The Eurofi Financial Forum 2014

Organised in association
with the **Italian EU Council Presidency**

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10 - 11 & 12 SEPTEMBER // MILAN

SUMMARY OF DISCUSSIONS

RELAUNCHING GROWTH IN THE CURRENT EU ECONOMIC AND REGULATORY ENVIRONMENT

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The European Think Tank dedicated to Financial Services

- **A not-for-profit organization created in 2000 chaired by Jacques de Larosière**
- **A platform for exchanges between the financial services industry and the public authorities addressing issues related to the evolution of financial regulation and supervision**

MAIN ACTIVITIES

The main objectives of Eurofi are to help industry and public decision-makers reach a common understanding of possible evolutions required in the regulation and supervision of financial services and to open the way to legislative or industry-driven solutions that may enhance the safety and effectiveness of the EU financial sector.

Eurofi acts in a general interest perspective, facilitating exchanges of views between diverse financial industry players and the public authorities. These exchanges are prepared by objective fact finding and issue analyses.

Eurofi has two main types of activities conducted by **Didier Cahen**, Secretary General of Eurofi, **Jean-Marie Andrès** and **Marc Truchet**, Senior Fellows:

Events and meetings:

- **Eurofi organizes annually two major international events (the High Level Seminar in March / April and the Financial Forum in September)** gathering together industry leaders and EU and non-EU public decision makers for discussions on the major on-going regulatory projects in the financial area, as well as informal networking.
- These events have been organised in recent years in association with the EU or G20 Presidencies in parallel with informal ECOFIN councils or G20 Finance Ministers meetings. They are organised with the support of **Christian Hawkins** and his team.
- **Additional workshops** involving the members of Eurofi are set up to exchange views on regulatory issues. Bilateral meetings are also regularly organised with representatives of the public authorities and other stakeholders (e.g. end-users, experts) to fine-tune assessments and proposals.

Research and documentation:

- Assessments and proposals taking into account economic, risk and end-user impacts are prepared with the support of cross-sectoral working groups comprising members of Eurofi.
- Topics addressed include prospective and on-going regulatory proposals at the EU and global levels, as well as industry trends.

MAIN TOPICS CURRENTLY ADDRESSED

- **Measures and instruments needed to ensure an appropriate financing of the EU economy:** assessment of the economic and growth challenges to be addressed in the EU (on-going deleveraging of EU economies, low inflation...), measures to support bank financing (securitization of high quality loans), proposals for developing a long term investment perspective and for further diversifying the financing of EU SMEs, measures to stimulate EU bond and equity markets...
- **Prospects of further EU integration:** conditions for an effective implementation of the banking union and for reducing financial fragmentation within the EU, possible evolution towards a fiscal union and towards a capital markets union, evolution of the EU regulatory and supervisory institutions (ESRB, ESAs)...
- **Optimizing the EU financial services internal market:** conditions for enabling a sustainable SEPA business case, review of the IORP directive, regulation of CRAs...
- **Evolutions of the prudential and regulatory framework of banks and insurance companies:** fine-tuning and implementation of banking and insurance prudential frameworks (liquidity provisions, RWA evaluations, Solvency II), structural banking reform projects, recovery and resolution of bank and non-banks
- **Capital markets and investment products regulations:** regulation of securities, derivatives and commodities markets and infrastructures, recovery and resolution of financial market infrastructures, collateral requirements, asset management regulations, investor protection regulation (PRIPs, MiFID, IMD...) and fund depositary rules, regulation of shadow banking
- **Financial regulation at the global level:** feasibility of bank crisis management at the global level, conditions for implementing market regulations consistently...

EUROFI MEMBERS

The membership of Eurofi comprises many leading global and European financial institutions from different sectors of the industry (banking, insurance, market infrastructures, asset management, credit rating agencies...).

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W W W . E U R O F I . N E T

EDITORIAL

Eurofi's Financial Forum took place this year in Milan and was organised in association with the Italian EU Council Presidency.

The measures needed to foster an appropriate financing of the EU economy and the ongoing reforms in the banking, insurance and capital markets sectors were the main focus of the discussions of the Forum.

More than 140 distinguished speakers from public institutions and the financial services industry and over 600 delegates participated in the 18 sessions of this international Forum.

We would like to thank very warmly Minister Padoan, Minister of Economy and Finance of Italy and President of the Ecofin Council, Governor Visco of the Bank of Italy and their teams for their valuable support in setting up this international event.

We are very grateful to all the representatives of the global and European public authorities who found the time to participate in this Forum.

We express our gratitude also to the sponsors of the event and the members of Eurofi for their support in setting up this event.

You will find all the publications and the relevant information regarding our latest events and forthcoming activities on our website: www.eurofi.net.

We hope you will enjoy reading this report and we welcome your feedback.

Jean-Marie **ANDRÈS**
Senior Fellow

Didier **CAHEN**
Secretary General

Marc **TRUCHET**
Senior Fellow

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SPEAKERS'
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SPEECHES AND EXCHANGES OF VIEWS

Exchange of views: Can growth be re-launched in the EU with falling credit and on-going deleveraging of Member States?

Jacques de Larosière, President, EUROFI
Pier Carlo Padoan, Minister of Economy and Finance, Italy

JACQUES DE LAROSIÈRE

Thank you very much. Well you have a full audience, Mr Minister. I'm delighted to be with you this afternoon, we have the honour of having with us Mr Padoan, Minister of Italy who is in charge of the Presidency of the ECOFIN. He is going to start off in a few moments and we'll have the privilege to listen to him.

So basically, I wanted to ask him two questions on which he can broach and speak as he will. One is on the macro-economic side – how do you see the situation, growth is very sluggish, in particular in Italy and we would like to have your views on how do we get out of this problem? Is the policy mix okay or are we missing something to get the economy moving again? And the second question is more financial – how do you think we can perhaps regenerate some form of credit through securitisation, an idea that is close to my heart and I often come back to it and use the presence of a person like you to broach on it. So basically these are the two things that we would like to hear you on.

PIER CARLO PADOAN

Thank you Jacques and good afternoon to everybody, it's a real pleasure and an honour for me to be here and share with you the views of the Italian Government and of the Italian Presidency of the European Union.

Let me start from facts. And the facts, we are all familiar with, are that the macro performance of the Euro area is disappointing again. Let me stress, the 'again.' I think this is very important.

While we see the United States growing more than expected; while we see emerging economies luckily growing at healthy rates again, we see the European economy, but especially the Euro area faltering, again. This is my concern.

How should we interpret the fact that almost everybody for the past few months and quarters, including the Italian Government, had to revise downward figures about growth and prices? Is this just a short term blip? Or are we facing something deeper?

There is no clear-cut answer to that. Economic models do not capture those aspects, which are related to deeper shifts and changes in the structure of the economies. But I would position myself with those who say that, when the uncertainty is high, it's more prudent to take one side of the view. The side I would take is that we should do all we can with the existing instruments and within the existing rules, to address the root causes of slow or sluggish growth and of persistently high unemployment.

After all, this should come more naturally if one goes a few years back and looks at what Europe has done and, in particular, what the Euro area has done to react to the big crisis, which started in 2007. The euro area and Europe have provided, as you all know, a sequenced response. The first step of the sequence was, immediately after the 2007 breakout of the crisis, to go back to a fiscal equilibrium. This has started a very important process of fiscal consolidation, which has produced very important results and needs to be continued. Many countries, including this country, have done a huge effort in fiscal consolidation, which has been instrumental and is instrumental to put growth on a sound basis, again.

Then the following step has been to look at financial markets, where the banking crisis started, and appropriately so, given that financial markets had been at the origin of the global economic crisis. And here is where the euro area has produced impressive results. The Banking Union was an idea floating in the air just a few years ago and it is almost a reality now. Of course more needs to be done; we have to deal with important details. You usually find the devil in the detail, so you better stay away from devils! At the same time, we are heading to a very important overall assessment of the banking sector, undertaken through the AQR and the stress test sequence, which, I am confident, will strengthen the way financial and banking markets work and operate in Europe.

So we have done a lot to preserve and strengthen fiscal consolidation, we have done a lot to repair financial markets, address fragmentation, and therefore facilitate the transmission of monetary policy. What have we not done, yet?

We have not done much on growth and jobs. So, I would not consider the policy makers' task in euro area to be fully accomplished until we obtain significant results on the growth and job front, at least comparable to what we have achieved in the fiscal consolidation and banking front. The reason is obvious, all those things need to be done to put Europe and the euro area back on a healthy and sustainable growth pattern again.

So this is why the Italian Presidency of the EU in this semester, has put growth and jobs on top of the agenda. And this is why we suggest a number of areas where more can be done in perspective and where national and European policies may interact and mutually support each other. We need to do that exactly because of what I said at the beginning: because we need to address the current situation of weakness in a systematic way.

So, we have put three basic and simple ideas on the table to address growth and jobs more effectively. First of all, and this is not a new idea, more integration, more single market and - I would also add - more global integration. Everybody is familiar with the economic history of Europe after the war and we all know that growth accelerations have been going hand in hand with integration. So, integration breeds growth. This is the European way to growth and welfare.

Secondly, more structural action. This crisis is not just the result of malfunctioning of financial markets, but also the result of a weakened long term performance of the European economy. Accordingly, we must address simultaneously weaknesses in the financial system, which is what we are doing, and weaknesses in the economic structure. The response to structural problems is obviously structural reforms, which is a broad concept that covers many specific areas of how markets work, how institutions work and has both a distinct national flavour and many cross country commonalities.

So, we need more emphasis on structural reform, better monitoring, better analysis, and peer pressure among European countries on the structural agenda. This is already being incorporated in the way Europe assesses the performance of individual countries and intervenes through country's specific recommendations on both the macro and budget side and the structural side.

Third element: investment. Investment has, if I may quote my friend, the Governor of the Bank of Italy, is the subtle point of the relationship between the short term and the long term, between supply and demand. More investment is at the same time a source of demand but also source of structural change, because it translates into new capital and into a new productive structure.

So, it's important that we make the best effort to revamp investment because investment as you all know, has been going down. Both private and public investments have been going down almost everywhere. So, it is a fair statement to say that we need more investment all across Europe. What can we do to boost investment? We can do two broad things, and the second one will bring me to your second question, Jacques.

The first thing is to create a situation in which companies are willing to invest more, because they find it easier and more profitable to do so, or to put it differently, because they find less obstacles to investment. This of course covers a long list of issues I will not bore you with.

The second component is: finance for investment and finance for growth. This is where I come a bit closer to the topics you have been discussing and you will be discussing here. In a nutshell, we think that we need and we can do a lot more to facilitate the flow of funds towards investment. And we can do that through several instruments, several actions – from regulatory actions to fiscal actions - at the European level, so that additional resources may be available for investment. The mismatch that we often see between savings and investment can be addressed much more effectively than in the past. The more so in Europe and especially in the euro area where as you all know, sources of financing for companies have been concentrating on some segments, neglecting others. I believe that our initiatives must be broad in scope and this is something which the Italian Presidency will put on the table and which will be discussed in the meeting with my colleagues, starting tomorrow.

This is where your contributions, by the way, will be mostly helpful. How can we do that? Well, here let me just remind things that will sound very familiar to you and I apologise for trying to add some value in the conversation, although I don't think there is any need in this room. We can think of a number of segments which can be enhanced, starting from securitisation, which has become particularly popular recently, also because of some of the moves and indications of action coming from ECB. How can we make the best use of what can be a very powerful financing instrument, while getting rid of - allow me to use this term - the 'stigma' that the financial crisis has attached to this concept.

Here, there is a very important role for public policy to play. First of all, to create a transparent environment for the diffusion of securitised products, avoiding opportunities for arbitrage, generating at the same time a level playing field, and a transparent playing field. So that the negative attitude vis a vis these instruments, which can still persist in some parts of the market, is swept away bringing us to a new start.

Of course, this would be a useful complement to the new actions undertaken by monetary policy, and here I'm using 'monetary policy' and I am not referring to the ECB alone because this is not only a euro area story. I think this is something that will remain with us as we enter a new phase of monetary policy making. I am aware that I may be contradicted by the governors sitting in front of me and so I hope I'm not saying anything wrong here.

We will try in ECOFIN not only to raise the issue but also and especially to find ways to find concrete, practical solutions to very specific problems in the strong belief that there is no silver bullet but a complex effort for policy makers to undertake. The joint implementation of coordinated initiatives may simply change the way markets operate.

There are other areas and segments, which can be addressed, I'm thinking of strengthening non-bank financing opportunities for companies and especially SMEs through a number of instruments, mini-bonds, covered bonds, and so forth. Again I'm not going to bore you with things you know much better than me! This requires changes in the regulation at the national level, hopefully with an integrated view. Let me just remind you that recently the Italian Government has introduced more than one package of regulation aimed exactly at facilitating these new instruments.

Then, there is the other segment, the part which looks at long term investment opportunities. How can we facilitate infrastructure investment knowing that the public and private roles have to be updated? We still need, I believe a role for the public sector to facilitate investment, which of course must be mostly funded by private resources. We need to understand how this facilitating role can be enhanced at the national level and how a much more prominent role can be played, at the European level, by what are usually referred to as 'National Development Banks'. Franco Bassanini, who is sitting in front of me, knows very well what I have in mind. These are long term investors that can do more, possibly operating jointly with the EIB and European institutions. Here I think that the role of governments, of policy makers is not only to provide political orientation but also translate these views into concrete measures of encouragement at the national level.

I will stop here because I'm starting to repeat myself. But those are the basic messages I'd like to share with you. As I said, the purpose is first of all, to put growth and jobs alongside the other elements of the European agenda on an equal footing. It's my strong belief that these targets have been neglected so far and that very concrete instruments are needed to translate them into practice and to improve the performance of European economy going forward. We are in a transition phase, there is a new Parliament, there is a new Commission that actually is coming in very fast, reflecting a swift decision process, which is very good news. We look forward to working with the new Commission. Considering that the Italian Presidency takes place in this transition phase I have always thought useful to offer elements for thought and action to the incoming Commission as it sets its agenda for the coming years. We hope that at the end of this semester this effort will be considered a useful contribution of our Presidency and one that has provided value added to the European construction.

