Britain) grew by a decent 2,1% per year in average while America's grew by 2,5%. Between 2014 and 2019 the Euro Area GDP growth averaged 1,5% per year, against 2,4% in the US and 7% in China. The bulk of lagging Euro Area performances is mainly attributable to Italy (0,4%) in particular.

**CHART 3.**  
**Real GDP Growth, 2000=100**

Source: AMECO



## 2. The Covid-19 crisis has exacerbated existing economic and fiscal heterogeneities across the EU Members States

### 2.1 The most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020

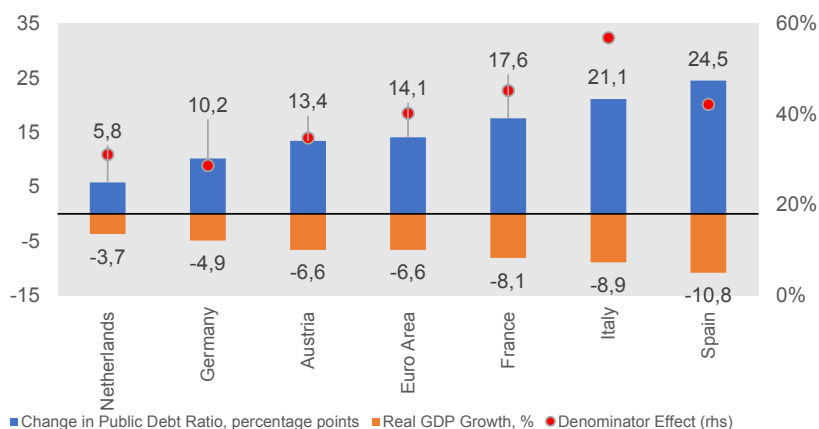
During the post-financial crisis period, the public debt ratio of Spain, Italy and France has kept rising. Between 2012 and 2019, France increased its public debt in relation to GDP from 90% to 97%; Italy's jumped from 126% to 136%, and Spain's rose from 86% to 95%.

The continuous rise of public-debt-to-GDP ratio is due to the accumulation of yearly fiscal deficits. As shown in Chart 6, the average deficit of France and Spain has been exceeding 3% of GDP, the threshold of Maastricht fiscal rules between 2013 and 2019. At the opposite of Italy, the two countries have not even delivered any positive primary surplus since 2002 for France and 2008 for Spain (see Chart 7 in section 2.2). Their primary deficit reached 1,6% of GDP and 0,8% respectively, while even Italy secured a surplus before paying interests at the same year (1,6%).

During the Covid-19 crisis, Spain, which has been the most severely hit in terms of output lost, registered the highest increase of its public-debt-to-GDP ratio (+24,5 percentage points, against 14,1 pp for the euro area). Italy and France follow, as their GDP fell by 8,9 percent and 8,1 percent in 2020, and their public debt grew by 21,1 and 17,6 pp respectively (see Chart 4).

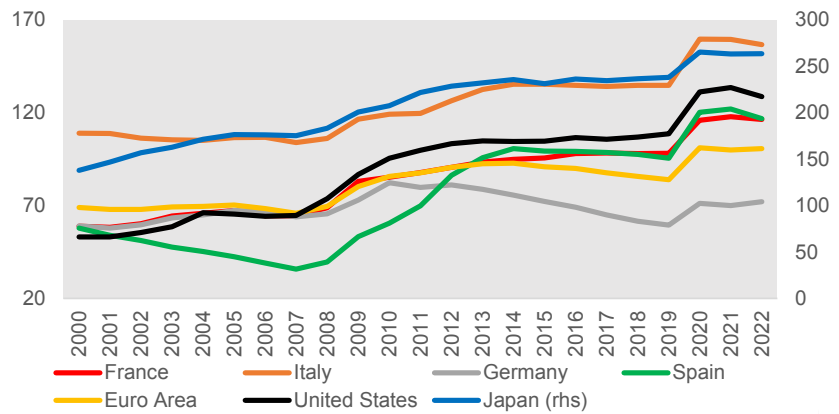
**CHART 4.**  
**Real GDP Growth, Change in Public Debt Ratio and Denominator Effect, 2020**

Source: AMECO



**CHART 5.****Gross Public Debt  
in Selected Advanced  
Economies, % of GDP**

Source: AMECO



However, about 40% of the surge in public-debt-to-GDP ratio in 2020 is due to the fall of GDP by itself in the euro area. For instance, taking into account the “denominator effect”, 42,1% of the rise of the Spanish public debt ratio is related to the fall of GDP. The figure reached 56,8% in Italy -the highest level in the eurozone- and 45,1% in France. It accounted for 31,1% in the Netherlands, 28,6% in Germany 34,7% in Austria.

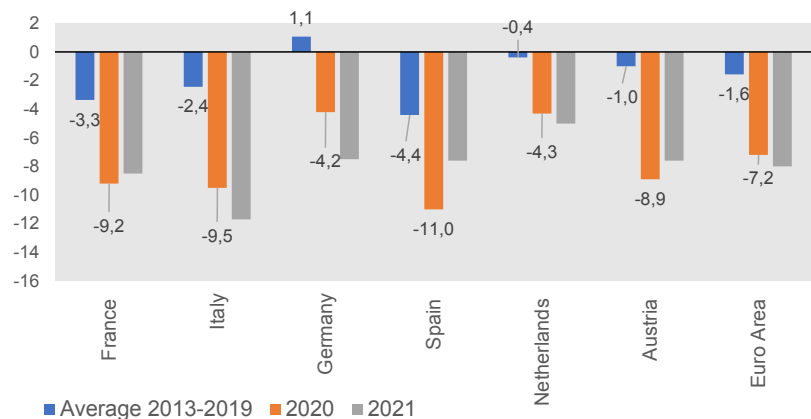
## 2.2 By contrast, the EU countries that have best managed their public finances after the Global Financial Crisis (2008) and the EU Sovereign crisis (2011-13) are those that have suffered the least from the Covid-19 shock

In 2019, the Netherlands and Germany, after several years of efforts to reduce their public deficit and debt, brought back their public finances in line with the EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of 1,2% and 0,04% of their GDP, respectively. Such fiscal efforts allowed them to gradually reduce and stabilize their public debt, at respectively 59,6% and 48,7% of GDP in 2019, from 81,1% and 66,7% in 2013. Austria also made such efforts over that period, contributing to reduce its public debt burden by nearly 11pp to 70,5% of GDP in 2019.

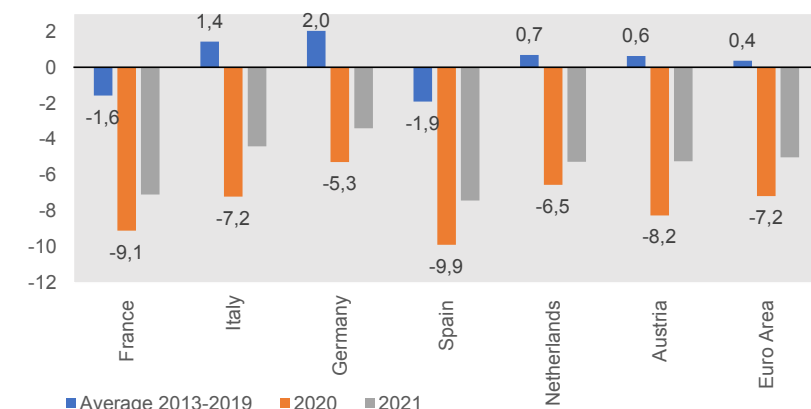
Thanks to the fiscal discipline hold since 2013, Germany and the Netherlands have much contained the shock induced by the Covid-19 crisis. At 4,2% of GDP and 4,3% respectively, their 2020 public deficit has remained mainly below the Eurozone average of 7,2%. This dynamic contrasts with the close to double-digit levels France (-9,2% of GDP), Spain (-11%) and Italy (-9,5%) have experienced during the crisis (see Chart 6).

**CHART 6.****General Government  
Budget Balance;  
% of GDP**

Source: AMECO

**CHART 7.****General Government  
Primary Budget Balance;  
% of GDP**

Source: AMECO



### 2.3 For 2021, a greater fiscal heterogeneity is expected across the EU members in terms of public-debt-to-GDP ratios

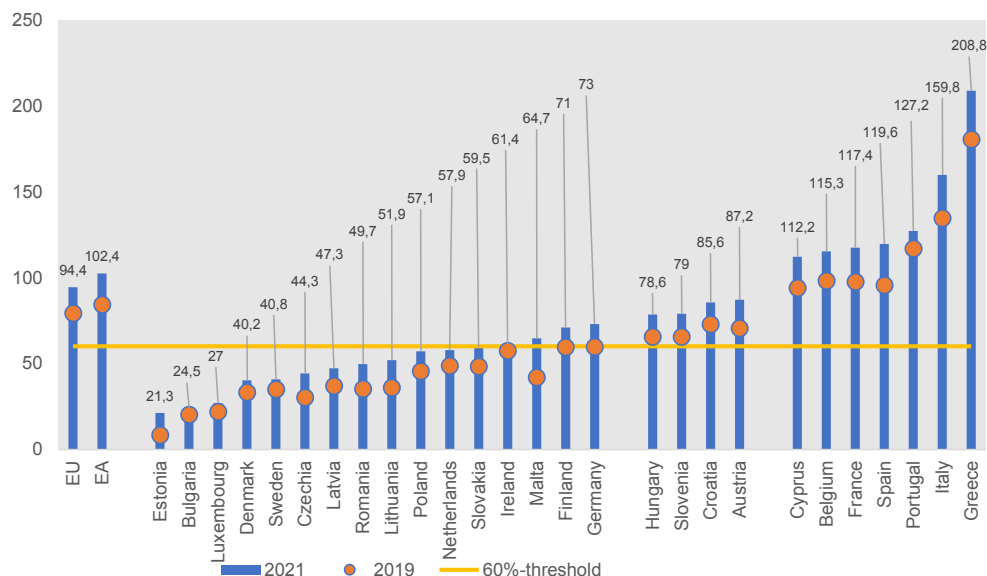
The ratio is set to end up ranging from 21,3% of GDP in Estonia to 208,8% in Greece. Within this range, two groups of countries can be distinguished in the European Union (see Chart 8).

A first group contains seven Member States that will have their public debt to remain above 110% of GDP in 2021-22. With Greece, it is forecast to remain above 150% of GDP for Italy (156,6%) and above 110% for Portugal (127,2% of GDP), Spain (116,9%), France (116,4%), Belgium (115,3%) and Cyprus (112,2%).

On the other hand, sixteen EU countries will keep their ratio at or below 75% of GDP in 2021. Among them, Germany, the Netherlands will see their public debt hovering at 72,1% of GDP, 56,8% in 2022, respectively. Within this second group, twelve countries will still maintain a level of public debt in line with the Maastricht threshold limited to 60% of GDP.

**CHART 8.**  
**Gross Public Debt**  
**of EU Member**  
**States,**  
**% of GDP**

Source: AMECO



### 3. Countries with the highest level of government expenditure as percentage of GDP are those with the least competitive firms

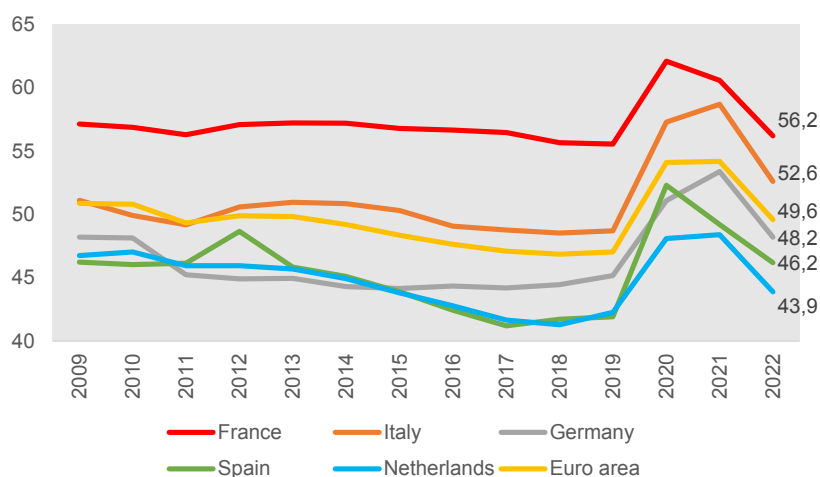
#### 3.1 With 55,6% of its GDP in 2019, France holds the record in terms of level of public spending in the EU

Finland (53,2%) and Belgium (52,1%) follow, as the only countries whose public expenditures to GDP ratio exceed 50% of GDP. By contrast, the level of public expenditures in Germany, Netherlands, Spain and in 16 other EU Member States has remained below the euro area-average of 47% of GDP in 2019 (see Chart 9).

**CHART 9.**

**Evolution of Public**  
**Expenditures,**  
**% of GDP**

Source: AMECO Projections



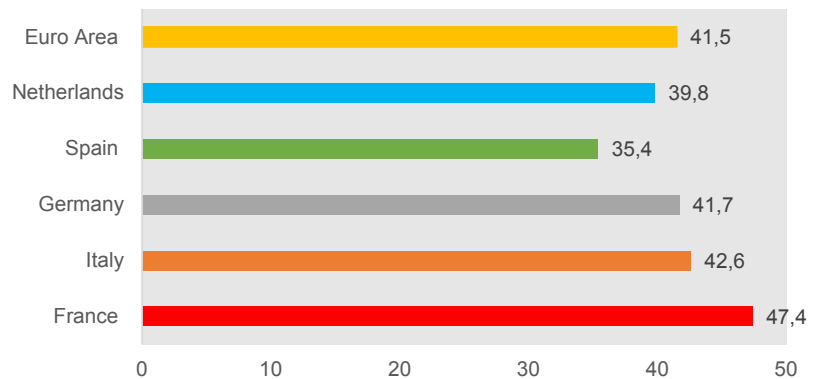


### 3.2 High levels of public expenditures imply high tax pressures on firms, lifting their production costs and so deteriorating their competitiveness

France is leading the Union. Its current tax burden – or amount of tax and social contributions collected on firms and households<sup>1</sup> – accounted for 47,4% of GDP in 2019. That is nearly six percentage points higher than the Euro Area average (see Chart 10).

**CHART 10.**  
**Current Tax Burden in 2019, % of GDP**

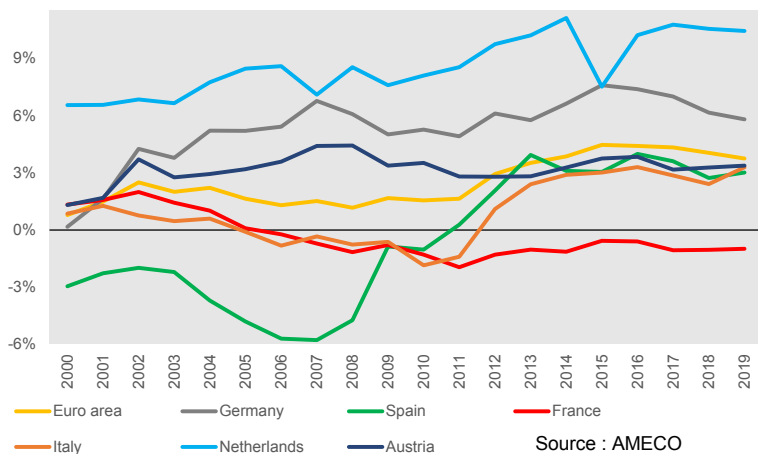
Source: AMECO



High taxation contributes to erode the competitiveness of domestic firms. In this respect, France has been suffering of a permanent deficit of its current account balance since 2007 (see Chart 12). Within the EU, eight other Members experienced a negative current account balance in average between 2013 and 2019. Among them, Cyprus has the highest deficit (-3,7% of GDP), followed by Romania (-2,3%) and Greece (-1,5%) in particular.

**CHART 11.**  
**Net Exports, as % of GDP**

Source: AMECO



Source : AMECO

**CHART 12.**  
**Current Account Balance, % of GDP**

Source: AMECO



1. The current tax burden of total economy is the sum of indirect taxes (VAT, imports production), direct taxes (income and wealth) and social security contributions (actual and imputed), according to the AMECO definition.

### 3.3 Most of the public expenditures are allocated to social protection, health and public services instead of productive investment

In average, the EU members allocated nearly 42% of their public expenditures to social protection in 2019, totaling 19,8% of GDP. As percent of GDP, France provides the second highest share, with 23,9%, behind Finland (24%). It is followed by Denmark (21,4%) and Italy (21,2%). Health is another most prominent function of public spending in the EU (15% of total expenditure in 2019), then followed by general public services (12,4%).

**TABLE 1.**  
*Major Functions  
of Public Expenditures  
of Selected EU Member States,  
% of GDP (2019)*

Source: Eurostat

	General public services	Health	Education	Social protection	... Total
Euro Area	5,8	7,2	4,6	19,8	47,0
Italy	7,5	6,8	3,9	21,2	48,7
France	5,5	8,0	5,3	23,9	55,6
Germany	5,7	7,4	4,3	19,7	45,2
Spain	5,5	6,1	4,0	17,4	42,3
Netherlands	4,1	7,7	5,0	15,4	41,9
Austria	5,7	8,3	4,8	20,1	48,4

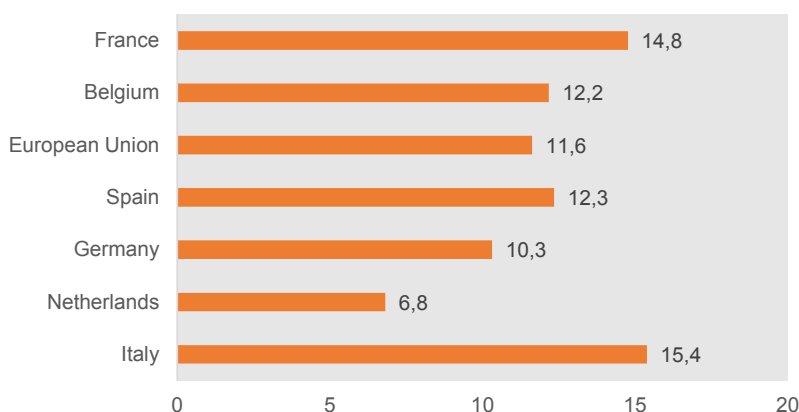
Considering the determinants of health expenditures, public pensions account for the highest proportion. At 11,6% of GDP in the EU in 2019, its level is mainly linked to the average effective labor market age. Excluding Italy, the earlier working-age people retire, the higher is the level of pensions expenditures in most EU countries. Having one of the lowest average labor market exit age in the EU (62,3), France spends the most on pensions schemes, representing 14,8% of its GDP in 2019, compared with 11,6% in the EU average. The issue is even more worrying in the context of ageing demographics, at which a growing number of elderlies will face a declining working-age population. By 2025, the share of 65+ in total population is projected to increase by 2 points to 22,3% in France, while the prime-age population ratio (25-64) will fall to 36%, from 37,5% in 2019 according to Eurostat.

Considering the case of Italy, the pension system remains one the most onerous for the government in terms of GDP despite the relatively high average effective labour exit age in the EU. There are three key reasons for this situation:

- **The generosity of the system:** the replacement rate - or percentage of an individual's annual employment income that is replaced by retirement income when they retire - was 20 pp higher than the EU average in 2019 (66,9% in Italy against 46,2% in the EU).
- **The persistent low level of employment rate:** In 2019, 59,1% of the 15-64 were employed. This is the second lowest employment rate in the EU, just 3pp above Greece (56,3%), and 12pp below the EU average (68,4%).
- **The population ageing problem.** The Italian downward demographics trend is one the most salient in the EU. In 2019, 23% of the Italian population was aged 65 or over. This is the highest level in the EU (20,4%). This figure contributes to further deteriorates the old-age dependency ratio - the number of dependents aged over the age of 65, compared with the total population. At 58,5% in 2019, the ratio is projected to reach 70% by 2030.

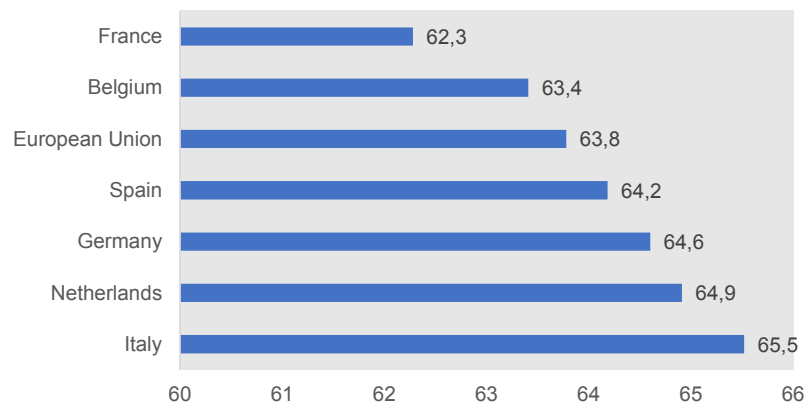
**CHART 13.**  
*Gross Public Pensions,  
as % of GDP  
in 2019*

Source:  
European Commission



**CHART 14.****Average effective  
labour market  
exit age,  
2019**

Source:  
European Commission



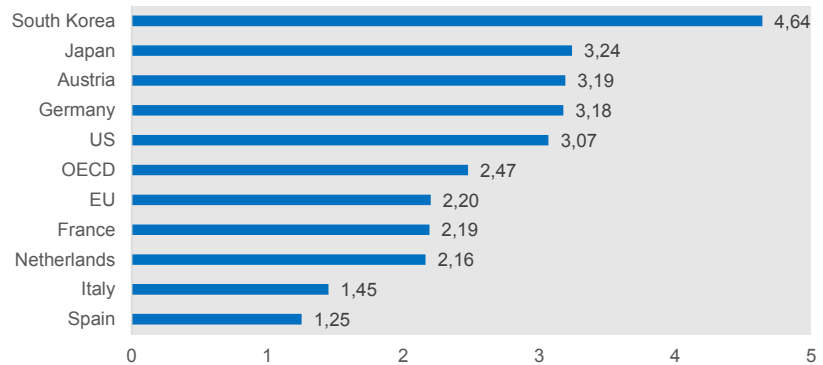
**Such levels of public expenditures may have been done at the expense of productive investment, hence negatively contributing to the formation of gross capital formation.**

As share of GDP, public investment has not exceeded 4% of GDP in Europe since 2010. Investment in Research and Development is also a concern. On this issue, most of EU members dedicate less of their spending than the OECD average (2,5% of GDP in 2019). Only Germany and Austria stand out, with levels close to the US and Japan (see Chart 15).

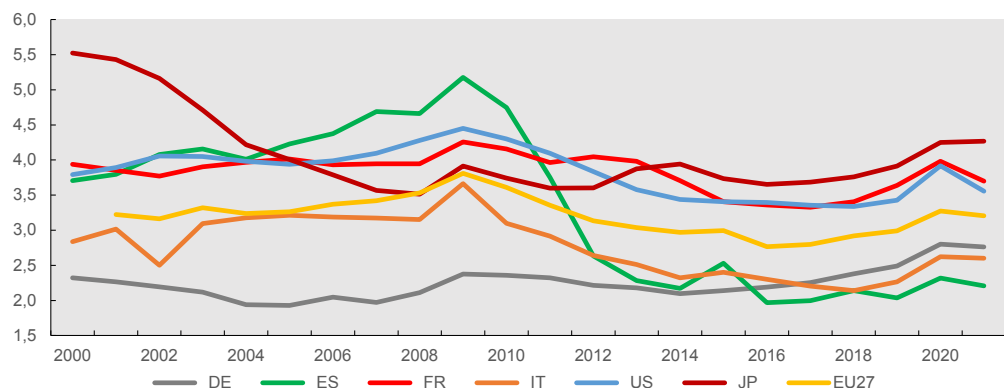
**CHART 15.****Gross domestic  
spending on R&D,  
% of GDP (2019)**

Source: OECD

Notes: Gross domestic spending on R&D is defined as the total expenditure (current and capital) on R&D carried out by all resident companies, research institutes, university and government laboratories

**CHART 16.****Gross fixed  
capital formation  
of public sector,  
% of GDP**

Source: AMECO

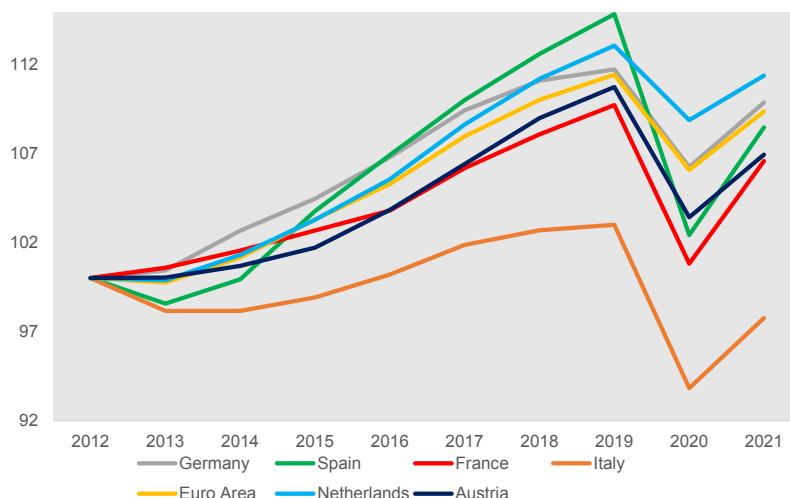


#### 4. Excessive level of public debt does not fuel GDP growth and employment

##### 4.1 The most indebted countries, as France and Italy, have achieved the lowest growth performance of the eurozone since 2013

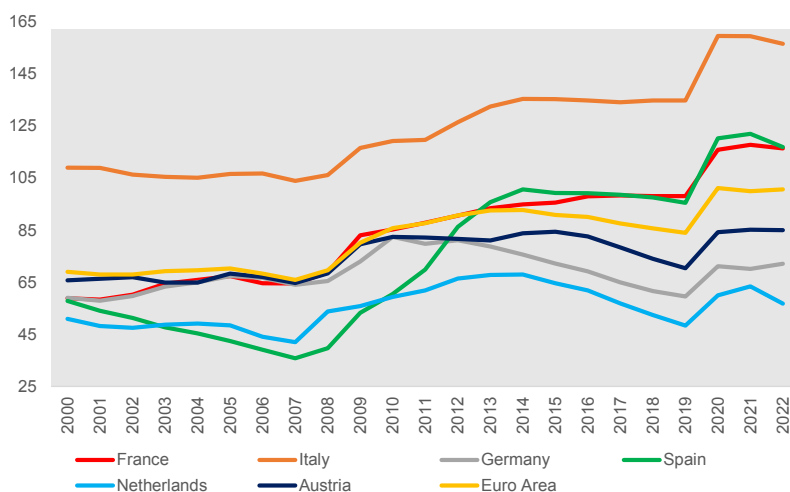
**CHART 17.**  
**GDP growth performance**  
**of Selected Eurozone**  
**Countries,**  
**2012 = 100**

Source: AMECO



**CHART 18.**  
**Evolution of**  
**Public-Debt-To-GDP ratio**  
**of Selected Eurozone**  
**Countries, %**

Source: AMECO

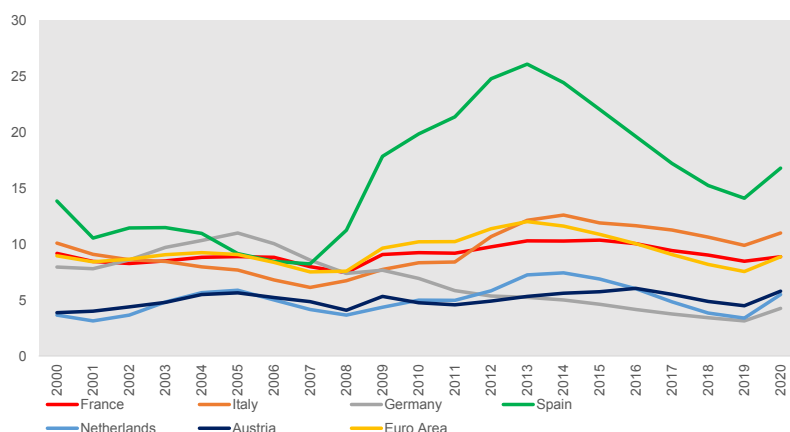


##### 4.2 The most indebted EU Members have experienced a double-digit level of unemployment rate since 2007, as Spain (14,5% in 2019), Italy (9,9%) and France (8,5%)

Although French's unemployment rate declined slowly below 9 per cent until 2019, massive unemployment reveals a key structural labor market problem. The three selected countries are among those with the highest share of long-term and young unemployment rate. With 40% of the youth population in January 2021, Spain has the highest share of 15-24 years unemployed in the EU, followed by Greece (34%) and Italy (29%). Despite the record-high share of spending allocated to education and formation (5,3% of GDP in 2019, against 4,7% in the euro area), France is also mainly concerned (18% of youth unemployment rate, against 16,9% for the euro area). **Such high level in public expenditure may thus reveal the lack of domestic structural reforms.**

**CHART 19.**  
**Unemployment Rate,**  
**as % of Total Labor Force**

Source: IMF

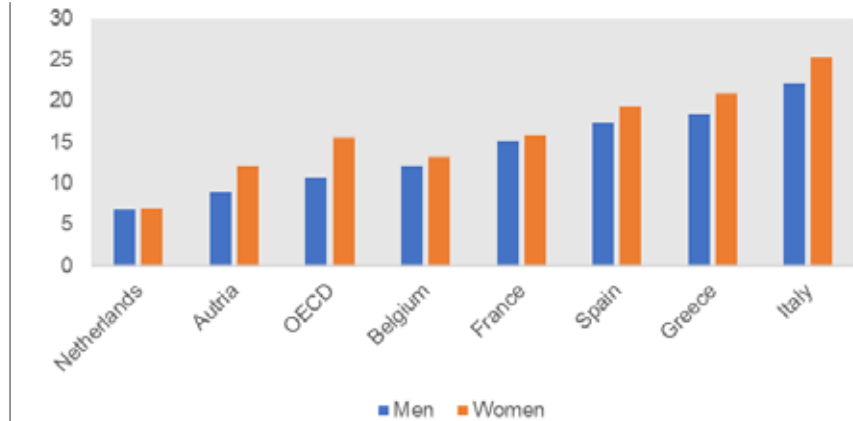


In 2019, 57% of the Italian unemployed people were in the situation of long-term unemployment<sup>2</sup>. France and Spain follow, with 38,8% and 37,1% respectively.

The significant share of youth unemployment rate in some EU countries reveals the existing difficulties in joining the labor market. Such failures favor the proliferation of the 'Neet' phenomenon, made of youth that are neither in employment, education or training. In Italy, more than 3 million young people aged between 15 and 34 are in this situation, the highest share among European Union countries.

**CHART 20.**  
**Share of 15-29**  
**in NEET situation,**  
**% (2019)**

Source: OECD



2. People staying unemployed for at least twelve consecutive months (OECD definition).

# IMPORTANCE OF SUPPLY SIDE POLICIES

Speech delivered by Jacques de Larosière\*

I will divide my remarks in 3 heading:

1. The present policy mix;
2. The importance of structural reforms;
3. The impact of the absence of a proper international Monetary System.

## 1. The issue of the policy mix

The art of macro-economic policies is to achieve a strong and balanced growth rate (i.e. combining the highest possible GDP compatible with least inflation).

This requires a proper combination ("mix") of:

- Fiscal;
- Monetary policy;
- And the right incentives to promote an increase in potential growth (supply side measures).

To cope with the existence of economic cycles, policies have to be adapted (stimulus in recession, contractionary monetary policy in case of overheating).

But the advanced countries have not been very good at managing the cycles over the past decades.

To simplify, one can observe the following episodes:

- a) During the 60's, the advanced countries were running faster than what capacity should normally have allowed. Therefore, inflation started to emerge.
- b) During the 70's, the fight against a soaring inflation became predominant and the high price increases in the 70's (double digit inflation) led to a policy mix where the slack (the room left between actual growth and potential) translated in higher unemployment.
- c) In the mid 80's Central Banks became more independent and were proud of the "great moderation" in terms of inflation.

But the world economy got more and more dependent on borrowing. In other words, the actual growth rate (albeit more subdued than it had been in the 60's) was fueled by more and more leveraged financing (the rate of growth of financing was twice the economic rate of growth).

- d) This "over financialisation" of the system was largely due to 2 factors:
  - Insufficient structural measures to boost productivity,
  - Accommodative Monetary Policy (that ended up in asset bubbles).

This combination led, eventually, to the 2007-2008 crisis.

The last 10 years were characterized by:

- Low – CPI – inflation (less than 2%);
- Sluggish growth;
- Extreme leverage and asset bubbles which are the harbingers of future financial crises.

e) After the pandemics that struck in the spring of 2020, a new shock on growth emanated followed the lockdown imposed by governments to mitigate health problems.

This has led to a severe hit on growth (the US economy contracted by -3,5% in real terms in 2020).

And this time, the reaction of the policy mix **has been particularly strong**, notably in the US.

- **Monetary Policy** has been extremely accommodative:
  - Large buying of securities by the Fed and the European Central Bank;
  - Interest rates close to zero.
- **And fiscal Policy** has literally exploded.

The 900 Billion \$ fiscal plan of end 2020 (equivalent to 4,5% of GDP) is being supplemented by the 1900 Billion of the Biden Plan (9% of GDP).

How can we assess this policy?

- In 2021 the US would grow by +5%;
- It is an ambitious plan that errs on the "safe" side of the equation : i.e.:  
*"Do as much as possible, and even more";*
- If one adds the overhang of "forced" savings that accumulated during the pandemics, which, in part, will be run down for consumption purposes, one can expect a significant overheating in the latter part of 2021 and in 2022 with a – perhaps temporary – rebound in inflation, which the markets are anticipating.

The determination of the exact inflationary impact of this present policy mix is a difficult exercise.

Indeed the "output gap" that expresses the slack in the economy is hard to measure (it depends on models used – to build a potential growth calculation) and on the choice of the right multiplier coefficients to gauge the final impact on demand of fiscal measures.

\* \*

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So, we are about to live a new episode of the bumpy history of our policy mix as it can be observed over half a century: what if inflation were to re-emerge after 20 years of moderation?

## 2. The insufficiencies of structural reforms

Let me explain this subject that is at the heart of all economic issues.

Over the last two or three decades, stimulating demand has been the name of the game.

But this has been to the detriment of supply side economic reforms.

When we consider the output gap we tend to equate unused capacity to unemployment, while we should be looking also at the other ways (than reducing unemployment) of boosting productive opportunities.

Among those ways, **productivity gains and investment have been, too often, the neglected orphans.**

Actually, global productive investment has **declined** by 3 percentage points of GDP over the last 10 years while the need for investment is rising and this in spite of very low interest rates.

So we should focus on all factors that influence production such as : demography, competition, labor/ market flexibility, fight against excessive bureaucratic complexity and inefficiency, reducing obstacles to new entrants on the markets, not protecting zombie companies that only survive because of low interest rates ...