Thank you for your attention.

J. DE LAROSIÈRE

Thank you very much Mr Minister for these extremely interesting remarks. If I may say so I was struck by the intellectual articulation of what you said which is I think very cogent, and also by the simple and clear exposition of some of the main ideas that, under your chairmanship, you will be proposing to your colleagues in terms of concrete action. I was really very heartened to hear your stress on concrete actions.

We've heard a lot of speeches over the last months and years on the need to re-launch growth, to stimulate production, and recruitment, and employment. But we have rarely heard a crisp presentation of some immediate things to do. I think you are absolutely right. The Commission is going to take over in the coming months and we have a window of opportunity now, to ask some changes or some inflections in some present regulations which are hindering legitimate actions. In particular, securitisation and creation of an asset class for infrastructure assets. If indeed, you manage to convince, which I'm sure you will, your colleagues tomorrow, we could well see and this would be a little bit new, in our EUROFI meetings, we could well see a practical change. Which I think is urgent because the degree of sluggishness of our economies is awesome and so we don't have much time to address these issues. So, we are very heartened to hear you and I thank you for having shared those moments. It is precious for us to understand what is your state of mind and your intentions. The only thing I can say is that I wish you well. Thank you again.

Achieving an effective economic and monetary union

Mario Draghi, President, European Central Bank

Summary

We are facing a set of conditions – low growth and low inflation, high debt and high unemployment – that can only be addressed by concerted action on both the demand and supply sides of the economy. This requires that all actors – both at national and European levels – play their parts in line with their respective mandate as laid down in the EU Treaties.

No monetary or fiscal stimulus can be successful if not accompanied by the right structural policies – policies that foster potential growth and instil confidence.

Investment has been one of the great casualties of the crisis. From peak to trough business investment in the euro area decreased by around 20% since 2008, against 15% in the 1992 recession. We will not see a sustainable recovery unless this changes.

A decisive rise in investment is essential to bring inflation where we would want to see it, to kick-start the economy and to bring down unemployment.

There are two key areas where national and European level government action can help revive investment. First, the regulatory environment should be made more favourable to economic growth. Second, companies need to have access to more diversified sources of financing: the launch of a capital markets union could contribute to achieving this. It is an idea that the ECB fully supports.

The development of the market for simple and transparent Asset Backed Securities deserves particular support. Member States should consider the provision of public guarantees to support lending to small and medium sized enterprises.

There also needs to be a consistent and credible application of the Stability and Growth Pact across time and across countries. Within the existing framework, countries should explore how to support productive investment.

In monetary policy, we have deployed a number of non-standard tools to ensure our very accommodative monetary policy stance is transmitted to the real economy. Last week, the Governing Council decided to start the

purchase of certain high-quality asset-backed securities and covered bonds in October. Senior tranches of such ABS have proven to be high quality assets.

Alongside our Targeted Longer Term Refinancing Operations, we expect these measures will enhance the functioning of monetary policy transmission, provide further accommodation now that we are at the lower bound, and have a sizeable impact on our balance sheet.

Speech

Ladies and gentlemen,

It is a pleasure to be here tonight with you in Milan.

In a recent speech in Jackson Hole, I spoke about the need for a policy mix involving monetary, fiscal and structural policies to jump-start the economic recovery in the euro area. We are currently facing a set of conditions – low growth and low inflation, high debt and high unemployment – that can only be addressed by concerted action on both the demand and supply sides of the economy. This requires all actors – both at national and European level – to play their parts in line with their respective mandates as laid down in the EU Treaties.

No monetary stimulus, indeed no fiscal stimulus, can be successful unless accompanied by the right structural policies – policies that foster potential growth and instil confidence.

I would like to illustrate this argument by focusing on investment, which will also be discussed at the informal ECOFIN this weekend. Investment has been one of the great casualties of this crisis.

The downturn in business investment in the euro area since 2008 has been much more severe than in earlier business cycles. From peak to trough, business investment decreased by around 20%, against 15% in the 1992 recession. The level of business investment in the euro area has only slightly improved since 2008, whereas in the US it is above its pre-crisis level.

We will not see a sustainable recovery unless this changes. A decisive rise in investment is essential to bring inflation closer to where we would want to see it, to stimulate the economy, and to bring down unemployment. So what can we policy-makers do to revive investment? My main message today is that only if structural, fiscal and monetary policies go hand in hand will the euro area see investment return. Let me focus in particular on the decisive contribution which structural policies can make.

A policy mix to revive investment

I see two key areas where government action both at national and European level should help to revive business investment. First, the regulatory environment should be made more favourable to economic growth. Second, companies need to have access to more diversified sources of financing: the launch of a capital markets union could contribute to achieving this and, at the same time, help overcome the remaining fragmentation of financial markets. Let me briefly elaborate on each of these points.

Improving the regulatory environment

Business activity would greatly benefit from an improvement in the regulatory environment, in particular as regards product and labour markets. The differences between Member States are quite striking in respect of wage differentiation (across workers and between sectors), employment adjustment rigidities, barriers to entry in product markets and the ease of opening and running businesses. For example, in some Member States contractual disputes between firms take on average little more than a year to resolve, while in other countries they take more than three years. Start-ups in the latter countries have to deal with more red tape than their counterparts elsewhere. Another telling example relates to the regulated professions whose number varies considerably across euro area Member States [from 45 in Estonia, 170 in Italy, 219 in France to 304 in Slovakia, according to European Commission figures]. Such barriers to entry limit competition and employment, creating undue rents for a select few to the detriment of customers. These are just a few examples.

In many cases, these obstacles sap entrepreneurial spirits, especially of young, innovative firms that create most of the new jobs and that are highly sensitive to changes in investment opportunities. These examples show how converging towards best practice in the euro area would mean radical improvements in the business environment. Spain provides an encouraging example in this regard. Among the large euro area countries, investment in Spain is projected to rebound strongly over the coming two years, notably due to the combination of business-friendly reforms and lower personal and corporate taxes. More recently, other countries have also committed to improve the business environment. A forceful and swift implementation of the necessary reforms is now key in order to reap the benefits as quickly as possible.

Strengthening the financing side

A second area of key relevance for investment and also of direct interest to the Eurofi community here tonight is the need to diversify sources of financing and to overcome financial fragmentation. Until now, banks have been the main source of lending to companies. The crisis has shown the drawbacks of over-reliance on a bank-centred lending model. So we also need to develop reliable sources of non-bank lending, such as equity and bond markets, securitisation, lending from insurance companies and asset managers, venture capital and crowdfunding.

This is why the ECB fully supports the intention of the incoming President of the European Commission to create a capital markets union. Such a step would be a natural development of the Single Market and would benefit all EU Member States.

We believe that one area that deserves particular attention is the development of a wellfunctioning market for simple, transparent and real asset-backed securities (ABS). This would allow banks to still originate loans – notably to small and medium-sized enterprises (SMEs) – while preserving their balance sheet capacity. In order to achieve a well-functioning ABS market, it is important that the regulatory treatment of securitisation is proportional to the risk of ABS. In this respect, the ECB welcomes efforts to have a differentiated regulatory treatment of simple, transparent ABS built on real assets. Moreover, the provision of public guarantees should be considered to support lending to SMEs, as other countries do, such as the US.

A further integration of corporate bond and equities markets is also essential to overcome the present fragmentation in the euro area and to ensure more robust cross-border lending and investment flows. To achieve this, we will have to streamline differences between countries, for instance, in the legal protection of borrowers' and lenders' rights as well as in national taxation and insolvency procedures.

To sum up, structural policies are more multifaceted than they are often perceived to be in the political debate and can have a very significant impact on investment in a variety of ways.

Growth-friendly fiscal policy

Yet this is not the only area where governments can make a difference. They have at their disposal a second policy lever of direct relevance for investment, namely fiscal policy. Companies will only invest in the future when there is confidence and certainty about the future, about the medium-term fiscal path, and ultimately about taxes. We need a consistent and credible application of the Stability and Growth Pact across time and across countries. Within the existing framework, governments can find space to support productive investment, and achieve a more growth-friendly composition of fiscal policies by lowering the tax burden and reducing unproductive current expenditures. In parallel, it may be useful to have a discussion on the overall fiscal stance of the euro area with the view to raising public investment where there is fiscal space to do so. In this regard, there is also a complementary role to play at European level in supporting the rebound in private investment. I therefore welcome the €300 billion package announced by the incoming Commission President two months ago.

The role of monetary policy

Let me finally say a few words on the contribution of monetary policy. We successfully fought the confidence crisis in the euro that raised interest rates to abnormal levels. We provided the euro area banking system with unprecedented funding. We have continuously lowered our policy rates. Now we have reached the lower bound. To ensure that this very accommodative monetary policy stance is transmitted to the real economy across the euro area in an equal manner, we have also deployed a number of non-standard tools. Increasingly our focus here has shifted towards the financing of small and medium-sized enterprises, which heavily rely on bank financing and in many cases are struggling to retain access to credit. These companies may be small, but when they face a funding problem, it is a big problem for all of us, given that they employ around three-quarters of the euro area's workforce.

In June, we decided to launch a series of targeted longer-term refinancing operations – TLTROs – to ensure that banks have sufficient liquidity to lend to the real economy. The TLTROs have been designed to encourage banks to increase their lending to the nonfinancial corporate sector.

In addition, we have also taken measures to underpin specific market segments that play a key role in the financing of the economy. Last week, the Governing Council decided to start buying high-quality asset-backed securities and covered bonds in October. We will purchase both existing and newly issued ABS, which are simple, transparent and real in the sense that the underlying assets consist of loans to the euro area non-financial private sector.

Let me respond to the concerns recently expressed about the risks posed to the integrity of our balance sheet. It is worth recalling that senior tranches of ABS have proven to be highquality assets. According to the Association of Financial Markets in Europe, only 0.12% of European residential mortgage-backed securities (RMBS) outstanding in mid-2007 have defaulted since then – compared with 22.05% for US RMBS. Default rates for consumer finance ABS and SME collateralised loan obligations have also remained low, well below 1%, throughout the worst financial and economic crisis we have experienced.

As regards covered bonds, credit quality is ensured by a double recourse (on the underlying assets and on the issuer), which is in fact comparable with the double protection that exists in our standard repo operations.

Overall, the decisions announced last week were taken with a view to underpinning the firm anchoring of medium to long-term inflation expectations, in line with our aim of maintaining inflation rates below, but close to, 2%. We expect the two purchase programmes to effectively complement the TLTROs in enhancing the functioning of the monetary policy transmission and in providing further monetary accommodation given that we have now reached the lower bound. The newly decided measures, together with the TLTROs, will have a sizeable impact on our balance sheet, which is expected to move towards the dimensions it used to have at the beginning of 2012, and the Governing Council stands ready to take further action if needed, in compliance with its mandate to maintain price stability.

Conclusion

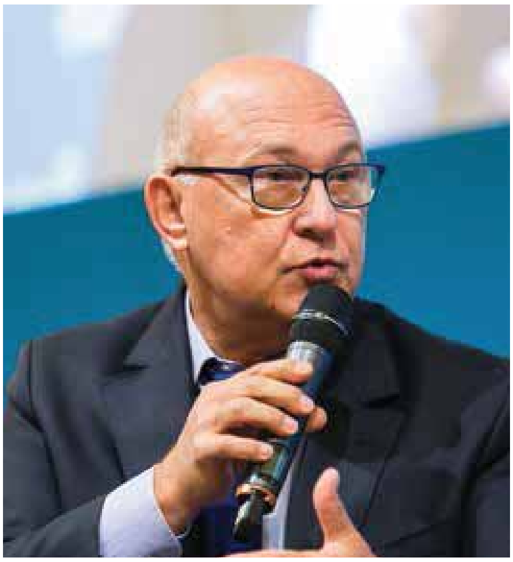
Ladies and gentlemen, it is time for me to conclude.

My bottom line is also my starting line. Investment is rightly said to be today's demand and tomorrow's supply. Yet investment in Europe is falling short. If we don't manage to get investment going again, we will weaken the economy in the short run and undermine its prospects in the long run.

Our efforts should therefore be focused on jump-starting investment. However, and this was really the crux of my argument, we will only manage to stimulate investment if structural, fiscal and monetary policies mutually reinforce each other.

Exchange of views with members of the Eurogroup

Jacques de Larosière, President, EUROFI
Michel Sapin, Minister of Finance, France
Rimantas Šadžius, Minister of Finance, Republic of Lithuania



JACQUES DE LAROSIÈRE

Good morning ladies and gentlemen, we are honoured this morning to have the presence of two ministers, Mr Sapin who is the Minister of Finance and Economy in France and Mr Šadžius who is Minister of Finance of Lithuania.

Minister, I'd like to ask you to tell us what is your general feeling and impression about the economic evolution and the European macro economy? More specifically, if I may, many Ecofin meetings are under the aegis of the re-launching of investments which is so needed in Europe considering the economic situation. What are your views, your ideas particularly on securitisation which is a way to sustain the channel of credit for enterprises, especially for SMEs and also the creation of new asset classes for infrastructures for instance?

MICHEL SAPIN

Thank you very much, Jacques, it's a great pleasure to be with you. With Jacques, we have known each other for over 20 years, and we have experienced very tense moments at least as tense as this moment now. This is the reason why one should not be afraid of difficulties because we can always overcome them.

The Euro area is now going through a new period. We first had a financial and banking crisis to overcome, we then went through a period of much hardship, with the Euro currency being challenged, which we had to cope with and take the necessary measures and the budgetary discipline to address this. And now, I would say, we've entered a third era, which is a period of revival, back to a sustainable, deep, long-term growth which is absolutely essential for Europe, first of all to repair the damage of the first two periods and then to give new prospects to our people, particularly regarding employment.

Within that framework we need a suitable currency and monetary policy, and the one currently conducted by the European Central Bank is suitable in my opinion. And certainly, there are needs for structural policies, structural reforms, in-depth reforms, in each of our countries and projects and France is accountable in this respect. But we should also support investments. Besides, it is only by supporting investments that this theological debate between the supply and demand policies can be addressed. The policy of investments is a way to respond to both, by constructing a better supply while at the same time stimulating a demand to build up a policy of supply of a higher quality.

As far as investments go, there are many European measures that can be taken and there is certainly a field, which you're interested in today, which is that of developing new channels, new tools and instruments to allow companies and organisations to recover a pace of investments at least equal to that before the crisis. So we should aim at this kind of level. New channels and methods are needed and there should be a focus within this debate on securitisation. This is only one of many elements, but it's a key driver amongst many other elements of the European policy.

There is one difficulty however and that is the bad memories of past securitisations. So it is certainly useful as an instrument but has to be done in a very safe way, certainly preserving a relationship between the two counterparties of a deal and with risk in mind. So this has to be done with a new approach which removes the negative elements of the past and constructs the future. We all know that France is extremely favourable to this. We are working on this in France, obviously in a dialogue with the European Commission. The European Commission has a number of decisions to make. There are delegated acts being defined for Solvency II for instance. We need to adapt them to European realities, allowing for these realities. I'm very careful about certain evolutions that have already been taking place within the European Union. I think that we should continue to work to make sure that this is well adapted to European realities.

Beyond that, especially in France you have to remember that the banking industry is an extremely important channel. Well of course, we need to develop direct access to the market and there are new possibilities to gain direct access to the market. Of course we must make sure that enterprises and businesses of medium size, just like large enterprises may have an easier access to the market. Nonetheless, and this is especially true in France and in the countries of the south where banks are the main channel by far, there is a need to favour for SMEs this new instrument of securitisation that may help to support the banking channel.

You may have seen in the headlines that with Wolfgang Schäuble, who is a friend and a partner even in difficult times, there are difficulties - I'm saying this for the journalists. We have made with Wolfgang Schäuble a proposal to develop investment, especially relying on the mobilisation of top quality securitisation. There is no opposition - you shouldn't believe this because it is only fictitious and only useful for writing articles - there is no opposition between our own position and the policy of the ECB, which is also advocating a development of securitisation, and by the way, has announced measures to favour this kind of process. Of course maybe with public support, let's stress this.

However, we need to be very careful, because this topic has to be addressed in a very subtle way. If we were to say that securitisation is only possible if there is an absolute public guarantee, where would the link be between the primary risk of the asset and the stock itself? We have to preserve this link. Let's forget the events of the past, let's find now a well balanced position between these two things. So this is what we have suggested with Wolfgang.

Dear Jacques there are other instruments, as you have suggested, especially to develop the investment in infrastructures. When I say infrastructures I'm thinking of the transport and energy industries, developing other industries and equally important investment for life science, for instance in R&D. I'm talking about the three major core categories, there again we need to create new instruments, we are working on this and we are supporting this in Europe and at the French level.

Growth in Europe is our goal. I don't want to get into the details, Jacques, because we have many experts much more qualified than myself to do that. We are now really working for this durable, sustainable growth based on regulations and rules. Rules need to be adapted, they are not losing their value, they need to be adapted to the current situation, we need to cut our public deficit very much in line with the support of this growth, and within this growth we must develop new industries. I'd like to thank you very much, Jacques and all of you, for really getting to work to build new instruments taking into account the painful lessons of the past. That's the only way to build a sound future for our economies and for our populations, thank you very much.

J. DE LAROSIÈRE

Thank you very much for these extremely clear comments and for the very determinate thoughts on these issues. I think that you have rightly mentioned the decisions made by the European Central Bank whereby we are seeing the acquisition by the ECB of asset backed securities. I think that what we are now trying to do through Eurofi and what you will also be doing at the Ecofin, is proposing ways to develop a viable market for securitisation in Europe. Beyond the ECB buying securities directly from banks, we need to have also pension funds, investors and other management resources participating in the market.

I don't want to get into technicalities too much, but to do that we have to amend some regulatory measures of Solvency II and the Basel framework that are not justified if we think of a top quality securitisation. The holding of these securities if the quality is very good should not be penalized by these regulation, otherwise we risk jeopardising the relaunching of the market. With respect to Solvency II we don't need an international agreement, I believe, because it is really a European initiative.

Now, I think that we have to act very quickly now. Minister I have for a long time participated in these meetings, and I hear a lot of people saying that we should re-launch good quality securitisation but we are not seeing the results of these proposals yet. So I allow myself the liberty to say, especially in the light of the ties that we have had for a long time, that now we need to act very quickly because of the current economic context, especially on the Solvency II legislation on which Europe has the means to act. For this the Commission and the monitoring entity – EIOPA - should have a mandate by the political power that you represent. I have been very strongly impressed by the willpower that you have shown with these matters. So good luck for today and for tomorrow's meetings; I think this is feasible, possible but we need a political incentive for this.

M. SAPIN

Thank you, Jacques. These are suggestions that I will certainly convey to other people as well, and not only to my staff. Thank you very much and I wish you good luck.

J. DE LAROSIÈRE

So, we will continue now with Mr Šadžius who has been kind enough to come very early this morning to exchange some views with us. Mr Šadžius has a lot of things to tell us because his country has gone through a crisis that was extremely difficult to tackle, and I must say that I have a lot of admiration for what the Lithuanians did and therefore it's very interesting for us to hear someone who is in a way a more recent member in the European Union and whose country will join the Eurozone on 1 January 2015.

RIMANTAS ŠADŽIUS

Thank you, Jacques, actually the topic of this session is exchange of views with members of the Eurozone. I am not yet a member but I will become one soon because we will adopt Euro from 1st January 2015 and I have been invited to the official Eurogroup meeting as an observer country. I am very pleased to be here because the Eurogroup consists not only of old countries. Newcomers can also tell their story and this story is really important and the experience can be used for other countries.

Lithuania will be the third and the last Baltic country to join the Eurozone. Latvia joined as of January 1st this year, Estonia joined in 2011. This, to some extent closes the ring around the Baltic Sea apart from one country, Poland, a huge and very important country, but this is quite another story perhaps.

Lithuania is a specific case because we were at the door of the Eurozone for quite a long time. Formerly, the first attempt to join the Eurozone was in 2006. We introduced our new currency after the breakdown of the Soviet Union in 1993. We immediately realised that the only logical way forward for such a small, open economy, three million inhabitants at that time, was to back the currency. The economic development level was very low. We backed it to the dollar because there was a strong belief that the dollar will govern the world at the time, 1994. But 1999 changed the game field with the advent of the Euro and so on 2nd February 2002 we backed Litas, our currency, to the Euro.

This was not only formal action. Whilst sitting in the waiting room for the Euro, we actually experienced all the drawbacks that were brought by economic reality to all the countries of the Eurozone, and even more I would say, given the size and the characteristics of our economy, especially when we missed the target in 2006. We didn't become a member of the Eurozone in 2007. During the crisis in 2008-2009 there was a huge economic drop down. In 2009 the real GDP dropped by 15% in one year. This was a shock, some other countries experienced recession during two or three years, and to some extent I think this was a softer shock to their economies. We had a sharp shock and we had to react, we had two ways of reacting as was discussed yesterday with my colleague Andris Vilks during an extremely interesting panel that concluded yesterday. There were pressures to go down a simple path and to devaluate.

In the Latvian case it's no secret to say that there was pressure from outside to devalue. In Lithuania we had pressure inside from people who didn't understand what devaluation would mean for such a small economy that imports much. We refrained from these temptations but instead we had to undergo internal devaluation. In real terms, that means a real improvement of competitiveness as it is understood by very cynical economists. Finance ministers are cynical as well, but not to that extent. But still, we had real cuts in salaries and we even had very a controversial step with cuts in social benefits and pensions. Pensions have already been restored.

So this internal devaluation is an experience that shows, to my mind, on the one hand that there is economic reality that you can't overcome. On the other hand, what you need is actually a structural reform. Joining the Eurozone is a huge structural reform. For this structural reform you don't only have to have a framework, a theoretical framework, a practical framework, you must also have political willingness, political determination and agreement in society which is the most complicated part of the game. For example internal devaluation doesn't only mean cuts of salaries in the public sector, not at all. Private sectors should also adjust to the new economic reality, and they did. There were two kinds of enterprises, some enterprises decided that they didn't need that many people, pushed some people out and closed part of their production. Some other enterprises decided, well let's talk together and let's cut salaries for everyone from the cleaner to the general director, say by 10%. This was a real cut of 10% corresponding to the 15% drop in the GDP.

Our experience shows a very interesting fact, those who retained people but cut salaries, got, at the beginning, some minor social problems but then they became very strong entities that survived. They are still there, they are producing much more, they're giving their input to our economy and have become stronger. As for the other firms, many of them have simply died.

Of course in the new market economy that started in the '90s we did not have firms with vast experience of several generations of general managers or shareholders. All firms were new. But now we have a set of 20 year old enterprises that do know what to do. They need credit to expand, going back to yesterday's discussion, and our obligation as politicians is to ensure that this is possible, with securitisation as one of the measures that have been discussed. I will not go into details. So we have this playground.

Of course now, we are cutting down our economic outlook because of different factors. Two main factors, I think. One is the stagnation of the development in the Eurozone. This was another step for Lithuania to integrate its exports into the Eurozone. This had already started I think from the first Russian crisis when we had to reorient our business experts from east to west. This was, I think, the first real step of the integration of Lithuania into the western world, despite us joining the European Union in 2004 only.

But the other side of the coin, a very important side of the coin I would not like to elaborate on very much because it is not an economic factor, is a political factor. But we all must keep in mind – I'm not an economist, I'm an employer - that there are no pure economics in the world. You always must have in mind that there are political conditions, difficult political situations that can exist within your country, social tensions. It is a terribly difficult job to do, easing political tensions or social tensions in your country; but also external tensions which play their role today.

So just to conclude, I think the way forward for all these ideas that being are discussed during these three days in this extremely interesting forum is that we need not only ideas, not only schemes but also political willingness, a real working political framework. And it is not enough to have this framework and political support within one country, however strong it might be, for example France or Germany. French or German initiatives are very important, very interesting and will be discussed in detail during the informal Ecofin. But Europe-wide structures, Europe-wide decisiveness and Europe-wide political determination are also needed. I wish us all to have this. So thank you, Jacques, for the invitation, I'm delighted to be here.

J. DE LAROSIÈRE

Thank you so much for this illuminating, lucid, courageous statement. I think we need people with visions like yours and what you said at the very end of your little speech is most inspiring. So thank you very much.

Opening speeches: How to react to the fragmentation and the slowdown of the EU Economy?

Jacques de Larosière, President, EUROFI
Jaime Caruana, General Manager, Bank for International Settlements
Ignazio Visco, Governor, Banca d'Italia

JACQUES DE LAROSIÈRE

Good morning, ladies and gentlemen, it's a pleasure and an honour for me to be today with two eminent personalities of the financial world. To my left, Jaime Caruana is the General Manager for the Bank of International Settlement in Basle, and Ignazio Visco, the Governor of the Bank of Italy. So I will give them the floor in succession, the theme of these opening remarks is how to react to the fragmentation and the slowdown also of the EU economy. So without further ado I would like to ask, perhaps, Mr Caruana to start off and to tell us what he feels about all this.

JAIME CARUANA

Thank you very much, thank you for the invitation, it's a real pleasure to be here I think that the subject of this session is appropriate because it links the recovery and the real economy with developments in financial markets. How do we, from the BIS, see these ongoing issues?

We know that we have had a number of years already of disappointing and elusive recovery. We see now that things are improving particularly in some areas: we see in particular that the United States and the UK are in a more advanced stage of recovery that gives prospects for more divergence in policy among the major economies – and more clarity regarding this divergence. But the Eurozone is still lagging behind and we are going to focus our discussion basically on the Eurozone.

So we need to understand why this growth has been so elusive and so weak. To do so we need to internalise properly the interplay between the real economy and how financial markets have worked.

The aftermath of the recent crisis is a complex one; we call it a "balance sheet recession". And a balance sheet recession is much more complicated to manage after a very long period of boom in the financial cycle. We have seen that it is very difficult to ignite growth in such a context. Despite the stimulus that has been put on the table, risk taking has happened in financial markets, but there is much less risk taken in the real economy. We have seen that it is difficult to reignite real investment.

Investments go to where there are good opportunities to invest. It also happens with credit. We have seen here that credit in the Eurozone is very weak, but at the same time you see credit in euros growing at a significant pace in other areas. Even though we have characterised this crisis as a financial crisis, the return to a sustainable path of growth cannot rely only on finance; it will have to mean a balance of reforms in the real economy and reforms in the financial sector.

And I would like to explain why we need to look back at the build-up of the imbalances and see what was going on then in order to explain the current economic situation. Basically, the build-up of the financial imbalances that preceded the crisis had, in my view, three main effects.

First, the debt overhang – or heavy build-up of debt, especially in banks – was one of the major reasons of the crisis. A lot has since been done to repair the financial sectors of crisis-hit economies. But at the same time, the debt has continued to increase significantly in other sectors and other places. And what we see is, perhaps, a transmutation or a transformation of leverage but not really a reduction of leverage. And I will come back to that later.

The second effect is a significant misallocation of resources when the build-up of the financial imbalances was created. The truth is that the credit and GDP growth back then was not evenly spread across sectors; it was not balanced. Indeed, the credit growth favoured some specific sectors. I think one of the two obvious sectors was construction in some countries. My own country, Spain and others have been in this camp. But there were also other sectors such as finance: we saw excessive allocation of resources there as well. So the slow recovery in crisis-hit countries is in part the consequence of the previous build-up of such sectoral imbalances, which now have to be redressed.