We must understand that all policies that contribute to shaping an efficient eco-system are thus crucial. If they are neglected, reasonably good employment could well coexist with economic inefficiency and poor productivity, which therefore would entail long term economic decline.

Therefore, if we want – as we should – to eliminate the negative output gap, we have to look at supply side factors as well as demand related ones. Fostering the potential growth element is as crucial as stimulating demand.

**If you look at Japan** – which is a caricatural example of the lack of structural measures, what do you see ?

A very rapid ageing of the population accompanied by a fall in birth rates. This ends up in a shrinking labor market.

And to face that situation, instead of opening Japan to reasonable immigration (which would be a powerful way to revive the labour markets), the Government has engaged in a policy of no immigration and of abundant liquidity creation accompanied by zero interest rates.

This liquidity has not seeped into the real economy nor has it been invested in capital equipment (because of the economic stagnation linked to demography). It has been

hoarded and kept in liquid riskless placements (Treasury bonds). Who would invest in risky assets with no return?

The result of this very accommodative monetary and fiscal policy in Japan has been:

- Huge increases in the BOJ balance sheet (120% of GDP – 3 times US: US = 40%);
- Large public deficits: public debt = 260%/GDP (world record);
- And no growth;
- But the weakening of the financial system is apparent: zero interest rates cannot ensure a minimum margin for financial institutions and investors.

\* \*

\*

My point can be summed up as follows:

Structural issues can only be solved by structural measures: simpler regulations, immigration policy, birth rate incentives, fiscal incentives to invest, ...

But the problem is this one:

The following diagnosis has been made:

*« Keynesian stimulus will repair the sluggish global demand and unlock the savings glut ».*

But the diagnosis as well as the medication proposed are both, in my view, misconceived:

- First in a long-term perspective, it is not so much the lack of consumer demand that is the problem, but the lack of investment and of productivity gains.
- Second, throwing more money at these structural issues is of no help. It pushes up leverage but does not end up in more investment (because the absence of remuneration on risky capital investments encourages savers to keep their money in liquid forms).

**So my conclusion is simple:**

- Structural problems call for structural solutions;
- The mistake is to believe that the sluggish global demand can be corrected by monetary and fiscal stimulus;
- The “secular decline” is more the result of structural weakness (ageing) or of globalization than a conjunctural lack of demand;
- The savings glut is in part the result of monetary policy and pushes households to save more (0 interest rates foster liquidity hoarding);
- Zero interest rates are a disincentive for structural reforms (since Governments can raise billions at no cost).

\* \*

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### **3. The absence of a proper international monetary system compounds the macro economic issues**

**The Bretton Woods system was, in fact, a source of macro-economic discipline**

Exchange rates were fixed to the dollar. If the 1% corridor around the \$ was exceeded, a country had to ask permission to the IMF to devalue.

Therefore, macro-economic behavior had to be restored (Fund conditionality).

**The system broke down in 1971-73**

When the US abandoned the gold convertibility of the \$ because of their deficits (Vietnam war, Welfare State) and the accumulation of dollars by foreign Central Banks, the US gold reserves were not enough to ensure the convertibility of the dollar.

The result was: exchange rates are free to float.

And the way out was: "borrow" nationally and don't mind about the exchange rate.

**Since the 70's**

The system has been replaced by more and more leverage ... And the crises flourish. But we see now that the exchange rate has become a fear or a threat for all countries. Risk of "beggar your neighbor" and trade wars.

We need a form of discipline.

*\* Speech delivered in May 2021 by Jacques de Larosi re on the occasion of the Seminar organised by Professor Steve Hanke and his John Hopkins students.*



# **2**

## **THE EU BANKING LANDSCAPE**

BANKING FRAGMENTATION ISSUES IN THE EU .....	25
THE CONDITIONS TO BENEFIT IN THE EU FROM THE DIVERSITY OF BANKING MODELS .....	35

# BANKING FRAGMENTATION ISSUES IN THE EU

Note written by Didier Cahen, EUROFI

While we have come a long way since the establishment of the Single Supervisory Mechanism (SSM), the Banking Union is far from complete. An efficient banking Union would break the sovereign- bank vicious circle, foster a more effective allocation of resources across the Eurozone (e.g. companies would be able to tap wider and cheaper sources of funding in all parts of the euro area), and help to achieve a better diversification of risks thus contributing to private risk sharing within the Union.

Despite the challenges faced in recent years, many European countries' banking systems remain oversized and still have surplus capacity. Bank profitability continues to be hampered in Europe by overcapacity and a competitive environment, with revenues under pressure not just from their peers but also from new entrants from outside the sector, such as fintech companies. In addition, international or cross-border consolidation processes have been few and far between, and this pattern has not changed since the launch of Banking Union.

The limited strength of private risk-sharing channels in the euro area reflects both the underdevelopment of capital markets and a highly segmented banking system at the national level. There is little progress in cross-border lending, especially in the retail markets, or in other words, in lending to households and firms. Expanding this foreign activity would be important for the sound working of the euro area.

Consolidation through mergers and acquisitions is one way of tackling structural problems, by helping to unlock economies of scale and diversify revenues. Little progress has been made on this front over the past few years within the EU, with only a small number of – mainly domestic – deals taking place.

## 1. The Banking Union is failing to provide the expected degree of financial integration

The existence of the SSM and the SRM have not had any marked impact on the banking industry's structure in Europe. Indeed, the banking sector in Europe is too fragmented along national borders, not concentrated enough if we take a pan European view<sup>1</sup> and oversized.

### 1.1 A fragmented banking landscape in the European Union

Indicators are continuing to signal banking fragmentation in Europe. The share of cross-border loans to households and cross-border deposits from households remain negligible at around 1% (see Chart 2). Direct cross-border loans to firms accounts for only around 8% and this figure has hardly changed since the creation of the Banking Union (see Chart 1).

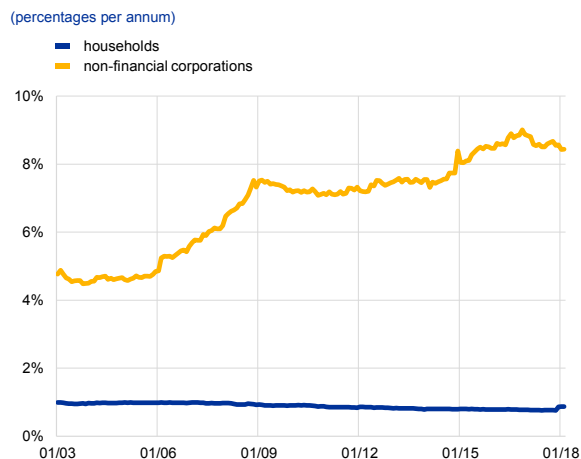
**1.1.1 The share of cross-border deposits in the euro area from firms is also very low (around 6%) and has fallen slightly over the last few years. The level of foreign bank penetration is, overall, relatively low for a Banking Union**

CHART 1.

**Share of cross-border loans in the euro area for NFCs and households**

Source: ECB (BSI)

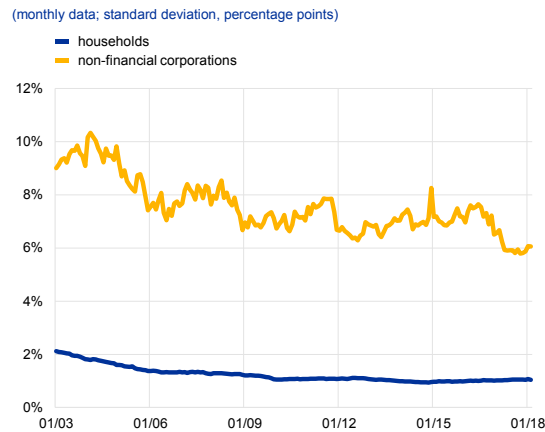
Note: Cross-border loans include loans to other euro area Member States for all maturities and currencies



1. In some individual Member States it can be very concentrated already, this is why purely national consolidation will reach a limit at some point.

**CHART 2.****Share of cross-border deposits in the euro area for NFCs and households**

Source: ECB (BSI)

**1.1.2 Sovereign bank nexus on the rise**

Moreover, despite the quantitative easing policy of the ECB, the doom loop between banks and their sovereigns is far from being resolved.

According to the ECB, between January 2020 and September 2020, euro area banks' exposures to domestic sovereign debt securities have risen by almost 19% in nominal amount – the largest increase since 2012<sup>2</sup>.

The share of total assets invested in domestic sovereign securities varies across countries. At the end of September 2020, it was equal to 11,9% for Italian banks and 7,2% for Spanish banks, but close to 2% for French and German banks (see Chart 3 below).

**CHART 3.****Euro Area Banks' exposures to domestic sovereign debt relative to total assets**

Source: ECB Financial Stability Review of November 2020

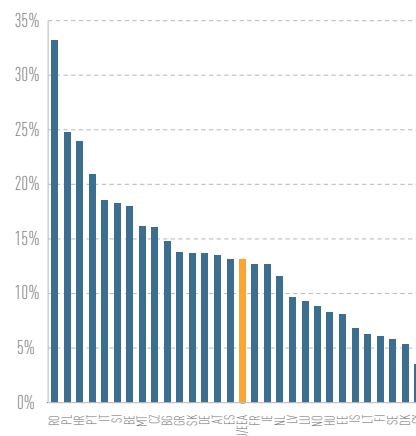
Note: Latest data from September 2020



The EBA report on the "Risk assessment of the European banking system" (December 2020) stated that in June 2020, sovereign exposures were close to 13% of the total assets. Banks in central and eastern European (CEE) countries and southern Europe generally reported a higher ratio of sovereign exposures to total assets than, for instance, their peers in the Nordic countries (see Chart 4).

**CHART 4.****Sovereign exposures as a percentage of total assets by country, June 2020**

Source: EBA Risk Assessment of the European Banking System based on Supervisory reporting data, December 2020



2. ECB, Financial Stability Review, November 2020, page 60.



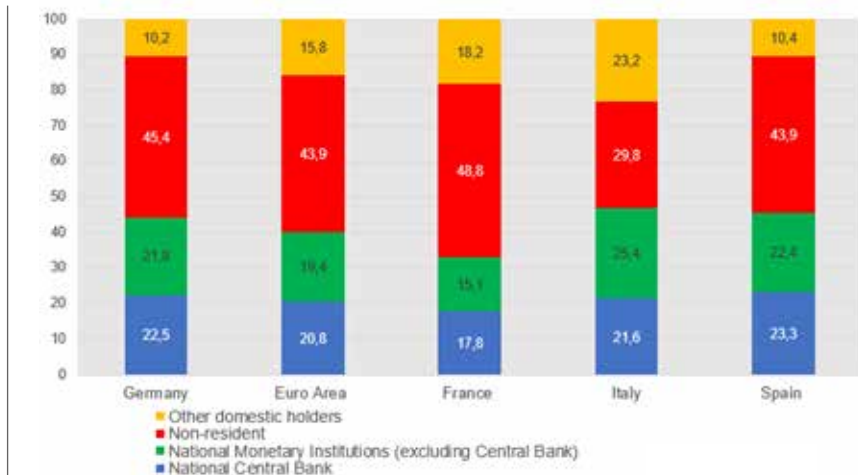
In addition to direct sovereign exposures, the loan guarantee schemes set up in many countries to support lending to the real economy during the pandemic potentially reinforces the sovereign-bank loop. Although the amount publicly guaranteed loans is comparatively low (EUR 378bn in March 2021 vs EUR 3.2tn of sovereign exposures in December 2020), these are concentrated on a few EU countries. Nonetheless, in contrast to direct sovereign exposures accounted at fair value through P&L or through other comprehensive income, or held for trading, publicly guaranteed loans are not subject to mark-to-market adjustments that might end up affecting banks' capital levels.

### 1.1.3 Sovereign-Central Bank loop is reaching significant levels

The asset purchase programs of the ECB mainly have contributed to this dynamic since 2015. Indeed, the share of government debt held by the National Central Bank has almost tripled in Italy and Spain between 2015 and 2020. As of December 2020, nearly 21,6% and 23,3% of the government debt was held by the Italian and Spanish Central Bank respectively (see Chart 5), from 7,5% and 8,3% in 2015.

**CHART 5.**  
**Holders of government debt in 2020**  
**(% of Total Government Debt)**

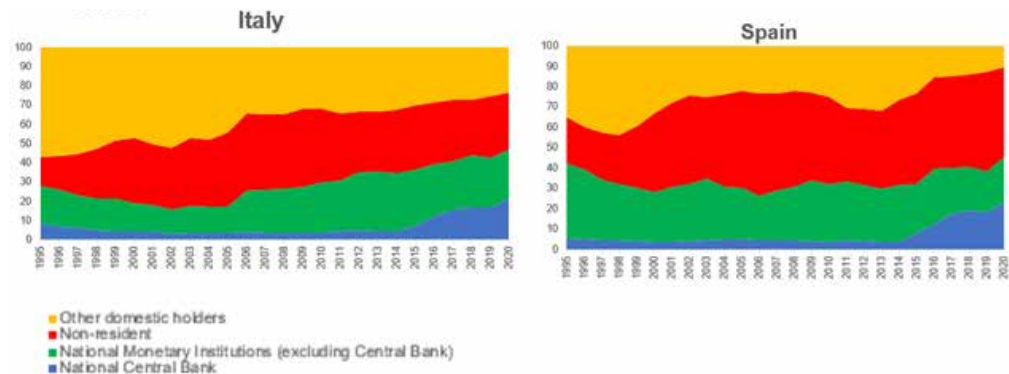
Source: ECB



Over the past decade, the share of public debt held domestically has been rising in some EU Member States (see Chart 6). In Italy, the proportion of domestic holders has risen by nearly 8 percentage points, from 61,8% to 70,1% between 2010 and 2020. In Spain, it has been growing gradually to 56% since 2015.

**CHART 6.**  
**Holders of Government Debt in Selected Euro Area Member States**

Source: ECB



## 1.2 An Oversized banking system in Europe

The fragmented banking sector across domestic lines leads to overcapacities of the banking sector in many countries; according to the IMF<sup>3</sup>, the European Union is particularly concerned by overbanking, i.e. an "overly large banking sector that in the end affects the profitability of the banks in the system".

### 1.2.1 Some indicators point to this excess capacity

The European banking sector still has too many banks with heavy cost structures competing for the same customers. A comparison with the United States after the Great Financial Crisis makes this extremely clear – between 2009 and 2011, the number of banks in the United States fell roughly three times as much as in Europe.

Efficiency indicators (see Charts 7 and 8) such as branches per population (60 per 100,000 inhabitants in Italy, 55 in France, 52 in Spain, 32 in Germany versus 25 in the United States in 2019) illustrate this overcapacity in Europe.

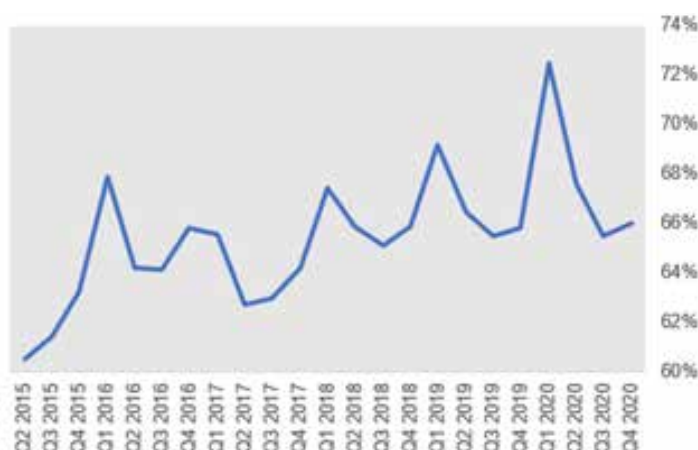
3. IMF, Global Financial Stability Report, April 2017.

Even though the cost to income ratio of US and EU banks do not differ significantly (65.9% for the US and 65.2% for the EU in December 2020), since December 2014, this ratio has fallen in the US from 71.8% to 65.9% whereas in the EU it has gone up from 62.9% to 65.2%.

**CHART 7.**

**Cost-to-income ratio  
of EU Banks, %**

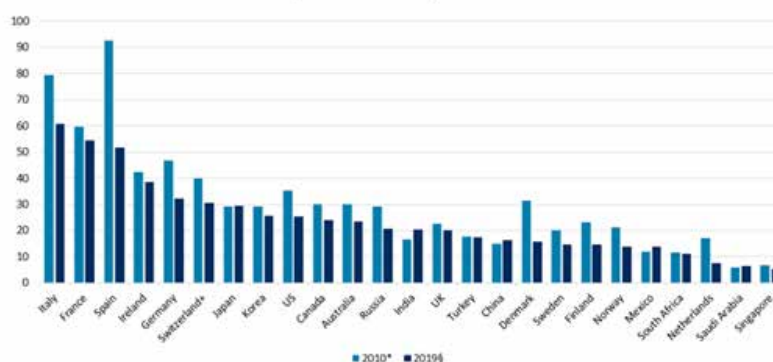
Source: EBA

**CHART 8.**

**Bank Branches  
per 100k Population**

Source: IMF, Worldbank, S&P Global Ratings, (\*) 2012 for China, (§) 2018 for Australia, 2017 for Norway, 2013 for UK. (+)Switzerland excludes branches of other deposit taking institutions for comparability over time.

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Banks in Europe have to face a much more competitive environment than in the United States and therefore a much stronger pressure on their margins since the EU banking sector is not globally concentrated enough (see 1.3) notably compared to the US one.

### 1.2.2 The profitability of many EU banks remains a concern

Since the Global Financial Crisis, average profitability levels have been below the estimated cost of equity, which is estimated at between 8% and 10%. The profitability of European banks has fallen from 6,5 % at the end of 2018 to around 2 % at the end of 2020. Although the estimated cost of equity of US banks is not materially different, during this period, their return on equity has only fallen below 9.5% in some quarters of 2020<sup>4</sup>.

The Covid- 19 outbreak has only heightened the profitability challenge. In June 2020, the EBA stressed that the average return on equity (RoE) of EU banks stood at 0.5%, down from 6.7% in June 2019<sup>5</sup>. The decline was largely explained by the surge in impairment costs and, to a lesser extent, by the contraction in revenues. In contrast, operating expenses have registered a positive contribution to the RoE due to their contraction YoY (see chart 9).

**CHART 9.**

**Contribution to the fall in RoE  
of the main profit and loss (P&L)  
items, calculated as a ratio to  
total equity (2019-2020)**

Source: EBA based on Supervisory reporting data



4. E. Fernandez Bollo, Consolidation in the European banking sector: challenges and opportunities, 11 June 2021.

5. EBA, Risk assessment of the European Banking System, December 2020 & New-York Fed, Quarterly Trends of the US Banking Sector.

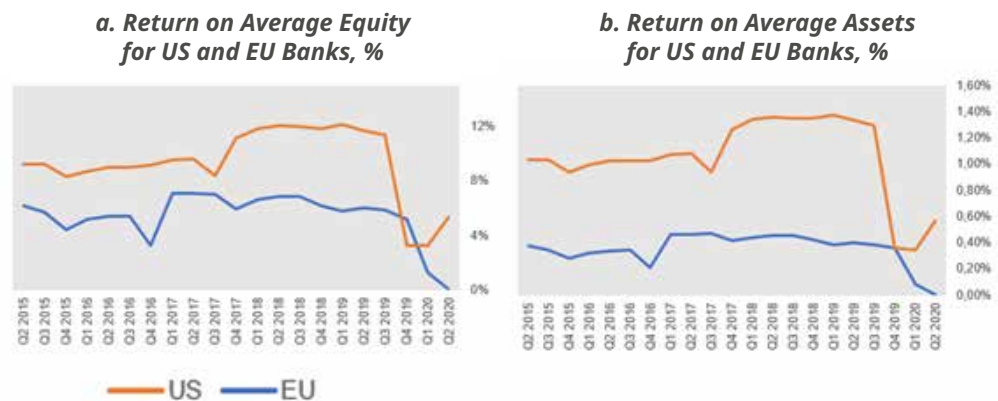
While the first quarter of 2021 has seen a rebound of profitability, (see the EBA quarterly Risk Dashboard ) RoE rose to 7.6% in the first quarter from 1.9% in the year ending 2020, this was driven by fee and commission as well as trading income and low cost of risk in the context of the massive public support programmes for the economy. The net interest margin (NIM) significantly contracted from 133bps to 124bps, ranging from 75bps up to 302bps among countries, adding pressure to net interest income, which still represents more than 50% of EU banks' net operating income.

Intense competition and lasting very low interest rate environment in several EU countries have resulted in a rather subdued increase in banks' revenues over the past few years. According to the EBA, in 2020 the sharp GDP contraction and the lingering low interest rate environment drove net operating income (NOI) down by 3.2%.

Lasting low interest rates have negative consequences on EU banks profitability: it compresses net interest margins - which penalizes them vis-à-vis their American counterparts. As shown by the charts below (see Chart 10.a et 10.b), the trend in US and European bank profitability has diverged over the last years, with US banks constantly more profitable than their European counterparts (at least twice as much).

**CHART 10.**  
**Selected Profitability Indicators of EU and US banks**

Source: ECB, Fed



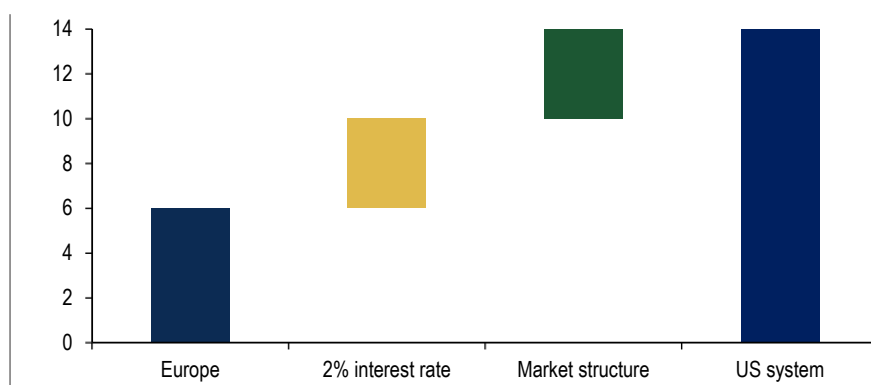
Interest rates in Europe have been lower for longer, negative, and the yield curve much flatter than in the US, creating a major drag on banks' biggest revenue source, net interest income. In addition, quantitative easing (QE) and the associated rise in bond and equity markets had a greater – more positive- impact in the US with its larger capital market.

The Chart 11 issued by Bank of America Securities<sup>6</sup> shows their estimate of the drivers of the yawning profitability gap between the euro banks at a 6% ROE in 2019 and the US at 14%. About half is the difference in market structure: absence in Europe of a genuine securitisation market and of a single capital market. The other half is simply the 200 bp gap in interest rates.

The European financial market remains small and most of the financing in Europe is provided by the banking sector. The situation is the opposite in the US. This entails a major bias in the implementation of the prudential regulation. Indeed the EU banking sector is more impacted by the Basel prudential framework than the US one and this lead to a lower profitability: US banks can transfer the risks to public structures (Freddie Mac, Fanny and Ginny Mae) or private investors through securitisation. In addition to that, a large part of their profits comes from fees on market operations which have limited impacts on their balance sheets. It explains for instance that with a total assets similar to BNPP, JP Morgan had a net profit 3,5 times higher in 2020. Basel 4 is going to aggravate the situation according to many representatives of the EU banking sector.

**CHART 11.**  
**Return on Equity differential between the EU and the US (%)**

Source: BofA Estimations



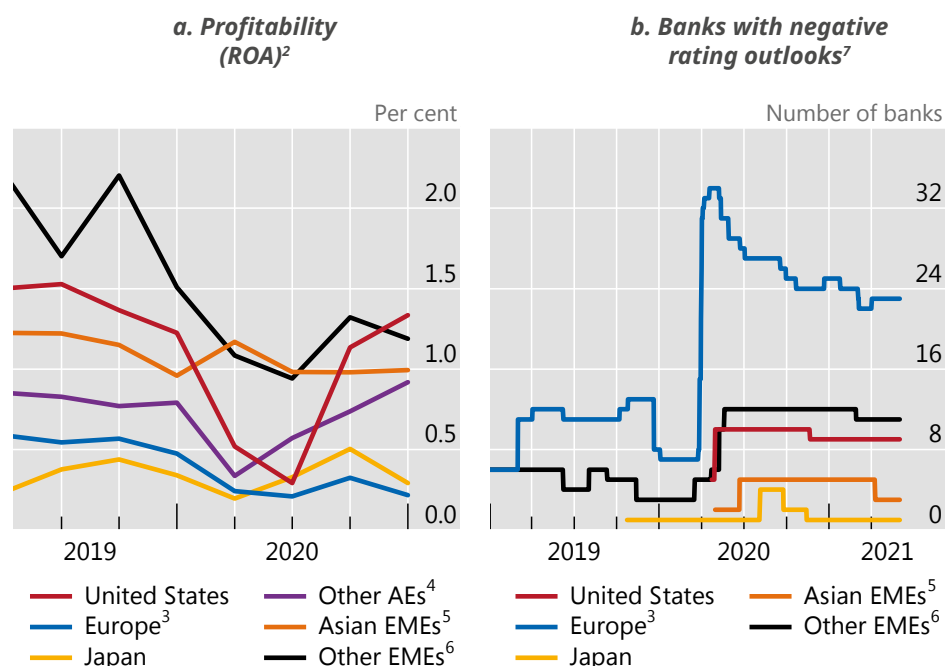
6. Bank of America Securities Global Research, "Fit for an island continent", February 2020.

According to the ECB, the outlook for bank profitability remains weak. Despite recently improving market sentiment towards euro area banks, market analysts still expect profitability to recover only gradually, projecting a ROE of 3% and 6% for 2021 and 2022 respectively, given higher provisioning needs and lower expected operating income, while Return on Equity of large US Banks is currently projected to reach about 12% by 2022<sup>7</sup>.

Euro area bank valuations remain low when compared with those of their peers around the world, particularly those of US banks and even with the recent surge in European bank valuations the gap with the US system has widened, not narrowed. The number of banks with negative rating outlooks also remains elevated. This reflects the uncertain outlook for corporate insolvencies as well as the persistent challenges to bank profitability from low interest rates and competition from technology firms (see Chart 12 below).

**CHART 12.**  
**Outlooks for the Banking Sector**

Source: BIS Annual Economic Report, June 2021



### 1.3 Not concentrated enough

Bank Merger & Acquisition (M&A) transactions within the Euro Area have been on a steadily declining trend, both in terms of number and value, since the year 2000 (see Charts 14 and 15).

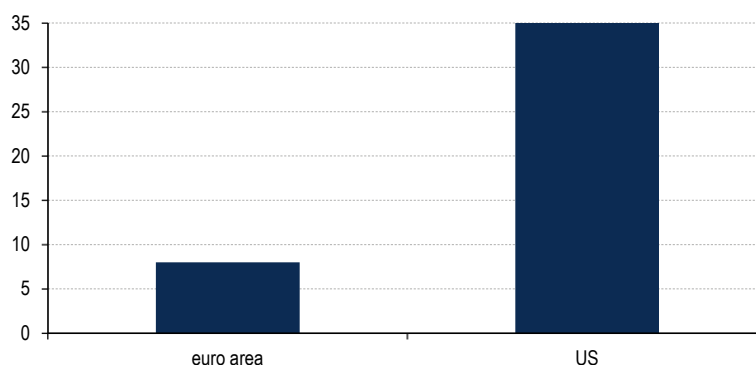
#### 1.3.1 The banking system in the EU is much less concentrated than the US

The market share of the top five US banks within the United States was more than 40% before the Covid crisis, whereas the market share in the Eurozone of the top five European banks stands at more or less 20%.<sup>8</sup>

Moreover Chart 13 shows that the top 3 banks account for over one third of primary current accounts, while the equivalent for the euro area is two-thirds smaller - and that is heavily dependant on Credit Agricole's unusually high deposit share in just one market, France.

**CHART 13.**  
**Top 3 banks: current account market share (%)**

Source: BofA Global Research



7. Luis de Guindos, Euro Area Banks in the Recovery, 28 June 2021.

8. Compared with other jurisdictions, only a few banks exited the market in the euro area. Many banks were bailed out and kept alive due to a lack of European crisis management tools. This underlines the need for further review of the EU bank crisis management.

### 1.3.2 Bank Merger & Acquisition (M&A) transactions within the Euro Area have been on a steadily declining trend, both in terms of number and value, since the year 2000

Cross-border merger and acquisition activity among banks within Europe have practically disappeared until 2019. Indeed, bank Merger and Acquisition within the euro area has been on a steadily declining trend both in terms of number of transactions and value, since the year 2000.

Compared with pre-2008, the post-crisis period is characterised by a predominant proportion of 'domestic' transactions (see Chart 15). The EU Commission added<sup>9</sup> that in recent years, more euro area banks were acquired from outside the euro area than from within.

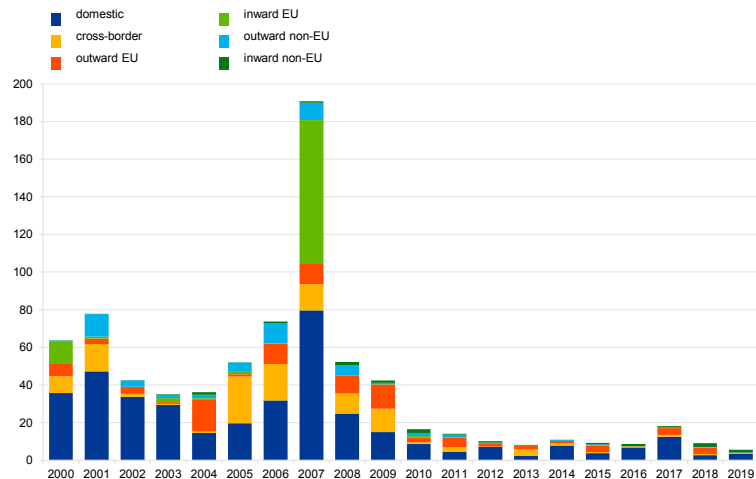
One might need to admit that domestic M&A is presumably a key component to improve profitability: this way synergies can be realised quickly and quite for sure. Latest transactions in ES and IE would all fulfill this purpose.

**CHART 14.**

#### **Bank M&A in the euro area: value of transactions**

Source: ECB calculations  
based on Dealogic

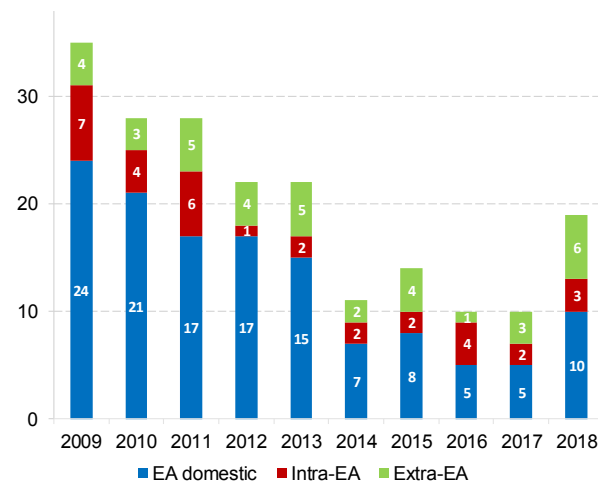
This chart is extracted from the EBA Staff Paper: «Potential Regulatory Obstacles to Cross Border Mergers and Acquisitions in the Banking Sector» (February 2020)



**CHART 15.**

#### **Bank M&A in the euro area: number of transactions**

Source: Dealogic



In 2018, there were only \$5,0 bn of mergers between European banks, the lowest level for more than a decade and a tiny fraction of the €193,8 bn of such deals done on the eve of the financial crisis in 2007, according to data from Dealogic<sup>10</sup>. 2020 was also stable in respect of deal value and number of transactions compared to 2019 according to Dealogic.

### 1.3.3 Cross-border bank activity differs significantly between Member States

Cross-border bank activity differs significantly between Member States, with foreign banks having a strong or even dominant market position in most central and eastern European (CEE) Member States and a small position in the largest Member States.

9. EU Commission, Financial Stability and Integration Review 2020 (EFSIR), March 2020, see chapter 4.

10. Two-thirds of Europe's banking consolidation in 2018 was from domestic deals, such as Banco Santander's takeover of Banco Popular for €1 in June or Intesa Sanpaolo's acquisition of two failed domestic rivals in Italy's Veneto region for a token price. The value of European cross-border deals done in 2017 exceeds all such deals agreed in 2018.

**CHART 16.**

**Market Share of Foreign Banks  
in EU Member States  
and share of Banks' income  
earn in EU Member States**

Source: ECB and banks' annual reports.  
DG FISMA calculations

Note: The x-axis report the percentage of banks' total operating income in 2018 that was earned in a certain Member State, excluding the bank's home market. The y-axis reports the percentage of a banking sector's total operating income in Member States that was earned by foreign banks in 2018, except IE (Q4-2017 data) and LT (Q1-2019 data).



The report of the Commission cited above (see Chart 16) suggests three clusters: (i) Member States with a share of foreign banks higher than 65%, as is the case in seven CEE Member States and Luxembourg; (ii) the largest euro-area Member States plus Denmark, Cyprus, Greece and Finland, where foreign banks have a market share below 15%; and (iii) all other Member States where foreign banks have a share between 15% and 65%.

The analysis at country level suggests that cross-border banks are significant in CEE Member States and lack significance in the larger Member States. However, the view from the banks' perspective leads to a different assessment. For large EU banks, a significant share of operating income stems from large Member States, while the share of operating income from CEE Member States is small. This also holds if the residence of the large banks is taken into account: a significant part of their foreign profits originates from large Member States and a small part of their profits comes from the CEE Member States.

The comparison of banks' geographical income distribution between all banks, large banks, and foreign large banks reveals that France and the Netherlands have a disproportionately low share derived from foreign banks; while Belgium, Luxembourg and Poland have a disproportionately large share derived from foreign banks.

## 2. Why have we seen such a decline in banking M&As?

For five major reasons:

- The single banking market is not yet a reality although banking regulation has become more uniform in the EU through the single rulebook and the ECB clarified its supervisory approach to consolidation<sup>11</sup>. Indeed, a number of traditional factors such as legal systems, language and traditions remain and fragment banking markets. The EU Commission adds that "differences in taxation, borrower protection, or anti money laundering provisions at member state level result in bank -specific entry and adjustment costs that discourage cross-border banking". Foreexample, there is no single EU-wide loan registry, as is the case in the US.

This fragmentation along national lines puts new cross-border market entrants at a disadvantage. In particular, banks that want to expand and diversify their activities throughout the EU have to create local service units in each member state, which reduces economies of scale. Finally, improving the profitability of the EU banking sector is only possible on a country-by-country basis, through national mergers. New and innovative players have no choice but to develop a specific business case for each member state. The opportunities promised by the single market of (retail) financial services are not materializing.