The third effect is one that we don't pay enough attention to. It is all the neglected important factors that were masked during the boom by this good feeling that the economy was going well. And the issue is that this boom masked not only these sectoral imbalances that I have just mentioned, but also some processes that had been happening well before the crisis started but became apparent or perhaps even amplified only after the boom gave way to the bust. For example, we see a trend decline in productivity growth in advance economies that had started in the 1980s. The decline was perhaps masked by the fact that we were living in a boom and so we didn't pay enough attention to correct this. And there are other such developments, which I will mention later.

From the BIS perspective, we have said on various occasions that the global economy needs to make some transitions. I will summarise today two transitions: First, growth has to be less dependent on debt. Second, we need to achieve a more robust, resilient and reliable financial sector. And both these transitions go together.

The first transition is, again, the same concept that I was explaining before: the unsustainable pre-crisis financial boom created a false sense of prosperity, masking some of the vulnerabilities and resource misallocations, and diverted attention from important factors such as the trend decline in productivity growth or even a secular decline in the capacity of markets to reallocate resources. That was well expressed in one of the papers presented during the recent Jackson Hole conference: even in the United States, which is a flexible economy, there has been a deterioration that started well before the crisis in the capacity of markets to create flows of adjustment, of labour to move from one sector to another.

In the aftermath of this kind of crisis, I think we need to find a new balance. The size of previously over-bloated industries isn't going to grow back to the same level as before the crisis. So the recovery from this crisis will require significant adjustments of workers moving from some sectors to others. New firms will need to be born, to replace the failing firms. All this will require flexibility in terms of labour and product markets. It will also require a good financial sector that is able to provide the financing.

The second transition is the need to achieve a more robust, resilient and also reliable financial system. We need to manage a very complex recovery – one that requires deleveraging of overstretched banks and at the same time provision of credit to sustainable firms. I think it is possible, but certainly it implies that banks have to first clean their balance sheets and write off very rapidly whatever assets they have that they feel are not going to be performing. And that will give banks the room to lend. Otherwise, we will not see this kind of new credit growth that is needed to support a sustainable recovery.

But I will wrap up now because I think this second transition will be the subject of a lot of further discussion during this event. So let me conclude by making two observations:

First, what has been done in terms of regulatory reforms and recapitalising banks is very important, but we also need to see what the new risks are. The world economy as a whole is in fact more leveraged now than it was at the beginning of the crisis. We need to pay attention to this phenomenon.

Second, I think that Europe is making significant progress towards the banking union. I know that we tend to think that the glass is always half filled – or half empty – in this project, but this is the way Europe has always worked. The good thing is that the glass is increasing in size, now that the project is more ambitious. And I think this is a significant progress: there is in fact more and more content in the glass, even though it continues to appear half filled. I will stop here.

J. DE LAROSIÈRE

Thank you very much, Jaime, for this comprehensive and interesting presentation. I have a few remarks to make but I will refrain and I will give the floor now to the Governor of the Bank of Italy, Mr Visco.

IGNAZIO VISCO

Ladies and Gentlemen, it is a pleasure to join Jacques de Larosière in welcoming you here in Milan. This event occurs at a crucial juncture for the European project and I hope it can be useful to shape our minds on what needs to be done. On my side, I will offer some thoughts on the current economic situation in the euro area and on the actions that are in my view most urgently needed.

1. Economic situation in the euro area and the monetary policy response

Let me start by briefly recalling the latest macroeconomic developments.

In the euro area recent data indicate that growth perspectives remain subdued and economic weakness is no longer confined to countries under stress. Amid ongoing geopolitical tensions, the stimulus provided by exports may be losing momentum, while domestic demand continues to drag because of the contraction in gross fixed capital formation.

Confidence indicators worsened in recent months. Among firms, the deterioration is particularly pronounced in the manufacturing sector, owing to the heightened uncertainty regarding world trade. Households' confidence is affected by the persistently weak conditions in labour markets, with too high rates of unemployment in the euro area at large. The overall outlook is still consistent with a moderate growth of economic activity in the second half of the year, but downside risks have clearly increased. Last week, the ECB revised downwards the projections of GDP growth for the next two years.

Since Autumn 2013 inflation has been declining at a pace faster than expected, prompting continuous downward revisions of forecasts. In August the headline inflation rate was as low as 0.4 percent in the euro area and has turned negative in a number of countries. Declining inflation reflects not only the fall in energy prices, compounded by the past appreciation of the euro, but also the persistent weakness of the economy. Core components are in fact proving to be increasingly sensitive to the prolonged slackness in domestic demand.

Medium-term inflation expectations have decreased markedly. At the end of August, based on inflation swaps, 1 and 2 year-ahead expected inflation rates were, respectively, at 0.8 and 1.1 percent; only at horizons as far as 2022 does expected inflation appear to be consistent with the ECB definition of price stability. With declining, even negative, inflation rates the consolidation of public and private debt is more difficult, while persisting nominal rigidities hamper the adjustment of relative prices.

This difficult situation is aggravated by persistent divergences among countries. The fragmentation of financial markets along national lines in the euro area has progressively receded after the announcement of the OMT programme in the summer of 2012, but is still present. Firms' and households' borrowing costs in stressed countries are still higher than average, mainly reflecting the larger credit risk. For example, in July the cost of new bank loans for Italian non-financial corporations remained 60 basis points higher than the euro area average.

The response of monetary policy has been wide-ranging. Last week the ECB's Governing Council decided to further cut policy rates to new unprecedented levels, basically reaching the zero lower bound for the Main Refinancing Operations; it also launched two asset purchase programs (entailing ABS and covered bonds), which together with the two Targeted Longer-Term Refinancing Operations decided in June to go clearly in the direction of fully restoring the monetary policy transmission mechanism and supporting the provision of credit to the broad economy.

2. Macro-prudential policy can support the monetary policy task

Averting the risk that a too-prolonged period of low inflation would eventually lead to a dis-anchoring of medium-term inflation expectations is paramount. If needed, further monetary policy actions can be undertaken.

Of course, we are well aware that, as the crisis has dramatically revealed, a prolonged period of low interest rates may fuel financial vulnerabilities and imbalances. In a monetary union with diversified financial conditions, tensions may emerge in some countries or in specific market segments or asset classes.

However, compared to the past, in the present circumstances monetary policy has a powerful ally: macroprudential policy. In the European Union, with the new powers resulting from the entry into force of the CRDIV-CRR package, national authorities now have at their disposal an array of instruments to tackle localized emerging pressures. Indeed a number of countries have already started to act, in particular to address pressures in real estate markets.

The new framework ensures also a Europe-wide leg for macroprudential policy, with a view to addressing potential negative spillovers of country-specific measures. The European Systemic Risk Board is tasked with monitoring and assessing systemic risks at EU level and represents the European forum where national authorities can discuss and coordinate their positions and policies. Moreover, the SSM Regulation has empowered the ECB with specific macroprudential tasks, such as the possibility to directly apply more stringent capital buffers to banks, as well as with a coordinating role within the euro area.

Overall, there appear to be no constraints for monetary policy to continue providing the required stimulus to the euro area economy. At the same time, we know that the use of macroprudential tools as a leaning-against-the-wind response to the accumulation of financial risks depends on both the instruments used (e.g., countercyclical capital buffers, Loan-to-Value or Debt-to-Income ratios) and the targeted sector/asset class (e.g., real estate, corporate bonds).At any rate, even more than to counter the building-up of financial imbalances in the face of shocks, macro-prudential measures should be effectively used to increase the resilience of the financial system.

3. Financing investment and the recovery

Following deep financial crises, economic recovery has always been slow to materialize. However, the disappointing economic performance in the European Union goes well beyond previous experiences. At the heart of the problem is the weakness of aggregate demand, in particular investment.

Since the beginning of the global crisis, in the euro area public and private investments have collapsed, by 20 percent in real terms over 2007–13, more than in the European Union. In Italy the fall was even larger, by more than 25 and 30 percent, respectively, for private and public investment. Reviving investment – public and private, national and European – is critical in order to jumpstart recovery.

Several factors held back investment; among them:
- widespread uncertainty about prospective demand growth;
- deleveraging by over-indebted firms;
- difficult access to credit.

Today’s overarching goal is to make the business environment more conducive to investment. Besides the implementation of country-specific structural reforms, which is of critical importance, investment requires supportive financing conditions. The Italian Presidency has placed this theme at the top of its agenda.

To foster investment and to improve access to credit, four priorities stand out:
- reducing the cost of capital;
- reviving securitization;
- developing capital market sources of finance;
- investing in infrastructure.

Let me briefly discuss each of them in turn.

Reducing the cost of capital

The latest indicators of credit supply display some signals of improvement in lending conditions. The Eurosystem Bank lending survey shows that, in the second quarter of 2014, euro area banks, including Italian ones, reported a net easing of credit standards on loans to enterprises for the first time since the second quarter of 2007. Credit terms have been eased for households too, following a trend which started at the beginning of the year.

While these signals are encouraging, there is still significant room for improvement as credit standards remain tight compared to the pre-crisis years, also in countries that did not experience any credit boom before the financial crisis.

As mentioned, monetary policy is doing its part to reduce the cost of capital and secure more uniform credit conditions across the monetary union. An important contribution to sustain and accelerate the flow of credit to the economy will come from the TLTROs, as they contain specific built-in incentives for banks to on-lend to the private sector the funds obtained from the Eurosystem. Our own estimates for Italy show that if banks fully took up the additional funding and passed on the cost advantage to borrowers, the beneficial impact on GDP could reach 0.5 percent, a sizeable amount.

The completion of Banking Union, including a smooth start of the Single Supervisory Mechanism and a swift implementation of the Single Resolution Mechanism, together with the continuation of an ordered process of balance sheet repair at European banks will help ensure the full functioning of credit markets. Beyond Banking Union, it remains critical to address country-specific macroeconomic risks and vulnerabilities, such as weak competitiveness and current account imbalances, as well as to ensure sustained progress towards sound and sustainable public finances.

Reviving securitization

Reviving securitization has been long recognized as an essential complementary instrument and several initiatives have been debated (also in a joint paper by the ECB and the Bank of England) to revive this market.

In particular, it is necessary that simple and transparent securitizations be defined, and then promoted, in a consistent way across the EU. Furthermore, a set of common rules applicable throughout the financial sector should aim to avoid arbitrage opportunities across financial intermediaries and types of securities. Finally, more information on the characteristics of securitization and the underlying loans should be made available to investors. In order to achieve these objectives, there is now a need to agree on an EU-shared regulatory framework for high-quality securitization.

Developing capital market sources of finance

From a medium-term perspective, it will be important to develop capital market sources of finance in order to progressively make euro area firms less reliant on bank credit. This would also contribute to a rebalancing of firms' financial structure after the fast increase in their leverage during most of the past decade in several euro countries.

The Italian Presidency's agenda emphasizes the development of capital market sources of finance and of non-bank financial intermediaries (venture capital funds, debt funds, European Long-Term Investment Funds – ELTIFs). In the face of the several valid proposals that have already been put forward, notably by the Commission, this agenda thus offers a good starting point towards selecting a well-defined set of priorities and moving to the implementation phase.

A first important lever is to provide non-financial firms with incentives for more equity financing, which allows them to better undertake medium and long term investments, including those in research and development (best financed by risk capital), while decreasing their financial vulnerability. Taxation may play a key role in providing these incentives. For example, the use of an allowance for corporate equity (ACE), which allows corporations to deduct a notional return to new shareholders' equity, reduces the tax advantage of debt funding while generally implying, due to its incremental nature, only a limited loss in tax revenues (an ACE was introduced in Italy in 2011 and reinforced in 2013 and 2014.)

Increasing non-bank sources of finance for the economy, and specifically for SMEs, also requires the development of financial intermediaries such as equity and debt funds, closed-end funds that invest in loans, bonds and shares issued by unlisted companies. This semester could see the final approval of the Regulation on European Long-Term Investment Funds, a major step to stimulate their activity across Europe.

Investing in infrastructures

Along with country-specific structural reforms on the supply side, broader economic policy action is required to accelerate the building-up of infrastructure, both tangible and intangible, indispensable to the success of a true Single Market.

The financing of infrastructures and the proposal for an EU plan of public investment require a more efficient use of public resources along with greater involvement of private funds. To this end, euro project bonds, public-private partnerships, infrastructural funds and public guarantees could be the instruments to lever on private investments.

Strengthening the role of European Union's financing institutions (EIB, EIF) and improving the coordination among national investment banks should be essential parts of the process to ensure the development of efficient and well-functioning infrastructure networks, which represent the backbone of prospering economies.

4. European integration as the ultimate way out of the crisis

To conclude, let me reiterate that a substantial strengthening of the EU recovery, one that would go a long way towards the definite exit from the crisis, cannot be achieved by the isolated actions of individual economic policy authorities. In particular, monetary policy alone cannot revive growth and guarantee financial stability in the euro area if the problems underlying the crisis are not resolved at both national and European levels.

The return to sustained and balanced growth requires broader economic policy action centered on investment – as I said, private and public, national and European – which is the linkage between today's demand and tomorrow's supply. The favorable financial conditions that both monetary policy and Banking Union are ushering in must not be missed.

From a longer-term perspective, we need to resume the process of European integration, while recognizing that it is a long and arduous one, and far from being linear. The debate on the euro area's "fiscal capacity" needs to be restarted. Beyond the important achievement of the Banking Union, it is essential to continue resolutely along the path to a fuller Union.

Let me conclude by emphasizing once again that the benefits of strengthening European integration far outweigh the alleged advantages of weakening it. Choices must be made responsibly. The risks of inertia far outweigh those of action.

Thank you.

J. DE LAROSIÈRE

Thank you very much indeed and I think it's very interesting to hear you speaking about the need to revive investment of good quality. And I appreciated what you said in particular on securitisation and infrastructure investment.

I have to bring this session to a close because we have another one which is more formal and in the format of a panel and touches on similar questions. Let me just comment, perhaps, on the gist of what has been said this morning.

We say in France a train can hide another train, so you have to be very careful. This comes to me when I look at fragmentation. We often think that fragmentation is a financial phenomenon; you have countries afflicted with very high interest rates, some others that can borrow at close to zero. And, indeed, this is a manifestation of fragmentation but it's probably only a symptomatic element. I think more fundamentally there is another type of fragmentation which goes back to the formation of the imbalances that have characterised the Eurozone in particular since the beginning of the launching of the euro from, let's say, 2000 to 2010. And the big fragmentation was really in the nest during those years and it was the difference in fiscal behaviour, in labour mobility behaviour, etc.

And this has created a very significant amount of fragmentation basically in the way economies function and in the productivity of economic agents. Some countries were better off in terms of productivity because they had kept their costs at a more moderate level. And some others were completely out of the market. But the markets allowed this formation of very significant fragmented structural differentials. Why? Because they probably thought that the Euro area was a true Euro area in terms of having a mutualisation of the financial consequences of these differentials.

And when they realised, around 2010, that this was not the case, we had indeed a monetary union but we did not have an economic and fiscal union, then the train of structural fragmentation appeared with all its terrible consequences. And I happened to read very carefully the monthly bulletins of the ECB and there is a chart that I would advise you to look at. It's the chart that shows the evolution of operating margins of enterprises. And if you look at that chart, which is an average chart, you see that over the last three, four years the operating margins of enterprises have come down. Now, they haven't come down everywhere, so you have to disaggregate those figures. They have come down in a number of countries where labour mobility is insufficient and where tax and para-tax burdens are excessive because of the fiscal imbalances that have crept up over the years.

And you can't do anything to cure that problem by just throwing money at companies. It's not going to work because if you don't have the minimum of operating margins that allow you, normally, to invest, to innovate, to recruit, you're not going to access credit because your balance sheet doesn't allow you to do so. So in that case it's inevitable that enterprises of that type have difficulty accessing credit.

So I'm all for the ECB policy that has been recently decided and which I think is a very decisive and a very courageous policy. And it's destined to provide more financial means to the banking system and ultimately to the economy. But I think that if we don't really address the structural fragmentation that exists in Europe we're going to buy time. At the margin, it's going to be good. But we're not going to address fundamentally the problems.

So this means that in some countries, it's not the case for all, but in some countries and some of them I know particularly well, we're going to have to address the problem that I'm focusing on which is the rigidity of the functioning of markets and the fact that many companies are just not able to invest.

A little final word on the functioning of the banking system; basically I don't disagree with Jaime. It is true that global indebtedness has kept stable over the period. But I am worried, of course, of the distribution of this stable situation because in fact, as Jaime said, there has been an increase in some forms of lending or indebtedness of the public sector. Some other forms of a more financial nature have also increased but credit to the private sector has diminished as we all know by a factor of two and a half percent a year over the last two and a half years.

So we really have to focus on that part of the deleveraging behind the sort of stable leverage figure that Jaime is rightly insisting upon. And we have to ask ourselves why, when a bank can get money at almost zero percent at the Central Bank, it's not lending more to companies And I think the reason is twofold, and here I differ a little bit from my friend, Jaime.

The first reason is structural, of course. You can't lend to an ailing company and you should not lend to an ailing company and we should not incite banks to do that. That's good deleveraging, as we said in our paper. But there is also bad deleveraging which I think is caused by the rapidity and force of the recent accumulation of capital constraints.

I think when you ask a banking system which represents 75% of the financing of an economy, which is the case in Europe, very different from what happens in the US, if you ask such a system which is totally instrumental in the way you can finance, at least the SME part of an economy, as the SMEs can't go directly to the markets you have to be very careful on the direction, of course, you want to achieve which is to reinforce the own funds of the banks, but also on the timing.

And I think regulators were well inspired when they looked at a horizon of 2019 to achieve, through a gradual process, the ratios that are called for. But, as you know, this happened in a much shorter time span; it happened in practically two or three years. And this has led to a traumatic situation. I mean you can't imagine that imposing a doubling or in some cases a trebling of the capital base of a banking system that represents three quarters of the financing of an economy, nothing's going to happen structurally. Of course something happens.

And what happens is what Mr Visco said, you're creating an incentive, a major regulatory driven incentive for the banking system to get away risk because risk is much penalised in the regulation. And as capital is very expensive the more you ask a bank to put aside, or to raise capital, the less the bank is going to be productive in terms of financial returns. And the less it is productive in terms of financial returns the more it is going to use the regulation to find its way into what is the optimisation of exposure and utilisation of its balance sheet. That's exactly what's happening.

And I would advise you to read a little paper produced by one of the great bankers present here Douglas Flint. He shows that the present risk adverse behaviour is a pervasive phenomenon that is affecting the banking system. So I don't say, Jaime, that this is the cause of everything. I've been very careful to explain that the true basic problem is structural. But I think we have added a probably excessive financial constraint which is pushing the curve, between growth and financial stability a bit too much towards financial safety and is putting off some bankers from lending to healthy SMEs.

We have very precise indications on the rate of refusal or difficulty of access of credit and if you disaggregate those figures, you can't say that all that is refused or difficult to access is bad stuff. If you could say that, I would be completely on your side, but you can't say that. There is a part -those who live in countries like Italy, for instance, are probably more sensitive to that than even in my country or in others where credit is relatively easy to access - of good credit that is difficult to access.

Then you would ask: haven't we created a pro-cyclical problem? So even if that is still a limited problem minimum we really have to look into this and the way to do it is to rely a little more on bank supervision where local conditions are perhaps better understood by the supervisors and a bit less on permanently accumulating more regulatory constraints.

So that's my bit, I'm not asking you to respond, my dear friends, because it's the privilege of the President to throw that sort of stone in the pond. So thank you very much and now we'll move towards the next plenary session.


J. de Larosière


CURRENT EU
VIRONMENT

Exchange of views: Economic and financial policy priorities for the incoming EU Commission to relaunch growth in the EU

Objectives of the session

This session was devoted to discussing the economic and financial policy priorities for the incoming EU institutions (Commission, Parliament) in order to relaunch growth in the EU in the present monetary, economic and fiscal context.

The first objective was to explain why current very low interest rates are not driving an upturn in investments in the EU and define the appropriate policy – mix for the Eurozone. The second objective was to discuss the short and medium term regulatory financial priorities of the incoming EU institutions for relaunching growth.

1. The current very low interest rates are not yet driving an upturn in investment and in growth in the EU

A public decision marker tried to explain this paradox.

First, he underlined that we are observing a gap between risk taking in financial markets which is on a roll while risk taking in the real economy is very low. This wedge is at the heart of many problems around the world and this issue is not very easy to solve.

Second, he explained that this is a much more generalised problem. We have indeed observed around the world during the last few years easy financing conditions, which are basically reflected in unusually low volatility across the whole asset spectrum, and also in unusually low risk spreads. The disconnect between very low interest rates on the one hand and low investment and growth on the other in the EU does not only concern just the EU. Even countries that are further advanced towards the recovery, such as the United States or Australia are slowing down. Enterprises in such countries prefer to issue debt and not to invest in any new capacity but rather to pay back shares and this is a very common phenomenon.

Big companies are indeed investing but they are not investing a great deal in the advanced economies. In fact, taking into account the world as a whole, the investment as regards to GDP ratio is not low; it is actually above its long term average. Big companies invest in the geographical areas where they perceive long term prospects. In addition, the balance between risks and rewards in the corporate world is unfavorable to investment with interest rates as low as they are, and financial conditions so easy, and with medium term and longer term prospects being as uncertain.

The third argument is the fact that the post-crisis recession in which we are still living, is a "balance sheet recession", linked to the bust phase of a long financial cycle. The speaker specified that the unsustainable pre-crisis financial boom created a false sense of prosperity while masking balance sheet vulnerabilities and real resource misallocations, both across sectors and in the aggregate. As the boom turned to bust, the subsequent balance sheet recession revealed and exacerbated these weaknesses. In addressing a balance sheet recession, the key is to target the nexus between debt overhangs, poor asset quality and the misallocation of both capital and labour.

These problems cannot be redressed by traditional aggregate demand and monetary policies alone because economic agents are trying to repay their debt and are unwilling to lend. Strong sustainable growth requires deleveraging, tackling these impediments head-on and restoring productivity growth, the speaker said.

In this context, he added that not all countries in Europe faced a full balance sheet recession. Countries facing balance sheet recessions include the UK, Spain, Ireland, the Baltics, other economies (France and Germany in particular), have seen their banks facing problems mainly on their cross-border exposures (United States, UK). Some countries imported the recession largely through trade; that is the case with Sweden, in which we saw a further increase in credit and property prices which is causing problems for the authorities.

And of course in the Euro area, we had these institutional specificities that have led to the so called, 'Doom Loop' between the sovereign and the banks. But in most countries, the banking sector has actually had very deep scars as a result of the crisis.

2. Can growth be relaunched in the Union with a failing credit channel and a persistent deleveraging of banks, especially in some parts of the Union?

A speaker answered this question and stated two priorities for re-launching growth.

The first priority for re-launching growth is to fix the banking sector, to have full balance sheet repair in the system in order to establish the basis for self-sustained and prompt recovery and resolve the legacy of the crisis. This is not just a matter of increasing capital it is a matter of recognising the losses that exist on the balance sheets and making sure that people perceive that the balance sheets are in good shape.

The speaker argued that "the fact that banks are not in good shape is one reason why credit has been misallocated during recovery from the crisis, and we're still facing problems because obviously if you have some possible losses on your balance sheet and you don't want to recognise them, you will continue to provide financing to the sectors that maybe do not deserve it. And you will try and increase the cost or possibly restrict overall credit if you are somehow limited to the sectors that could actually pay, and in fact I think small and medium sized enterprises are one of the victims of this condition".

During balance sheet recessions or following balance sheet recessions in the periods of recovery, he noticed that the allocation of credit is much more important than the overall size of credit extension. "When you look historically at periods in which you had these problems, then you did have so called credit less recoveries. You actually have output which expands before credit starts growing again, and the reason is obvious, because you've simply started from a situation in which you had too much credit to start with".

The second policy priority is to redouble efforts to maintain sustainable fiscal policies and implement the structural reforms required to address the competitiveness problem, the long term prospects issue and the need to increase productivity growth which appears to be on a gradual trend decline which started well before the crisis in advanced economies.

The speaker concluded by stressing the need to get away from the very unbalanced policy mix, in which monetary policy has been overburdened for too long.

Jacques de Larosière made some comments following this intervention. He agreed with the need for a "good" deleveraging. He stressed that a credit less recovery is indeed something possible and that has been observed in the past. However, he noted that you usually only get it "when the borrowers in the system have recovered a very sound balance sheet, have enough own funds, have regained margins and operating profitability that allow them to grow again without relying excessively on debt".

But the situation today is dramatically different in Europe. Jacques de Larosière emphasized that in many countries companies are indeed burdened by the legacies, debt of the past and have very thin margins. So what has been said strengthens the absolute need for structural reforms because throwing money at an ailing industry is not going to cure the problems. And as the previous speaker rightly said," it's going to plant the seeds of future problems which have to do with excess liquidity, lowering the premium for risk, and creating asset bubbles which we don't always see, but are in the logic of an excessively abundant liquidity monetary policy."

So the moderator shared the views expressed but felt nonetheless that we have to help re-open, the closed credit channel. In a number of cases, granular observations indeed show that some companies with sustainable balance sheets have difficulty in finding credit. And they're not finding credit because, in some cases, banks are prevented or decentivised to take risks. And "there is an excessive risk aversion which is in part, stemming from a very sharp increase in regulation and in capital requirements that adds, I don't know if it's a lot or a little, but adds that is for sure, to the problem that we both agree upon". So, he wanted to add that point because "it is important for the work of those who are going to look at the banking system" the moderator added.

3. Restoring competitiveness in Europe

Another representative of the public authorities started his intervention by pointing out that the current EU monetary and economic context where very low interest rates for more than five years are combined with low inflation and weak growth looks like the one which happened in Japan. "So we should learn from the Japanese experience in the 1990s", he said.

The financial crisis started in 2007/8, it was a world financial crisis at the beginning and became a world economic crisis but this speaker noticed that this crisis is not still underway around the whole world. This is this is still the case in Europe but some non EU countries like China or some South American countries emerged from the crisis in six months. The United States has rebounded reasonably well.

Then this speaker explained that "we have a European problem and that it is a problem of the productivity of European economies". This is why the implementation of structural reforms in EU member states should be the priority. Indeed following tough political and economic decisions taken prior to the crisis, Germany came out of the crisis much faster than many member states. Spain is another interesting example which shows that structural reform works. In18 months, its trade balance that was highly in deficit is now in surplus.

Concerning the situation where enough credit would not be sufficiently available, he stressed that it is not only eventually banks that are not lending enough. The main reason for this issue is that we do not have enough projects; and if we do not have enough projects this is because economies and enterprises are not competitive enough. The productive sector is not demanding because its margins are extremely thin and one of the reasons why they are extremely thin is that they are affected by a rate of taxation, or bad taxation that hinders their activities.

In the five past years, this public decision maker explained that productivity in Europe has decreased because both public and private investment declined during this period while at the same time China in particular continued to invest a great deal. He noticed that "therefore, the innovation gap which existed between Europe and the rest of the world in our favour, has been reduced in some cases and when Europe was not number one, the gap in favour of the others has increased".

The speaker also stated that re-launching demand in Europe at this stage, as certain observers are advocating would only increase imports and raise the deficit of our trade balances due to the current state of the production facilities in most of the EU member states. According to him, the only solution to foster growth and which is doable is to relaunch investment in infrastructure and innovation. This means additional spending but spending in order to make our economies more competitive. In this perspective, the 300 billion programme of the new Commission that has been announced by President Juncker is definitely one good answer. In Europe, partners like the European Investment Bank can actively contribute to the achievement of this programme, he added.