- Furthermore, the EU legislative prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union. Moreover, ring-fencing policies (capital, liquidity, bail-in instruments, leverage ratio...) by host supervisors, applied to subsidiaries of transnational banking groups, which are located in their countries, impose higher costs and discourage large EU banks to increase the number of their subsidiaries in the EU since scale effects through the centralisation of capital and liquidity cannot be achieved.

11. ECB Banking Supervision, Guide on the supervisory approach to consolidation in the banking sector, January 2021. This guide clarifies particularly three key prudential issues that are often discussed in this context: how the ECB sets Pillar 2 capital requirements for newly formed entities; how it treats badwill from a prudential perspective; and how it treats and assesses internal models..

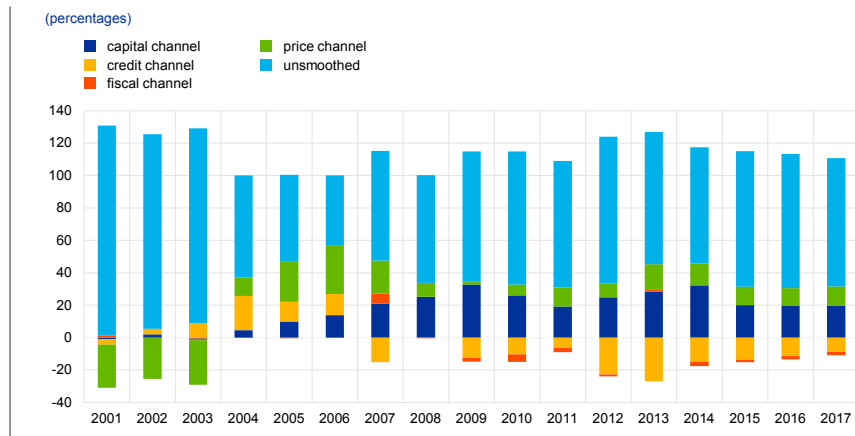


- Digitalization and fintech challenges may be seen to have overpast the aim of consolidation.
- Another obstacle to merger activity is the structure of the banking industry: only 30% of the significant banks in the euro zone (directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the Eurozone are saving banks, regional banks or cooperative banks;
- Finally, in the current political context, no State would be happy to see the disappearance of one of its banks due to a takeover by a bank in another European country.

**3. Overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a shock amplifier rather than a shock absorber (see Chart 17)**

**CHART 17.**  
**Consumption risk sharing**  
**in the euro area**  
**and its channels, %**

Source: ECB calculations



Whereas they used to be mostly cross-border in the pre-crisis period, they have increasingly become of a domestic type. Furthermore, as unveiled in research by Raposo and Wolff (2017), domestic M&A transactions have become increasingly of a 'controlling participation' type, whereas cross-border transactions have become increasingly of a 'minority participation' type. Certainly, all of this was, to some extent, driven by the post-crisis inward-looking bank restructuring strategies put in place by supervisors and Member States.

According to A. Enria<sup>12</sup>, overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a shock amplifier rather than a shock absorber.

Private risk sharing has indeed been impaired in the euro area, and a fortiori in the EU. This should be a concern, as it is through risk-sharing channels that the overall system becomes, at the same time, more resilient and more productive.

**4. What are the consequences of this geographical nationalization of the European Banking system and regulatory framework?**

As explained by Jacques de Larosière in a speech delivered in October 2018 at the European Financial Committee, the consequences of this fragmentation are severe and notably mean:

- Weak profitability of banks. Analysts expect euro area banks' return on equity to recover only gradually, reaching 6% by 2022. Bank profitability in the euro area is expected to trail well behind that of large US banks, whose return on equity is currently projected to reach about 12% by 2022. Only banks with healthy profits can invest in technology, talent and scale;
- Reducing costs through economies of scale is more difficult and in addition, there is much less transfer of technology and knowledge;
- Competitive disadvantage for Pan-European banks versus US ones, which benefit from a large domestic base;
- The EU resistance to asymmetric shocks is weaker (in the United States the capital and credit markets absorb alone more than 50% of the consumer impacts; in Europe is only 10% because of the lack of capital mobility and of credit which stay within national borders. In total, including the fiscal element, more than 2/3 of the shocks are absorbed in the US whereas it is only 1/5 in Europe.

12. A. Enria, "Fragmentation in banking markets: crisis legacy and the challenge of Brexit", Speech, BCBS-FSI High Level Meeting for Europe on Banking Supervision 17 September 2018.

Conversely further banking integration would foster resilience against economic shocks. A geographically diversified loan book and deposit base make banks less vulnerable to domestic shocks and thus reduce the volatility of their lending and income streams; private risk sharing via the banking channel would thus be made possible by a higher degree of risk diversification enabled by diminishing the domestic bias, be it in the shareholding of banks, in the attribution of credit or in the detention by banks of domestic sovereign debt.

It is evident that « ring fencing » is a significant contribution to explain these consequences. If we continue to condone ring-fencing and hinder cross-border banking consolidation, we could see banking groups split into branches instead of subsidiaries.



Despite remarkable achievements in terms of balance sheets cleaning, regulatory harmonisation, and deepening institutional integration within the Banking Union, where the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are up and running, financial integration is lagging behind. The Banking Union is failing to provide the degree of financial integration that we would have expected. Rather than smoothing idiosyncratic shocks to individual Member States, the banking sector still operates as a shock amplifier.

If the EU wants to keep up with the US and China economically as well as politically, it must break out this downward spiral and strengthen its banking industry. Only competitive and profitable banks can take on the risks necessary to finance sustainable growth. This is why a financial integration agenda for the Banking Union should rank high among the priorities of legislators and authorities for the coming semesters. It is essential to give to the markets the message that the path to further integration is still there to ensure that the banking system will be in the future able to finance the necessary transformation of the economy, to address the challenges and opportunities of both digitalization and climate change. Furthermore, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks. There is indeed a serious gap between the impact recently measured by EBA and G20 that the reform should not lead to a significant increase of capital requirements.



Baron Louis, Minister of Finance in France said to his government around 1820:

- *“Faites-moi de la bonne politique et je vous ferai de la bonne finance”*, which can be translated as *“Make good policies, and I will bring you good finance”*.

We could say under his tutelage and inspiration:

*“Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you Banking Union”.*

In other words, it is not the Union that makes the Force, but the Force that makes the Union: only strong Member States – which have corrected their fiscal imbalances and are effectively converging economically among themselves – will make Europe stronger.

# THE CONDITIONS TO BENEFIT IN THE EU FROM THE DIVERSITY OF BANKING MODELS

**Note written by Eurofi, with the contribution of BPCE, DSGV, La Banque Postale, RBI International**

## 1. The diversity of banking business models favours financial stability and bank service diversification

The diversity of banking business models is a source of financial stability for the EU banking sector. Indeed, a reduced number of business models results in an increased correlation of risks between institutions, increasing financial instability in the event of a shock. The more diverse the banking sector, the more resilient it is overall to a variety of shocks.

In addition, the more diversified banking models are, the best customer needs are addressed because this leads to a diversification of bank offers and services.

Business models' diversity is rooted in various aspects among which ownership and governance, physical proximity, extent and complexity of the product mix, value chain arrangements, ...

Regarding capital holding for example, state-owned banks, private owned banks, or cooperative banks are very specific.

Similarly, while universal banks provide a large variety of customers with a one-stop-shop service whatever their needs, other business models enable certain banks to be more tailored regarding a specific type of clients or service.

Banks with a very dense network have an advantage in terms of proximity with their clients, which is expected to enable them to better adapt to clients' needs and provide them with more tailored services. Furthermore, such a proximity corresponds sometimes to public service missions certain banking networks are entrusted with (e.g., financial inclusion...). Proximity also facilitates covering local or regional authorities, local public services like hospital.

As general principle, banking institutions should therefore have to fulfil regulatory requirements which fit both their size and their business model although it would of course be easier for supervisors to address a limited number of bank models. For example, smaller and less-complex banks that operate at a regional level only, need a more proportionate regulatory and supervisory approach.

One should also do away from assuming that answering local specificities goes against building the EU single market or reduces the level of competition.

## 2. Combining banking rules uniformity and businesses model diversity is not so easy

A certain level of standardisation and homogenisation of the banking rules as part of Banking Union, is unavoidable. Furthermore, the appropriate balance between the uniformity of banking rules and the diversity of businesses is not so easy to find.

Consequently, certain EU regulation as well as the SSM benchmark model approach, fail to fully factor in the benefits that a diversified European banking sector generates nor the fundamental differences existing in comparison to banking markets in other regions globally.

Indeed, it is difficult to have a uniform approach for the sector as banking models are different on several dimensions.

In this context, the risk reduction measures implemented in the 'RRM'-package should be only a first step on a longer journey toward further enhancing the application of the principle of proportionality. This is - for example - particularly true in the areas of disclosure (Part 8 CRR) and outsourcing requirements (the EBA Guidelines on outsourcing arrangements require from decentralised banking sectors, a high level of resource to comply with bureaucratic burdens).

## 3. Banking diversity also challenges supervisory practices

The SSM sets a European supervision framework that is intended to be the same for all banking players, which tends to ignore the specificity of their business model. In this context, the overall supervisory pressure has contributed to the increase of mergers between smaller banks and therefore to an overall reduction of smaller institutions in the Eurozone. This process will continue in the coming years.

Indeed, this EU supervision focuses mainly on the currently observed risk and profitability parameters of the clients of a bank. Doing so the EU supervision tends to ignore their historical profitability as well as the wide knowledge of each client that the bank gathered all along the relationship, which improves notably risk decision making. Indeed, institutions that accompany their clients on a long-term basis are best able to support them in the event of difficulties and consequently play an essential role in financing national economies, especially in times of economic crisis.

Additionally, the use of activity-based harmonised supervisory approaches has also failed to consider the specificities of banking institutions, which leads to the standardisation of banking practices. Transaction based banking models are favoured to the detriment of those which put the emphasis on the individual relationship with each customer, and which elaborate the consistent set of financial services they require.

Moreover, the SSM seeks the harmonisation of governance arrangements and practices within the institutions (the technical competence of managers is favoured at the expense of knowledge of local specificities and potential advantages resulting therefrom).

Similarly, the SSM based on its main objective of improving for prudential reasons, the profitability of European banks up to levels corresponding to those of listed institutions being active globally, call to question the approach of those banks aiming to serve all clients (rather than most profitable clients or businesses).

What is at stake is an excessive focus on cutting costs in order to increase profitability and subsequently capitalisation on the short term. In turn this encompasses reducing the number of outlets and reducing staff to the detriment of service coverage and inclusive banking, bearing the danger that certain EU citizens are left behind.

Yet, while the profitability of banks that ensure a long-term, global, and multi-product relationship is lower than that of specialised, short-term-oriented banks, it is at the same time more stable in the medium to long term and more resilient in times of crisis. In addition, the sustainable-relationship banking model does not prevent the voluntary adoption of digital and innovative solutions (see for example the successful app. of the Deutsche Sparkassen).

The current supervisory approach, by trying to apply a similar supervisory approach to all banks, also ignores the differences in legal systems, size of market and customer preferences prevailing in each member states of the European Union.

An additional risk is that, beyond to the abandonment of less profitable clients and the reduction of customer convenience, such a European approach also lead banking institutions more and more to adopt capital markets behaviour including by increasing risk-taking in search for yields.

Finally, harmonising banking practices play against the plurality and diversity of different business models and the proximity to the clients contribute to financial stability in Europe.

#### **4. Implementing forthcoming regulation evolutions and completing the Banking Union require cautious policy approaches**

Regarding prudential regulation, Europe has long been following a particularly uniform approach with common binding rules for all banks. This has had an asymmetric impact penalising smaller institutions due to fixed-costs effects.

The introduction of the new Basel III rules will magnify such a risk. Indeed, the increase in regulatory capital regardless to banks' risk profile (a consequence of the output floor concept) will encourage banks to take more risks and to develop leveraged businesses to achieve levels of earnings usually required by shareholders in line with global standards. Alternatively, in the absence of such riskier practices, increased prudential requirements would result in these institutions reducing the financing of the economy. Consequently, the European legislator should implement the new Basel III rules in a well-balanced way for smaller banks as they are primarily designed for globally active banks and should also take the opportunity to further enhance the principle of proportionality in the current legal framework of CRR/CRD.

An increasing awareness of policymakers has led to more proportionality in EU legislation, as seen in the banking package (CRD V & CRR II), which lays the initial groundwork for a ruleset better tailored to smaller and non-complex banks. It is important to follow through with a commitment for proportionality when implementing the final revisions to the Basel III framework.

Looking at the debate on the completion of the Banking Union, the primary focus should be to combine a proper functioning of the single market and maintaining the diversity of the EU banking system and its stabilizing effects. These objectives require considering that for a sustainable economic environment, profitability – especially in the short term – is not the only performance indicator to measure the value added of the financial industry to the economy.

#### **5. Better understanding the added value of each banking models and their diversity, is necessary**

A “one size fits all” regulation runs the risk to undo the stabilising effect of a diversified European banking sector and the advantages it brings for individuals, households, industry and small businesses sectors. Decision makers should have this in mind when responding to the current situation, but also when shaping the regulatory framework of tomorrow.

For them to succeed, one open question is to clarify how the different banking models among which those of networks of banks (e.g., the savings banks in Germany) or cooperative banks, avoid excessive risk-taking and allow low-priced services to be offered.

In other words, it is necessary to clarify how such banking models beyond the mere level of remuneration going to shareholders, offer more to all the stakeholders, or whether their feature early warning and intervention systems that prevent effectively excessive risk-taking.

In the same way, one should try to clarify - let alone their culture and history - the elements, notably public policy ones, that support specific regulatory and supervisory approach for state-owned banks. There is a need to focus - not in abstracto but in the challenging context of a rapidly changing world - on identifying and fostering the key success factors specific to each business model rather than unwittingly triggering their gradual standardisation.

Finally, achieving an effective regulatory and supervisory framework, makes also unavoidable to accurately assess the added value notably in financial stability terms of the diversification of the banking models in the EU.



# **3**

## **DIGITAL FINANCE POLICY**

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# TECH COMPANIES IN FINANCE: OPPORTUNITIES, CHALLENGES AND POLICY OPTIONS

Note written by Marc Truchet, EUROFI

## 1. Opportunities associated with the increasing presence of tech companies in the financial sector

Technology is playing an increasing role in the financial sector and becoming a key success factor in all the main sectors of finance and in all steps of the financial value chain, a trend which has accelerated with the pandemic. In this context, tech companies are intensifying their activities in the financial sector both directly, as providers of financial services and indirectly, as suppliers of ICT (information and communications technology) services for financial institutions.

Some bigtech firms have now acquired a significant market share in payment services in several jurisdictions including the EU and have also expanded in other sectors of finance such as credit underwriting, banking, insurance or asset management notably in Asia. Fintechs, which operate on a smaller scale, tend to focus on certain market segments where they provide innovative or targeted services (e.g. credit underwriting for SMEs, mobile payments, account aggregation, robo-advice, targeted digital banks...). These developments contribute to enhancing innovation and choice in the financial sector with new value propositions leveraging data analytics and alternative data in particular and they may also help to facilitate access to financial services for certain customer segments, with more customised and cheaper offerings.

Tech companies are also important providers of ICT services and infrastructure for the financial sector, leveraging their strong technology capabilities. The use of cloud computing in particular, which is mainly provided by subsidiaries of large bigtech companies at present, is rapidly expanding in the financial sector. First implemented for cost and flexibility reasons, cloud services are increasingly used to facilitate and optimize the use of sophisticated data analytics and also of artificial intelligence (AI), machine learning (ML) and distributed ledger technology (DLT) applications. Developing partnerships with tech companies such as cloud service providers (CSPs) is indeed a way for financial institutions to accelerate their digitalisation and implement more effectively data-driven processes and services, which may otherwise be hindered by their existing legacy systems. Some banks for example have concluded large-scale partnerships with CSPs in this perspective. On a smaller scale, financial institutions also partner with or purchase

stakes in fintechs for the provision of new products and services or for improving their processes.

These partnerships enhance the ability of traditional financial institutions to innovate, differentiate themselves with new service offerings (e.g. with a higher degree of personalisation or pay per use models) and target new or specific customer segments, thus contributing to improve customer service and facilitating access to financial services and information for customers. Technology also helps financial institutions to implement more efficient and flexible operating models, allowing them to reduce their cost structure and improve their profitability and also to provide customers with better value for money. With technology, financial institutions can also upgrade their management and decision-making processes. Finally they can also enhance their security and operational resilience capabilities thanks to the security at scale and redundant architecture provided by cloud services and also with the use of new tools to fight cyber-risk and money laundering.

## 2. New challenges created by the developing role of tech companies in finance

The developing role of tech companies in finance however raises new questions in terms of financial stability, competition and supervisory capabilities, in addition to the challenges generally associated with the increasing digitalisation of financial services (e.g. greater exposure to potential cyber- and ICT operational risks, data protection and privacy issues...).

### 2.1 Financial stability issues

According to assessments of the BIS Financial Stability Institute<sup>1</sup>, new vulnerabilities could be created by operational incidents affecting the activities of tech companies operating in the financial sector and particularly the larger ones, either directly or by spill-over effects across the different activities that they perform<sup>2</sup> and leading to possible systemic disruptions of financial services.

Such operational failures could have financial stability implications in cases where tech companies have acquired a significant position in the provision of certain financial services, which could be facilitated in the future by the capacity of large tech companies to rapidly scale up their operations in different data-driven

1. Big techs in finance : regulatory approaches and policy options – FSI brief – March 2021 and Fintech regulation: how to achieve a level playing field – Occasional paper N°17 – February 2021.

2. i.e. an operational incident in a specific business line that may impact the continuation of the activities conducted by the tech firm in the financial sector.



sectors such as finance, by leveraging their data analytics capabilities and wide user base and thanks to strong network effects<sup>3</sup>.

Financial stability risks may also spread through the growing interconnections between tech companies and the financial sector. The outsourcing by financial institutions of core activities to tech companies, such as CSPs, indeed potentially exposes them to operational resilience<sup>4</sup> and business continuity risks caused by operational incidents affecting these tech providers, which may in turn threaten the continuous and adequate performance of critical financial activities. Another issue cited that however seems more remote are reputational risks, if a tech firm having partnered with a financial firm for the development and distribution of new products and services is accused of misconduct such as a breach of AML/CFT (anti-money laundering and combatting the financing of terrorism) rules or a violation of consumer protection obligations.

## 2.2 Competition and level playing field issues

Tech companies operating in the financial sector (fintechs or financial entities of bigtechs) also represent an additional source of competition for financial institutions, potentially creating new level playing issues.

Tech companies are subject to the same activity-based regulations as financial institutions, for the financial services that they provide. They need to obtain the relevant licence corresponding to these financial services and implement the same sectoral regulations as financial institutions. They are also subject to the same general regulations concerning data and consumer protection, AML/CFT, cyber-security, competition etc. as financial institutions, and will also be in the scope of the future digital finance regulations being negotiated in the EU as part of the Digital Finance Package<sup>5</sup>.

However, despite this, there may be differences in the obligations that apply to different providers of

similar financial activities, depending on whether they belong or not to a financial group subject to prudential regulation.

According to observations of the BIS Financial Stability Institute (FSI), the subsidiaries of regulated financial institutions providing similar services to tech entities, may be exposed to more stringent rules because they are part of a financial group subject to prudential regulation. Indeed banks, unlike non-banks such as tech companies<sup>6</sup>, are regulated and supervised in a consolidated way, which means that their prudential requirements are calculated on a consolidated level<sup>7</sup> and impact all their subsidiaries (including those competing with tech providers such as those providing payment services). Bank deposits are also subject to contributions to a deposit protection scheme, which is not the case for e-wallets for example provided by some tech companies fulfilling a relatively similar function<sup>8</sup>. Banking subsidiaries are also usually subject to more stringent compliance and supervisory requirements, as part of a regulated financial group<sup>9</sup>. These level playing field questions are common to all non-banks providing financial services, however, they may be more acute in the case of some tech companies that have the capacity to scale-up more quickly than traditional non-banks by leveraging technology and data insights across their different activities, while also being exposed to potential spill-over effects from operational incidents across a broad range of activities.

Moreover, some rules designed to encourage innovation and digitalisation, such as open-banking rules may create differences in terms of data access between incumbents and new entrants. The example of the payment services directive (PSD2) is often emphasized by bank representatives. Under PSD2, banks have to give access to bank accounts for payment services provided by new payment providers (including tech companies), but they consider that there is an asymmetry in terms of data access. Indeed, while tech companies (as any payment service provider) are required to share the payment account

3. This is what the BIS describes as the DNA loop (Data analytics, Network externalities and interwoven Activities), which characterizes the activities of bigtechs - i.e. their capacity to leverage data analytics and the information gathered from a large user base for different activities in an effective way with significant network effects, together with their possible gatekeeper role. (BIS, Annual Economic Report 2019). Once a bigtech has attracted a sufficient mass of users on both sides of its platform, network effects kick in, accelerating its growth and increasing returns to scale: more data generated by users, in turn provide a better basis for data analytics, which enhances existing services and thereby attracts more users. Bigtechs also have a large and captive user base at their disposal, according to the BIS that allows them to scale up quickly in market segments that are outside their core business and are able to leverage state-of-the-art technology and also use insights derived from data analytics as a basis for developing novel services in other sectors.

4. The concept of operational resilience includes all factors affecting the ability of entities to deliver critical operations including outsourcing, business continuity, cyber-security.

5. The EU Digital Finance Package proposed by the Commission in September 2020 and that is currently being negotiated includes several legislations for supporting the digitalisation of the EU financial sector, adapting existing financial legislations to new developments such as crypto-assets, the use of AI and cloud services for financial services and also addressing the risks that digitalisation may pose for the financial sector. The package includes the Digital Finance Strategy, the Digital Operational Resilience Act (DORA), the regulation on Markets in Crypto-Assets (MiCA), the new retail payments strategy and the DLT pilot regime (see detail of the objectives of these different initiatives in the Eurofi Regulatory Update April 2021 'Digital Finance Strategy and Digital Finance Package: objectives and main proposals' [https://www.eurofi.net/wp-content/uploads/2021/04/regulatory-update\\_lisbon\\_april-2021.pdf](https://www.eurofi.net/wp-content/uploads/2021/04/regulatory-update_lisbon_april-2021.pdf).)

6. Tech companies do not generally hold bank licences at present in the EU and US.

7. i.e. capital requirements are based on an assessment of the risks posed by the institution as a whole e.g. credit, market and operational risks.

8. Source Eurofi April 2021 Seminar summary "Is the current EU financial regulatory and supervisory framework fit for the digital age?"

9. There may be differences in the way the implementation of similar requirements is supervised, because of differences in the way supervision is conducted across sectors. According to the BIS FSI, supervisors may apply more stringent standards (e.g. concerning consumer protection, AML/CFT or data protection) to credit institutions than to fintech players for example, because of proportionality principles and also due to the fragmentation of supervision (except when supervision is organized according to a twin-peaks functional model).



information of their clients, upon their consent, with other licensed third-parties that provide payment initiation and account information services, they are not required to share any other data generated on their platforms, which means that banks cannot access the full extent of the data generated by these new players concerning their clients. This creates a potential competitive disadvantage for financial institutions in their view, in a context where access to relevant customer data is increasingly constituting a source of innovation and differentiation, and could restrict the future provision of digital financial services leveraging a wide range of customer data. GDPR rules can potentially support a wider portability and sharing of data in this context, since they establish the principle of user data ownership, requiring firms to share clients' data with third parties at the customers' request and create structures for European data protection authorities to cooperate. However GDPR is limited by the fact that it applies only to the data of natural persons (and not to non-financial company data for example) and does not contain a technical standard for the transmission of information that would guarantee its efficient use by the recipient.

A further issue that has been cited is the difficulty to address, with current competition policy, which is mostly ex-post, potential competitive distortions<sup>10</sup> that may be caused by rapidly scaling-up tech business models or services. Some policy-makers argue that ex-ante entity-specific rules would be needed to address certain potential anti-competitive practices of large tech companies acting as so-called gatekeepers. This is the direction taken for example with the measures recently proposed by the Commission in the EU Digital Markets Act (DMA), which aim at preventing gatekeepers from imposing unfair conditions on businesses and consumers and at ensuring the openness of digital services<sup>11</sup>.

### 2.3 Supervisory challenges

The increasing role of tech players in the financial sector and the use of technologies, which are outside the scope of those used traditionally in the financial sector also create challenges for regulators and supervisors in terms of skills, resources and working processes. Fast changing technologies can also create

new regulatory loopholes if financial regulations do not evolve fast enough with the latest digital innovations.

Providing appropriate guidance regarding these evolutions, i.e. with a balance between risk mitigation and innovation objectives, indeed requires a detailed understanding of the opportunities and risks associated with new technologies for different financial activities and of their interaction with existing financial and operational risks.

Financial supervisors are also faced with the additional complexity of monitoring a wider range of market participants and operating models (with an increasing role of third-party ICT service providers of different natures for example). The speed of change and innovation happening in the tech sector both in terms of technology and operating model, combined with on-going innovation in the financial sector, is a further challenge.

## 3. Policy options for addressing the challenges associated with the development of tech firms in finance

### 3.1 Adapting the financial regulatory and supervisory framework to the digital age

A first option to address potential opportunities and risks associated with the growing role of tech companies in finance is to ensure that the regulatory and supervisory approach is adapted to this transformation. The EU financial policy framework has not evolved significantly so far with the advent of digitalisation in finance<sup>12</sup>, with the exception of payments in particular (with PSD 2). In addition, most EU policy frameworks concerning digitalisation and technology have remained horizontal, applying to all sectors<sup>13</sup>.

The situation is however due to change in the EU with the upcoming implementation of the Digital Finance Package proposed by the Commission in September 2020. This legislative package includes a Digital Finance Strategy - which aims to adapt the financial regulatory and supervisory framework

10. e.g. potential issues related to the bundling of different services, personal data misuse or discriminatory access conditions for participants.

11. Gatekeepers are defined by the European Commission as companies that meet the following criteria: they have a strong economic position, significant impact on the internal market and are active in multiple EU countries; have a strong intermediation position, meaning that they link a large user base to a large number of businesses; have (or are about to have) an entrenched and durable position in the market, meaning that it is stable over time. The DMA for example proposes that gatekeepers should not treat services and products offered by the gatekeeper itself more favourably in ranking than similar services or products offered by third parties on the gatekeeper's platform; prevent consumers from linking up to businesses outside their platforms; prevent users from un-installing any pre-installed software or app if they wish to.

12. The situation is similar at the international level. Some sectoral regulations have been updated in areas with significant fintech penetration, such as wealth management, payment services or insurance and efforts have been made to update existing regulations to eliminate barriers to digitalisation 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 however. 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. See Eurofi April 2021 Seminar Summary "Is the current EU financial regulatory and supervisory framework fit for the digital age?"<sup>8</sup>. Source Eurofi April 2021 Seminar summary "Is the current EU financial regulatory and supervisory framework fit for the digital age?".

13. A fintech action plan on how to harness the opportunities presented by technology-enabled innovation in financial services was published by the Commission in 2018, but it focuses mainly on measures to explore the potential of fintech and the exchange of best practices, rather than on regulatory changes.

to the increasing digitalisation of the EU financial sector, remove potential obstacles to digitalisation and also address possible new risks and level playing field issues related to this digital transformation – as well as several other legislative proposals targeting different areas of digitalisation: the Digital Operational Resilience Act (DORA), the regulation on Markets in Crypto-Assets (MiCA), the new retail payments strategy and the DLT pilot regime.

Efforts are also being made to adapt regulatory and supervisory approaches to digital innovation. New concepts such as innovation hubs or sandboxes have been put in place by many national competent authorities over the last few years in order to monitor fintech developments, facilitate the safe testing of new fintech concepts and accelerate the learning curve of regulators in this area. Specific policy regimes, such as the one proposed in the EU DLT pilot regime, also aim to allow market players and regulators to gain more experience with the use of DLT technology in securities markets, while ensuring an appropriate monitoring of risks.

### 3.2 Optimizing the mix of activity- vs entity-based regulation

The appropriate mix of activity- and entity-based regulation for supporting the development of tech companies in finance and tackling related challenges is also being considered. Many market stakeholders advocate the use of ‘same activity, same regulation’ principles for guiding financial services policy in order to ensure a level playing field between financial and non-financial players such as tech companies and also an equivalent mitigation of risks. This would potentially imply a wider use of activity-based regulations, applying the same system of rules to all types of entities providing the same activity.

The FSI however points out that while an activity-based regulatory approach can help to eliminate regulatory arbitrage in the provision of a given activity and is also effective for tackling the risks related to the operation of this activity (consumer protection, conduct, AML / CFT risks for example), it is insufficient for mitigating risks that may stem from the combination of different activities within a given entity, such as financial stability and competition risks. Another caveat of activity-based regulation is that activities must be defined precisely, which can be challenging with rapidly changing and hard to define fintech activities. For these reasons, most regulatory frameworks in the financial sector contain both activity- and entity-based rules.

For example in the banking sector, maturity transformation, which involves a combination

of deposit taking, investment and underwriting activities, is a major potential source of financial stability risk, alongside liquidity transformation risk<sup>14</sup>. In order to tackle these risks, prudential capital requirements are imposed on banks at a consolidated level - i.e. at the bank entity-level - in addition to activity-based requirements, with the result that a different set of obligations may be imposed on a given activity, depending on the characteristics of the entity performing it (e.g. a deposit-taking bank or a non-bank), as mentioned previously in § 2.2. Banking regulators justify this approach by the fact that the same credit underwriting activity for instance, may generate different risks for the financial system, depending on how the activity is funded<sup>15</sup> (e.g. by the own resources of the firm providing the activity, market leverage or deposits taken from the public). The maturity transformation business of banks therefore requires a specific prudential regulatory treatment for their credit provision activities, which may not be necessary for non-bank credit providers that cannot accept deposits.

Tech companies do not perform such risk transformation activities at present in the EU and therefore do not require the same kind of prudential requirements. However, in the view of the FSI, they may be associated with other risks that can threaten the adequate functioning of the financial system, as previously mentioned, such as operational resilience and fair competition risks, which would not be appropriately addressed from a policy perspective if the focus is exclusively on specific financial activities. The FSI has therefore suggested that a combination of activity-based and entity-based regulation should be considered for addressing the different risks posed by tech companies operating in the financial sector.

The proposed EU Digital Markets Act (DMA) and Digital Operational Resilience Act (DORA) both adopt this type of approach, since they include specific entity-level measures for tech companies playing a significant role in the market, together with activity-based rules. As per the Commission's DORA proposal, a specific regime would be introduced for third-party ICT providers considered to be ‘critical’ for the functioning of the financial sector<sup>16</sup>, subjecting them to an EU oversight framework in order to improve the management of the risks posed by these providers. At the global level, the FSB is also working on the regulatory and supervisory issues relating to outsourcing and third-party relationships, addressing both activity-related and entity-related risks and issues: i.e. potential stability risks to financial institutions associated with third-party providers becoming single points of failure, because of their criticality and lack of substitutability, and also supervisory approaches for managing outsourcing and third-party risks<sup>17</sup>.

14. Source Eurofi April 2021 Seminar Summary.

15. Source BIS FSI Speech F. Restoy 16 June 2021.

16. Based on criteria such as the systemic impact of a potential failure of the provider, the systemic character of financial entities that rely on the service provider and its geographical coverage and degree of substitutability.

17. Regulatory and Supervisory Issues Relating to Outsourcing and Third-Party Relationships - Discussion paper – FSB – November 2020.

This combined approach would also imply an entity-level supervision for monitoring the build-up of risks from tech firms and the evolution of their business models, potentially requiring a close cooperation between financial regulators and other sectoral, competition and data protection authorities, as well as supervisory cooperation at the international level, since many large tech companies have their headquarters outside the EU<sup>18</sup>.

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18. The challenges of implementing a wider-scale supervision of tech companies have been stressed by T. Adrian (IMF) for example in a recent paper (Bigtechs in financial services, June 16 2021). Many of the larger tech companies are based outside of Europe at present, therefore potentially requiring a cooperation between EU supervisors acting as host supervisors and US or Chinese supervisors acting as home supervisors and in charge of supervising possible entity-based requirements at group level.

# DIGITAL OPERATIONAL RESILIENCE ACT (DORA): MAIN PROPOSALS AND PENDING ISSUES

Note written by Marc Truchet, EUROFI

## 1. Objectives and context of the DORA proposal

In September 2020, the European Commission published the Digital Operational Resilience Act (DORA) proposal, which aims to ensure that financial institutions in the EU can support the continued provision of services and their quality, and thus preserve the stability of the EU financial system, in the event of any potential disruption or threat to operational resilience in relation to their use of information and communication technology (ICT).

Digitalisation and the use of technologies such as cloud computing, distributed ledger technology (DLT), artificial intelligence (AI), machine learning (ML) are progressing at a fast pace in the financial sector, making ICT risks such as cyber-attacks, system failures and other ICT-related incidents a focal point for regulators. In addition, potential risks stemming from the dependency of financial entities on ICT third-party service providers (such as providers of cloud services, software, data analytics and data centres), have been emphasized by regulators at the global and EU levels in a context of increasing outsourcing of activities and services to these providers, although no specific signs of fragility have been evidenced so far, notably throughout the Covid crisis, during which cloud services in particular supported business continuity.

In order to avoid major operational disruptions from these risks, DORA proposes to establish a comprehensive and harmonized framework for the management of ICT risks by financial institutions and also to introduce an oversight framework for third-party

providers of ICT deemed 'critical' for the EU financial sector. DORA is part of a wider Digital Finance Package proposed by the European Commission, which seeks to support a further digitalisation of the EU financial sector in terms of innovation and competition, while mitigating the risks arising from it<sup>1</sup>.

DORA also builds on a number of existing European policies and standards addressing ICT and outsourcing risks including the Network and Information Security (NIS) Directive<sup>2</sup> on cybersecurity currently under review, the TIBER-EU framework of the ECB<sup>3</sup> concerning voluntary penetration testing, the EBA ICT and security risk guidelines and the guidelines published by the European Supervisory Authorities (ESAs) for the outsourcing of cloud services. General operational resilience requirements are also embedded in the main financial regulations such as CRDIV, Solvency II, MiFID II and PSDII.

The combination of these different EU measures with international principles on operational resilience<sup>4</sup> and with national reporting and testing requirements<sup>5</sup>, however results in overlaps and inconsistencies across jurisdictions, leading to the potential risk of regulatory fragmentation. The Commission is aiming to improve the consistency of these requirements with DORA, in order to support supervisory effectiveness of ICT risks in the financial sector and reduce the administrative and compliance burden for firms. The DORA framework will moreover apply to a wide range of entities (financial entities and intermediaries, infrastructures, service providers), in order to ensure consistency in the way ICT risk management is implemented across the financial sector.