Concerning the risk taking issue mentioned by the previous speaker, Europe should make its stock markets more dynamic. He said that "this is an angle that we should be looked at in a cohesive way together in Europe in order to reinforce our stock exchanges and provide EU companies with some additional source of finance. Any form of revitalisation of the stock market is something that could enormously help".






Last but not least, monetary policy can help and we pay tribute to the unconventional measures taken by the ECB. But monetary policy cannot do everything, and in fact it is only efficient if structural reform goes along with it.

4. Finding the right balance between stability, growth, fiscal discipline and promoting investment

Europe is facing an on-going unprecedented, parallel deleveraging in both the public and private sectors. Another eminent speaker from the public sector stressed that a solution only based on fixing the banks and implementing structural reforms would not be sufficient to address this situation. "We need to do both of course, but in this context of the double private and public double parallel deleveraging, I am afraid this would create damages and also make it more difficult to address the long term problems of the competitiveness of Europe" he said.

This is the reason why a political consensus on the ways to better balance stability and growth and on the investment programme of the new Commission is needed. We need growth and stability; "we cannot have sustainable growth without stability, but at the same time without growth, we will not get even stability and this is valid for both areas" he stated.

So in the financial area a lot of work has still to be done. The speaker expressed his views on the priorities of the ECON Commission of the European Parliament.

The first one is to continue this unprecedented construction of the banking union and of the single rule book. The speaker specified that the ECON Committee will work with the Italian presidency and the Council in particular to finalise some important pieces of legislation on ELTIF, on anti money laundering and to address important issues like the money market funds, the benchmarks and the structural banking reform taking into account the overall tsunami regulatory initiatives imposed on this sector.

This Committee will also contribute to the design and the implementation of the "capital market union" whose creation has been indicated by Jean- Claude Juncker as one of the goal of the new Commission.

Whilst recognizing that banks will also in the future remain the main source of financing, the speaker pointed out that Parliament has called for establishing alternative funding mechanisms. This is why Parliament considers it as very good news the incoming ABS purchase programme suggested by the ECB which should provide additional funding source for the real economy. In this perspective, the ECON committee supports a balanced solution in the incoming delegated acts on liquidity and Solvency 2 in order to avoid regulatory penalization of high quality securitized holdings.

Otherwise, the Econ Committee also wants to contribute in a better regulatory framework to encourage long term investments. But at the same time, a more combined policy effort that leads to a sustainable fiscal policy encourages structural reform but also supports the right demand is required, which is very challenging.

This speaker also noted that the policy mix that has been characterised these last years, did not fully succeed. "We have to find a better way to combine fiscal responsibilities, structural reform and productive investment, creating a kind of virtual circle".

According to him, this cannot be achieved by relaxing the Stability and Growth Pact. On the contrary we have to strengthen economic governance and create the better fine tuning in which some flexibility on the fiscal side, should be aimed at addressing on the one hand the market economic condition, and on the other hand, supporting and encouraging structural reform, and productive investment. He announced that the ECON Committee will contribute to this debate. The Committee will produce an initiative report on the revision of the Stability and Growth Pact and will contribute to this institutional dynamic which is vital to address the present economic crisis.

5. Do well then expand

Growth in Europe at this moment is quite sluggish, slower than expected. "Investments are still negative and the recovery is dampened by high unemployment which creates a lot of disappointment", another public official stated. If people expect growth potential to be lower tomorrow, they will cut back on investment and consumption today. This dynamic could seriously impede the recovery."In this complex economic environment, there is a need to stabilize what has been achieved and complete what has been promised" he added.

Then he specified that we are at the beginning of a long way route towards a homogeneous or harmonized pan- European banking system. The existing fragmentation of the EU financial markets reflects the existing fragmentation of the real economy in the EU. He mentioned that "the implementation of the Banking Union is extremely important because it has the potential to contribute to overcome the fragmentation of the banking sector and to stabilize Eurozone economies at the macro-economic level". Most EU countries have a system of development banks, partly taking care of the development needs of enterprises, especially SMEs and micro- businesses, which often are governmental, delivering subsidized development loans.

This means, according to this speaker, that at least part of lending goes through national business support policies, which are far from being harmonised and that fragmentation of financial markets will last for some time. At this time we should work at strengthening the progress reached so far and transform banking union regulation into a functioning and effective banking mechanism.

This representative of the EU authorities also stressed that "Do well, then expand" is a basic management principle that should apply to the Banking Union and also to the new ways to provide a source of financings for the real economy.

The EU should indeed look in parallel for innovative financing mechanisms which can support business. Securitization seems an appropriate additional channel in this respect and the recent proposals of the ECB to purchase Asset-Backed Securities are very attractive.

Nevertheless restoring the strong economic fundamentals of the euro-zone countries is essential for reviving confidence, investment and restoring competitiveness and growth. "We can do a lot just to try to pump as much money as possible into the economy but if the economy is not ready at that moment it will not get a result" he concluded.

6. Financing investment: a priority for European policy making

A representative of the industry started his intervention on the financial priorities for the incoming EU Institutions by indicating that he EU financial system has been given a double objective: we want on a solid financial system that protects tax payers and investors on the one hand, but on the other hand, we want this financial system to help entrepreneurs and companies to invest in the economy and thus generate growth.

"We have been making great progress to rebuild a very solid financial system in Europe, and actually in the world; and we have to be thankful to all parties that contributed to this success: regulators, government, international financial institutions who have delivered a huge work" he pointed out.

If we look at the list of the achievements one can observed that the European financial landscape has really changed with the Banking Union, the single supervisory mechanism, the single resolution mechanism, the Bank Recovery and Resolution Directive, the Capital Requirement Directive and the European Market and Infrastructure Regulation. Therefore if we compare how the world of the financial system was five years ago and what it is now thanks to all the effort and huge great pains taken by all parties involved, we can appreciate how it has changed dramatically.

The speaker stressed that the same cannot be said about reinvigorating growth. There must be a way to achieve this and what is the way? he asked. He answered that the crucial issue is investment. He recalled what Minister Padoan said earlier: "Investment is like a bridge between short term and long term; it is a bridge between supply and demand, and is really the crucial engine of growth anywhere."

Unfortunately in Europe "we have been doing a bad job on investment for more than at least five years" he added. With this public and private deleveraging process still going on since 5 years ago, the first things that finance ministers cut is investment. And this has had a hugely negative impact on medium and long term growth. He suggested that "Now filling the gap that we created in the past and reviving growth potential should be a priority and the financial industry can contribute to reverting this trend".

According to him, there are indeed three important things the financial market can do:

The first thing is securitisation and the market for asset backed securities. If appropriately regulated and well supervised, securitization is a channel by which banks and non-bank lenders can fund their own lending. The financial industry has a big role to play because revitalising that market and making sure that we can create assets that are really good quality from the point of view of managing global risk in a better way, is fundamental, the speaker emphasized.

Second, it is the role of development banks. It is crucial to be able to fund major investment programmes within the Union, and clearly the European Investment Bank and the National Development Banks are already very fully engaged in that. They have been actually increasing the tools with which they help financing and this is very welcome. What has been proven more difficult but absolutely necessary is a bigger involvement of the Development Bank into funding SMEs; because we know that in Europe that is a huge part of our economic activity. Finding the way in which to be more effective is essential, the speaker said.

Third, Europe has to look at infrastructure investment as a common goal. Investment in infrastructure networks, in the digital economy, in electricity and gas, in railways, in roads should become a collective target. This representative of the industry stressed that "we need to create a crash programme for modernising or building this common infrastructure, this is the way to make Europe as a whole a much more attractive market for investors than it is now".

"That is the way we can change the potential growth of Europe, rebuild up the potential output of Europe from the dent we put in it in the last few years by under investing. This has to be done collectively. If EU member states are committed to build such networks, I also think that finding a common way to funding it, is part of that common effort" he also added.

Here the industry can be very instrumental in creating asset classes for that kind of funding. Individual national budgets and the European budget must be used in an intelligent way. We know that national budgets are under great strain so we have to find ways in which national budgets can help but spread the effort over time. We also need to create an infrastructure asset class of bonds or security that can attract private funding to this. Defining infrastructure investment in networks across Europe is a prerequisite and this requires a political vision, a "golden book of infrastructure for a golden rule of investment for Europe." And I think this can be clearly engineered from the financial point of view but needs also to be 'engineered' from a common policy point of view in Europe, he concluded.

7. Concluding remarks: Jacques de Larosière

Thank you very much. This is the best conclusion that I have ever thought of because you've delineated exactly the financial aspects of the programme that I think the new Commission should be working upon. And I completely share your views.

I would perhaps add to the very pertinent list of proposals you made perhaps something on not only lending through public financial institutions to SMEs but also rebuilding their capital base. I think they need that, and it is already done to some extent but I think the EIB for instance could do more in terms of equity injections in SMEs because when you have a very strained productive system as I underlined a moment ago, in particular because of taxation, it makes a lot of sense to rebalance this through an active policy of European and national development institutions that would rekindle the own funds of these companies which are for the time being lacking which makes them less amenable to invest and to expand.

Otherwise, you formulated your thoughts very briefly on securitisation in a way that I fully agree with. Perhaps you could have said that the regulatory setting had to be neutral and therefore not penalising that particular form of security. An asset backed security is basically, a corporate bond and I don't think it should be treated differently if it is originated through a sound and robust mechanism of securitisation as opposed to when it is issued directly on the market.

So that is what I have tried to impress on my friends of the regulatory sector. I take advantage of my presence here to repeat it in front of you but I think you basically agree and Padoan actually said it also.

Exchange of views: Evolution of the EU regulatory and supervisory institutions

Objectives of the session

This plenary session was dedicated to discussing the main evolutions that would be required from the EU regulatory and supervisory authorities (ESRB, ESMA, EIOPA, EBA) taking into account the increasing role of policy making at the global level.

The first objective of this session was to discuss how the EU can speak with a stronger and more converging voice in international fora (Financial Stability Board, IOSCO, International Association of Insurance Supervisors, Basel Committee on Banking Supervision...).

The second objective was to discuss the possible evolution of these authorities in the European context in the perspective of the European Supervisory Authorities review and the forthcoming implementation of key regulatory measures (Banking Union, Solvency II, market regulations...).

JACQUES DE LAROSIÈRE

We don't have much time but we can use intelligently our limited time.

The notion that we would like to touch on is the evolution of the EU regulatory and supervisory institutions. It's not so much the substance but the way these authorities function. And I would like to thank Gabriel Bernardino, Andrea Enria, and Steven Maljoor who are the chairs of the three authorities, to be here today. It's a great pleasure and a great honour for me to have them near me.

We also have the presence of two external, I would say, experts and participants. One is Vincenzo La Via, who is the Director General of the Treasury of the Ministry of the Economy of Italy. I'm very glad to have him with us. And we have my friend, Rainer Masera, who is the Dean of the School of Business, Università Marconi. He's a very good friend of mine, as I said, he has also been a participant in the committee which I had the honour to chair. So he has some very meaningful responsibility also in the creation of these authorities, and I much appreciate his work on the financial system which he is pursuing.

The first objective of this session is to discuss how the EU can speak in international fora (Financial Stability Board, IOSCO, International Association of Insurance Supervisors, Basel Committee on Banking Supervision…) with a stronger and more converging voice.

The second objective is to discuss the main issues to be addressed with regard to the evolution of these authorities in the European context in the perspective of the European Supervisory Authorities review and the forthcoming implementation of key regulatory measures (Banking Union, Solvency II, market regulations…).

So I'll start with Mr La Via first.

VINCENZO LA VIA

Thank you. Thank you Mr Chairman. Thank you very much for inviting me to this panel. In the interest of time I will refrain from long developments. Let me only mention in passing how much we owe to the work of the high level group that you chair under the Barroso Commission.

The De Larosière Report of 2009 provided the necessary inspiration and spin to the EU institution's reflection on their legislative work. This process gave birth to the European System of Financial Supervision, which came into operation in 2011.

That said, there is, as you all know, a major difference in the present set with respect to the Larosière recommendations 2009, and here I'm referring to the central role that has been given to the ECB in banking supervision to the Single Supervisory Mechanism (SSM), starting with the URS debate this morning. The SSM will deliver its full potential in November following the stress test and comprehensive assessment of a number of significant banks. In the meantime the review of the 2010 European System of Financial Supervision has gathered momentum with the two commission reports published in early August.

These Commission reports bear respectively on the operation of the European Supervisory Authorities and the mission and the organisation of the European Systemic Risk Board. In this context let me stress that a council like the European Parliament is in the process of assessing the ESFS review, and this process has been running through the Council Financial Services Committee, which I chair, and the Economic and Financial Committee.

It's premature to prejudge the final conclusion of the Council we'll draw from it, but this said, let me say that it's fair to say that the commission reports constitute the main comprehensive basis on which the Council is approaching the ESFS review, so I'll a spend a few words on this.

First, I know that the Commission's review tends to conclude first that there is no need for a major overhaul on the existing ESFS. And, second, that those institutions could, however, benefit from targeted adaptations. The possible adaptations listed by the Commission would aim to improve, in particular, the ESA's performance and resources, while the SRB might warrant a more significant evolution of its role and governance.

Indeed, in an important step, the Commission is determining in its review which adaptations could be undertaken, in the short term we doubt requiring legislative modifications. I personally feel these possible improvements wouldn't turn out to be very controversial. In addition, the Commission has also identified potential areas for improvement in the longer term. Those potential changes may warrant additional reflection with the benefit of further experience. This is particularly true for the possible expansion of the statutory missions and tasks of the ESAs for these two reasons:

First, they are still in the process of fully exploiting their present mandates.

Second, we need to strike a right balance between a possible broadening of mandate and budgetary implications.

I will not spell out these improvements; I am sure most of you have their a summary of them in the Commission's support memos.

Now, let me rather highlight a couple of challenges: evidence by the Commission to show that there is indeed room for improvement and even for a further review in the next couple of years. So let me stress that this is a personal selection which does not prejudge the assessment by the Council.

First, the need to further improve supervisory convergence. It is striking to note that a good five years after the De Larosière report, this remains an important issue. It is thanks to the crisis that they have brought about additional priorities for supervision, but I would emphasise that common supervisory practice and spirit are important to underpin mutual cooperation and the strengthening of the internal marketing financial services. Certainly, the SSM will bring about additional convergence in banking supervision, but supervisory convergence will remain crucial if the political focus on regulatory implementation increases.

Second point. The jury is still out on the so-called macro prudential instruments, and I recall that the De Larosière report emphasised the importance of these new tools and the role that the ECB could play. It is now indeed the case in the context of the SSM. This is certainly an area where more hindsight is necessary and where the role of the ESRB and its challenge to be fully effective and streamlined cannot be understated.

These were just two examples of the case for further assessment of the performance of financial supervision in the EU. Indeed, there will be a need to factor in the changes stemming from the phasing in of the SSM and the forthcoming establishment of the SRM. Hence, a later review may prove necessary than the direction at the latest by 2016 as provided for in the EU regulations.

Let me spend just a few words on the evolution of the EU regulation. I shall start with paying tribute to the work already undertaken following the outbreak of the financial crisis. The reform of the EU financial sector has been deep and comprehensive. It has in particular fulfilled the commitments undertaken in the critical areas. It is essentially aimed at repairing the banking system and restoring market confidence. The Commission's review of the EU regulation agenda published last May provides in this respect a very good stocktaking of all the relevant measures.

A number of key areas of achievements and progress are in fact highlighted in other panels today. They've concurred to strengthen financial stability and potential requirements, as well as improving the transparency, integrity, and safety of markets and infrastructures. The implementation of the Banking Union represents a decisive step to break the bank's sovereign loop that was frustrating the integrity of the single market. But we all know this is not enough. There is a need to enhance the effectiveness of our financial systems, and secure financing for economic projects conducive to growth.

In the perspective of this finance for growth, it's fair to recognise that with a number of nuances across countries we're heading overall for a more diversified financial system in the EU with a more pronounced role for the shadow banking system, in some respect. So regulation must adapt to these new trends and their challenges, so must the performance of a supervisory architecture.

How does that evolution impact on the concrete operational settings on the performance of the ESAs and the ESRB? I will not detail the challenges in terms of data access, resources, funding and so on, which Steven, Andrea, and Gabriel are certainly better placed to elaborate; I will simply note to conclude that in a more diversified environment I was just referring to, cooperation between the ESA and with the SRB, and input from all of them to form policy decision making are vital. So let me stop here.

J. DE LAROSIÈRE

Thank you very much for this comprehensive assessment, which I think is rather positive and encouraging. I'll ask now Mr Masera to be very brief in his statement, and perhaps to focus on one of the weakest parts of the construction that we participated in, Rainer, and that is the macro systemic perspective.

The Single Supervisory Mechanism, the SSM, does provide perhaps an opportunity to improve, or perhaps does not provide an opportunity (I don't know) to improve macro prudential oversight, which is perhaps the weakest part of our report, the ESRB, which I don't think has really achieved all the effectiveness which we might have imagined.

So perhaps you could give us your sharp view on this thing and then afterwards I'll call on those who make all this work.

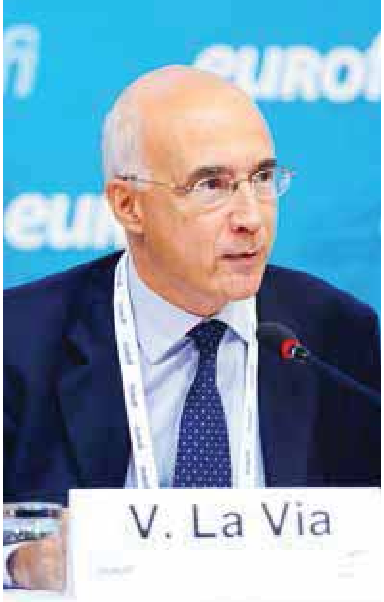
RAINER MASERA

Thank you very much. I will try to be sharp and brief at the cost of being provocative perhaps.

I agree with you. Somehow the European Systemic Risk Board, in my humble view, did not live up to the expectations that the De Larosière group had. We thought that this element of the European construction would be at the heart of the repair of the system. This did not take place: just a couple of examples might perhaps bring some life into what I am indicating.

The major problem for the European Union was the intertwining of sovereign and banking risk, with the possibility of the Euro collapsing. This was clearly a systemic risk and this was not detected by the ESRB. It was left, admittedly, to the political authorities and then to Mr Draghi to say. Unless we do something, and we will do "whatever it takes", the system will collapse.

I would have expected that this kind of risk should have been detected beforehand by the ESRB, and not left



to the ECB both as systemic risk analyser and then as monetary policy player.

Another instance is whether or not the imposition of very high capital requirements on the European banking system without the cushions provided in the United States – let's recall TARP, and the securitisation processes engineered by Fannie & Freddy and by the Small Business Administration in the United States – which helped bankers restore their asset positions.

This did not take place in Europe, and our Chairman argued-and many (including myself) concur with him-that there were and there are still problems in the deleveraging exercise. Here again we have a clear example, of the possibility of a fallacy of composition. I will give you just one example. If all banks are simultaneously required to strengthen their capital positions, but private capital markets do not necessarily respond, because of low expected profitability and because of country risk, a vicious circle can be set in motion.

Suppose that deleveraging takes place and assets are sold by all banks. The VAR approach leads to herding behaviour and adopts models which break under stress (the issue of endogenous risk). In this framework assume that a bank with a leverage of 30 decides to sell some of its assets. If the sale is not coupled with liquidity cushions at a systemic level, it is sufficient to see a 3.3% decline in the value of its outstanding assets offset the deleveraging. That is to say, the bank sells its assets in order to deleverage, but the fall in the value of existing assets is such as to imply that the leverage ratio does not decline.

I'll close because I have to be short. In my view, a key issue which the de Larosière Group had envisaged, but which was not solved, was corporate governance. The General Board is responsible for the decisions to ensure the performance of the ESRB: identify risks with a systemic dimension and prevent/mitigate their impact in the EU. The corporate governance of the General Board requires a common agreement of some 60 members (33 of which cast a formal vote). It is very difficult in these conditions to take timely and effective action on highly complex issues.

Thank you.

J. DE LAROSIÈRE

Thank you very much for these brief and very thought provoking remarks which, as you know, I very much share. I'll call now on the three chairs of the authorities. Start with Gabriel.

GABRIEL BERNARDINO

Well, you know, Jacques, I try always to be clear. Let me take two or three points in terms of the future of the European Supervisory Authorities, and of course we are now in the process of this review.

On the insurance side definitely we are now going from a process of regulation to supervision and to implementation. I think that what we have been seeing this morning and discussing regarding the importance of an implementation of level playing field consistency, that's what we are focused on right now. And in order to deliver on these in the insurance sector, I think we have a tremendous opportunity to do it right because we have Solvency II, a new complete system being implemented.

So we have the opportunity to do it right. What do we need to do it right? Three things:

Firstly, we need to strengthen the operational independence of the others, and it's about a number of things. For the sake of simplicity I will talk only about budget. Why budget? Because the process that we have got right now, it is I would say, a mess. And the result of all these processes is that we are now confronted with a situation that, for example, for next year, for 2015, where EIOPA, for example, is in charged by the political institutions in Europe to implement many aspects of Solvency II concerned for example with long term guarantee packages, all these things that we have introduced.

We have a proposal from the European Commission and from the European Council for a reduction of close to 10% on EIOPA's budget, and I think that this is impossible. I'm really happy that the European Parliament is quite keen and is saying very loudly that this should not be the way. I hope that, of course, the Commission and the Council will also discuss these very thoroughly, and I hope and I'm sure that they will in the end find the right solution.

But this reveals of I think a rather ambiguous decision regarding what we want from the others: on the one hand we want them to perform important rules; but on the other hand we have these elements of budget and of operational independence. We need an independent line of budget, we need of course more flexibility, and we need to explore the fees. I'm happy that both in the reports from the Commission and the Parliament this is in there–explore the possibility of fees from the industry.

My second point is that we need to do this in a clever way. We need to reinforce our powers to challenge the quality and the consistency of supervision in the individual member states. This, as I used to say, this is an added value for the process; it's not a reduced value–it's to add value, and we need that and we need to have, I would say, for example, a centralised role on internal models in Solvency II, because that's an area where a level playing field and consistency needs to be there. And we need also to think of the insurance sector going forward of course, what to do about the cross border big insurance groups? We need more coordination of supervision in that sense, and I would say that we should think of looking at EIOPA and granting, for example, a kind of a mandate of coordination from the insurance side towards the SSM, because we have the issue of conglomerates, and I think that we need to have this coordination element in there.

So I think that there are issues, there are solutions, and there are opportunities. It's about courage.

J. DE LAROSIÈRE

Thank you very much. This is a very strong and telling statement. After having heard you I really don't understand how one could imagine a reduction of about 10% of your budget. Honestly.

G. BERNARDINO

Yeah.

J. DE LAROSIÈRE

But you've made your point. Steven?

STEVEN MAIJOOR

Well, speaking after Gabriel on this point, it's kind of difficult to add anything, but let's focus on a couple of things.

I would like to really emphasise the importance of supervisory convergence. We're now moving from the regulatory phase, which had a very strong focus on the rules and regulations, to the implementation phase. And I think we should not make the mistake of suggesting that most of the regulatory reform is now done. It means indeed that we now need to focus on implementation, we need to focus on supervision.

That is resource intensive, and nafter Gabriel's words on this I don't want to appear as beggars for money, but it's right, it takes money, it takes time to work on supervisory convergence and to make sure that we progress on getting the 28 national supervisory practices closer together. It is resource intensive, but it's also difficult. It's to some extent less visible, it will take more time. When you do a regulatory job, you kind of feel very satisfied when you deliver the rule and a regulation. With the supervisory convergence it is a story without an end and it's about slow progress.

Let me make a few other points on this one. It's also about data access. We've had discussions on our board whether once there was a decision by the board to do a certain peer review whether it would it be possible to do on-site visits at national regulators and then, to subsequently also access data at the national regulators. I think that needs to be clarified. You cannot take the point that supervisory convergence is very important-when there is no clarity on the access to data and doubts about the possibilities to assess supervisory practices at the national regulators.

Finally, I think it's important to make a connection between supervisory convergence and the importance of implementation in the current discussions on conduct risks. We all know that there is now a lot of debate about the conduct risks that we see across Europe, and I see that as an issue related to: How seriously do we take implementation? How seriously do we take supervision? And the fact that there has been a growing gap between the regulations and the rules and subsequently the supervision and the activities of the financial sector on the ground floor, the fact that we have this gap results in conduct risks. And we need to make sure with implementation, with supervision, that the practices of the financial sector are close to the regulatory requirements and that in itself, I will reduce conduct risks.

J. DE LAROSIÈRE

Thank you very much indeed. This is most telling and important, and I finish with Andrea Enria. You have the floor.

ANDREA ENRIA

Thank you. Yes, the debate on the ESA is very much now focusing on this issue of supervisory convergence. So I would like to try to put on the table some thoughts on this point. And I would like to say what is my experience so far.

The first is what is very close to regulation, something that we can do very, very well and we have done very well, I think. I mean all the supervisory reporting, having a& common supervisory definition of nonperforming loans, of forbearance; all this has been done and it is I think a great step forward, which also the ECB will take advantage of, starting with common supervision.

Then there is what are concrete supervisory decisions taken by colleges of supervisors for cross border groups. So where you have, let's say, different authorities which have their own different traditions, methodologies and the like, and which need to count on common decisions on something, here progress has been more difficult, but I'm a little bit encouraged by the development of some mediation at the table.

So starting in the last 18 months, we have had eight cases of mediation. All of them were settled positively with, let's say, a satisfaction of both parties, but I must say that there is still a difficulty in conducting these processes. Sometimes these conflicts are not brought to the college table, it's difficult to address them, and sometimes also I think we have a problem with the legislation, because the legislation seems to give us a responsibility only when there are breaches of law.

The third area is when you have work on supervisory methodologies. I mean, I think this is the most difficult part. This is the area in which I think that we have worked with guidelines. Sometimes this does not really affect the way in which supervision is done in the field, and the banks don't feel the difference. If you talk to banks they don't feel the difference. We issue guidelines and then the different practices remain.

Here I think that we need to be probably changing tack in a sense, and I agree with Gabriel, maybe we need to identify maybe a few tasks in which there is some benefit in having a collegial exercise at the European level instead of having the different session of guidance versus local implementation. I'm thinking, for instance, of the work we have done on risky assets. Now we've done huge work trying to understand whether the internal models can deliver reliable and consistent results. We've seen that there are issues with internal models, everybody is raising that, and there is a credibility issue out there now.

Now the point is how do we act on that? How do we ensure that there is a result on that? I'm not really convinced that by giving guidance only we could overcome these issues. We need probably to pool our resources and do a good deal of work on internal models than jointly at the European level, I think.

We now have to understand that our difficulty is that in many areas, stress tests, risky assets, we cannot have a dialogue with the banks. It is even controversial whether we can have dialogue with the banks, and if you deal with these supervisory matters you need to call the banks, understand their model, why their model delivers certain results instead of others.

J. DE LAROSIÈRE

But that, Andrea, that's an absolutely fundamental point.

A. ENRIA

Exactly.

J. DE LAROSIÈRE

Since Mr La Via, is with us, now if you could promote the idea that EBA should be able to discuss with banks individually such or such a problem, I mean, it would be an enormous leap forward. And I think this is not something evolutionary, it's quite banal, and please try and make it.

Now I'm reminded that I have to close the session. Thank you very much.

Exchange of views: How resilient can we say the financial system is 6 years after the financial crisis?