1. The Digital Finance Package includes the Digital Finance Strategy (DFS), which aims to ensure that the EU financial sector and its customers embrace the digital revolution by improving the functioning of the Digital Single market for financial services, ensuring that EU financial regulation and supervision are fit for the digital age and establishing a common European financial data space to facilitate data sharing and promote data-driven innovation. The DFS is completed by four additional regulatory proposals covering different technologies and areas of digitalisation: MiCA (the regulation on Markets in Crypto-Assets), a pilot regime for DLT market infrastructures, DORA (the Digital Operational Resilience Act) and the EU Retail Payments Strategy.

2. The NIS Directive provides legal requirements and best practices to boost the overall level of cybersecurity in the EU including measures to ensure (i) Member States' preparedness to tackle cyber-risks, by requiring them to be appropriately equipped, for example, with a Computer Security Incident Response Team (CSIRT) and a competent national NIS authority; (ii) cooperation among all the Member States, by setting up a Cooperation Group to support and facilitate strategic cooperation and the exchange of information among Member States; and (iii) a culture of security across sectors that are vital for the EU economy and society and that rely heavily on ICTs, such as energy, transport, water, banking, financial market infrastructures, healthcare and digital infrastructure. Moreover, improving cybersecurity is an objective that is pursued in several other European on-going initiatives including the European strategy for data, which promotes an effective use of data in the EU and the report of the European Parliament on digital finance, which inter alia calls for a common approach on cyber-resilience of the financial sector.

3. The TIBER-EU European framework for Threat Intelligence-Based Ethical Red-teaming established by the ECB is the first EU-wide guide on how authorities, entities and threat intelligence and red-team providers should work together to test and improve the cyber resilience of entities by carrying out a controlled cyberattack. It constitutes a European framework for putting in place voluntary programmes to test and improve the resilience of financial infrastructures and institutions against sophisticated cyber-attacks.

4. For example the BCBS consulted on principles for operational resilience in the banking sector in October 2020.

5. Domestic requirements include reporting obligations of operational events to domestic supervisory authorities and threat-led penetration testing frameworks. Threat penetration testing is also mandatory at the EU level for certain types of financial market infrastructures (FMIs).

Following a public consultation conducted by the Commission on the DORA legislative proposal, which ended in May 2021, negotiations involving the European Parliament and the Council have started. The aim is to have the regulations in the Digital Finance package, including DORA, in full effect by 2024.

## 2. ICT risk management measures

DORA proposes a harmonised approach to ICT risk management across financial services sectors, covering three main elements: ICT risk identification and mitigation, ICT incident reporting and information sharing and digital operational resilience testing. While the proposed set of rules will apply to all financial sector players, requirements are planned to be enforced proportionally in order to be tailored to a firm's size and business profile.

Market stakeholders generally support the streamlining of ICT risk management and reporting at EU level proposed by DORA, which should reduce inefficiencies and legal uncertainty for market players due to the current differing and overlapping requirements and also facilitate the supervision of ICT risks, thus contributing to enhance operational resilience at overall market level. Some market players have emphasized the importance of a proportionate approach to these requirements and also stressed that the common framework defined by DORA should remain flexible enough to manage future evolutions and risks.

### 2.1 ICT risk identification and mitigation

Under DORA, financial entities would be required to create and maintain a solid and comprehensive ICT risk management framework allowing the identification, classification and documentation of ICT risks. This must include a dedicated and comprehensive business continuity policy, disaster recovery plans and a communication policy to customers and stakeholders. Alongside this framework, financial entities would have to follow certain requirements for the use and maintenance of ICT systems, identify and analyse risks on a continuous basis, design and implement security and threat-prevention measures and promptly detect anomalous activities. These measures need to be approved and overseen by the management of financial entities who will bear the final responsibility for managing ICT risks.

### 2.2 ICT incident reporting and information sharing

Financial entities would need to establish and implement a robust ICT-related incident reporting

process and to put in place early warning indicators. This involves classifying ICT-related incidents, according to prescribed criteria to be established at EU level and reporting all "major" ICT-related incidents and their potential root causes to their national competent authority (NCA) within predetermined timeframes<sup>6</sup>. DORA also proposes the establishment, at a later stage, of a single EU hub for ICT-incident reporting in order to streamline incident gathering at the EU level, replacing the current reporting to domestic NCAs. Moreover, concerning interconnected ecosystems, DORA would allow the exchange of information and intelligence on ICT risks and cyber-threats between financial entities in order to enhance risk prevention and mitigation.

### 2.3 Digital operational resilience testing

Financial entities would need to test their ICT risk management frameworks on a regular basis, so that they can prove their readiness to handle any potential disruption from ICT use and also demonstrate that they are in a position to identify and solve possible failures. Common standards for digital operational resilience testing<sup>7</sup> are due to be defined in a proportionate way to the size, business and risk profile of financial entities. A mutual recognition of tests across EU Member States is also foreseen, in order to ensure that firms do not face duplicate requirements in the EU and that supervisors can optimize their resources.

At the end of the tests carried out at least every 3 years, financial entities would be required to communicate the agreed reports and remediation plans to the competent authorities and confirm that penetration tests have been performed in accordance with the requirements. These requirements and the application of mandatory threshold criteria are likely to increase the number of entities conducting threat penetration testing, and the cross-border recognition of tests should also help to reduce duplications across Member States for cross-border firms.

## 3. Management of ICT third-party risks

The second main pillar of the DORA proposal concerns the management of ICT third-party risks by financial entities.

First, and building on the ESA's cloud outsourcing guidelines, DORA proposes principles-based rules for the monitoring by financial entities of risks arising from the use of ICT third-party providers and the harmonisation of key elements of the relationship between financial entities and ICT third-party providers. This includes standard terms and clauses for the establishment of outsourcing contracts, notably

6. Three types of reporting to the NCAs have been identified: (i) initial notification no later than the end of the business day; (ii) intermediate report no later than one week after the initial notification, providing a status update; (iii) final report when the root cause analysis has been completed, no later than one month after the initial report, regardless of whether or not mitigation measures have already been implemented.

7. Beyond the testing of ICT tools, systems and processes based on threat led penetration testing this involves a range of tests including vulnerability assessments and scans, open source analyses, network security assessments, penetration testing and source code reviews, when feasible. The technical standards to apply for conducting intelligence-based penetration testing are due to be developed by the joint ESAs and are likely to be aligned with the voluntary TIBER-EU framework developed by the ECB.



for cloud computing services, the identification of circumstances in which such contracts must be terminated and the granting of auditing rights for financial entities outsourcing these services.

Secondly, DORA seeks to improve the management of risks posed by ICT third-party service providers that may be considered to be 'critical' for the functioning of the financial sector, by subjecting them to an EU level oversight framework. As per the Commission's proposal, this framework involves first the designation by the ESAs Joint Committee of critical ICT third-party service providers (CTPPs) based on criteria such as the systemic impact of a potential failure of the provider, the systemic character of financial entities that rely on the service provider and its geographical coverage and degree of substitutability. For each of the CTPPs identified, one of the ESAs would be appointed as Lead Overseer<sup>8</sup> in charge of monitoring at the EU level the rules, procedures and mechanisms put in place by the CTPP and evaluating whether they are sufficient to manage the risks that it may pose to financial entities. In terms of powers, the Lead Overseer would have an unrestricted right to access all information that is necessary to carry out its duties, including all relevant business and operational documents, contracts and policies. Powers would also be granted to the Lead Overseer to conduct on-site inspections of any premises of CTPPs and possibly impose fines if CTPPs fail to comply with requirements. Finally the DORA proposal also includes rules concerning third-country ICT providers, preventing EU financial firms from using the services of an ICT third-party provider that is 'established' in a third-country and that would be designated as 'critical' if it was established in the EU<sup>9</sup>.

The recommendations concerning the oversight of CTPPs have raised a number of comments and questions from supervisors and market stakeholders. In a letter sent in February 2021 to the European Commission, Parliament and Council, the chairs of the ESAs were supportive of these recommendations but they emphasized the need to grant the ESAs with the appropriate powers and mandate, along with the necessary resources and expertise, for conducting this oversight. They also highlighted a certain number of areas that need clarifying, including the way the oversight of a CTPP providing ICT services to the entire financial sector should be conducted and the scope of services this oversight should cover. Regarding this latter point, some market participants have suggested limiting the oversight scope to the services of CTPPs used for critical or important functions of financial entities. Issues raised by some market players also concern the restrictions on the

use of third-country service providers proposed in DORA. Certain players argue that this measure may lead to greater concentration risk and reduced choice for financial players, ultimately impacting their competitiveness. Clarifications are also asked about the service providers that this rule may apply to and notably whether intra-group ICT providers would be concerned. The fact that the criteria for determining CTPPs should be based on the materiality and impact of the outsourced services, rather than on the type or scale of the ICT provider, was also stressed by certain market participants.

Concerning the monitoring of ICT third-party risks by financial entities, some financial market players have asked for further assurances for being in a position to implement audit and inspection requirements concerning large ICT service providers and emphasized that the termination of a contractual relation with a CTPP in particular should only be used as a last resort solution, given the potential operational challenges and possible impacts on financial stability. The interactions between DORA and the NIS2 Directive are a further issue to be tackled particularly for CTPPs<sup>10</sup>. While DORA should generally prevail over the NIS Directive for financial entities, the fact that non-financial third-party ICT providers would be subject to overlapping and possibly inconsistent or conflicting rules due to inconsistencies between DORA, NIS2 and the ESA cloud outsourcing rules has been emphasized requiring a further harmonisation of these frameworks in the context of the on-going legislative process<sup>11</sup>. The need to ensure that these frameworks remain fit-for-purpose and consistent in the future with continuously evolving technologies has also been stressed.

8. The Joint Committee and the ESAs would be supported in this task by an Oversight Forum carrying out preparatory work for the decisions and recommendations concerning CTPPs.

9. In preamble 58 to the Commission's DORA proposal it is mentioned that this requirement for legal incorporation in the Union of ICT third-party service providers which have been designated as critical does not amount to data localisation since DORA does not entail any further requirement on data storage or processing to be undertaken in the Union.

10. This issue has been mentioned for example by the ECB in its Opinion on the DORA proposal (4 June 2021). See also Eurofi April 2021 Seminar Summary 'EU financial data space and cloud infrastructure: is the EU moving in the right direction?'.

11. Article 29 (5) of the Commission's DORA proposal states that the CTPP oversight requirements are without prejudice to the application of the NIS Directive and of other Union rules on oversight applicable to cloud computing services, therefore there is a risk of overlap. Whether there will be conflicting or inconsistent rules depends on how the Lead Overseer and the NIS2 competent authorities will fulfil their roles.



# **4**

## **CAPITAL MARKET DEVELOPMENT**

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# OPTIMIZING THE FINANCING OF EU ENTERPRISES: MAIN ISSUES AND CHALLENGES

Note written by Marc Truchet, EUROFI and Elias Krief

## 1. The level of non-financial corporate (NFC) debt is high in Europe and is on an increasing trend

### 1.1 NFC debt levels are high in Europe, but the situation varies across EU countries

Expressed as a share of GDP, the debt level of non-financial corporates (NFC) was higher in the Euro area (106%) in 2019 than in the US (88%) and comparable to Japan (105%), according to the most recent BIS statistics (see Chart 1).

Moreover, this ratio has been continuously increasing over the last 15 years in the Euro area<sup>1</sup>. This increase in debt levels can be explained in part by the significant reduction of interest rates since the 2008 financial crisis (lending rates of loans and cost of market debt)<sup>2</sup>. On average European NFCs borrow at less than 2%, which is a historically low figure. The Covid crisis will likely lead to higher levels of indebtedness of EU NFCs, since bank credit has been widely used to support NFCs during the pandemic.

A significant part of this debt is constituted by cash holdings (30 to 40% in most European countries), the share of which has tended to increase over the last 10 years. Many companies indeed prefer to hold non-remunerated liquid assets rather than invest in more productive assets in order to build buffers against future economic shocks and also because of a lack of investment opportunity, especially in a context of heightened uncertainty, potentially showing certain limits of a monetary policy imposing a prolonged period of low interest rates<sup>3</sup>.

Within the Euro Area, three groups of countries stand out (see Chart 2):

- A first group of countries had a debt to GDP ratio exceeding 140% in 2019, including: the Netherlands (154% of GDP), France (150%) and Belgium (146%);

- A second group had debt levels of approximately 90-100%: Austria (91%), Portugal (96%), Spain (93%);
- A third group had much lower levels: Italy (69%) and Germany (59%) in particular.

These differences in the level of indebtedness of NFCs across EU member states can be explained by several factors, including: the level of corporate tax (the higher the rate, the more debt financing is attractive compared to equity financing), the way NFCs organize their financing (for example in countries where intra-group financing is high, NFCs tend to use external sources of financing less) and the level of investment (a higher level of debt should normally contribute to more investment). Concerning the level of investment, a recent OECD report<sup>4</sup> points out that investment dynamics differ depending on the financing characteristics of companies. Low leverage companies indeed devote on average a larger share of their revenues to R&D relative to high leverage companies and the opposite is true for Capex, underlining the importance of equity financing to support riskier and innovative projects that require R&D investment<sup>5</sup>.

When considering different Member States, the high level of indebtedness of French NFCs for example can be explained in part by a high level of corporate tax (33% in 2019, compared to an OECD average of 23%) and a relatively high level of investment<sup>6</sup>. However these investments mainly corresponded to the renewal of existing equipment rather than to new investments. Indeed, while “gross fixed capital formation” figures have increased in France over the last few years, net capital figures taking into account depreciation were stagnant<sup>7</sup>.

By contrast, in Germany, there has been an increase of equity compared to bank loans in the funding of NFCs since the Great Financial Crisis (GFC) that may be attributable to three key elements, according to a

1. In some countries however, such as Spain or Italy, NFCs have significantly reduced their level of debt over the last few years.

2. With the aim to bring inflation back to its 2% target, the ECB gradually loosened its stance, from lowering its key interest rates to negative levels.

3. Some observers indeed point out that the preference for liquid assets and cash holdings in a context of low interest rates may reveal a liquidity trap situation, i.e. an economic situation in which efforts to stimulate the economic activity with low interest rates reach their limits or fail because economic agents prefer to save or hold cash rather than investing due to a negative economic view or to expectations that interest rates will remain very low for a long period of time or further decline.

4. The future of corporate governance in capital markets following the Covid 19 crisis – June 2021.

5. Having the lowest leverage among all industries, technology companies tend to generate the highest cash ratio with more than 20% of total assets in cash or short term liquid investment.

6. Standards & Poor's, “What's Behind The Rise Of French Corporate Debt?”, March 2019.

7. Using ‘Gross’ fixed capital formation figures, may indeed be misleading according to P. Artus (Is there, or is there not, a corporate investment shortfall in France?”, Natixis Economic Research, June 28, 2021) because it does not take into account the capital depreciation (required investment to make up for the capital obsolescence). Accordingly, taking the ‘net’ fixed capital formation provides a more appropriate view, showing that net corporate investment is stable over the last 15 years, with the exception of a strong decrease in 2020.

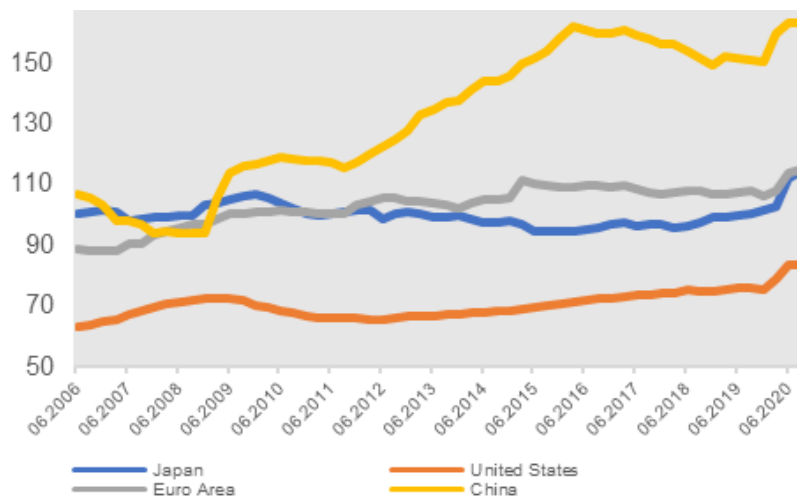
Bundesbank report<sup>8</sup>: first, the internationalization of the main German corporate groups, which has fostered the growth of intragroup liabilities instead of external debt financing; second, significant efforts to increase

the equity base of the German corporate sector following the GFC in order to strengthen their financial resilience; and third an increase in their level of profits, as global demand bounced back after 2010.

**CHART 1.**

**Euro area Corporate Debt  
Against the Rest of the World  
% of GDP**

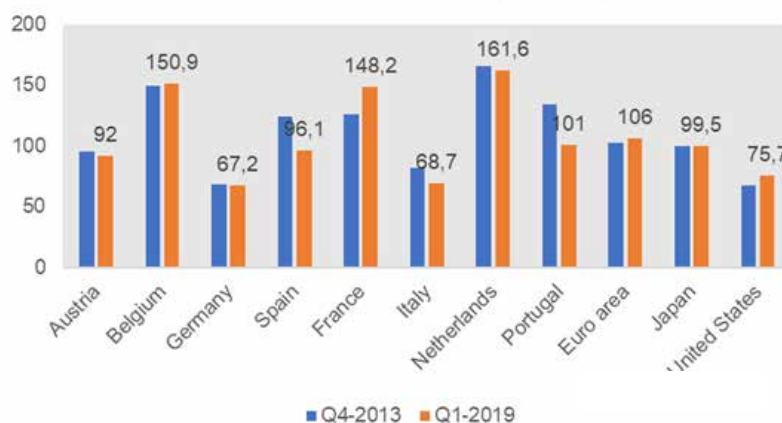
Source: BIS



**CHART 2.**

**Unconsolidated Non-Financial  
Corporate Debt, % of GDP**

Source: BIS



## 1.2 Bank credit remains the dominant source of debt financing in the EU

While the use of all debt instruments has increased in the Euro area since 2008, the expansion of debt securities issuance has been more pronounced than that of bank loans.

The use of debt securities increased following the 2008 GFC and the EU Sovereign Debt Crisis of 2010-13 that saw a reduction of bank financing (see Chart 3 for France). Indeed, non-performing loans surged following the crisis, particularly in some southern and CEE countries, leading to credit contraction and bank deleveraging, and stricter prudential requirements increased the cost of lending for banks. During the same period there

was a significant growth of the corporate bond market and a shift in the composition of NFC debt from bank loans towards debt securities due to a contraction of bank credit following the GFC and also more recently to the large-scale asset purchase programmes of the ECB, which were progressively extended to high quality corporate bonds<sup>9</sup>. In addition, bond financing has advantages for NFCs compared to ordinary bank loans, since it requires less restrictive covenants and potentially offers longer tenors, thus providing NFCs with longer term financing and a source of diversification of their capital structure. The same trend in favour of bond financing was seen at the international level with an average annual global issuance of NFC corporate bonds since 2008 amounting to more than twice the average issuance between 2000 and 2007<sup>10</sup>.

8. "Trends in the financing structures of German non-financial corporations as reflected in the corporate financial statements statistics", Deutsche Bundesbank Monthly Report, July 2018.

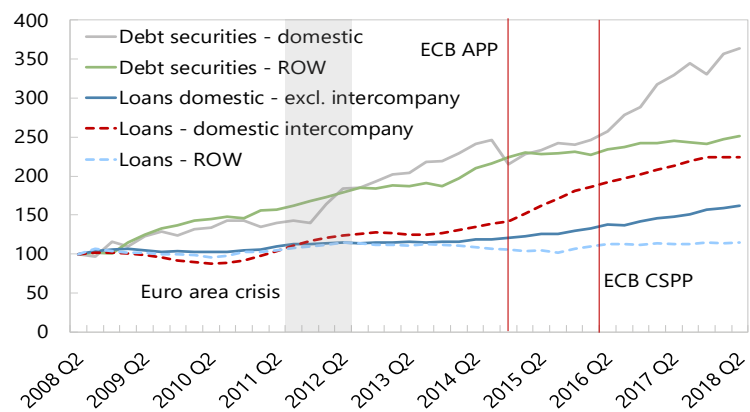
9. Bonds issued by non-financial firms in the EU significantly increased between 2013 and 2016, a trend that can be mainly explained by the accommodative path of the ECB, that embarked in a range of large-scale asset purchase programs in attempt to bring inflation back to its 2% target. Initially targeting public securities in 2015 as part of the Asset Purchase Program (APP), the program has been extended to the quality bonds (credit rating of at least BBB) issued by euro-area corporations other than banks under the corporate sector purchase program (CSPP). Source: "The euro area: corporate bond issuances are starting 2017 in good shape", Caixa Bank, January 2017.

10. The future of corporate governance in capital markets following the Covid 19 crisis – June 2021.

**CHART 3.**

**Cumulative Flows of Debt Liabilities of Non-Financial Companies in France, in bn of euros (2008Q2= 100)**

Source: IMF



Bank credit however remains the main source of debt financing in the EU and it is likely that the measures put in place to facilitate bank loans during the Covid crisis will have led to a further increase of bank credit in the total debt of NFCs.

In 2019 about 80% of total financial debt consisted of bank loans in the Euro area (compared to 89% in 2008), according to the Banque de France (see Chart 4). This share exceeded 90% in most CEE countries and also in Greece and Cyprus, whereas in France the share of

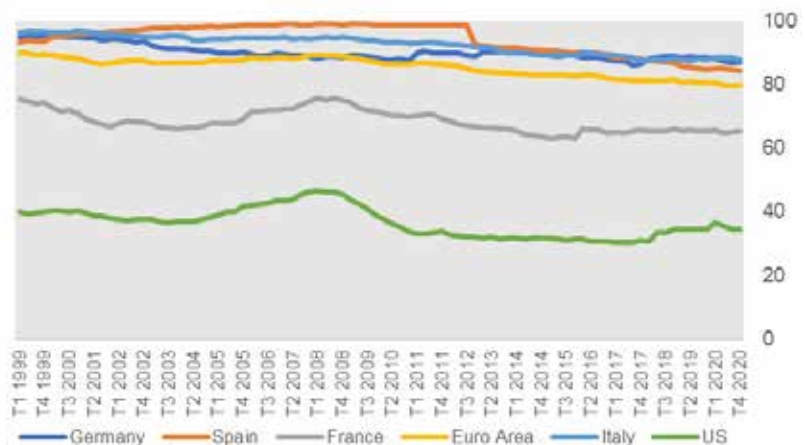
bank credit was closer to 65% in 2019. Comparatively, the share of bank loans compared to total debt in the US and Canada, where capital markets are more developed, did not exceed 40% at the same period.

When comparing aggregate NFC bank credit to GDP, the proportion of bank credit is also higher in Europe than in the US: 88,5% of GDP in the euro area, against 51% in the US, according to the BIS. Among advanced economies, only Japan (110,6%) exceeded this level.

**CHART 4.**

**Share of Bank Credit in Total Corporate Debt, %**

Source: Banque de France



## 2. While NFC debt seems more sustainable in the EU than in some other developed economies, its high level may be a drag on growth and reduce economic resilience

### 2.1 EU NFC debt seems more sustainable than in some other developed economies...

When considering the debt to gross surplus ratio<sup>11</sup>, the situation of European NFCs in terms of debt sustainability appears to be more favourable than in the US or Japan on the whole. According to the OECD, the debt outstanding is 3.6 to 4.2 times larger than the annual flow of gross operating surplus in large European countries such as

Italy, Germany and Spain in 2019, which is nearly half of the US level (8.8) (see Chart 5).

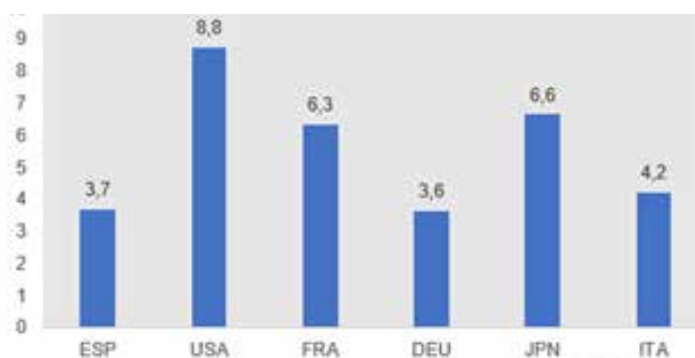
These statistics indicate that NFC debt may be relatively more sustainable in Europe than in the US for example, even if the level of debt of European NFCs compared to GDP is higher.

In addition, record-low borrowing costs contribute to supporting the sustainability of corporate debt in the short term with a significant decrease in interest payments in most advanced economies. A progressive normalization of monetary policy would nevertheless call this into question.

11. Considered as relevant for assessing the sustainability of debt, the debt to gross surplus ratio indicates the capacity of non-financial corporations to "meet the cost of interest and debt repayments with the operational profits generated", according to the OECD definition. Hence, "the higher (lower) the ratio, the greater (smaller) is the risk that non-financial corporations" may not be able to meet their debt repayments. Source na\_glance-2014-34-en.pdf (oecd-ilibrary.org).

**CHART 5.****Debt to Surplus ratio, 2019**

Source: OECD

**2.2 ...however high indebtedness is likely to impede the growth and resilience of EU NFCs over time**

First, high indebtedness may reduce the economic performance of NFCs<sup>12</sup>. Although corporate debt is essential to finance tangible investments and the cash requirements of firms, an excessive level of debt reduces their future investment capacity and thus their growth potential, because it forces borrowers to use a larger share of gross cash flow to pay interest services, at the expense of financing new investments. In addition, highly leveraged firms are more exposed to roll-over risk (i.e. to the risk that lenders may not renew expiring short term credit lines), particularly during a crisis, when collateral values drop. Empirical evidence published by the ECB<sup>13</sup> shows for example that after the 2008 GFC, corporate investment declined more in EU periphery countries where NFCs had accumulated large amounts of debt prior to the crisis than in the overall Euro area.

Secondly, indebtedness reduces the resilience of NFCs. As debt levels increase, borrowers' ability to repay becomes progressively more sensitive to drops in income and sales, as well as to potential increases in interest rates.

Past examples moreover show that recovery after a crisis (for example after the 2008 GFC) is slower in a bank-based economy, such as the EU, than in a market-based economy such as the US<sup>14</sup>. This can be attributed in part to the fact that market instruments allow firms to take more risks in their investments than bank loans with less restrictive covenants and longer tenors, potentially generating higher returns and also

to the greater exposure of banking activities to financial stability risks and economic cycles, leading to a greater potential rationing of bank funding in times of stress than markets<sup>15</sup>.

Hence the objective pursued notably in the Capital Markets Union (CMU) initiative to further diversify the financing of EU corporates with more equity in order to increase their resilience and growth potential.

For smaller growing and innovative companies, which have limited cash flows and need significant investments notably in intangible assets, further developing equity financing is essential. Indeed the financing of intangible fixed assets relies more on equity and other financial debts than that of tangible assets, which can more easily be financed by bank credit<sup>16</sup>.

Consequently, there is at present a strong deficit of intangible investment<sup>17</sup> in Europe: between 2014 and 2017, intangible capital amounted to 7,6% of GDP while it was over 10% in the US<sup>18</sup>.

**3. Equity financing remains under-developed in Europe despite some progress****3.1 Debt-to-equity ratios of NFCs are higher in the EU than in other developed countries and a significant proportion of firms are considered to have insufficient own funds**

The average debt-to-equity ratio of EU27 NFCs stood at 58.5% in 2019 according to Eurostat statistics (see Chart 6), which is higher than many other major economies such as the US (50%), China (52%) and Japan (55%)<sup>19</sup>.

12. Economists generally consider that debt-to-GDP levels become a drag on growth when they exceed 90%, which is the case for several European countries such as France, the NL, Belgium and to a lesser extent Portugal and Spain. Beyond this threshold, statistics show that a 1 percentage point increase in corporate debt is associated with an approximatively 2 basis points reduction in per capita GDP. Economic growth hence is more sensitive to the level of debt when the latter exceeds that threshold. Source: "The real effects of debt", BIS Working Paper, September 2011.

13. "Debt overhang, rollover risk, and corporate investment: evidence from the European crisis", Moreno et al (February 2019).

14. "Structure de la dette des entreprises et reprises économiques : analyse d'un groupe de pays", Grjebine, Szczerbowicz, Tripier, Banque de France (2018).

15. As highlighted in a working paper from the DNB "Banks overextend and misallocate credit in financial upturns and ration credit in financial downturns more than markets". The credit tightening of the banking sector during the EU Sovereign Crisis confirms that view (see Section 1.2). By contrast, market financing may contribute less to systemic risk, since they serve as platforms, directly channeling financial resources between savers and borrowers, rather than intermediating on separate balance sheets. "Markets are thus less dependent on highly leveraged institutions for the financial intermediation process, have more asset-liability matching, are financially less interconnected." Source Bank-based versus market-based financing: Implications for systemic risk, DNB Working Paper (December 2017).

16. Considering for example French companies, bank credit strongly contributes to the funding of tangible fixed assets (43%) but to a lower extent to the funding of intangible fixed assets (23%), according to Lé & Vinas in "The Financing of Investment: Firm Size, Asset Tangibility and the Size of Investment", Working Paper Banque de France (July 2020).

17. Computer software and databases, entertainment, artistic and literary originals, mineral explorations, design, new product development costs in the financial industry, research and development, branding, organizational capital and training...

18. According to INTAN-Invest.

When considering the situation across the EU, overall, there has been an improvement in the level of equity relative to debt since 2011 in most of the Member States and over this period, only 5 countries of the 27 experienced a surge of their debt-to-equity ratio. In addition, although there is a high dispersion of debt-to-equity ratios across EU Member States (ranging between 40% in Lithuania to 127% in Cyprus)<sup>20</sup>, the largest economies of the block are close to the EU average, with Germany and Spain standing at 56,6% and 58% respectively, France at 61% and Italy at 65%.

As for the size of NFCs, debt to equity ratios tend to be higher in smaller companies in the EU, although an

increase of the share of equity capital in total assets was observed for all sizes of firms until 2019.

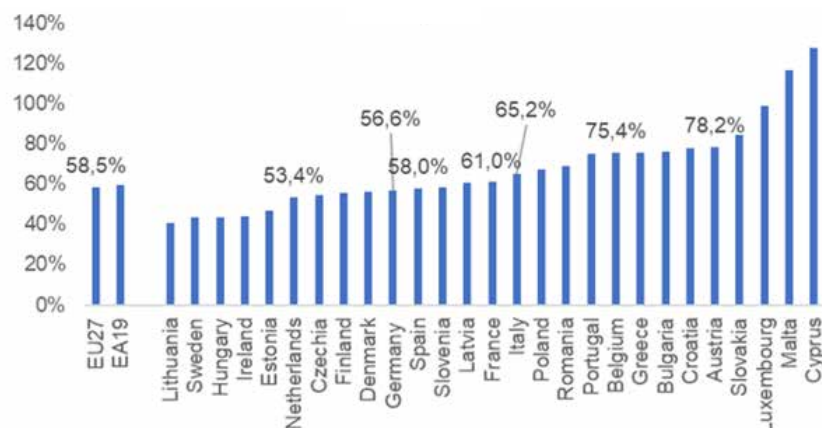
A significant number of smaller European companies are also considered to be under-capitalized. For example, in France, 20% of small companies are 'undercapitalized' according to the Banque de France, meaning that their total debt exceeds the level of equity by twice or more (i.e. a debt to equity ratio superior to 200%)<sup>21</sup>. Moreover significant equity financing gaps concerning SMEs have been identified by the EIB<sup>22</sup> in several member states including France (€ 146bn), Greece (€ 100bn), Germany (€ 98bn), Sweden (€ 97bn), Belgium (€ 68bn), the Netherlands (€ 41bn), and Denmark (€ 26bn).

**CHART 6.**

**Debt to Equity Ratio  
in the EU Member States  
in 2019, %**

Source: Eurostat,  
Eurofi calculations

Note: debt is the sum of Bank Loans  
and debt securities; Equity includes  
«Listed Shares», «Unlisted Shares» and  
«Other Equity», as classified by Eurostat



### 3.2 Stock markets and venture capital investment are under-developed in Europe compared to the US and Japan

European stock markets are significantly smaller and less liquid than US stock markets.

In 2019, the capitalization of European Stock Markets totalled \$ 10trn, which is less than one quarter of the US market (\$ 45 trn). Moreover, compared to GDP the capitalisation of the EU stock market is much smaller than that of the US (60% for Europe compared to 180% for the US) and also other developed countries notably in Asia (e.g. Japan 120%, Korea 90%).

In terms of market issuance of equity (both IPOs and secondary offerings), the European market is also smaller, representing around 2/3 of the US (adjusted for GDP).

Concerning investments in smaller company equity, the difference between the EU and the US is even

more striking with an amount of Venture Capital (VC) investment more than 10 times lower in the EU than in the US<sup>23</sup> in 2019, according to Bruegel<sup>24</sup>. In addition, around 84% of all venture debt deals in the last decade took place in the US and Canada, whereas only 6% were in Europe with most VC transactions concentrated in the UK, France and Germany. As a share of GDP, VC investment only accounted for 0,044% in Europe, versus 0,633% in the US; 1,83% in Singapore; 1,82% in China; 1,5% in India. One of the main reasons for this is the less developed, more risk averse start-up ecosystem in most EU countries, mainly relying on traditional bank financing.

The same is true for investments in larger SMEs. In terms of private equity (VC and PE) markets, the US market was about three times the absolute size of the EU counterpart in 2017, when measured as equity issuance for nonfinancial SME corporates, according to a study from the European Commission<sup>25</sup>.

19. The figures for the US, China and Japan are based on listed firms.

20. According to ORBIS database and data compiled by Bruegel, the average debt-to-equity ratio (i.e. proportion of debt compared to equity) of European listed firms is 1.41, meaning that European companies have \$1.41 of debt for every dollar of equity i.e. 58%. This is the highest level among advanced economies, compared to 1.02 in the US, 1.09 in China, 1.20 in Japan and 1.14 in South Korea.

21. "Les fonds propres des TPE et PME", Observatoire du financement des entreprises (Mai 2021).

22. Gap analysis for small and medium-sized enterprises financing in the European Union" (December 2019).

23. The main providers of venture debt in Europe are funds, banks and international financial institutions such as the EIB. The EIB is Europe's largest provider of venture debt, with EUR 600 million per year in long-term financing for highly innovative companies.

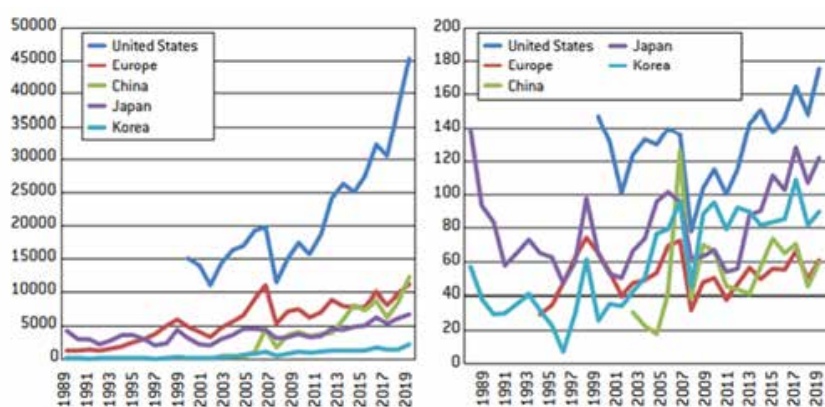
24. Demertzis, M., M. Domínguez-Jiménez and L. Guetta-Jeanrenaud (2021) 'Europe should not neglect its Capital Markets Union', Policy Contribution 13/2021, Bruegel.

25. "Study on Equity Investments in Europe: Mind the Gap", Research and Innovation Department, European Commission (February 2021).



**CHART 7.****Total Market Capitalisation,  
\$ billions and % of GDP**

Source: Bruegel based on  
World Federation of Exchanges  
database



#### 4. Several factors explain the high proportion of debt financing used by NFCs in the EU

##### 4.1 External listed equity financing is 4 times more expensive than debt financing for issuers at present

The external debt financing costs of NFCs (lending rates and market-based debt costs) have significantly decreased over the last 15 years in the Euro area and are lower than 2% since 2018.

During the same period, the cost of funding via listed equity has stagnated at a high level (see Chart 8): approximately 8% since 2014, according to ECB<sup>26</sup> estimates, compared to 5 to 7% in the US. In addition, the cost of external equity has not decreased during the Covid crisis, with shareholders maintaining their expectations in terms of return, when at the same time interest rates have decreased due to the action of the ECB<sup>27</sup>. This persistently high cost of equity funding in the EU, measured by a high “equity risk premium” (ERP) level<sup>28</sup> reflecting the compensation that investors demand for the risk of holding shares, is due to higher

risk aversion and relatively lower expected earning on future investments in Europe than in the US in particular, according to the ECB<sup>29</sup>.

This means that in effect the cost of external equity financing is 6 percentage points higher than debt<sup>30</sup> in Europe (or 4 times higher), putting equity financing at a strong disadvantage.

A further issue is the fiscal bias in favour of debt, which increases the cost of equity financing compared to debt financing. Indeed many corporate tax systems across the EU provide unintended incentives for debt financing via the tax-deductibility of interest payments, since a company can deduct interests attached to debt financing but not the costs related to equity financing, such as the payment of dividends. Six Member States (Belgium, Cyprus, Italy, Malta, Poland and Portugal) however have measures in place aiming to tackle this tax induced debt-equity bias. The measures differ in policy design but all provide for a tax allowance on equity funding calculated on the basis of the tax reduction that a firm would have obtained for an equivalent financing in debt.

**CHART 8.****Nominal External Financing  
Cost of Euro Area Non-Financial  
Companies, %**

Source: ECB

Notes: The latest observations are  
from February 2018 (short-term and  
long-term bank lending rates)  
and March 2018 (cost of listed equity  
and cost of market-based debt)



26. D. Kapp, K. Kristiansen “Euro area risk premia and monetary policy: a longer-term perspective”, (April 2021).

27. Source Eurofi April 2021 Seminar Summary.

28. The ERP summarizes the potential for future corporate profits, the interest rate to discount such profits and the perception of risk related to the investment considered.

29. Source: “Euro area risk premia and monetary policy: a longer-term perspective”, Daniel Kapp, Kristian Kristiansen (April 2021). Although the OECD report on the future of corporate governance (June 2021) referenced further up emphasizes that underwriting costs of IPOs for small and large companies are lower in Europe (3-4%) than in other major jurisdictions (US 7%, China 6-8% or Japan 6-8%).

30. The policy of lasting low interest rates has kept borrowing cost lower than equity cost, estimated through the equity risk premium (ERP). Source: Measuring and interpreting the cost of equity in the euro area (europa.eu).

#### 4.2 Debt financing is more accessible than equity financing for most companies in the EU

Beyond the cost of equity financing vs debt financing and the favourable tax treatment of debt compared to equity, many companies prefer debt as a financing channel because it is easier to access, despite the positive features of equity financing (e.g. longer term funding, capacity to finance intangible investments...) <sup>31</sup>.

Companies have an established relationship with several banks usually and can get access to more credit relatively easily in most cases thanks to this, except for financing intangible assets or a new business plan approach.

Obtaining additional equity financing is comparatively more difficult for most companies, particularly SMEs. Indeed it involves complying with regulatory and listing requirements such as establishing a prospectus, which are expensive and complex to handle for entrepreneurs, requires a great deal of disclosure on the company's strategy that entrepreneurs are not always ready to make public and also implies giving up an ownership stake and therefore losing part of the control over the company.

Small companies also face several structural problems inherent to the European equity market. These are related to the limited size of exchanges for smaller companies in Europe, to the fact that guiding smaller companies through a listing process is not the core business of many European banks and also that SMEs tend to use smaller banks in many cases that find it difficult to fully support the initiatives of their clients in this area <sup>32</sup>.

There are also many obstacles to the development of equity financing on the investor side including limited financial literacy in most EU countries, risk aversion and an access to research on companies that has been reduced since the implementation of MiFID II unbundling requirements, according to many market stakeholders. The potential disincentives to equity investment created by MiFID investor protection rules for retail investors and distributors are also emphasized, as well as the obstacles to institutional investment created by Solvency II rules applying to life insurers.

These different challenges, including the tax bias in favour of debt, are being tackled in the context of the Capital Markets Union (CMU) initiative and the MiFID II review, however significantly improving these different issues remains a relatively long term objective.

31. See Eurofi April 2021 Seminar Summary "Developing equity financing".

32. See Eurofi April 2021 Seminar Summary "Developing equity financing"

# RETAIL INVESTMENT STRATEGY: OBJECTIVES AND KEY ISSUES

Note written by Marc Truchet, EUROFI

## 1. Developing retail investment in capital markets is one of the key objectives of the CMU

Making the EU an “even safer place for individuals to save and invest long-term” is one of the main objectives of the new Capital Markets Union (CMU) action plan published in September 2020, which aims to put capital markets “at the service of people”. This was confirmed by the Ecofin of December 2020 which identified the development of investment by EU citizens as one of the short term priorities for the CMU.

Retail investment is indeed essential for the funding of the EU economy, with most of the potential long-term funding of the EU economy coming directly or indirectly (i.e. via funds or pension products) from households. Retail investors also tend to have a longer term investment horizon than institutional investors, who are usually assessed and remunerated on a shorter-time horizon. In addition, favouring long-term investment is also essential for the future well-being of EU citizens, notably for the preparation of their retirement. At present, more than 18% of EU citizens are indeed at risk of poverty or social exclusion in older age, making pension adequacy and coverage a priority for the Union and its governments<sup>1</sup>.

Europe has one of the highest individual savings rates<sup>2</sup> in the world and it has further increased with the Covid crisis. This saving rate has grown to 19% in the EU at the end of 2020<sup>3</sup>, compared to approximately 14% in the US<sup>4</sup>. This has led to the accumulation of significant cash savings in the EU. For example in France it is estimated that more than € 150 billion have been saved by citizens since the beginning of the Covid crisis, corresponding to 7% of the annual GDP and similar trends have been observed throughout Europe.

However, the rate of retail investor participation in capital markets remains low in the EU compared to other major economies such as the US. In 2019, 29% of EU27 household financial assets were held in equity

and investment fund shares<sup>5</sup>, but it is estimated that this percentage is closer to 15% when taking out securities held by family offices, holding companies etc. In comparison in the US approximately 45 to 50% of retail financial assets are held in equity and investment funds, with about 20% in direct corporate equity ownership compared to 4% in the EU<sup>6</sup>. Consequently, the proportion of household financial assets held in bank deposits and traditional savings accounts is high in the EU (32% of household financial assets, compared to approximately 15% in the US<sup>7</sup>), reducing long-term financing options for enterprises and potential returns for savers. Most of the remaining part of EU household assets (about 34%) was held in pensions and insurance-based products, which usually have a dominant share of fixed income instruments.

There is also quite a strong heterogeneity of situations across the EU, with deposits and currency representing more than 50% of financial assets in several CEE and southern Europe member states<sup>8</sup> for example.

Some positive trends have nevertheless been observed since the beginning of the Covid crisis, e.g. with a significant increase in the number of new openings of securities accounts, particularly among the younger population<sup>9</sup>, and a move from guaranteed products to unit-linked products within life insurance contacts. These changes are partly due to the opportunities for gains created by the market downfall at the outset of the Covid crisis and also to the low interest rates served by savings accounts and bond-based products, due to the current monetary policy.

## 2. A significant retail investment regulatory framework already exists in the EU but its effectiveness has been questioned in several areas

Retail investor protection rules are set out in a number of sector-specific EU legislations addressing different

1. Source CMU High Level Forum report June 2020.

2. Defined by gross saving divided by gross disposable income, with the latter being adjusted for the change in the net equity of households in pension funds reserves. Gross saving is the part of the gross disposable income which is not spent as final consumption expenditure.

3. Source Eurostat.

4. Source FRED – St Louis Fed December 2020.

5. Source Eurostat [https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Households\\_-\\_statistics\\_on\\_financial\\_assets\\_and\\_liabilities#Value\\_of\\_assets\\_and\\_liabilities](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Households_-_statistics_on_financial_assets_and_liabilities#Value_of_assets_and_liabilities)  
Figures published by Better Finance for the EU28 in 2019 are slightly different with 12% of household assets in listed equity and investment funds, 2% in debt securities 30% in bank deposits and currency (instead of 32%) and 39% in life insurances and pensions (instead of 34%).

6. The EU percentage is the proportion held in listed equity.

7. Source BIS Household wealth in the main advanced countries - 2019.

8. Source ESMA Performance and Costs of Retail Investment Products in the EU 2020 and 2021 and Speech by S. Maijoor October 2020 “Retail investors and asset management are the pillars of a successful CMU”.

9. For example, statistics from a major French e-broker indicate that new client accounts increased by +120% in 2020 and that 39% of all new clients are between 28 and 35 years old – Source Eurofi April 2021 seminar “Developing equity funding”.



aspects of investor protection at the product, distribution and order execution levels. These rules are completed by general consumer protection frameworks under domestic rules and also supervision that remains largely domestic in this field, although actions are being undertaken at ESMA level to enhance supervisory convergence. Educational aspects are also managed at national level.

Concerning EU frameworks, MiFID (Markets in Financial Instruments Directive) and IDD (Insurance Distribution Directive) provide rules for the distribution respectively of securities and insurance-based products covering issues such as investor classification, product suitability and appropriateness assessment, advice and information at the point of sale and also restrictions on the use of inducements. MiFID, MiFIR and other securities market regulations<sup>10</sup> also regulate the execution of securities transactions.

These distribution and securities market rules are completed by the PRIIPs regulation (Packaged Retail and Insurance-based Investment Products) which aims to enhance the consistency of investor disclosure across comparable investment products and to make it easier for retail investors to understand and compare the key features, risk, rewards and costs of different investment products<sup>11</sup> through the provision of the pre-contractual Key Investor Document (KID) prior to the conclusion of any transaction. Product frameworks such as the UCITS Directive, the ELTIF regulation and PEPP moreover contain measures for ensuring the protection of retail customers investing in these products, and cover in part similar ground to the legislations previously mentioned. UCITS for example, includes eligible asset and liquidity rules designed for retail investors, but also investor disclosure rules.

These EU frameworks tackle the main areas of investor protection, but since they are related to specific products they can differ from one instrument to another or overlap to a certain extent. This makes investment decisions across comparable products potentially more difficult for consumers and increases the complexity for producers and distributors of marketing investment products to the retail market. In addition the effectiveness of MiFID and IDD rules regarding suitability assessments and inducements in particular has been questioned, as well as the product disclosure requirements of PRIIPs. The current client categorisation in MiFID is also criticized as it may lead to unnecessary precautions and burdensome suitability verification processes particularly for the more sophisticated retail investors.

The appropriate way forward for addressing these different issues is still under discussion. Many stakeholders are in favour of a more consistent or holistic

approach to investor protection across EU regulations. However some are against a significant overhaul of the current approach<sup>12</sup>, if this implies merging or significantly modifying current legislations, considering that existing legislations have common bases concerning investor protection that need to be preserved and that making targeted improvements within the existing legislations would be sufficient.

Inducement rules also give rise to heated debates. While some stakeholders consider that the current restrictions on inducements<sup>13</sup> are not sufficient for eliminating biased advice, others argue that a stricter ban of inducements would be detrimental for investors, potentially increasing the price of advice and reducing its availability for non-high net worth clients.

Furthermore, digitalisation, which is becoming an increasingly important feature for retail investment with the development of investment apps, robo-advice platforms and social media needs to be appropriately taken into account in legislation. Investor protection rules need to be adapted to the new digital environment in order to allow investors to benefit from the new opportunities offered by digitalisation (e.g. in terms of easier access to investment products and information, improved comparability, lower costs) and also to mitigate related risks (e.g. related to an easier access to risky products or to possible gamification). Sustainable finance is another major trend that needs to be taken into account in the retail investment approach.

Finally, additional areas of improvement have been identified in the context of the CMU initiative concerning the level of financial literacy of retail investors, the skills of financial advisors and the access of citizens to appropriate information about their pensions.

### 3. Objectives of the EU Retail Investment Strategy

In the new CMU action plan proposed in September 2020, the Commission announced its intention to publish a comprehensive strategy for retail investment in Europe in the first half of 2022 aiming to ensure that retail investors can take full advantage of capital markets and improve the coherence of rules across different investment products. The objective of the upcoming Retail Investment Strategy is to ensure that retail investors benefit from (i) adequate protection, (ii) bias-free advice and fair treatment, (iii) open markets with a variety of competitive and cost-efficient financial services and products and (iv) transparent, comparable and understandable product information. In addition, EU legislation in this area should be forward-looking and should reflect on-going developments in digitalisation

10. Together with other market regulations such as the Market Abuse Regulation (MAR) and post-trading regulations (EMIR, CSDR).

11. The following products are in the scope of PRIIPs: Investment funds (UCITS have exemption until 31 December 2021); Life insurance-based investment products (such as unit-linked or with-profits policies); Retail structured securities (including instruments issued by securitisation institutions and corporate bonds); Structured term deposits; Derivatives; Convertible bonds and other structured securities with embedded derivatives; Pension products and annuities not recognised by the national law.

12. See for example FBF contribution – EU strategy for retail investors – May 2021.

13. The general inducements MiFID II rule prohibits firms from paying benefits to or receiving benefits from third parties, unless the benefits are designed to enhance the quality of the relevant service to the client, and do not impair compliance with the firm's duty to act honestly, fairly, and professionally in accordance with the best interests of its clients.

and sustainability, according to the Commission, as well as the increasing need for retirement savings. The new CMU action plan also includes further proposals concerning financial education<sup>14</sup>, inducements, investor categorisation, professional qualifications<sup>15</sup> and pension adequacy<sup>16</sup>.

In this perspective the Commission is conducting an extensive study of the different disclosure regimes in the EU, of current practices in terms of advice provision and of the impact of inducements. A consultation for preparing a proposal for a Retail Investment Strategy has also been launched<sup>17</sup>. This consultation covers the main topics that have been identified as potential areas of improvement for encouraging more retail investment in the context of the CMU initiative and also of the reviews of existing regulations such as MiFID II, IDD or PRIIPs including: financial literacy, digital innovation, disclosure requirements, PRIIPs, suitability and appropriateness assessment, investor categorisation, inducements and quality of advice, product complexity, redress and complaints, intervention powers and sustainable investing.

Other on-going areas of assessment include the performance and costs of retail investment products, which are monitored on an annual basis by ESMA and EIOPA.

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

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

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

17. Consequently, the reviews of MiFID II, IDD and PRIIPs concerning retail investors will probably not be implemented until the Retail Investment Strategy has been completed.

# SECURITISATION: THE INDISPENSABLE REFORM<sup>1</sup>

Note written by Ian Bell, PCS

## 1. Introduction

Securitisation is a financial tool whereby a lender (usually a bank but sometimes a non-bank finance house or a non-financial corporation) is able to refinance a pool of loans by turning them into securities and placing these with capital market investors.

There are a number of advantages to securitisation. One is that the investors can take the risk of the assets themselves (e.g., residential mortgages, consumer loans) without taking the risk of the financial institution which originated them. It is a way for capital market investors to invest into direct lending to the economy which would not otherwise be open to them.

Another advantage is that securitisation includes “tranching” where the risk of the securitised assets is bundled into tranches of risk which are more or less risky. Any losses on the securitised assets are first taken by the most junior tranches whereas the investors in the senior tranches are only at risk if losses are greater than a pre-set amount. Properly executed, this enables the creation of very safe bonds and the allocation of different risks to different types of capital market investors depending on their risk appetite.

A further advantage of securitisation is turning illiquid bank type assets into liquid capital market instruments, thereby providing attractive investment opportunities to pension funds, insurance companies and other funds.

Finally, if the securitisation meets certain rules, it allows banks to rebalance their balance sheet by removing risk and freeing up capital for new lending to the economy.

However, despite the positive potential of securitisation, one of the triggers of the financial crisis of 2007/2008 was the devastation inflicted on the world's financial system by opaque and badly structured securitisations coming out of the United States. During the first phase of crisis management, the reaction of most European public institutions towards securitisation generally was extremely negative and the regulatory measures proposed for dealing with this finance tool were punitive.

However, as the management of the crisis progressed, data emerged that led policy makers' views to revise their assessment.

First, European securitisations in the basic and simplest asset classes displayed spectacularly good credit performance through the severe economic downturn triggered by both GFC and the subsequent Eurozone crisis. To this day, thirteen years on, AAA to single-A rated senior tranches of traditional asset class securitisations in Europe have still not suffered a single euro of loss. This includes securitisations in what became at times highly stressed economies such as Spain, Greece and Italy. It became clear that properly structured transparent securitisations, such as Europe had been issuing, were a safe and resilient financing tool.

Secondly, institutions such as the European Central Bank, the Bank of England and the European Banking Authority began to point out that well-structured securitisations could play a very desirable role in shifting risk in the financial system in systemically positive ways<sup>2</sup>. Good securitisation could play a role in increasing banking resilience.

Thirdly, a key lesson of the crisis was that Europe was too dependent on banks to finance its economy and it was therefore vital, to ensure future stability and protect European citizens from a repeat of the 2011/2012 crisis, to boost the role and size of the capital markets. Hence the Capital Markets Union project.

All this led the Commission in 2014 to seek to create a differentiated regulatory system for securitisations which, grounded in what was learned during the crisis, could define and identify safe, simple and transparent securitisations. This was done with the explicit aim to increase meaningfully the volume of issuance of such instruments. Such increase would allow the reduction of systemic risk in the European banking system whilst, simultaneously increasing the size of the European capital markets – in line with the CMU project – and avoid the reduction in the financing of the economy that could result from additional capital requirements for banks.

The Securitisation Regulation<sup>3</sup>, incorporating these policy aims, was passed in December 2017 and came into effect on January 1, 2019. It was then amended in 2021 to extend the new STS status to on-balance-sheet securitisations and effect some necessary changes to the treatment of non-performing loan securitisations.<sup>4</sup>

1. This article is an update of an article written in April 2020.

2. Joint ECB/BoE discussion paper: “the case for a better functioning securitisation in the European Union” (2014) - <https://www.bankofengland.co.uk/-/media/boe/files/news/2014/may/case-for-a-better-functioning-securitisation-market-discussion-paper.pdf?la=en&hash=3AC4F391CB45870260134F53BCB67BEE587CC856> and EBA discussion paper: “Simple, standard and transparent securitisations” (2014) - <https://eba.europa.eu/sites/default/documents/files/documents/10180/846157/ceefdf3f-58ea-452f-a924-2563410d1705/EBA-DP-2014-02%20Discussion%20Paper%20on%20simple%20standard%20and%20transparent%20securitisations.pdf?retry=1>.

3. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=enf>.

4. <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557&from=EN>.

However, it did not result in the hoped-for increase in issuance. This paper will try to analyse why this may be the case, why this matters, and what could be done to improve the situation.

## 2. State of play

### 2.1 The STS regime

The Securitisation Regulation created a new European framework. This regulation was drafted very much with the lessons of the crisis of 2007/2008 in mind and is designed to prevent any repetition of the weaknesses that were displayed in the US securitisation market. In particular, it:

- Banned re-securitisations;
- Mandatorily imposed the most extensive transparency and disclosure requirements in the world;
- Codified extensive due diligence requirements which must be complied with by all European investors;
- Created new categories capital market actors (data repositories and third-party verification agents) designed to increase the robustness of the European securitisation market and subjected them to regulation to ensure their independence and integrity.
- Set up a severe sanctions' regime for any breaches by market participants of the new rules.

Most innovative of all, European policy makers, advised by the European Banking Authority, created a new regulated definition of "simple, transparent and standardised securitisations" ("STS securitisations"). To meet this new and exacting standard, a securitisation must meet each and every one of 102 separate criteria. These criteria were designed to capture all the aspects of securitisations which had been an issue during the crisis as well as additional elements deemed by regulators and the legislators to be important aspects of safe and transparent securitisations. This standard is the highest, most comprehensive, and most demanding regulatory securitisation standard in the world.

All this was designed to restart a strong but also safe and socially useful securitisation market.

### 2.2 STS is successful, but only on its own terms

Despite misgivings by some stakeholders that the definition of STS securitisations was overcomplex and the Regulation's requirements for data disclosure overburdensome, for securitisations that are able to achieve the standard, it has become the norm.

Since the regime came into force, 535 securitisations have been notified to ESMA as meeting the STS standard.<sup>5</sup> In 2020 alone that number reached 300. Effectively, almost all transactions publicly placed with investors since March 2019, and which may achieve the STS standard have elected to do so.

The STS standard is being used extensively and is therefore a workable standard. However, in line with what we write below, the trend is concerning. After 300 STS transactions notified in 2020, the number so far in 2021 is less than one hundred and it is very unlikely that the rest of the year will make up the shortfall. Even more concerning, of those, less than 40 are public placed securitisations of the type the new STS standard was designed to promote.

### 2.3 Securitisation issuance is stagnating

What the STS regime has not been able to achieve though is to increase the use of securitisation as a financing channel. Even though this was explicitly the purpose of the Regulation, issuance – in fact – has continued to decrease.

Between 2018 and 2019, European placed issuance fell 10% from €116bn to €108bn. In 2020 that fall just accelerated with issuance of €81.8 only just three quarter of the previous year<sup>6</sup>. Although 2021 looks marginally better, it is most unlikely that it will return to even the depressed numbers of 2019.

In the securitisation of prime residential mortgages – the backbone of any securitisation market – the numbers are even starker. In the EU27, placed issuance in 2019 fell to €6.8bn, to further fall in 2020 to €6.2bn. This is the lowest post-crisis issuance. This can be contrasted with covered bond issuance in both years of around €300bn.

Moving from a purely quantitative analysis to a qualitative one, the post-STs European securitisation market shows no meaningful difference in the identity of the participants than that of the earlier period. Post-2019 is merely a smaller version of pre-2019: the same issuers issuing the same types of securitisation, just in smaller volumes.

As for attracting a large and more diverse investor base, there is no sign. One investor group in particular on which the STS reforms were counting – through changes to Solvency II – were European insurers. Here the data are nothing short of catastrophic. The Joint Committee of the ESA's report on the functioning of the European securitisation market<sup>7</sup>, revealed not only that securitisation represented only 2.3% of the overall investment portfolios of European insurers but that STS securitisation, the asset class policy makers explicitly wished to find its way there, was only 2% of that small number, in other words, **a staggering 0.046% only of total investment**.

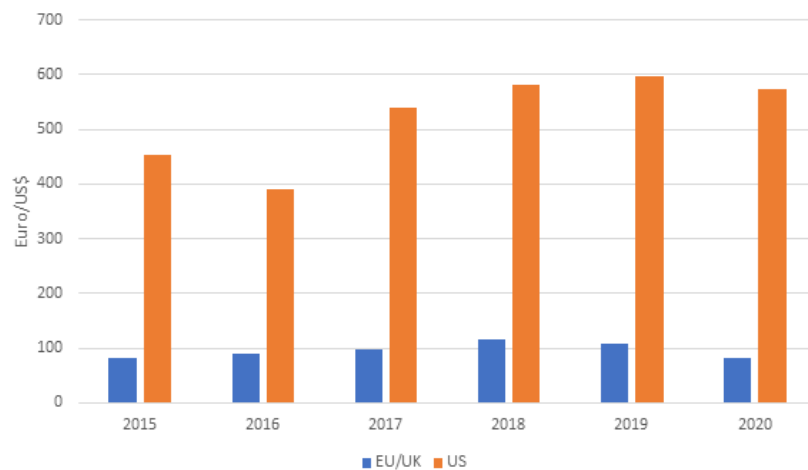
Some of the weakness continues to reflect the impact of the ECB's monetary policy and, for 2020, the effect of COVID on lending volumes but comparisons with earlier years and with the United States are telling. Central bank policy in the US has been no less accommodating, nor the economic impact of COVID meaningfully less.

5. As at 24th August 2021, see <https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation>.

6. These numbers include the UK, but the EU only trendline is the same with total 2020 issuance at €62bn.

7. [https://www.eba.europa.eu/sites/default/documents/files/document\\_library/Publications/Reports/2021/1001427/JC%202021%2031%20\(JC%20Report%20on%20the%20implementation%20and%20functioning%20of%20the%20Securitisation%20Regulation\)%20\(1\).pdf](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1001427/JC%202021%2031%20(JC%20Report%20on%20the%20implementation%20and%20functioning%20of%20the%20Securitisation%20Regulation)%20(1).pdf)

CHART 1.

**Placed Issuance  
(Non-Agency)****2.4 Growing importance of SRT**

Another key trend in recent years has been the growing importance of securitisations used by European banks to remove risk from their balance sheet and thus free some capital for further lending. Technically, this may be achieved when a bank demonstrates to its prudential regulator that it has

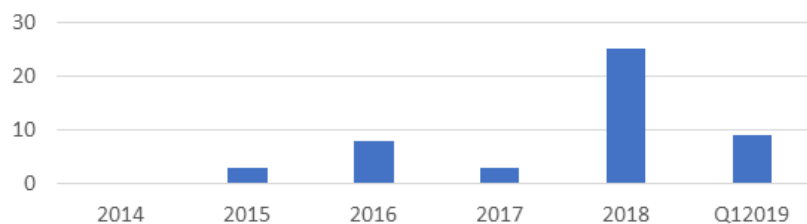
met the “significant risk transfer” rules (or “SRT” rules – so that securitisations that meet these rules are called SRT securitisations).

Very rare until a few years ago, recently released EBA data shows a very notable growth in SRT securitisations<sup>8</sup>. This is unsurprising in light of forthcoming changes to the Basel requirements.

CHART 2.

**SRT Transactions  
by number (top)  
and by EUR volume  
(bottom)**

Source: EBA

**2.5 Growing role of synthetic securitisations**

One way to achieve SRT securitisations is to issue “synthetic securitisations” (also known as “on-balance-sheet securitisations”). Behind the intimidating name is a fairly simple instrument. Instead of relying on a sale by the financial institution of its assets to a vehicle that issues securitisation bonds, in a synthetic securitisation, the financial institution insures those assets against credit losses. Once properly insured, these assets do not require capital to be held by the financial institution since, in cases of loss, the loss is covered by the insuring investor.

A key aspect of synthetic securitisations though is that they are, legally, “securitisations” and are therefore subject to the European regulations on securitisations, including the rules on Basel capital requirements. As a result, they are also strongly negatively impacted by the newly introduced capital requirements. This resulted, in some cases, in transactions which could no longer be

made to work as capital freeing tools or, in most other cases, in transactions with much reduced benefits in terms of the amount of capital becoming available for additional lending.

Acknowledging the importance of synthetic securitisations, the co-legislators amended both the Securitisation Regulation and the Capital Requirements Regulation to allow synthetic securitisations to achieve STS status and to provide more appropriate capital charges for banks using such securitisations to manage risk and capital.<sup>9</sup>

**Conclusion**

***Despite the passing of the Securitisation Regulation, European securitisation is stagnating at historically low levels. This is despite the increased use of securitisation for SRT purposes both via traditional securitisation and synthetic securitisation.***

8. See page 22 of the EBA's Discussion Paper: <https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20synthetic%20securitisation.pdf?retry=1>

9. See link in footnote 5



### 3. We should now examine why this is and why this matters

There are three main reasons why reviving the European securitisation market is urgent and vital for the well-being of the European economy and the fulfilment of Europe's global ambitions as an economy but also as a leader of sustainable development.

#### 3.1 Basel implementation

According to the EBA, the coming implementation of the Basel capital requirements will require European banks to raise their capital by 25% on average and 28.5% for systemically important institutions.<sup>10</sup>

The EBA's figures though only cover the legal bare minimum. In their recent paper<sup>11</sup>, the economists at Copenhagen Economics have convincingly analysed the additional capital required by European banks to be in the order of €170bn to €230bn. Put in a different way, this represents €2 to €2.3 trillion in lending.

More concerning yet, these numbers do not take into account any impact of the COVID crisis on losses and the concomitant potential erosion in existing bank capital. A recent IMF paper estimates these could result in the loss of €100bn in bank capital<sup>12</sup>.

This would take the capital gap for European banks to €270bn to €330bn.

Banks can confront this capital gap in one or a combination of three ways:

##### a) Raise capital

A bank can raise additional capital by issuing shares or other capital market instruments meeting the regulatory definition of capital or retaining profits.

Raising new cash for capital in a minimum amount of €170bn to €230bn (or more depending on COVID losses) – just to stand still – is a challenge containing many uncertainties and risks for the European economy. There are good reasons to doubt that it is even feasible.

##### b) Reduce lending

To the extent a bank cannot raise additional capital – the numerator of the capital formula – it can attack the denominator by reducing the amount of lending it needs to hold that capital against.

Looking at past crisis, Copenhagen Economics in their paper have determined that banks faced with steep capital raising requirements usually meet 30% of that requirement via a reduction in lending.

Based on €170bn to €230bn of capital requirements, this would translate into **a reduction of €600bn to €700bn in European bank lending.**

Faced with the challenges of keeping the economy on a growth path post-COVID and funding the European Green Plan (of which more later), such a reduction would be catastrophic.

##### c) Reducing risk

A bank can remove risk from its balance sheet so that capital allocated to that risk is now free to be used for new lending.

This is what SRT securitisation can do.

This can also be done by selling whole loans. Although sales occur these are, for a number of reasons, unlikely to be sufficient. Additionally, many key potential purchasers of such loans are themselves reliant on securitisation as their financing source. So substantial whole loan sales themselves will depend on a healthy securitisation market.

To give a sense of the size of the challenge, even on the extremely conservative EBA figures, if we assume that half of the capital EU-27 bank increase is due to residential mortgages and half of that increase is addressed via securitisation, then we estimate a need for €800bn of new RMBS issuance over 5-10 years. As mentioned, RMBS issuance for the whole of 2020 was €6.2bn.

It is also worth noting that this is not only a challenge for the large international universal banks that operate in Europe but for the whole banking system, including the smaller regional lending institutions that dot the European landscape.

It is sometimes argued that Basel is an international agreement applicable to all nations and therefore designed to create a "level playing field". So, in this context, we should point out that these challenges are nowhere as relevant to the United States. By excluding all their small regional banks from the Basel accords, the US have shielded the small lenders that play such an important role in Europe. By effectively nationalising the mortgage market via institutions such as Fanny Mae and Freddy Mac, the US has provided a state-sponsored and state-backed means for all banks to manage their capital with enormous flexibility. This has allowed the United States the luxury to take very strong positions on Basel in the knowledge that these did not affect their own banking system's lending envelope. Adding to this the much more developed capital market in the US, it becomes clear that Europe's challenges are very different, and Europe's solutions will need to be its own.

10. These numbers do not take into account the short term measures taken by bank regulators in the face of the COVID19 emergency which have artificially reduced the immediate current "point in time" capital shortfall..

11. "EU implementation of the final Basel iii standard" (June 2021) [https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/567/1623766208/copenhagen-economics\\_eu-implementation-of-the-final-basel-iii.pdf](https://www.copenhageneconomics.com/dyn/resources/Publication/publicationPDF/7/567/1623766208/copenhagen-economics_eu-implementation-of-the-final-basel-iii.pdf)

12. "COVID-19: How will European Banks Fare?" Aiyar, IMF (March 2021) <https://www.imf.org/en/Publications/Departmental-Papers-Policy-Papers/Issues/2021/03/24/COVID-19-How-Will-European-Banks-Fare-50214>

### 3.2 Capital Markets Union

Set up under the previous Commission in response to the crisis of 2008/2009, the Capital Markets Union project retains all of its importance and validity today, and even more so in the context of Brexit.

Whereas around 70% of the financing of the economy in the United States is derived from capital markets and 30% from banks, the proportions in the EU are basically reversed.

This creates a number of problems for Europe:

- An over-reliance on banks which makes any crisis in the banking sector almost immediately systemic;
- An over-reliance on banks which creates an artificial ceiling to the amount of financing the European economy may access – namely the amount of capital banks can raise. In other words, if banks find it difficult or expensive to raise capital, in the absence of a securitisation market, necessary lending to the economy may not materialise (as outlined above);
- A hurdle in moving away from Europe's over-reliance on banks as new entrants to the lending business

(including fintech firms) rely on capital markets, especially securitisation, to grow;

- An absence of channels for European savers providing safe yet decent returns on investments – a problem likely to become ever more acute as the population ages and pensions become a key issue.

There are many causes to the much greater role of capital markets in financing growth in the United States, but one of them is the difference between an EU27 securitisation market that stands at €743bn and a comparable US market that stands at €2420bn in 2020. And this comparison excludes all the US state-guaranteed mortgage securitisations which accounts for a staggering €7,000 bn of additional funding to the US economy. Even if only half of the mortgages currently funded in the US through state sponsored securitisations were to be funded by the private securitisation market, Europe's €740bn market would be set against a US\$6,000bn US market. Overall securitisation outstandings in the US are ten times those of the EU and represent 45% of GDP compared to 5.7% in the EU.

**TABLE 1.**

Sources: AFME,  
World Bank,  
all amounts in Euros

	2021	GDP	Private Securitisation		Agency Securitisation	
		bn	bn	%GDP	bn	%GDP
USA		20,937	2,420	11.5	7,000	33.4
EU27		12,985	743	5.75	0	0
UK		2,307	243	10.5	0	0

One should stress also that in addition to capital relief opportunities, securitisation provides banks with a day-to-day tool for diversifying their risk portfolio and optimising their risk profile. Indeed, securitisation enables them to address any excessive concentration within their loan portfolio in certain economic areas (real estate, consumer finance, residential mortgages...) or geographies. This should greatly contribute to improving bank resilience in the EU and dampening the consequences of any future asymmetric shock, notably by facilitating cross border private risk sharing.

### 3.3 Green Finance

In addition to funding COVID recovery, as well as "business-as-usual", Europe has also set for itself a very ambitious green target. This project will require funding above and beyond what would be expected for traditional growth. The European Commission estimates, in its Sustainable Finance Action Plan<sup>13</sup>, that, in addition to public money, there is a yearly €180bn investment gap to achieve EU climate and energy targets by 2030. The Commission also cites the EIB's estimate of an overall yearly investment gap in transport, energy, and resource management infrastructure of €270 bn.

To find this funding, it is essential that no legitimate and safe financing channels be blocked, and that Europe can find ways to mobilise its deep savings pools.

One of the conundrums of green finance is that a substantial part of it will be required to fund innovative solutions often from new companies. Much of it will be in the form of green projects which require upfront finance and produce income streams later. These types of financings are often somewhat or completely speculative. As such, it is not always clear that they would be safe investments into which policy makers would want to direct those deep savings pools of mainly retail savings. The risk profiles of these investments do not make them obvious candidates for the savings backing the retirements of European citizens.

However, the definition of a "securitisation" is a financial investment which is "tranching". This means that securitisation is a financing that is uniquely capable of unbundling risk and segregating it in discrete blocks of higher and lower quality. Risk-averse savers could invest solely in the least risky part of a green financing, letting more speculative funds invest in the riskier parts.

13. "Action Plan: Financing Sustainable Growth" (March 2018) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN>



This would enable conservative and risk averse investors (eg insurance companies and pension funds as well as retail funds) to invest in green projects in a safe way.

At the same time, the riskier tranches can be funded by growth funds as well as equity finance houses backing sustainable projects.

Finally, since, the safest tranches of a green securitisation are likely to represent the bulk of the investment, investing in the riskier tranches can provide a multiplier effect for limited public funds. For example, a €500m securitisation of solar panel installations could be split into a €400m senior AAA tranche and a €100m junior tranche. The AAA tranche is attractive to risk averse investors. The €100m tranche could be funded with public money. The entire €500m financing is too risky without tranching for risk averse capital market players, so if it were to be funded by public money, the taxpayer would have to provide the full €500m. By funding only €100m the public purse has created a one to five leverage in its deployable investment. So €500m that would otherwise have funded one solar panel investment can now fund five times that number.

Another key aspect of securitisation is that it bundles together small financings (such as mortgages, auto loans, SME loans, etc...) allowing them to be funded by the capital markets even though each individual loan is too small to attract capital market investors. In turn, many green projects are also very small: the installation of solar panels on a house, the purchase of an electric vehicle, the transformation by an SME of its production cycle. Securitisation is the only financing technique that can mobilise capital market investment pools for such financings by pooling them together.<sup>14</sup>

This is why securitisation can provide additional and not substitutional funding to the Green Plan as well as a leverage effect for limited public funding

We have already seen, globally, securitisations of green mortgages, water processing plants, solar panels, clean energy projects and other ESG asset classes.

Also, as we saw above, by allowing banks to extend more finance to the economy – including green projects – even when raising capital is difficult, securitisation also, in a more general but yet important sense, allows banks to mobilise more resources for green initiatives.

## Conclusion

***Without a deep and safe securitisation market, Europe could face meaningful constraints on the borrowing capacity of its economic actors, a continued over-reliance on banks, a struggle to create a modern fintech sector and an artificial and unnecessary restriction on its capacity to fund its green ambitions.***

## Taking as a basis:

- **€135bn a year representing the very conservative €800bn over say 6 years for Basel capital reduction to help maintain “business as usual” lending (see above);**
- **€55bn a year for green securitisations representing 20% of the EIB estimated investment gap; and**
- **an additional €75bn of bank securitisations to further free capital to allow an equivalent level of new and green lending;**

***we conclude that anything below €265bn of yearly new securitisations in the EU27 would fail to unlock the value of the STS reforms. We stress that this is the floor of our hopes should the proper measures be put in place. In 2006, the last year before the crisis, Europe saw €450bn of securitisation issuance in its traditional asset classes.***

## 4. What can be done?

To understand what can be done, we need to understand why the STS Regulation has not spurred the market.

For a strong but safe market to arise, one needs to have a larger group of issuers and investors able to agree on a mutually attractive price for safe securitisations taking into account any regulatory capital costs and benefits. Currently, that balance cannot be achieved because the capital costs and benefits are not commensurate with the risks of safe STS securitisations and distort the market to a point where it is not attractive for many players. This is particularly obvious when compared to other asset classes such as covered bonds whose admittedly excellent credit performance during the crisis is not better than that of senior STS securitisations.

### 4.1 CRR calibration for banks

The new CRR calibrations have substantially increased the cost for banks to hold securitisations. Even at the floor for STS of 10%, this is more than a 40% increase over earlier requirements. (For non-STS, the floor has more than doubled.) From this point of view, it is clear that – although STS has been rightly presented as a “gold standard” for securitisations – the introduction of this higher standard has, in fact, resulted in a much more severe treatment regulatory-capital wise.

Although many highly mathematical and data abundant arguments are bandied around in this area, the basic flaw of the current calibrations is simple. After the crisis, regulators agreed that risk weights for securitisations should be (much) greater than the risks of the underlying securitised assets because of “agency risk”. This expression covers the idea that the

14. It has sometimes been argued that covered bonds can also mobilise capital market funding for bundled pools. This, however, is to misunderstand covered bonds. Covered bonds are a direct borrowing by a bank which is cheaper because it is secured. But the investors do not technically become the lenders under the assets nor do they accept the risk of those assets as the bond is a direct obligation of the issuer. In turn the issuer does not remove any of the risks associated with those assets. Covered bonds mobilise capital market funding for banks, not assets.

very act of securitising creates additional risks<sup>15</sup>. To counter agency risk, the Basel committee introduced to the formulae setting the capital required to hold a securitisation an added number: the p factor.

It is this p factor (together with the arbitrary floors on senior tranches) that accounts for the non-neutrality of the capital requirements – i.e., that the capital requirements of the same pool of assets in securitised form is a multiple of the capital requirement of those assets before they were securitised. By way of example, for the exact same standard mortgage portfolio, the capital is over two and a half times greater when securitised as when on the bank's balance sheet.

At the same time, learning from the crisis, policy makers – together with the regulators – designed the new extremely detailed and comprehensive STS standard. One of the aims of the STS standard was to identify all agency risks and remove them. We would argue that this has been successfully done.

But largely because of an accident of how these changes were sequenced through time, the achievement of the STS criteria – i.e. the removal of all the causes of non-neutrality – was never incorporated in the final CRR formulae.

We need to remedy this error and see through to its logical conclusion the work of the Commission and the Co-Legislators when they created the STS standard.

(In conversation with some regulators, we have sometimes heard the contention that maybe not all agency risks had been removed by STS. Although this contention is not always buttressed with examples and often remains vague, the counter remains straightforward: if an agency risk is identified that is not yet addressed in the STS criteria, then the STS criteria should be adapted, so that the p factor can be reduced to an appropriate level rather than maintained, with all the negative consequences this entails, to cover the last minuscule risk factor.).

The calibration bias in securitisation capital for banks can be corrected through reviewing the CRR calibration of the p factor for the SEC-IRBA (art. 259 of the CRR) and of the p factor for SEC-SA (art. 261 of the CRR). Although we believe that in the absence of identified agency risks, the p factor should logically be set at zero, we acknowledge the conservative approach of regulators and recommend a p factor of no more than 0.25 for STS deals.

The risk-weight floor should also be recalibrated: at present, senior tranches attract between c. 25% and c. 50% of the total risk-weight although they cover only a minimal share of the risk. For instance, for a typical transaction on residential mortgages with loan-to-value ratios of 80%, the senior tranche would be attracting c. 50% of total risk weights. We should aim at applying the initial 7% RW floor to STS senior tranches and 15% for non-STS, in order to provide an

incentive for the market to focus on the STS regime and reflect both the actual performance through the crisis of those senior tranches of securitisations which would have met the STS standards had it then been in existence.

## 4.2 LCR Eligibility

With the introduction of the STS standard, on 13 July 2018, the Commission published the final text of revisions to the LCR Delegated Act. This amendment did not provide any recognition of the new standard's strength and thoroughness and simply inserted the new standard (STS) in place of the old.

Yet, the new STS standard is more comprehensive than the old LCR eligibility standard – containing over 100 separate criteria. The new STS standard is backed by a new severe sanctions' regime. The new standard is framed by new regulated market participants – third party verification agents and data repositories – to reinforce its integrity and transparency. The new standard is an official designation enhancing its market liquidity. And yet, the new standard was granted no benefits whatsoever in the revised LCR rules.

Considering how strict those rules were at the outset, it is difficult to conclude that either (i) they were in fact too lax – even passed at a time of great diffidence toward securitisation or (ii) the STS standard devised after considerable work by the Commission and Co-Legislators really added nothing to the existing rules.

Again, it is essential to complete the reforms of the securitisation framework begun with the creation of an STS criteria and re-classify STS senior tranches to Level 1 or, at worse, 2A and restore the eligibility at a single-A rating level to recognise the resilience and transparency of the new standard.

Finally, securitisation is the only asset class that has a maturity cap at five years for LCR eligibility. This arbitrary cap does not appear to be backed by any empirical data and fits oddly with the possibility of including a twenty year covered bond in the LCR pools. This maturity cap should be removed.

## 4.3 Solvency II calibrations

A key target for increased investor involvement in securitisation, are insurance undertakings. Here, again Solvency II calibrations display an unjustifiable non-neutrality. This time, the non-neutrality does not arise from an artificial p factor but as an artificial artefact of the division within the legislation of risk assessment into different «modules» using completely different methodologies.

The result of this artificial distinction is that the capital required by an insurer to be set aside for the purchase of a whole pool of mortgages is less than the capital required to purchase via a securitisation only the senior 80% of the risk of the identical pool and

15. The most obvious agency risk was the originate-to-distribute model common in the US sub-prime sector where it was rightly perceived that a finance house originating mortgages which would all be swiftly sold would originate worse quality assets. Similarly, lack of transparency was an agency risk.

considerably less than purchasing the exact same pool in securitised form. This is even though the securitised pool is considerably more liquid than the un-securitised whole loan pool.

In addition, the data on which the original calculations, were based adversely and idiosyncratically affected securitisations compared to other asset classes. Much of the worse effects of this in the original Solvency II calibrations was ameliorated following the STS Regulation, but – as with CRR – to fulfil the purpose of the new STS standard it is necessary to revisit what we believe to be a no-longer justified non-neutrality. This is particularly, but not only, true of the treatment of junior tranches of STS securitisations.

#### 4.4 STS for synthetics

With the amendments allowing synthetic/on-balance-sheet securitisations to achieve STS, a great step was made towards allowing banks to adjust their risk and capital in a safe, ongoing and pro-active way.

A number of technical standards remain to be published though and it is important that they do not undermine the progress embodied in the new legislation.

This is particularly the case of the technical standard on “synthetic excess spread”, where the EBA are required to draft a proposal for its capitalisation under the CRR. Specifically, we encourage the EBA to adopt the approach currently used by the ECB as a prudential regulator when analysing the impact of synthetic excess spread.

#### 4.5 A proper and reasonable SRT infrastructure

As we have noted, achieving SRT and capital reduction is a key to the benefits of securitisation. That key, in turn, can unlock the issuance volume to drive the CMU. But this is dependent on a reasonable process and clear rules through which European banks can be confident that their transactions will, if the rules are followed, result in an improvement of their capital use.

There are currently two stumbling blocks to this.

##### ECB process

For systemic banks, it is the ECB that determines whether SRT is achieved.

Thanks to intensified dialogue with the ECB, very substantial improvements in the process have been implemented, for which the regulator must be given their fair due.

However, the process continues to lack the necessary transparency and ease in key areas.

EU banks are currently required to inform the ECB of their intention to execute a significant risk transfer

transaction at least 3 months in advance, the ECB has then 3 months to assess the risk transfer before reverting to banks and indicate if it has an objection or not to the recognition of capital relief from the transaction. The ECB can add new conditions to this recognition. However, some of the deal characteristics that the ECB will incorporate in its analysis, such as the thickness of tranches and the market prices of the tranches, typically evolve until closing. As and when the ECB considers that one of the material characteristics of the transaction has changed, it requires a new 3-month period to revise its SRT analysis. Such a requirement is therefore impossible to meet since, for securitisation as for any other type of market transaction, market conditions evolve until the last minute. If they evolve outside of the ECB decreed parameters, the transaction built over many months of negotiations with potential investors has to be cancelled or proceed with no SRT benefit to the bank.

While these improvements are helpful overall, additional steps are necessary to achieve the right balance of predictability and dialogue so that the market can function effectively:

- Transparency of the ECB methodology applied to assess significant risk transfer transactions and the criteria used. Banks should be able to understand and anticipate an objection from the ECB based on public, objective and stable criteria.
- Changes could be made to the ECB public guidance for the simplification of data requirements (notably for simple transactions) and to achieve greater proportionality of information required to ensure information requests are relevant to SRT assessment objectives.

Finally, a “fast track” process should be put in place for “simple and repeat” transactions, i.e. transactions which do not contain any new or non-standard features, are a repeat of previously approved transactions or, for traditional securitisations only, where 95% of the tranches are placed. These transactions should benefit from a faster assessment process: full documentation would not have to be re-submitted pre-closing and permission to recognise SRT would be deemed granted in the absence of objection pre-closing. In addition, more limited / pro-forma information requirements should be envisaged. For transactions with new or non-standard features, of course, the process would be more extensive.

Articles 244(3) and 245(3) of the CRR provide a mandate to national competent authorities (or the ECB for large banks) to assess whether significant credit risk transfer is justified by a commensurate transfer of credit risk to third parties, for both traditional and synthetic securitisations.<sup>16</sup> However, the wording of these articles is too vague, leaving the ECB and the national competent authorities with an insufficiently defined latitude for interpretation with the ensuing risk of the growth of an additional layer of pre-conditions,

16. « By way of derogation from paragraph 2, competent authorities may allow originator institutions to recognise significant credit risk transfer in relation to a securitisation where the originator institution demonstrates in each case that the reduction in own funds requirements which the originator achieves by the securitisation is justified by a commensurate transfer of credit risk to third parties. ».

beyond the intent of the Co-legislators. This problem is even greater in the absence of the still to be finalised EBA guidelines.

The SRT assessment must therefore be better structured, to prevent individual national competent authorities or the ECB from imposing diverse and inconsistent additional non-legislative rules. Such rules undermine one of the key initial aims of the SRT rules, namely to avoid regulatory arbitrage. They prevent the creation of a European level playing field and the emergence of a standardised securitisation market – especially in the synthetic area. Yet, such standardised markets are key to volumes.

### Conclusion

***The SRT process should be considered to be a normal day-to-day process of insurance and capital allocation rather, as appears to be currently the case, an exceptional measure requiring individual bespoke analysis by the prudential regulator and involving unpredictable yet unchallengeable additional rules. It needs to move to a rules-based supervised regime consistent across European jurisdictions in the same way as the rest of the CRR framework.***

### EBA rules

The final shape of the SRT landscape will be created by the EBA rules which are still in drafting.

This paper is not the forum to go into a detailed analysis of the prospective rules, but serious concern has been raised by market stakeholders about the regulatory approach to some specific topic. These concerns have been raised in circumstances where the results of the discussed rules are not only highly deleterious to the hopes of a robust and effective market but also deeply puzzling and, at time, seemingly inexplicable to market observers.

Some of the highly technical areas of concern would be:

- The differing treatment of sequential and pro-rata pay;
- The definition of tranche maturity;
- The zero pre-payment assumptions.

It should also be noted that many of these proposed rules are currently being applied by the ECB.

### Conclusion

***It is essential for the whole future of the European securitisation market that the SRT rules to be published by the EBA, whilst conservative, should be realistic and capable of operation. There is a real concern from market participants and market observers that any positive changes of the types outlined elsewhere in this paper could be totally negated by highly technical but deeply damaging and unnecessarily conservative SRT rules.***

## 4.6 A level playing field

Issuing a securitisation for a financial institution or purchasing one for an investor is never an absolute decision but a relative one. Both almost always have the option of different instruments and will judge the benefits of choosing one – securitisation – against the other options.

As a result of the GFC and despite vast amounts of data showing the resilience, safety and quality of European STS securitisations, securitisation legislation imposes the heaviest burdens on both securitisation issuers and investors. These burdens fall mainly in two categories. For issuers, disclosure burdens<sup>17</sup> and for investors due diligence burdens<sup>18</sup>.

Issuers must disclose an enormous amount of information about the assets and do so on an ongoing basis for as long as the securitisation is outstanding. This information must be disclosed in an extremely prescriptive and granular format mandated by ESMA and must be housed in specific regulated data repositories.

These requirements are costly both in time and IT investment.

Investors must not only perform extensive mandated due diligence but must record this due diligence to be able to demonstrate its execution to their regulators. This due diligence must be performed at regular intervals even when no adverse event has occurred that would justify it.

These requirements are costly in time and IT investment as well as compliance costs.

We are broadly supportive of these requirements but not insofar as they only apply to securitisation and not to other similar assets. In particular, covered bonds, which are asset-based financing instruments are not subject to any such requirements.

The benefits to Europe of a safe and deep securitisation market have been examined in this article. But, so long as it is so much cheaper and easier to issue or buy a covered bond, despite the similar credit performance of senior STS securitisation and covered bonds, securitisation will struggle.

It is therefore crucial that a holistic look at capital market regulation been taken, not with the intention of lowering standards but with the aim of levelling the playing field between instruments of equal risk profiles and complexities.

## 4.7 Additional measures

In addition to these key five measures, a number of additional steps should be considered.

17. These are broadly found in article 7 of the securitisation regulation.

18. These are broadly found in article 5 of the securitisation regulation.



#### 4.8 Simplify / better target ESMA disclosure templates

Although we are broadly supportive of the securitisation disclosure standards, it remains the case that the ESMA templates are extremely granular. They apply to both public and private transactions, penalising the private market. Securitisation market participants have faced major difficulties in achieving the new standard because of very substantial additional information required to be made available, beyond long-standing market practices and the requirements of investors and rating agencies. This is particularly pressing for less sophisticated issuers, and in particular for corporates who rely upon private securitisation to finance trade receivables – an important source of funding for the real economy. Achieving complete compliance across all market sectors and asset classes is not achievable as a practical matter, nor necessary as a prudential one.

Disclosure templates should be adapted to various asset classes and unrealistic expectations should be eliminated, based on an open dialogue with market practitioners. Reporting should also be simplified as relates to private transactions, which by construction should not require public disclosure.

#### 4.9 Re-examine CRR and Solvency II calibrations for non-STS

Thirteen years on from the crisis we have acquired considerable additional data both on the performance and behaviour of non-STS securitisations and other asset classes. It would be useful to use this data to see whether a re-calibration of non-STS securitisations or some subclass of non-STS securitisations would be justified, so as to broaden the whole market in a safe way.

#### 4.10 Adopting the STS standard in the ECB rules

Currently the ECB makes no space in its rules – whether with regards to outright purchases or repo collateral eligibility via the Eurosystem – for the STS standard.

This is strange considering that the standard, in addition to embodying the best aspects of securitisation as defined by regulators and policy makers, is a key tool in assisting the recovery of the European market. This recovery is in line with the ECB's own obligations to assist in creating a stable European banking system and could be achieved without taking additional risks on the ECB's balance sheet.

Such adoption need not be achieved by excluding non-STS securitisations but by providing differential treatment for STS and non-STS securitisations within the different ECB programs and collateral frameworks.

### 5. Conclusion

The Securitisation Regulation and, in particular, the creation of the STS standard, the most detailed and comprehensive securitisation standard in the world, was a necessary and laudable reform introduced by

European policy makers. Yet, it has failed in its aim to revive the European securitisation markets.

Those securitisation markets though are vital to avoid a shrinkage of European bank lending in the face of the new Basel capital requirements and possible COVID losses. They are vital to any successful development of the CMU. And they are vital to fund the European Green Project.

Revitalising the European securitisation market requires no new initiatives. It requires that the European Union completes the unfinished business that is the STS reforms.

This can be done in practical ways by modifying the CRR and Solvency II capital calibrations to reflect the work on European institutions in creating the STS standard.

It can be done by seeing through the value of this standard in the LCR eligibility rules and the ECB collateral rules.

It can be done by thoughtfully levelling the playing field between securitisations and similarly complex instruments with identical risk profiles (especially covered bonds and other asset-based instruments).

It can be done by creating a streamlined, safe but sensible SRT framework which allows European banks predictably and swiftly to incorporate risk adjustments in their normal business.

***We also want to emphasise that these reforms are not only a temporary set of transformations to get Europe over the COVID recovery and Green Plan financing gap. They represent, in our view, the most realistic and indispensable transformation of the European financial architecture to ensure the continent remains economically competitive, mobilises productively the potential locked in its savings pools and achieve a banking system able to adapt its risk and capital profile proactively in a safe manner to be able to finance the economy.***

***This is what makes it the indispensable reform of Europe's financial architecture.***



# **5**

## **MONETARY POLICY TRENDS AND IMPACTS**

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# MONETARY POLICY POST COVID: UNCONVENTIONAL ACTIONS IN THE FACE OF OBSTINATE FACTS

Note written by Jacques de Larosière (June 2021)

This is an appropriate time to pause and reflect on the future of policy mix and in particular on the stance of monetary policy.

Indeed, we seem to be getting out of the pandemic after having enormously relied on fiscal and monetary policies to inject liquidity in economies that had to be locked down by unprepared governments as a way to contain contagion, because of the insufficient medical testing capabilities. The price to pay has been an explosion of public indebtedness.

So, we are getting out of the woods but with a lot of wounds and scars.

How should we deal with the factors at play? Should we be hostage to the doctrine of present unconventional monetary policy, or should we pay more attention to "obstinate" facts?



## 1. The static approach would be to stick, as long as possible, to the present unconventional stance

This approach seems to be the Fed's preferred course, at least for the moment. It is based on the following arguments.

- a) Global demand is weak, and savings are high: therefore, the consensus says that there is a case for continuing stimulatory policies;
- b) Any, premature, monetary tightening would risk upsetting markets- that have skyrocketed- and could thus trigger a recession;
- c) In an environment of still very low inflation, and low expectations, real interest rates tend to become positive and monetary policy -facing the zero interest rate bound conundrum- cannot fully play its stimulatory role. Any monetary tightening would put an unnecessary break on demand;
- d) The Fed points out that the recent signs of overheating and of inflation are far from clear:
  - they are overwhelmingly related to sectors that have been especially hit by the pandemic and that are lately rebounding;
  - therefore, the push in inflation, linked also to the rise in energy prices, and to the disruption of supply

chains, is bound to be temporary and will abate as the economy normalizes;

- inflation remains subdued (the "sticky" part of the CPI, as computed by the Atlanta Fed, is still flat and the 5 year, 5year forward inflation expectations hover around 2%);
- labour markets have not reached full- and inclusive-employment.

For these reasons, the Fed does not express the intention to tighten soon:

- the buying program is maintained, and bonds coming to maturity will be reinvested;
- Fed Funds rates are to be left at present levels well within 2022;
- If inflation exceeds the target of 2%, the averaging with the recent years of under achievement will allow maintaining the present stance;
- the "outcome based" monetary policy (waiting for facts and full attainment of all objectives before any policy change, instead of allowing some room for the forecasting of -and the adjustment to -evolutions) is the rule that has been presented by M. Clarida, the Fed's Vice-President. Such a method does not seem to allow gradual changes nor a modicum of discretion when the picture starts moving.



## 2. The "adaptive" option to face the facts and the challenges of the future

I believe that the "static option" just described is fraught with dangers and does not face up to the real challenges that lie ahead. I will try to explain why:

### a) Monetary policy was already in an impasse before the Covid struck

The system had been swamped with liquidity through the very accommodative monetary stance of the past ten years or so.

And this has pushed indebtedness to record levels: Global debt now amounts to 355 % of world GDP, a historic ratio in peace times.

In turn, this huge leverage has weakened the financial system and endangered its stability: if CPI inflation has remained subdued, the prices of financial assets and real estate have skyrocketed.

**b) The pursuit of such a policy – “as if nothing had changed” – would be likely:**

- to trigger eventually a financial crisis with all its negative economic and social consequences;
- to weaken further the banking and insurance systems whose profitability is affected -especially in Europe-by low or negative interest rates;
- to consolidate zombie firms (over indebted and uncompetitive) that are only surviving because of the interest rate subsidy provided to them by monetary policy.

**c) The continuation of a policy of very low interest rates for a couple of more years** would intensify its negative consequences on growth and employment: Indeed, as we have learned over the last years experience, abundant liquidity and low rates do not result in higher productive investment but in liquidity hoarding. Since 2008, MO in major countries (i.e. banknotes in circulation and bank reserves held at the central banks) has increased by 13,50% per year, which is 4 times faster than nominal growth in the real economy. During the same period ,M3 that includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately ( 3,50% per year in the eurozone), showing that central money creation had not seeped into the economy.

The facts are undisputable: non-residential productive investment has significantly DECLINED over the past ten years of zero interest rates. (from 14, 4% to 12% of global GDP). And the “liquidity trap,” feared by Keynes, has manifested itself especially in Europe: since savings are no more remunerated, households prefer keeping their money in the most liquid forms (banknotes, sight deposits....) rather than investing in long term riskier projects with no return. The recent data on the explosion of liquid savings are staggering.

We must understand that the perspective-announced by the Fed- of extremely low interest rates for long is debilitating: it anchors in the public mind that there are no chances for growth ( growth has always been accompanied by positive real interest rates), and pushes the system in share buy -backs and speculative riskier alternatives.

**d) The above considerations lead to the conclusion that it is time now for central banks to start changing gears**

The moment has come to look to the future with the lens of reality and not to continue, because of doctrinaire preferences, to focus on the past 20 years.

The present return towards economic recovery offers the opportunity to start shifting from “slack dominant” considerations to overheating ones (which are already significant, given the magnitude of the fiscal US stimulus packages, the lack of qualified labor, supply chain bottlenecks and the first manifestations of inflation (4%) which can only be exacerbated by the secular demographic trend towards a shrinking of the labor force).

If the Fed does not start moving now in a very gradual way, it could face later a much tougher job when- and if- inflation takes hold in the coming years. The big risk then would be to have to resort to much more intensive tightening with its expected negative consequences on growth.

Recent growth (23,8% in March and 12,1% in April) of the US broad money signals the danger of inflation that could well continue its upward trend and stretch beyond the Fed’s comfort zone (see Center for Financial Stability June 2nd 2021).

We must understand that the world has been accustomed to live with higher and higher public and private debt over the past decades, this huge leverage being accompanied by skyrocketing market valuations. This is a pretty dangerous situation if inflation - and higher interest rates - were to resume, which is far from unlikely given the structural - demographic -factors at play. In that case, heavily over-extended institutions would start facing debt payment difficulties, and market reversal could well feed into recession. What would then be choice left to central banks? Fight inflation with much higher rates to the detriment of growth, or allow inflation to explode which would run the risk of stagflation?



If one considers that such risks cannot be dispelled out of hand, it would seem prudent to move gradually out of the present trap, to start reducing the calibration of QE, and not to systematically reinvest all bonds coming to maturity.

The “fiscal dominance” that is presently taking place carries two big dangers:

- it puts in question the independence of central banks;
- And, more importantly, it is a major disincentive for governments to engage in the structural reforms that are indispensable to meet the fundamental challenges of the ecological transformation of our world, challenges that cannot be faced by printing more and more money.

# MONETARY SCOREBOARD: UPDATE ON MONETARY POLICIES AND POSSIBLE IMPACTS

Note written by Jacques de Larosière & Didier Cahen  
with the support of Elias Krief and Lea De Greef

Monetary policy is moving into uncharted territory and faces basic questions and trade-offs. The objective of this scoreboard is to analyze the evolution of monetary policy and Central Banks decisions over the last two decades through the extensive use of data. Indeed, central banks' balance sheets have only rarely reached similar heights relative to GDP, except during wars. By presenting key numbers and charts, this document opens the debate on monetary policy and the need to change course<sup>1</sup>.

During the Global Financial Crisis (GFC), the EU sovereign debt and Covid crises, Central Banks played a crucial role and intervened on an unprecedented scale to keep financial markets liquid and stabilize the financial system. In addition, in Europe, the ECB measures have avoided financial fragmentation in the dynamics of bonds prices, particularly for sovereign bonds. These swift and decisive actions helped to prevent potential economic collapses.

However, the 2% inflation target has trapped monetary policy in a systematic and asymmetric accommodation. Lasting accommodative monetary policies has pushed the global debt to 355% of world GDP and has driven the monetary base of OECD economies to be multiplied by 10 since 2000. Persistent low interest rates have been fostering liquidity hoarding at the expense of productive investment in Europe in particular. The price paid in terms of overleverage, decline in corporate dynamism and productivity growth, bubbles and instability has been high. Through its monumental program of government bond purchases, the ECB has become a de facto agent of fiscal policies, buying most government bond issuances in 2020-21. In turn, this huge leverage has weakened the financial system stability: the search-for-yield behavior has fueled swelling bubbles, along eroding the profitability of the EU banking and life insurance sectors.

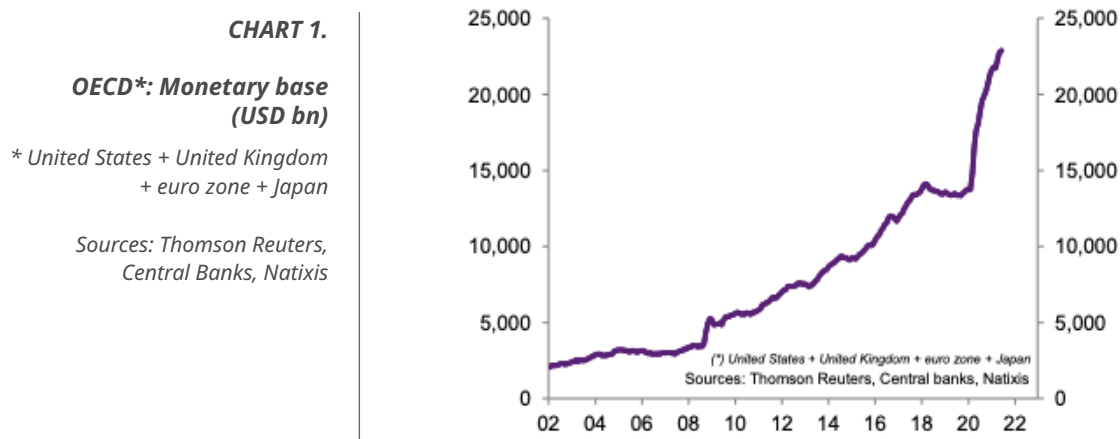
\* \*

\*

## 1. The monetary base of OECD economies has been multiplied by 10 since 2000, mainly as a result of the 2% inflation target which has become the absolute guide to monetary policy

Central Banks' balance sheets have grown significantly as a result of the non-standard monetary policies conducted in response to the 2008 and Covid crises and of the 2% target which has become the absolute guide to monetary policy.

The below graph (see Chart 1) shows the exceptional and significant increase of the monetary base in the OECD economies. Indeed, it accounted for less than \$2 500 bn in 2000, and increased to \$25 000 bn in 2020, i.e more than ten times larger. We can see that the rise in the monetary base has been much stronger in the response to the Covid crisis rather than to the Global Financial Crisis in 2008. The monetary base of OECD economies roughly doubled from 2009 to 2015, but it was approximately multiplied by 1.7 over March 2020 to May 2021 only.



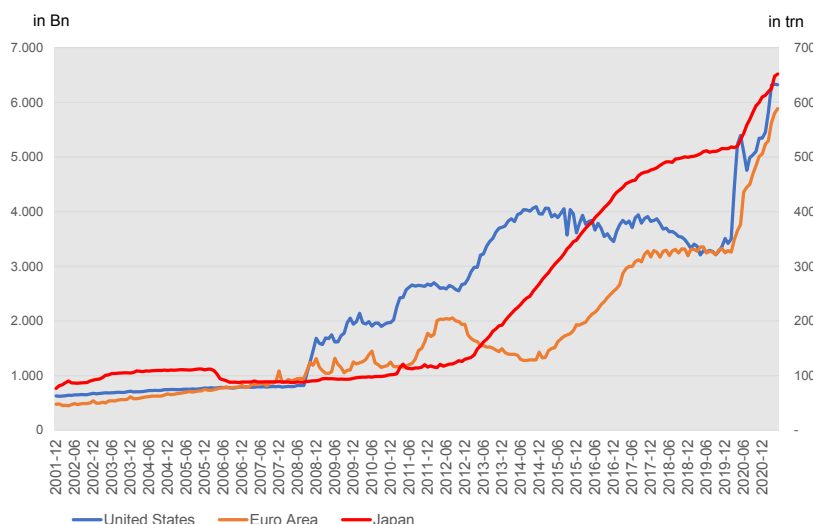
1. Normalization topics are discussed notably in two Eurofi documents: "Addressing the dangers of the monetary policy deadlock" – September 2020, and the Eurofi Lisbon Summary – April 2021.

Following the Covid crisis, monetary and fiscal policies have been more active than before, widely contributing to the shock absorption. Central Banks substantially eased the monetary policy stance over the course of 2020 to counter the negative impact of the Covid-19 pandemic on economies.

During the two past decades, the quantitative easing measures taken by the Fed, the ECB and the BOJ have been a main contributor to the monetary base global expansion. Since the end of 2008, both the Fed and the ECB's monetary base have tripled (see Chart 2).

**CHART 2.**  
**Monetary Base of Major Central Banks, National Currency**

Source:  
DBnomics, BOJ

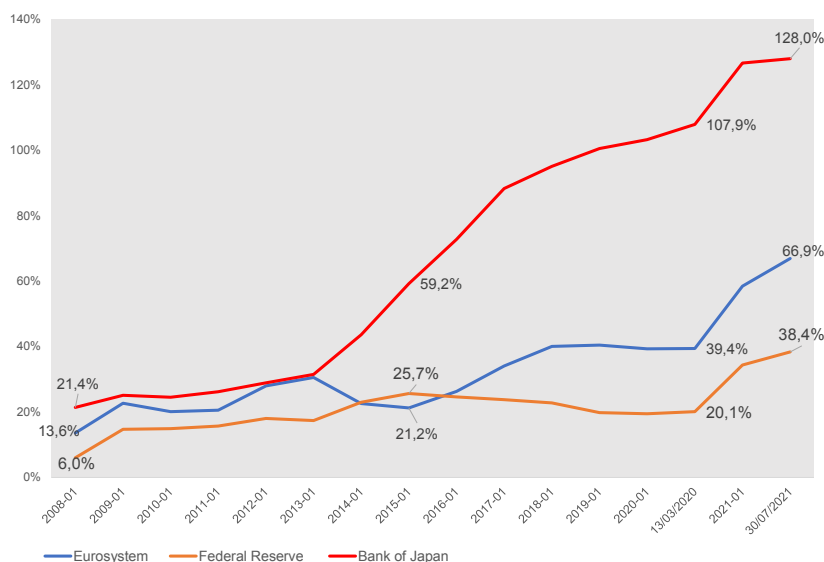


As a result, the Central Banks' total assets relative to GDP have surged. For instance, the Federal Reserve's balance sheet grew from 21.2% of the US GDP in 2015 to 37.7% in July 2021. Over the same period, the ECB's balance sheet increased from 25.6% of the EU GDP to 66%. Likewise, the Bank of Japan's balance sheet surged from 59.5% of the Japanese GDP in 2015 to 128% in 2021 (see Chart 3).

This continuous increase in the Central Banks' total assets from 2008 to 2021 (see Chart 3) also reflects the asymmetry of monetary policies which is further described in section 1.4. This has led the financial system into over financialization and repeated crisis.

**CHART 3.**  
**Central Banks' Total Assets Relative to GDP, %**

Sources: FedStLouis,  
Bank of Japan



### 1.1 Central Banks reacted swiftly and forcefully during the Lehman Brothers, EU sovereign debt and Covid crises

#### The Fed's purchases from 2008 to 2015 in reaction to the Global Financial Crisis (GFC)

In November 2008, the Federal Reserve announced that it would purchase up to \$600 billion in agency mortgage-backed securities (MBS) and agency debt. In March 2009, it announced that the program would be expanded by an additional \$850 billion in purchases of agency MBS and agency debt and \$300 billion in purchases of Treasury

securities. Between 2008 and 2015, the Federal Reserve's balance sheet expanded from **\$0.9 tr to \$4,5 tr<sup>2</sup>** (nearly 25% of the US GDP).

### The ECB's purchases from 2011 to 2015 to counter the GFC and EU sovereign debt crisis impacts

By December 2011, the Eurosystem had purchased securities under the Securities Markets Program (SMP) with a total settlement amount of around €211.4 billion. The Eurosystem's balance sheet expanded in an unprecedented way, overall more than doubling in size between 2008 and mid-2012, before starting to recede in the second half of 2012. The provision of Central Bank refinancing which had decreased substantially to around €90 billion at the end of December 2012, largely remained in a range of €90-130 billion throughout 2013.

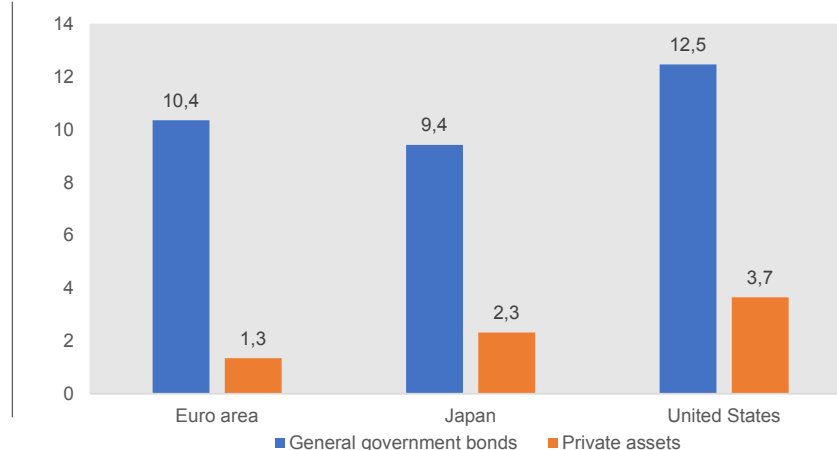
Between October 2014 and December 2018, the Eurosystem conducted net purchases of securities through the asset purchase program (APP)<sup>3</sup>. Between 2008 and 2015, the ECB's balance sheet expanded from \$1 tr to \$2.8 tr<sup>4</sup>.

### The Central Banks' responses to the Covid crisis

The ECB substantially eased monetary policy stance over the course of 2020-2021 to counter the impact of the Covid crisis. The European Central Bank's governing Council has decided on 18 March 2020 to launch a new Pandemic Emergency Purchase Program (PEPP) of up to €750bn until the end of 2020, on top of the €120bn in extra purchases announced on March as part of the APP program. The Governing Council decided to increase this PEPP envelope by €600bn in June 2020, and by €500bn in December 2020, to a total of €1 850bn to be disbursed before March 2022.

**CHART 4.**  
**Central Banks' assets purchases**  
**since end-2019, % of GDP**

Source: OECD



Since end-2019, the ECB's total assets have grown by 61.9% while the Fed's balance sheet rose by 81.6%. On overall, the global monetary base increased by 75% over one year, in response to the coronavirus crisis.

Regarding the Fed's action, in March 2020, the Fed stated that it would buy at least \$500 billion in Treasury securities and \$200 billion in government-guaranteed MBS over "the coming months". In March 2020, it made the purchases open-ended, saying it would buy securities "in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions".

Between mid-March and early December of 2020, the Fed's portfolio of securities held outright grew from \$3.9 trillion to \$6.6 trillion. The Fed is currently spending \$120bn every month to purchase public and private bonds. Among them, \$80bn are aimed at buying Treasury debt and \$40bn are allocated to buy mortgage-back-securities (MBS). Between April and December 2020, the Fed's actions helped unlock more than \$2tr of funding to support large and small businesses, nonprofits, state and local governments<sup>5</sup>.

In such a context, the Federal Reserve's balance sheet increased from **\$4,2 tr to \$8.1 trillion<sup>6</sup>** from March 2020 to June 2021. Over the same period, the size of the Eurosystem's balance sheet reached a historically high of €7.9tr in July 2020<sup>7</sup>, an increase of €3.2tr compared to March 2020. The Bank of Japan's balance sheet has grown from **JP¥ 588tr in March 2020 to JP¥ 719<sup>8</sup> tr in mid-July 2021** (see Chart 2 in section 1.1).

2. According to the Fred (the database of the Fed).

3. During the net asset purchase phase, monthly purchase pace averaged: €60 billion from March 2015 to March 2016, €80 billion from April 2016 to March 2017, €60 billion from April 2017 to December 2017, €30 billion from January 2018 to September 2018, €15 billion from October 2018 to December 2018.

4. According to the ECB website.

5. J.H.Powell, Speech before US House of Representatives - 22 June 2021.

6. According to the Fred (database of the Fed).

7. Consolidated financial statement of the Eurosystem - July 2021.

8. According to the Bank of Japan database.

## 1.2 Very accommodative monetary policies have allowed the financial markets to continue functioning and being liquid in the EU, and also prevented the tightening of financing conditions for states, firms and households

During the European sovereign debt crisis (2011-2012), the Italy-Germany spread reached a considerable level – up to 450 basis point in the first quarter of 2012. This led to a significant reaction from the ECB: indeed, the Eurosystem's balance sheet expanded in an unprecedented way, more than doubling in size between 2008 and mid-2012. Notably, the European Financial Stability Facility<sup>9</sup> delivered in June 2010 a €750 bn envelope coupled with Mario Draghi's "whatever it takes" speech in July 2012 contributed to control the spread and pave the way out of the crisis.

The sustained ultra-accommodating policies since 2015 have avoided the financial fragmentation within the euro area (maintenance of homogeneous financing conditions).

**CHART 5.**

### Italy-Germany Yield Spread, %

Source: OECD

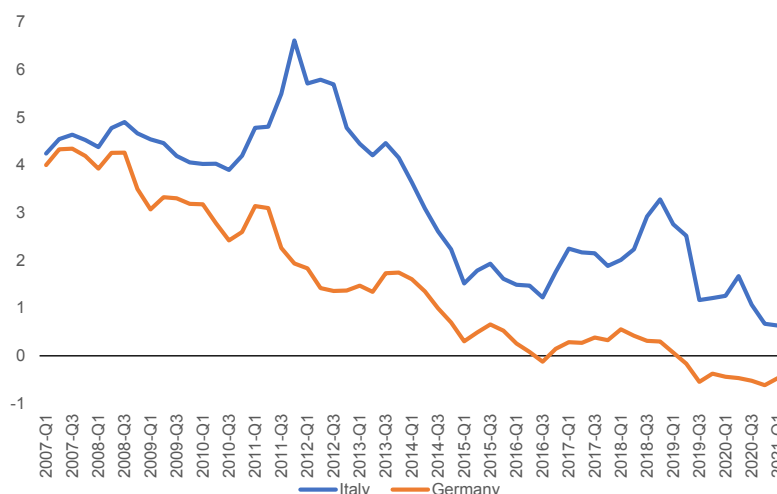


Chart 5 also illustrates how in the Euro area spreads between core and periphery countries have been narrowing since the EU sovereign debt crisis. As an example, the development in 2010-2011 were significant. In contrast, since August 2020, the Italian-German spread has not outreached the 150 basis points.

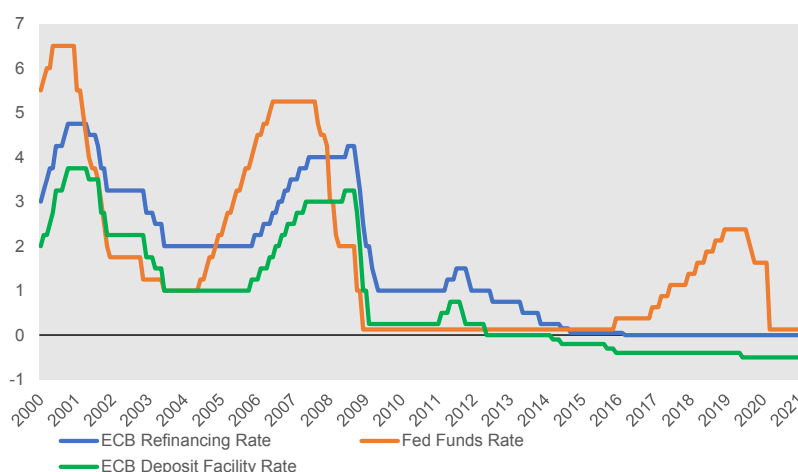
## 1.3 Lasting easy monetary policies have contributed to the downward path of interest rates

The continuation of very accommodative monetary policies have led to the downward path of interest rates. Notably, the EU deposit facility, one of the short-term interest rates of the ECB, has been negative since 2014 (see Chart 6).

**CHART 6.**

### Key Nominal Short-term Interest Rates for the US and the Euro Area

Sources: ECB, BIS



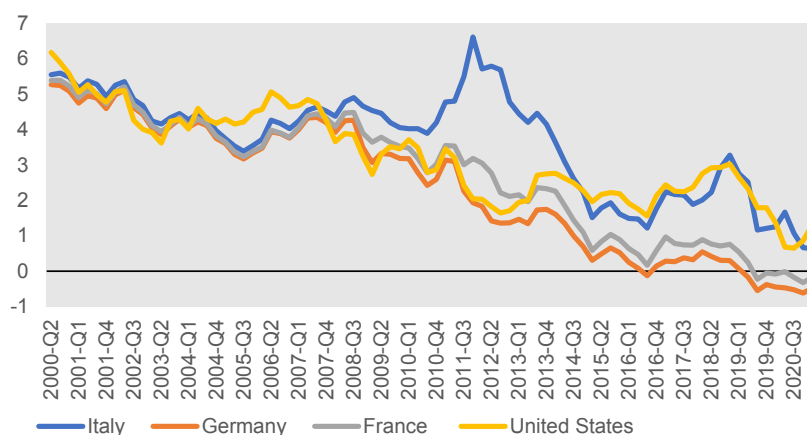
The following graph (Chart 7) displays the downward trend in interest rates in the main advanced economies over the last 20 years. The German 10-year interest rate was the first to become negative in end 2016, when the French 10-year interest rate was close to zero. Since end 2019, both are negative.

9. Temporary crisis resolution mechanism created by the euro area Member States in June 2010 to provide financial assistance.



**CHART 7.**  
**10-Year Interest Rates**  
**of Selected Advanced**  
**Economies, %**

Source: OECD



Empirical evidence suggests that the natural interest rate has been on a downward trend in the past few decades. It may well be that neutral interest rates are very low for secular reasons (ageing, globalization...) but zero or negative nominal interest rates are not a natural phenomenon. They are in large part the result of heavy Central Banks purchases which can be reversed over time.

Expansionary monetary policies partly influence risk-free rates but compresses the interest rate risk premium. Without the Central Bank intervention risk-free rates might not be significantly higher because they depend in part on the growth potential, which has been noticeably low for the past few years. However, the massive liquidity and quantitative easing programs injected by the Central Banks (e.g. ECB, Fed, BoJ) have been blurring the reading of the long-term interest rate which no longer play their discriminating role leading to mispricing of risk (See section 3.2.1).

As a result, Central Banks control the yield curve, usurping the traditional functions of markets.

#### 1.4 The 2% inflation target has led the ECB and Fed monetary policies to be asymmetric over the past 20 years

Over the past 20 years, monetary policies have been asymmetric and have broadly remained accommodative to achieve the 2% inflation target. This overwhelming objective has driven monetary policies since then. The evolution of the monetary base (Charts 1 and 2) and the massive increase in Central Banks' total assets (Chart 3) illustrates this asymmetry.

The reality is that overall monetary policy has become disconnected from the cycle: it has been highly expansionary over the past two decades. Central banks did not tighten monetary conditions when the economic situations improved. It has led the financial system into over financialization.

##### 1.4.1 Once the economic situation improved after the sovereign crisis, the ECB monetary policy has not been tightened nor normalized

The Global Financial Crisis and the EU sovereign debt crises legitimately called for substantial bond-buying programs. As soon as late 2013, GDP growth returned on a reasonable sustained path. The Fed started to raise its interest rate in December 2015. For instance, in 2017 the Euro area growth was about 2.6% when the USA growth was about 2.3%. The Fed funds rate reached 2.4% in early 2019, while the ECB refinancing rate was still at 0% since February 2016. Considering the strong recovery, the Federal Reserve decided to reduce the size of its balance sheet in 2018 and early 2019.

It was not the case of the ECB, who did not put an end to its purchases despite the economic recovery. Hence, between October 2014 and December 2018, the Eurosystem conducted net purchases of securities which brought the ECB's balance sheet from €2.2 tr in 2014 up to € 4.4 tr in 2018.

This purchasing trend has kept the same pace as in time of crisis. Meanwhile growth across euro area Member States had returned. In 2017-2018, the ECB kept its main refinancing rates at zero despite significant economic improvements. Indeed, the HICP had risen at or above 2% between May and October 2018, whereas the key rate was left unchanged to zero.

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

##### 1.4.2 Central Banks overly involved: the asymmetry of Fed and ECB monetary stance over the past 20 years can be illustrated by the trajectory of their real short term interest rate

As showed in Chart 8, the real short-term interest rate since 2010 has mainly evolved in the negative territory both in the euro area and the US. Monetary policy has become disconnected from the economic cycle: it has

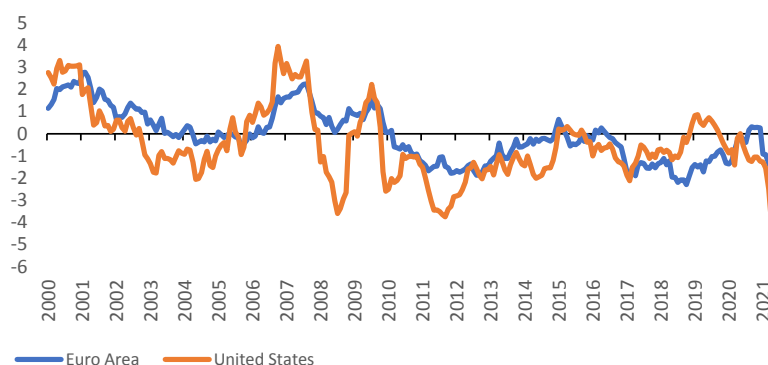


been accommodative over the two past decades. As interest rates were close to zero or even negative, Central Banks have also used QE programmes during as well as after the crises. Chart 18.a in section 2.3 also illustrates how the very accommodative stance of monetary policy have been continuous since 2014, even during no-crisis times.

**CHART 8.**  
**Real Refinancing Rates**  
**in the US**  
**and Euro Area**

Source: BIS

Note: for the Euro Area,  
refinancing rate - HICP; for the US,  
federal rate - CPI



The ECB did not tighten monetary conditions when the economic situation improved thus limiting the ability to act decisively at the next turning point.

For instance, the real refinancing rate in the euro area remained negative through 2019 despite of the economic improvement whereas the recovery in the United States translated to a slight normalization. In September 2019 the ECB decided to resume the asset purchase program at a monthly pace of €20bn in response to the decrease of the HICP inflation by 0.3%, while economic conditions had not reached worrying trends.

In other words, the leaning-against-the-wind mantra has been abandoned for 20 years. Before the 2008 crisis real interest rate were low but positive. Since then, the ECB has maintained negative rates despite of the economic recovery.

Changes in interest rates cannot affect the structural reasons which explain the downward trend in inflation (ageing of our societies, opening of international trade to imports from countries with very low wage rates, changes in labor market behaviors, productivity gains resulting from new technologies...).

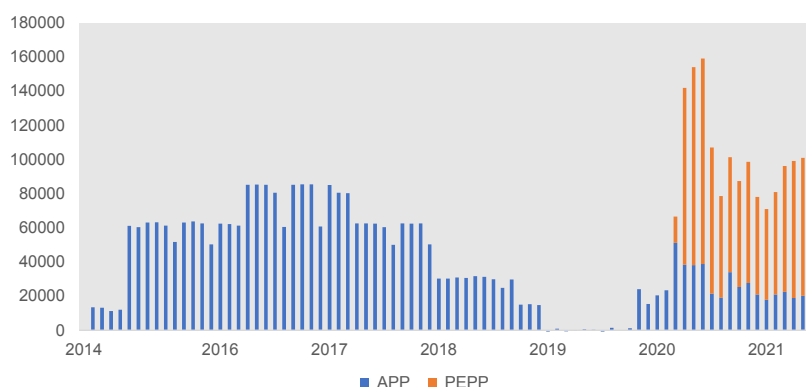
#### 1.4.3 While the vaccination campaign speeds up and the intensity of the economic crisis decreases, the Fed and ECB continue their QE policy at the same steady pace

Central Banks have not expressed the intention to tighten soon. The buying programs are maintained, interest rates are to be left at present levels well within 2022, and if inflation exceeds the 2% inflation target, the averaging with the recent years of “under achievement” will allow maintaining the present stance.

As of April 2021, the ECB kept a monthly purchasing pace of €100 bn, €20bn amounting through the APP program and €80bn via the PEPP program (see Chart 9).

**CHART 9.**  
**Monthly**  
**European Central Bank**  
**Debt Purchases**  
**(EUR millions)**

Source: ECB



As pointed out by Christine Lagarde few days after the meeting of Governing Council in June 2021<sup>10</sup>, the ECB “expects to continue to conduct net asset purchases under the PEPP over the coming quarter at a significantly higher pace than during the first months of the year”.

10. “Hearing of the Committee on Economic and Monetary Affairs of the European Parliament”, Speech, 21 June 2021.

## 1.5 The exchange rate: an implicit but unmentionable objective of the European monetary policy

For the euro area, the exchange rate serves as a crucial transmission channel not only for conventional, but also for unconventional monetary policy.

The depreciation of the dollar against the euro over 2010-2014 can be put in parallel with the implementation of the US QE policy. In 2015, there was a considerably sharper depreciation in the value of the euro against the United States dollar (16.5 %).

Chart 10 might suggest that the launch of the ECB+ QE policy, which started in 2015 also aimed at stabilizing the euro/dollar exchange rate and moderate the appreciation of the euro to avoid any additional competitiveness loss for EU non-financial companies.

**CHART 10.**  
**US dollar VS Euro**  
**exchange rate**

Source: ECB



Although 60% of euro zone trade is intra-zone, industry-relying European economies heavily depends on exports outside the euro zone. Exchange rate thus remains an implicit but crucial variable of monetary policy.

## 2. Such prolonged monetary policy easing have steadily been contributing to the indebtedness of economies

Central Banks have not acted to control the credit growth and hence have been contributing to the over indebtedness of economies. Both public and private sectors entered the Covid crisis with high levels of debt because of persistent loose credit conditions. The system has been swamped with liquidity through the highly accommodative monetary stance of the two past decades. This has pushed global debt to 355% of the world GDP and have disincentivized many countries to undertake structural reforms. In such a context, National Central Banks own a growing and significant share of the national government debts and have de facto become the agents of fiscal policies.

### 2.1 Central Banks have not acted to control - let alone rein in - the credit growth during the past decades

M0 (ie bank notes in circulation and bank reserves held at the Central Bank) has grown extremely fast since 2008: 13,5% a year in advanced countries, while their GDP grew on average 2% in real terms. Given an annual inflation around 1,5%, the average nominal growth of GDP in the advanced countries has been in the order of 3,5%. Therefore, during those 10 years, the money base had grown almost 4 times quicker than the nominal economy<sup>11</sup>.

**Monetary policy and its impact on the increase in the money supply has not been passed on to the real economy, notably in the euro area.**

Chart 11 shows that between 2007 and 2020, M0 in the euro area (i.e. banknotes in circulation and bank reserves held at the Central Banks) has increased by 12% per year in average, which is 8 times faster than nominal growth in the real economy (averaging 1,5% over the same period).

11. According to Jacques de Larosière in its speech at BNP Paribas – 15 April 2021.

**CHART 11.**

**Real GDP against Monetary Base  
quarterly growth in the Euro Area,  
% year-on-year**

Sources: IMF, Fed

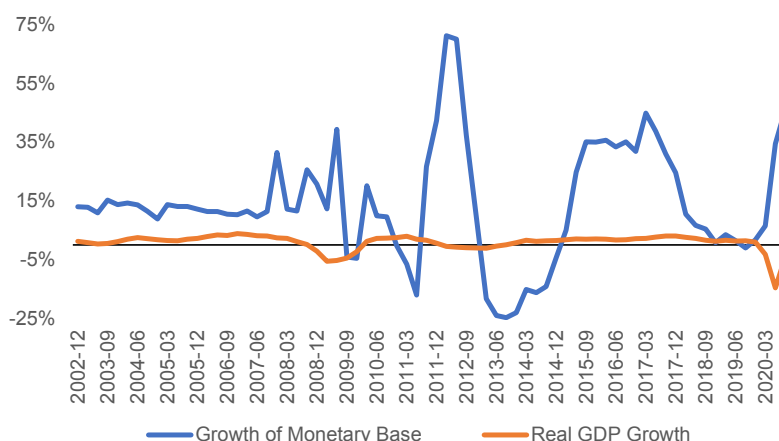


Chart 12 shows that during the same period, M3 that includes bank deposits (and therefore reflects the transformation function of the banking sector), grew at a pace of 5,5% per year in the eurozone<sup>12</sup>. The widening gap between the steady rise in debt and the more moderate economic growth can be illustrated by the divergent trajectory of real economic growth and broad money growth. For instance, the above graph attests how the M3 supply growth has been constantly stronger than the GDP growth in the euro area.

In the US, in the year to June 2020 the M3 measure of the quantity of money, broadly defined to include all time deposits, jumped by 26%.<sup>13</sup> The figure was the highest in modern peacetime history.

**CHART 12.**

**M3 growth rate  
vs GDP growth rate  
in the euro area  
year-on-year**

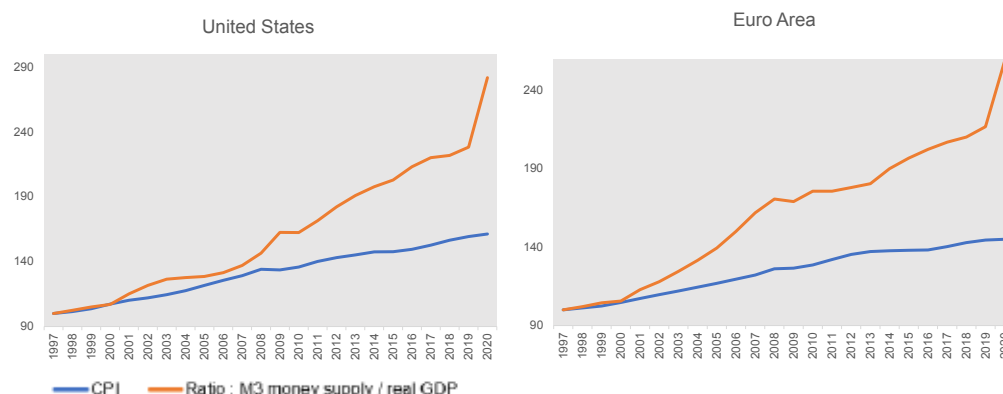
Source: Fed St Louis



Despite those unprecedented increases in the money supply over the past decade, the respective inflation targets of Central Banks have not been reached until the beginning of 2021. Chart 13 displays the disconnection between the monetary expansion and the weak increase in prices. It shows that the excess of liquidity in the economy (the difference between the monetary/GDP ratio and inflation) failed to stimulate inflation during the past years.

**CHART 13.**  
**Inflation,  
M3 money supply  
and Real GDP in  
the Euro Area  
and the  
United States,  
1997 = 100**

Sources:  
StLouis Fed,  
ECB, OECD



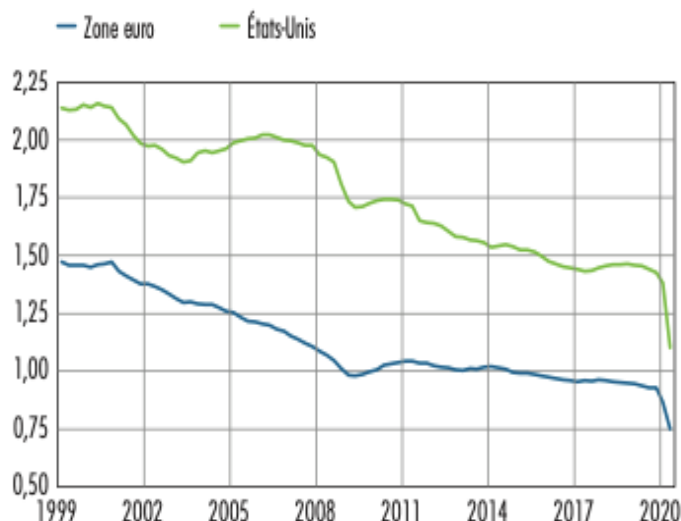
12. According to the FED data.

13. J.Castañeda & T.Congdon, "Where does US inflation go from here?" - June, 2021.

One way to settle the difference of evolution in money and growth is to look at the velocity circulation of money. The creation of money has not been seeping into the real economy because its transactional power and velocity have weakened. Hence, the equation of the theory quantitative of money does not seem to be functioning.

According to the Banque de France, the velocity of money in the euro area has been divided by two between 1999 and 2020 (see Chart 14).

**CHART 14.**  
**Velocity of  
money circulation**  
Source: Banque de France



According to some economists<sup>14</sup>, the Basel III regulatory framework and notably the implementation of the Liquidity Coverage Ratio (LCR) has led to a weakening of the credit multiplier<sup>15</sup>. They add that Central Banks might have responded to these regulatory constraints by further easing their monetary policies.

## 2.2 Lasting persistent low interest rates contributed to the over indebtedness of advanced economies

The continuation of very low interest rates has pushed global debt to records in peace time, even before the Covid crisis. Public deficits have been booming and the public debt-to-GDP ratio has risen from 100% to 120% in the advanced countries within five years (2015-2020). Private debt has also ballooned.

According to statistics issued by the IIF (see Chart 15), global debt reached a record high of 335% of GDP at the end of March 2020, up from 320% in 2019 and 200% in 2011.

**CHART 15.**  
**Global  
indebtedness**  
Sources: IIF, BIS, IMF,  
National sources



Global debt soared to a new record high of \$281 trillion in 2020: coupled with a sharp pandemic-driven decline in government and corporate revenues, total private and public debt rose by \$24 trillion<sup>16</sup> last year, making up over a quarter of the \$88 trillion rise over the past decade. According to the IIF, global debt-to-GDP ratio surged by 35 percentage points (%pts) to over 355% of GDP in 2020.

14. Quignon.L, Basel III, "The money multiplier and monetary policy" – December 2013.

15. The ratio of the increase in the monetary base newly issued by the central bank to the amount of money from credit extended by credit institutions allowed by this increase.

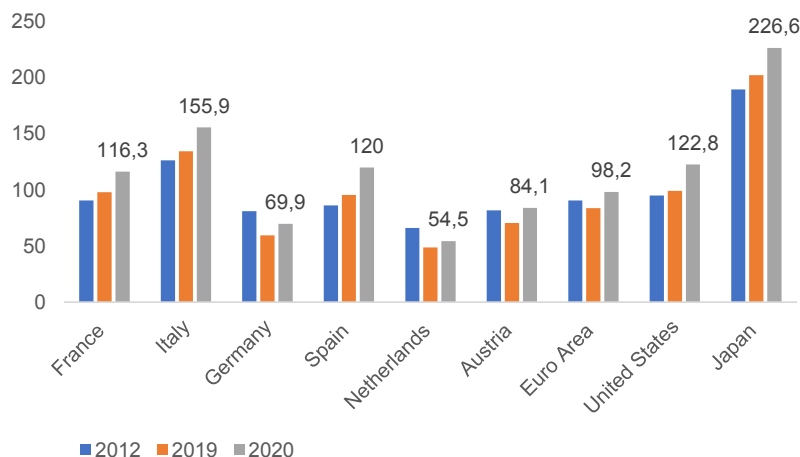
16. For the 61 countries included in the sample in the Global Debt Monitor IIF report – February 2021.

### 2.2.1 Loose credit conditions have entailed a huge public debt overhang

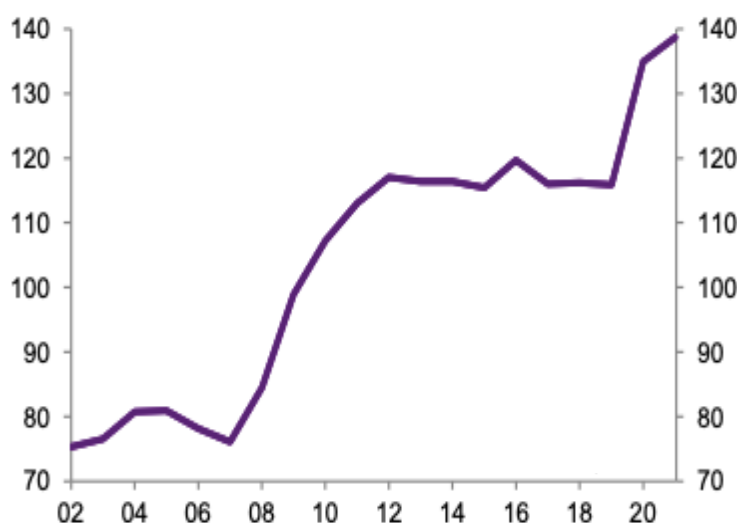
In terms of public debt, we see for example a noticeable expansion in France, Italy, Spain, the USA and Japan, whose public debt all exceed 100% of their GDP in 2020 (see *Chart 16.a*). General government gross debt in advanced economies has surged from 103.7% of GDP in 2019 to 122.5% in 2021<sup>17</sup>, a historic ratio in peace times.

According to the BIS, with the Covid crisis, the OECD economies public debt escalated to 117% of GDP in 2019, and 131% in 2020. Situations are rather heterogeneous throughout countries.

**CHART 16.a**  
**Public Debt,  
% of GDP**  
Sources: AMECO May 2021,  
IMF April 2021



**CHART 16.b**  
**OECD\*: Public debt (as % of  
nominal GDP)**  
(\* United States + United Kingdom  
+ euro zone + Japan)  
Sources:  
Refinitiv, Natixis



### 2.2.2 The corporate sector entered the Covid crisis with high levels of debt

In such a monetary context, international debt issued by non-financial corporates (NFCs) has expanded significantly over the past 30 years. Outstanding amounts grew from around \$0.5 trillion in 1990 to \$7.7 trillion at end- 2020, according to the BIS<sup>18</sup>.

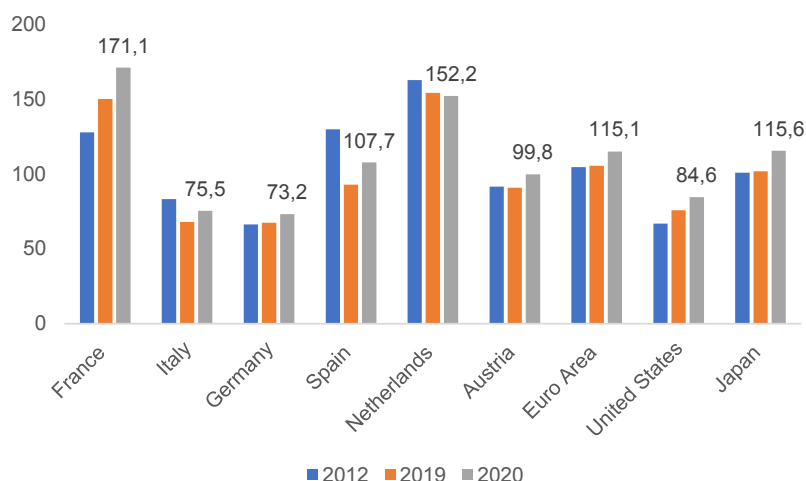
The international debt securities (IDS) of NFCs have expanded since the Great Financial Crisis, rising from 3.9% to 6.8% of GDP in advanced economies (AEs) between 2009 and 2020, according to the BIS. Since the pandemic's outbreak, overall debt issuance by NFCs from AEs and hard-hit EME sectors has surged, while average credit spreads have been wider than over the preceding year.

17. According to the IMF World Economic Outlook database.

18. BIS Quarterly Review - June 2021.

**CHART 17.****Credit to Non-Financial Corporations, % of GDP**

Source: BIS



The global outstanding stock of non-financial corporate bonds at the end of 2019 reached an all-time high of \$13.5 tr. Notably, in every year since 2010, around 20% of the total amount of all bond issues has been non-investment grade, testifying of a long-lasting decline in overall bond quality<sup>19</sup>. Hence, the corporate sector entered the Covid crisis with high levels of debt.

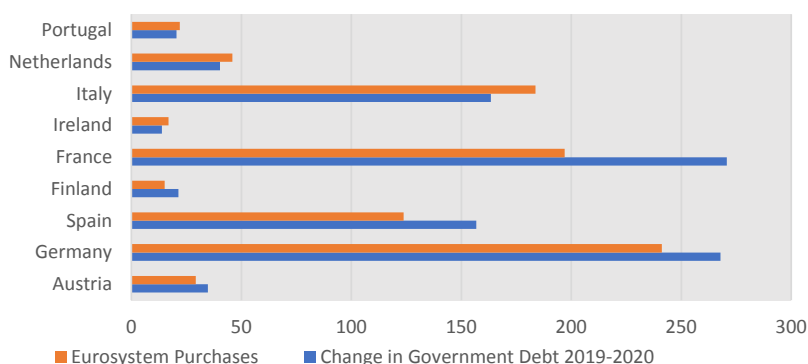
The corporate sector necessarily borrowed more to navigate the crisis, raising concerns for a significant number of borrowers.

### 2.3 Central Banks have, de facto, become the agents of fiscal policies

National Central Banks own a growing and significant share of the country general government debt. The Eurosystem have had a primary role in public debt monetization during the Covid crisis, as it purchases a large share of new public debt issuances to meet the financing needs of governments (*Chart 18.a*). According to some economists and to the following table (*Chart 18.b*), around 70% of French new debt issuances have been bought by the ECB<sup>20</sup> in 2020. The figure reaches 90% in Germany.

**CHART 18.a****Eurosystem's Purchases of Newly Issued Government Bonds in 2020, bn EUR**

Sources: ECB, BIS, Eurofi Calculations

**CHART 18.b****Approximation of the share of total Eurosystem's purchases in total debt issuances in 2020**

Sources: ECB, BIS, Eurofi Calculations

	Public Debt Change 2019-2020 (bn EUR)	Eurosystem Cumulative Purchases of Public Debt in 2020 (PEPP+PSPP) in bn EUR	Share of Total Eurosystem Purchases in Total Public Debt Issuance (2020)
Austria	34,8	29,3	84,1%
Germany	267,8	241,1	90,0%
Spain	156,8	123,7	78,9%
Finland	21,4	15,1	70,6%
France	270,6	197,0	72,8%
Ireland	13,9	16,9	121,4%
Italy	163,4	183,7	112,4%
Netherlands	40,3	45,9	113,9%
Portugal	20,5	22,0	107,3%
Euro Area	1 080,3	934,3	86,5%

19. Celik.S, Demirtas.G, Isaksson.M, "Corporate bond market trend, emerging risks and monetary policy" - OECD capital market series, 2020.

20. The approximation has been obtained by dividing the Eurosystem cumulative purchases of public debt in 2020 by the public debt change.



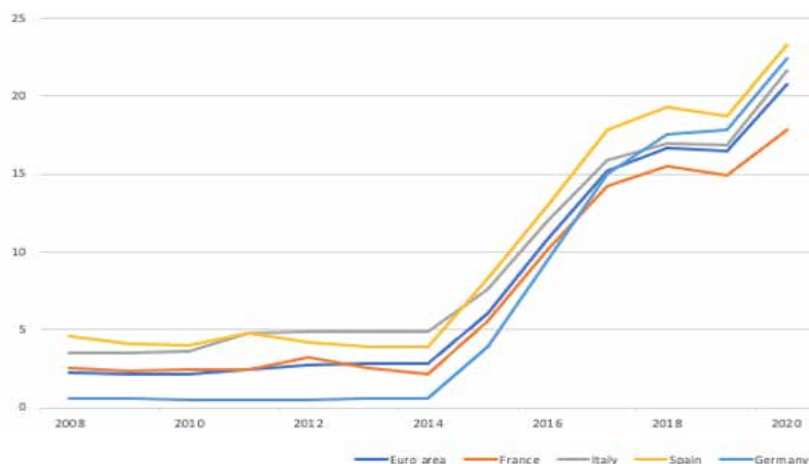
The above table also shows that all Italian, Dutch, Irish and Portuguese government debt issued in 2020 were bought up by the Eurosystem.

Chart 19.a illustrates the growing share of government debt held by Central Bank. This has been increasing continuously since 2014. Chart 19.b shows as of December 2020 that the Eurosystem holds 23.5% of the French public debt, 28.4% of the Spanish debt, and 21.3% of the Italian debt.

**CHART 19.a**

**Government Debt held by national Central Bank as % of government debt**

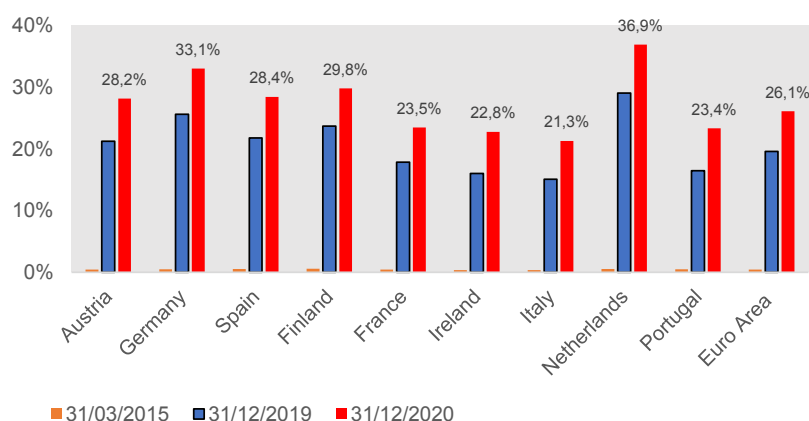
Source: ECB



**CHART 19.b**

**Share of Government Debt Held by The Eurosystem, %**

Sources: ECB, BIS, Eurofi Calculations



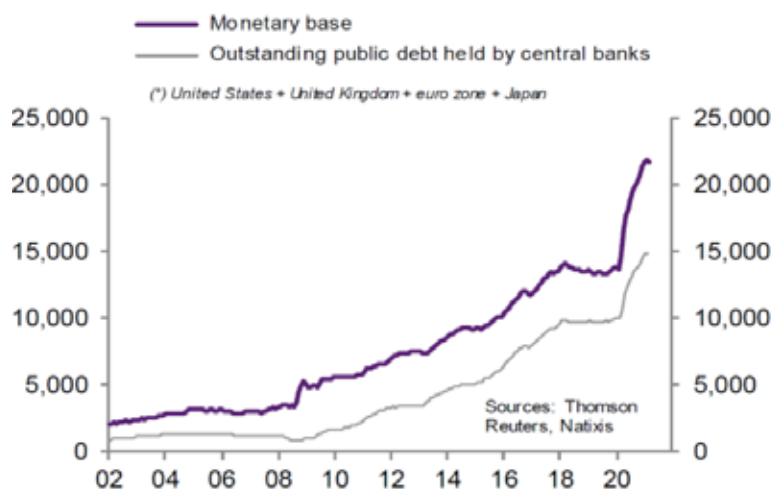
In December 2020, the Eurosystem owned up to €2 900 bn of national public debt from the euro area, amounting to 26,1%<sup>21</sup> of public debts.

**CHART 20.**

**OECD\*: Monetary base and outstanding public debt held by Central Banks (USD bn)**

(\*) United States + United Kingdom + euro zone + Japan

Sources: Thomson, Reuters, Natixis



21. According to Eurofi calculations.

The above graph (*Chart 20*) illustrates the intensification of the link between sovereign states and Central Banks. Advanced economies have seen their Central Banks endorsing stronger responsibilities, strengthening the sovereign-Central Bank loop.

Failure to meet the 2% level should no longer be used as an excuse for unnecessary easing. It should be clear that systematic buying of public bonds should not open the way for governments to finance vast stimulus plans without necessary conditions, including reform in increasing the efficiency of public spending and giving priority to public investment instead of current redistribution.

The “fiscal dominance” that is presently taking place carries two big dangers: it puts in question the independence of Central Banks. Furthermore, it is a major disincentive for governments to engage in the structural reforms that are indispensable to meet the fundamental challenges of the ecological transformation of our world, challenges that cannot be faced by printing more and more money.

In fact, lasting zero or even negative interest rates have been a disincentive for many Member States in the EU to undertake structural reforms which should lift potential growth. Indeed, with interest rates at ultra-low levels, governments are under no pressure to reduce their debts. Negative interest rates encourage them to borrow more. And if government borrowing becomes a free lunch there is a clear disincentive to fiscal discipline. Furthermore, the rules of the Stability and Growth Pact have not been respected by most of the EU Member States since their implementation.

In other words, the reassurance of low rates, given political imperatives, encourage governments to increase debt further. But thinking that monetary creation can solve the problems arising from excessive debt is an illusion<sup>22</sup>.

### **3. Persistent ultra-loose monetary policies have led to negative economic and financial stability consequences**

Lasting monetary policies have led to the downward path of interest rate, damaging productive investment and growth as the preference for liquidity prevails over investment. Such policies have fueled a misallocation of capital, encouraging zombie-firms proliferation and an increase in share buybacks. Persistent low rates exacerbated financial vulnerabilities, leading to mispricing of risks, asset bubbles and a weak profitability of the EU banking and life insurance sectors.

#### **3.1 Lasting zero interest rates damage productive investment and growth in Europe**

Abundant liquidity and low interest rates have not resulted in higher productive investment but in liquidity hoarding. Interest rates that remain at zero for an indefinite period discourage investors from investing in risky projects and instead move into yielding and speculative assets. Household savings have shifted to liquid and non-risky assets, as investments no longer yield any return, in Europe in particular. Furthermore, low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what John Maynard Keynes<sup>23</sup> called the ‘liquidity trap’, investors play safe by placing savings in very short-term instruments rather than deploying them longer term, where low interest rates bring them inadequate returns for higher risks.

As stated by the BIS<sup>24</sup>, “no well-functioning economy should operate with real interest rates that remain negative for too long: capital is misallocated and growth impaired”.

##### **3.1.1 Signs of the liquidity trap: preference for liquidity prevails over productive investment**

Loose monetary policies coupled with expected low returns on earnings drive a preference for liquidity. Chart 21 indicates that over the past 10 years, a massive increase occurred in the purely liquid part of household’s savings. Hence, the liquid share of financial assets held by all economic agents increased from 7% to 16% (Germany), from 5.8% to 7% (France). Such a preference for liquidity diverts savers away from long-term investment.

22. See the Eurofi note, “Addressing the dangers of the monetary policy deadlock” – September 2020.

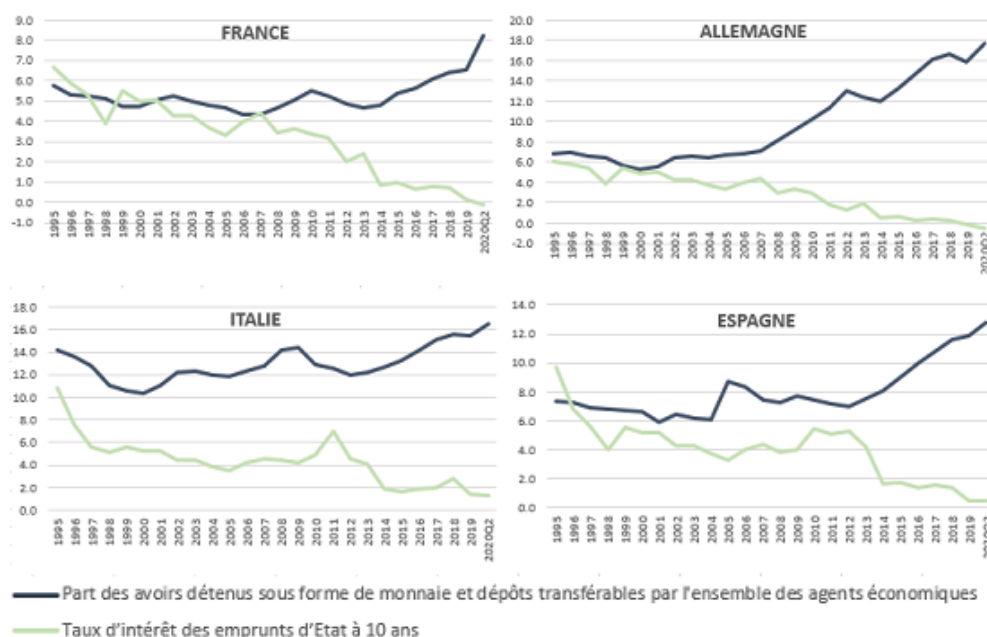
23. Keynes was in favour of low interest rates, but he specified not too low interest rates. Indeed, when they are too low, they deter savers from investing in long-term bonds and encourage them to either keep their savings in liquid forms, which they are doing, or in assets remunerated only because 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.

24. BIS, Annual economic report – June 2021.

**CHART 21.**

**Evolution of the liquid assets of economic agents and interest rates in government bonds**

Sources:  
Eurostat, Thomson Reuters, calculs OEE (observatoire de l'Épargne Européenne)



Weaker returns on investments in the event of rock-bottom interest rates has discouraged agents to undertake risky and productive projects. As can be displayed by Chart 22, the level of gross non-residential investment in advanced countries as a percentage of GDP has declined significantly, from above 14% in 2000 to less than 12% in 2018.

**CHART 22.**

**Advanced Economies:  
Non-residential Fixed Investment  
in GDP (Percent of GDP)**

Source: OECD;  
IMF Staff Calculations

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



### 3.1.2 'Too low for too long' policies have fueled the survival of weak firms, increasing a misallocation of capital

The lack of success from monetary policies at reviving economic growth can also be entailed to the capital and subvention allocation choices. Favorable borrowing conditions ensure the survival of non-productive firms – firms whose profitability is so low that they would not be viable if interest rates were higher.

Chart 23 illustrates the fact that the share of zombie firms in the OECD economies has grown from 1% in the late 1980s to 15% in 2017. Thus, productivity is hampered by zombie firms, which will dedicate their time and treasuries to reimburse their debt rather than invest in productive initiatives, impeding the reallocation of resources necessary for innovation and growth.

**CHART 23.****Zombie firms  
in 14 advanced  
economies, %**

Source: Banerjee and Hoffman  
(BIS Paper, 2018)



The expansion of zombie firms would have contributed to the trend decline in potential growth in OECD countries: when the share of zombie firms in an economy increases by 1%, TFP growth falls by about 0.3 percentage points<sup>25</sup>.

### 3.1.3 Lasting low interest rates incentivize companies to take on cheap debt to buy-back their shares rather than invest in long-term projects

Developments with respect to share buybacks cannot be decoupled from monetary policy. The OECD report<sup>26</sup> stresses that “this link is particularly important in the current low interest environment, which greatly affects the relative cost of debt and equity. Low interest rates may drive increases in corporate debt issuance to finance share buybacks, rather than invest in future projects. Expansionary monetary policy initiatives such as the ones undertaken in many OECD countries after the 2008 crisis and the Covid pandemic may directly affect the development in payout policy and adjustments in the companies’ capital structures”.

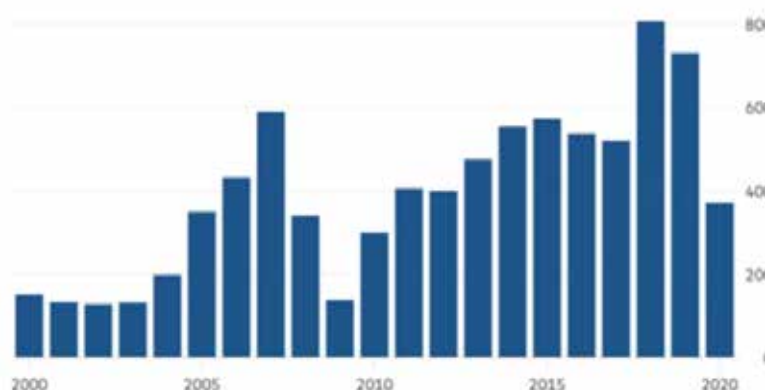
As shown in Chart 24, the S&P companies’ shares repurchase accounted for roughly \$800 bn in 2018, twice the 2010 amount.

**CHART 24.****Share repurchases  
for S&P 500 companies  
including 2020 estimated  
(\$bn)\***

\*2020 is estimated  
from Goldman Sachs

Source: S&P Dow Jones Indices,  
Goldman Sachs

©FT



According to the OECD, of the total value of share buybacks in 2018, approximately 83% was attributable to US corporations. A significant proportion of US share buybacks come from the financial sector, whose profitability has been impacted by lasting low interest rates.

In 2019, the total share buybacks in the OECD countries amounted to \$599 bn, over twice the amount of new equity issuance. The amount spent on share buybacks has exceeded the amount of equity every year from 2016-2019<sup>27</sup>.

## 3.2 Persistent low rates have been exacerbating financial vulnerabilities

### 3.2.1 Interest rates no longer play their discriminating role, thus leading to mispricing of risks

In a market-based economy, financial markets should discriminate against signatures according to their quality and not be dominated by the setting up of interest rates by Central Banks. But with their large-scale Central Bank purchases, as we have seen in section 1.3, Central Banks in OECD countries are controlling the prices

25. Baudchon.H, “Le choc de la Covid et la crainte d’une zombification accélérée” - Mars 2021.

26. Trends in the corporate sector and capitals markets pre-covid 19 - July 2021.

27. Trends in the corporate sector and capitals markets pre-covid 19, July 2021.

of a growing number of assets: not only short-term interest rates but those with QE which leads to monitor the yield curve. Indeed, with the control over long term interest rates through government bond purchases, sovereign risks premia do not reflect market forces nor provide savers with appropriate information about the economic and financial developments. In other words, sovereign bond prices are turned from market prices into administrated prices.

How can free markets assess value in these conditions? Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premia. This reduction of risk premia was already the phenomenon observed prior to the 2007-8 crisis.

**CHART 25.**

**Share of negatively remunerated debt in the euro area**

Source:  
Banque de France



Chart 25 exhibits that as of April 2021, roughly 20% of bond yield returns in Europe were negative, and around 60% were below 1%. As an example, the Greek 5-year bond yield turned negative for the first time in May 2021. Such a proportion of ultra-low remunerative assets has brought financial markets to shift away from the economic fundamentals. This has pushed investors into riskier segments in search of income, compelling them to lend to lower-quality companies and countries.

### 3.2.2 High leverage has massively increased market valuations: the development of asset bubbles

The money supply growth has been abundant over the last 20 years, without success in generating a proportional economic growth. This massive wave of money supply failed at achieving the 2% inflation target, but rather transferred to financial and real estate's prices. High leverage has massively increased market valuations. The abandon of a leaning-against-the-wind stance has nourished financial imbalances. The disconnection between asset and housing prices on the one side and the fundamentals on the other side is leading to bubbles. Indeed, lasting low interest rates open the floodgates of credit to both governments and the private sector, encourage search-for-yield behavior and represents a source of financial instability with the resulting assets bubbles. This can be illustrated by stock and real estate assets inflation and lately by the bitcoin price behavior.

**CHART 26.a**

**S&P 500 index**

Source: Fed

**CHART 26.b**

**Stock market indices (100 in 2002:1)**

Sources: Thomson Reuters, NATIXIS

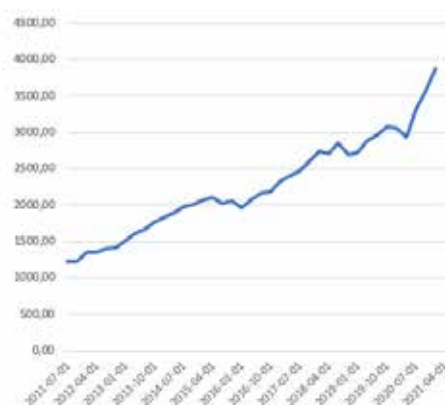


Chart 26.a shows that the S&P index valuation has almost been multiplied by 3 in less than 10 years. Following the same dynamic, Chart 26.b exhibits that the Eurostoxx 50 is at its highest level since 2009.

**CHART 27.**  
**Nominal house prices,**  
**2015=100**

Source: OECD



The systematically loose monetary policy has contributed to the building of the enormous credit bubble that nearly broke down the financial system in 2008. All financial indicators were flashing. But the CPI was low, Central Banks were not worrying. Such bubbles are indeed the present manifestation of inflation in an environment of technological price disinflation.

The associated graph (Chart 27) displays the steep rise in house prices, both in the United States and the Euro area. This illustrates the implied difficulty for youth to access housing. Since 2015, house prices rose by roughly 50% in the United States, by almost 30% in the Euro area.

**CHART 28.**  
**Price of Bitcoin,**  
**USD**

Source: Yahoo Finance



Among cryptocurrencies, the bitcoin price peaked at almost \$20 000 in 2018. Excess money supply has brought volatility in some asset markets. Chart 28 displays that after reaching \$60,000 in the first months of 2020, Bitcoin has fallen by 50% in only few weeks.

### 3.2.3 The weakening profitability of the banking and insurance system in the EU

The lasting ultra-low interest rates policy weakens the profitability of the EU banking sector<sup>28</sup>.

A report from Bank of America Securities<sup>29</sup> highlights the drivers of the yawning profitability gap between the euro banks at a 6% ROE in 2019 and the US at 14%. About half is the difference in market structure. The other half is simply the 200bp gap in interest rates.

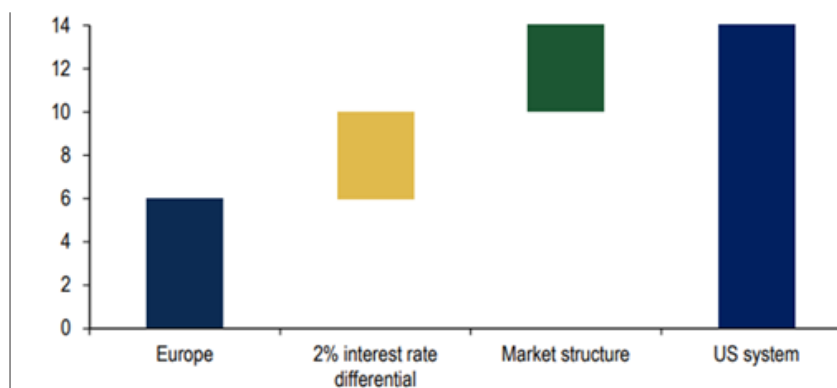
28. See the Eurofi note, "Banking fragmentation issues" – September 2021.

29. Bank of America Securities Global Research "Fit for an island continent", February 2020.



**CHART 29.**  
**Return on equity differential between the US and the EU (%)**

Source: BofA estimations



Lasting zero-interest rates also poses a problem for insurance companies and pension funds. Faced with long-term commitments, safe bond assets no longer yield much. This is a source of weakness that insurance companies must manage by increasing their equity, diversifying their investments into less liquid and more risky assets. For customers, low rates mean higher non-life insurance prices, lower guarantees and fewer long-term savings.

#### 4. The return of inflation: a temporary phenomenon?

Inflation has risen in many countries. In conjunction with a rebound in GDP growth and evidence of significant bottlenecks in some sectors, this has prompted concerns that the low inflation era of recent decades could be nearing its end.

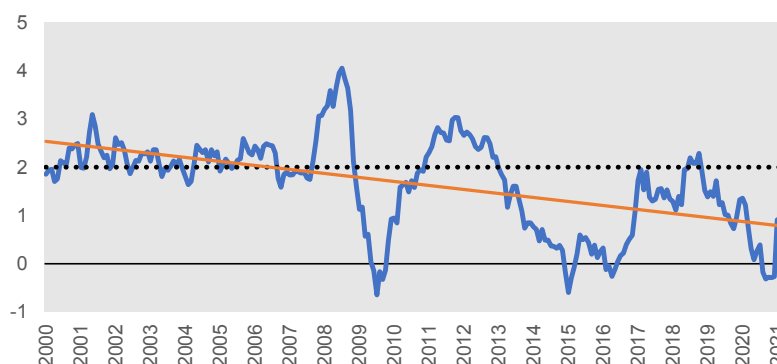
##### 4.1 In Europe, HICP inflation exceeds the 2% in May 2021 after years of undershooting

With regard to the inflation objective, the following Charts 30.a and 30.b give an idea of the dynamic. We notice that despite of the ECB efforts to achieve a close but below 2% inflation, this goal has generally not been matched since 2008. The ECB hit its 2% inflation target for the first time since 2018 in May 2021. Germany's Central Bank expects its inflation rate to hit 4 per cent later this year.

**CHART 30.a**

**HICP Dynamic in the Euro Area and Trend Curve, % annual change**

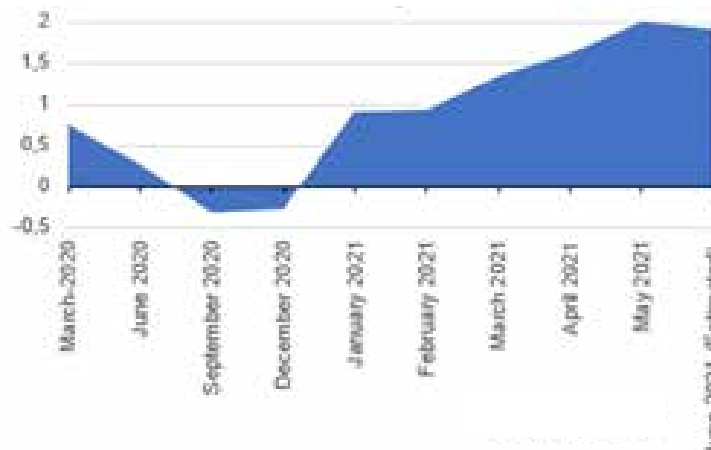
Source: BIS



**CHART 30.b**

**Recent inflation trend in the Euro Area, year-on-year, % change**

Source: ECB



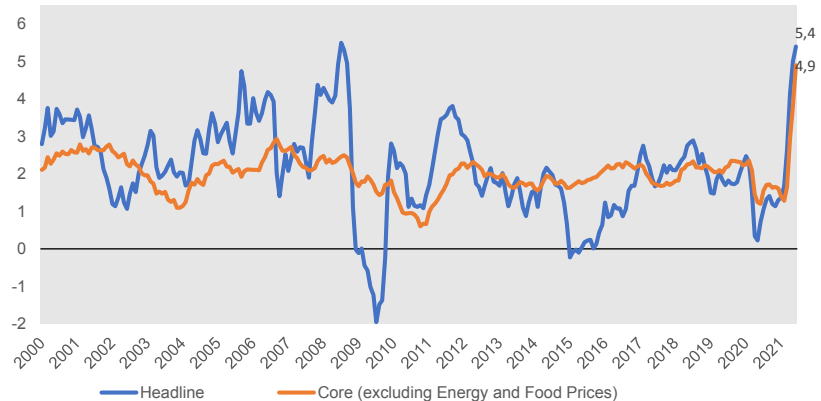
#### 4.2 The US is hit by a very high headline CPI inflation, above 5% in May 2021

The American situation displays a different pattern. Headline inflation has been quite volatile since 2008, and mainly under the 2%. But the latest figures do expose a harsh surge in prices, as reports show year-on-year headline inflation up to 4,2% in April 2021, up to 5% in May, and 5.4% in June.

According to Charts 31.a and 31.b, inflation has increased significantly in recent months in the US. According to J.Powell<sup>30</sup> this reflects, in part, the very low readings from early in the pandemic falling out of the calculation; the pass-through of past increase in oil prices to consumer energy prices; the rebound in spending as the economy reopen; and the exacerbating factor of supply bottlenecks, which have limited how quickly production in some sectors can respond in the near term. As these transitional supply effects abate, inflation is expected to drop back toward a longer-run goal.

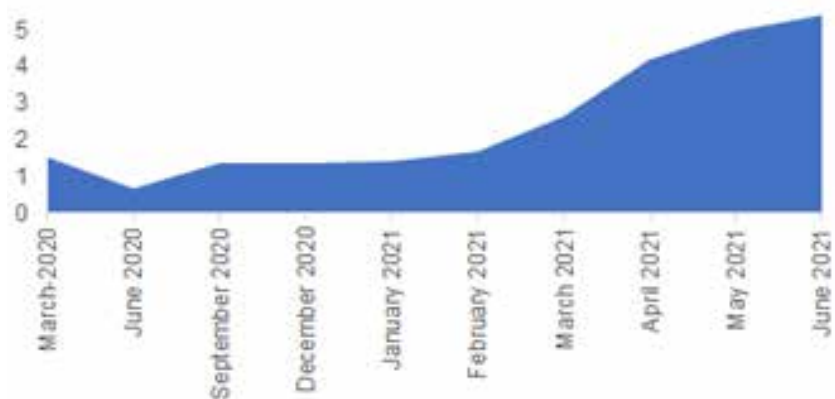
**CHART 31.a**  
**Core vs Headline**  
**Inflation in the US,**  
**Year-on-year, % change**

Source: Fed St Louis



**CHART 31.b**  
**Recent inflation**  
**trend in the US,**  
**year-on-year,**  
**% change**

Source: ECB



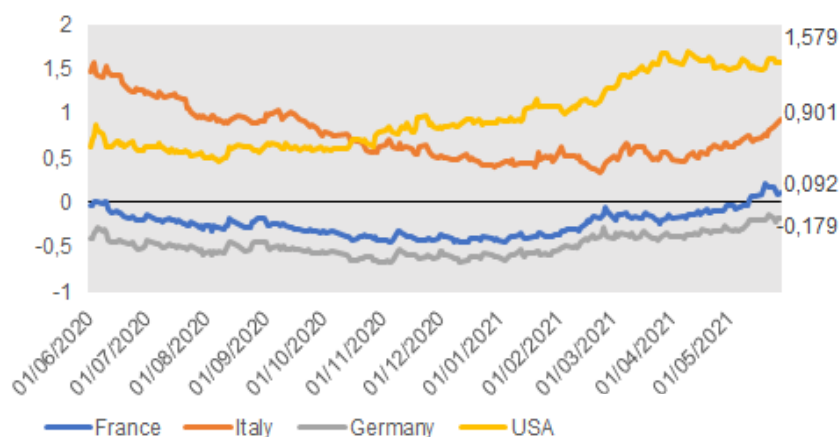
In May 2021, the US CPI experienced its highest jump since 1982, an annual rate of core inflation above 3% has never been seen for the past 43 years. The comeback in force of prices increase is ground to question whether the link between money supply and inflation is unlocking, or if this increase is rather due to temporary factors. Indeed, others argue that long-term inflationary pressures are at work: commodity costs, property prices.

They estimate that the inflationary surge quickly correcting itself has a low probability. Indeed, a temporary inflation would suppose that productivity will pick up and productive investment will increase, in a structural environment of low availability of skilled labor. This seems to be a very optimistic assumption according to L. Summers, P. Krugman...

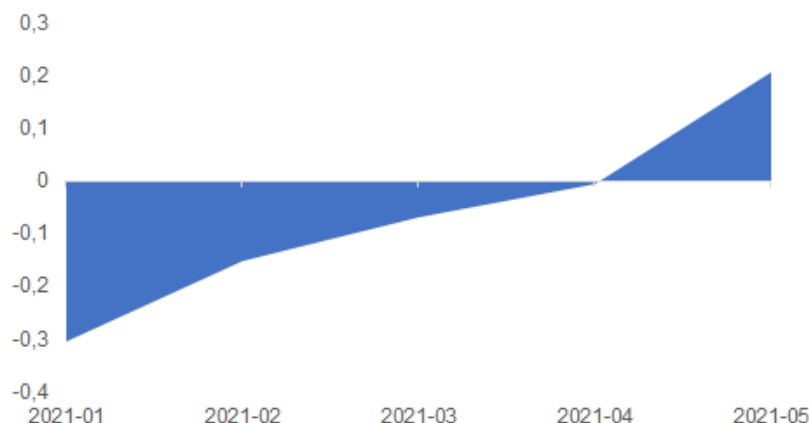
30. J.H.Powell, Speech before the US House of representatives, 22nd June 2021.

**CHART 32.****10-Year Sovereign Yield Trajectory, %**

Source: Boursorama

**CHART 33.****French 10-Year Government Yield**

Source: OECD



Charts 32 and 33 highlight a slight upswing in long-term interest rates, especially in the American interest rate which is closing up to its pre-crisis level. Re-opening economies are triggering a new pulse in inflation, without convincing at this stage the majority of Central Banks (Fed, ECB...) to slow down their asset purchase program rhythm nor to normalize their policies.

#### 4.3 First signs of normalization emerge as inflation takes up

The Bank of Canada (BoC) announced in April 2021 that it will begin to reduce the amount of its market purchases, three months ahead of schedule. As a result, net purchases of Government of Canada bonds will fall from a minimum of CAD 4 billion per week (EUR 2 billion) to a weekly target of CAD 3 billion. However, its key interest rates remain unchanged at 0.25%. This tapering or reduction in asset purchases is announced as the economic outlook has improved and there is more confidence in the resilience of the economy to the health crisis.

The Central Bank of Brazil (BCB) carried out its first rate hike since July 2015; it raised the key rate by 75 basis points to 2.75%, unanimously and beyond market expectations. The BCB is thus embarking on a process of «partial normalisation» of its monetary policy, which it is justifying on two counts: GDP recovered strongly at the end of 2020 and inflation expectations are above the central target of 3.75%.

The Fed now plans to start withdrawing in the coming months its massive pandemic stimulus programme. The minutes from the July meeting of the Federal Open Market Committee (27-28 July 2021) stated that “most participants noted that, provided the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year”. These minutes also indicated that “most participants remarked that they saw benefits in reducing the pace of net purchases of Treasury securities and agency MBS proportionally in order to end both sets of purchases at the same time”.



Central Banks have been overly involved during the past years. No well-functioning economy should operate with real interest rates that remain negative for too long: capital is misallocated and growth impaired.

The continuation of very low interest rates would intensify already negative consequences for financial stability, growth and employment. As this scoreboard demonstrates, pushing too hard and too long on the monetary pedal has severe negative consequences. Thinking that monetary creation can notably solve the problems arising from excessive debt is an illusion. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth.

Policy makers need to rebuild safety margins. As stated by the BIS in its Annual Economic Report (June 2021) “an economy that operates with thin safety margins is vulnerable to both unexpected events and future recessions which inevitably come. These margins have been narrowing over time. Rebuilding them means re-normalizing policy”.

The world should move gradually and cautiously towards monetary normalization, in order to avoid cliff effect. It seems prudent to start reducing the calibration of QE and not to systematically re-invest all bonds coming to maturity. Preparing for European interest rates to return to more normal levels would also be the first step to a more productive post-pandemic period of higher growth and investment. A key condition will be ample cooperation between the monetary authorities in the leading countries, in line with standard practice not just in the 1980s and 1990s but also during the 2008 crisis.

Fostering a sustainable path to stronger growth is essential, notably in the current indebtedness environment. Raising long term potential growth requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries in particular, has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything: only domestic structural reforms can resolve structural issues and increase productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

In over indebted countries, governments must take corrective actions to ensure a path of primary fiscal balances and reduce unproductive and inefficient public spending. Reforming the Stability and Growth Pact is an urgent necessity. It would be rational to propose that each member country should outline a specific path for reducing its public debt which would take account of specific local parameters<sup>31</sup>.

Only productivity enhancing, and productive investment can create sustainable increases in productivity, neither negative rates nor QE.

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31. de Larosière J., “A framework for a successor to the Stability and Growth Pact” – June 2021 (available in the Eurofi Regulatory Update - September 2021).



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# ABOUT EUROFI

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## 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

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### 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](http://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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