Jacques de Larosière, President, Eurofi
Terry Laughlin, President of Strategic Initiatives, Bank of America

JACQUES DE LAROSIÈRE

Good evening ladies and gentlemen. I am delighted to be here tonight with our friend Terry Laughlin, who is one of the most important bankers in the United States. He is the President of Strategic Initiatives of the Bank of America. We are honoured to have you with us. We are delighted that you have taken the time to be with us, and to share with us your views on the global financial situation, and perhaps also on the way you see the evolution of the Eurozone, or the European Union.

I have a couple of questions that we have prepared, so that we use our time together as efficiently as possible. The first one is on the resilience of the system. How resilient do you think the global financial system is now, as opposed to before the crisis, let's say in 2008? Some may argue that perhaps the inconsistent application of regulations from different jurisdictions around the world might not prevent a future crisis. Others consider that asset price inflation could generate a future crisis. What are your thoughts on these very general observations?

TERRRY LAUGHLIN

Jacques, thank you for inviting me here again. It is always a delight to be here.

I think it goes without saying that where we are today versus 2008 is markedly different across several important dimensions, whether it is the financial position of the global banking system, or whether it is the market structure or the regulatory structure. If you think about it, the top twenty five banks have essentially doubled their liquidity from 2008 to 2013. They have gone from three trillion dollars liquidity to six trillion dollars liquidity. Capital has also doubled, core capital has also doubled and it has basically gone from approximately a trillion dollars in capital to almost two and a half trillion dollars in capital.

Probably equally important, all these banking organisations have relooked at their strategies, and are simplifying their organisations and refocusing on core banking activity. That is obviously a very good thing. From a regulatory perspective, the amount of coordination between the G20, the FSB, Basel, IOSCO has been unprecedented. As a practitioner in a global organisation, I can tell you the coordination between the various regulators who we work with is much different and much better today versus 2008.

Now that doesn't suggest we don't have more room for improvement, but we are much better coordinated, we are implementing the various regulations, and we are all going in the right direction, whether it is liquidity or recovery and resolution planning. We are headed in the right direction, and I think particularly over the last two years very good progress has been made. I will tell you from my vantage point, BRRD is a real improvement here in Europe. So there are many positive elements to point to.

I think, and this has been said throughout the afternoon in some of the sessions, that we have to be careful how we align appropriately the different schemes, in the US, in Europe, and at, what I would call, the local national levels. We also have to be careful we do not, for lack of a better term, over-engineer these various regulatory schemes. There is a lot in play. The banks are working very hard to implement these Directives, whether it is Basel, whether it is LCR, whether it is recovery and resolution planning. And I think we are making a lot of progress along those lines.

J. DE LAROSIÈRE

Thank you very much. This is rather a positive assessment I must say, which is always pleasant to hear. Perhaps I could switch to the second question which has to do with lessons learned on lending?

We often hear banks being encouraged to lend more, particularly in some parts of Europe, and of course zero interest rates are designed to encourage borrowing to drive consumption. Yet in hindsight, we know that excessive liquidity was a large part of the problem leading up to the financial crisis. So I would like to have your views on whether we have learnt the right lessons, and how we make sure we won't fall into the same trap of excessive liquidity again? Does this, in your view, underline the importance and the need of macro-prudential policies?

T. LAUGHLIN

Yes, I do think that the current generation of bankers have learned the right lessons. I would say that risk taking in general, across the globe, is much more measured today. It is much better understood today versus 2008, without question.

The banks have a much better understanding of lending. I think the supervisory apparatus also has a much better understanding and there is much more transparency in terms of where risks are being taken and not taken. So I think that is a very positive development.

Obviously, and this has been spoken about today, there is certainly in Europe a demand to lend more. I would say, all of the larger banks as well as the smaller banks are standing ready to lend. But there is a demand part of the equation which I think at times is not spoken about. I will tell you until very recently, in our core middle market lending business in the US, usage of lines of credit was very low. It is starting to improve somewhat, but there is a demand element: there is not the kind of demand for loans that you've seen coming out of cycles in the past, so that would be issue number one.

I think part of that is due to the lack of consumer confidence in the US and I think the same can be said in Europe. There is also a business confidence issue with smaller and midsized businesses in the US; probably the same can be said here in Europe. So I think this element is often lost in the discussion.

Otherwise, macro prudential policies play a key role in ensuring the resilience of the financial system as a whole. Jacques, you know that as well as anybody, from your work of 2009-2010, when you were the author of the report which led to the creation of the European Systematic Risk Board. I think that is an important development, and you are starting to see the role of macro-prudential policies play out certainly in the US. You are seeing, through the FSB and the coordination between various regulators in the US, more systematic reviews of potential risk issues. One of the more recent examples in the US is that there is a real focus on the amount of leverage lending taking place. I think that this is probably a positive development. One of the speakers said earlier this afternoon, however, that we have to be very careful how we apply that macro prudential regulation so we don't artificially disrupt the markets. I think macro-prudential regulation is also a tool that can help ensure that we have a better view and a better oversight into markets.

J. DE LAROSIÈRE

I would like to ask you a question that we haven't really addressed previously, but it came to my mind whilst listening to you. The problem we have in a very large part, not all, but a very large part of the Euro area is that bank lending is shrinking (after 2012), by a percentage of two, two and a half per year, which is very significant. Moreover if you disaggregate those figures, you see that in countries of Southern Europe, the shrinking of the lending is much more important.

So if you look at the United States banking system, correct me if I am wrong, but I don't think you have that. I think banks have continued to increase their lending. And I would like to have your views on why that has been the case?

T. LAUGHLIN

I think a couple of factors are at play. There has been what I would call a longer-term growth trend in the US, probably a couple of percentage points higher than the GDP, when you average it up through the quarters, so there has been some growth. I think obviously part of that was the US came out of the recession a little stronger, and has recovered a little more quickly from an economic perspective. So there has been real fundamental demand. And I think as everybody knows, that the FED has been very accommodating from a monetary policy perspective to make sure we have that liquidity... that there is more than sufficient liquidity some might say, in the system to stimulate demand.

So I think it has been through a combination of very aggressive monetary policy and I think you are starting to see some employment programmes work as well. So I would say a little better economy, a little stronger economy and a little faster start is the reason that we are probably ahead of Europe from a growth perspective.

J. DE LAROSIÈRE

Yes, I think you are absolutely right. And it is not so much the difference in the monetary policy that catches my attention, it is the other factor. I think the US economy has come out of the crisis quicker than the wider European economy, which is still far from having attained the level of GDP that was prevalent before the crisis. And I think the reason why the European economy has been lagging, and has been much less dynamic in its rebounding, is that the flexibility of the market system in the United States is much greater than it is in Europe, where we have many regulations in the production sector, in the labour sector, which are very rigid and inimical to rebounding growth.

And therefore, this is seeping into the system you see, because the more enterprises are fragile, the more they are straight jacketed in a system that is detrimental to growth and flexibility, the more their balance sheets suffer, the more their operating margins decline, and the less they are able to legitimately, call for credit.

So this is emphasising the demand side of the deleveraging phenomenon. And the lesson I think we should draw from the comparison between the US and Europe, or at least part of Europe, is that the United States is a more flexible economy, even if it has its weaknesses and its fiscal problems etc. So I think we agree on that.

J. DE LAROSIÈRE

Now, the last point which we wanted to cover is the concept of too big to fail, which is still being debated in Europe and the United States. What are your thoughts on the subject, since you are a very large bank?

T. LAUGHLIN

Indeed, we are a very large bank, and it has been very timely. We have finally received some feedback on our living wills, our resolution plans in the US, several weeks ago. So that was much looked forward to.

Regarding too big to fail, I would say that the industry both in Europe and the US has made real progress in this space. And one other item that I think is often lost, more in the US than in Europe, is that recovery plans are an important element of recovery and resolution planning. I think the Europeans get that a little more than the US. There is so much discussion on the resolution plan, and obviously you never want to get to the resolution plan, and make sure the recovery plan works. And I often tend to point that out.

But here is how the debate is really beginning to form, at least from the US perspective. I think everybody in this room knows that at the end of the day banking is really about maturity transformation. And the old pact, the old social pact, unwritten or written, was if there was a crisis, the government would step in and fill that liquidity bucket. Fill that liquidity gap, and bridge the bank or the system to the other end.

Obviously in 2008, taxpayers in Europe as well as in the US said we don't want to do that anymore. And so what I would say where we stand now is that in my view, we have made under Title 1 of Dodd-Frank, as well as with BRRD, a lot of progress. As I said, I am very pleased with BRRD and what is coming out of that, but I will use the US scheme in Title 1 of Dodd-Frank to highlight that we have made good progress in having built capital, liquidity, de-risking the balance sheets, and in reducing the complexity of financial organizations.

As an industry, we feel good about Title 1 of Dodd-Frank even though we obviously have some more work to do on those plans, and we just received some feedback from the FED and FDIC. But we think we have made substantial progress.

J. DE LAROSIÈRE

What do you think of the gone concern loss absorbency capacity debate which is going to be touched upon in Australia in some time?

T. LAUGHLIN

Again, I think as a general concept, as a principle, it is fine. It is important in terms of BRRD and Title 1 of Dodd-Frank, that we have that. That shareholders' capital is going to absorb that loss, that first loss, if there is a problem. And that has to be a principle that is adhered to, to make these plans credible, and to stand up and to address taxpayers' and policy makers' concerns.

So, again I come back to how much capital are we going to put in here, into these institutions, and will that make the economics of banking attractive enough to attract capital?

J. DE LAROSIÈRE

No, it is the fundamental question actually. And it is the dilemma of all regulations. Do I move regulation so far in terms of intensity that I am completely safe, and citizens will never have to pay anything, or governments? But then, I pay a large price for that. And that is… do we have a banking system then that is able to effectively lend to the economy?

T. LAUGHLIN

And there is a version of that bill in the US Congress right now. It has not made it to the floor, but it is in the US Congress right now.

J. DE LAROSIÈRE

So the idea is to strike the right balance between regulation and financing the economy. We know that in Europe, this is our daily bread, and some feel that perhaps things are being tilted a bit towards too much regulation.

Thank you very much for your attention.

Exchange of views between Jacques de Larosière and Mario Monti

Jacques de Larosière, President, EUROFI
Mario Monti, President, Università Bocconi

JACQUES DE LAROSIÈRE

I'm extremely honoured to be at the same table as Mr Mario Monti who has agreed to participate in this exchange of views on how we could better imagine a more resilient financial system and perhaps concentrate a little more precisely on fiscal matters. We have agreed to touch on three parts of this question: firstly how do you assess, Mario the current economic and political situation in Europe and more specifically in the Euro zone? Second, how do you see the economic and financial challenges for the new Commission? And thirdly, do you believe that the achievement of a successful monetary union requires a move towards a fiscal union, a subject which you touched upon half an hour ago? How do you see the appropriate changes of the EU institution setting, to accompany such an evolution and what would be the main steps? So now the floor is yours.

MARIO MONTI

Thank you very much Mr President. I thank you for inviting me and I do wish to pay tribute for the enormous role that you personally and through one of your children, EUROFI, have been having in the last few years in inspiring and masterminding the reconstruction and the evolution of Europe's financial system.

How do I assess the current economic and political situation in Europe and the Euro zone? I agree with most people that the lack of growth, the lack of employment and the lack of youth employment in particular, are our number one by far problems. I do not, at the same time, believe that we basically have to change the main principles of our policy framework in Europe, but as I will say, some specific changes will be vital.

As for the political situation in Europe, I am very concerned by what was mentioned in the previous roundtable, namely we have now almost a dormant manifestation of anxiety about the European construction and the European integration. It was so virulent and visible during the European elections and I think that as soon as the new Commission starts putting its proposals before the European Parliament, or national parliaments ultimately, when any new directive or new measures will have to be transposed nationally, then we are going to see this backlash against integration coming out very, very strongly.

And I would add as a major political problem for Europe the North-South divide, including so many misunderstandings about the real situation of the North and of the South, but this is a very, very worrying aspect. In essence, I believe that the South has made huge progress under the pressure of the crisis, while the North in my view has not quite realised yet to what extent the individual countries in the South have made progress, some more than others, and it would be crucial in my view for the South to persist in the policies that it has recently embraced, namely budgetary discipline and structural reforms, and at the same time the North must come to realize that whatever progress each of the countries in the South makes in moving along the principles of the social market economy, i.e. improving their economic policies, they will not reach sustainable growth unless some changes in the whole policy framework for the European Union are introduced.

And which changes? Which in a sense, Mr. President, ties in with your question, how do I see the economic and financial challenges for the new Commission? Well, in the area of economy and finance, I really see two main issues for the new Commission. One is: How to help Europe stick to budgetary discipline, but making such budgetary discipline more rational from an economic point of view? I will say how. And secondly, how to devise a more effective framework to push and help member states to make progress in structural reforms.

Perhaps I will start from this second aspect. I think that most Member states, certainly those in the South... Well, before I proceed, let us step back for a moment. This EUROFI meeting is taking place in the only country in the South of Europe, Italy, which has come out of its very serious financial difficulties without any form of external support (consequently without any troika in Rome) and which currently is out of any excessive deficit procedure, whilst all the other countries in the South, plus some in an intermediate latitude (like France and Belgium), still are under the excessive deficit procedure.

Of course Italy has been paying a very strong real price to achieve this, and by the way, I have been somewhat disappointed at seeing the easiness with which the European Commission has been granting extensions to Member states in meeting their stability pact obligations. Italy might have obtained those extensions but, at least as far as my government (2011-2013) is concerned, we thought that Italy should not ask for extensions because with the debt to GDP ratio of Italy, it would have been unadvisable even if it were to be legally admitted, to postpone the vigorous budgetary adjustment process.

Most countries have achieved more progress in terms of budgetary discipline than in terms of structural reforms. Why is that? I think for a very, very simple reason, and here I can speak from my modest experience in government but also as an observer of other governments in Italy and elsewhere.

I believe in the area of structural reforms, resistances and oppositions are even stronger than in the area of budgetary discipline which, in many cases, can come through measures that affect rather wide constituencies, but do not normally affect a lot of small and well-organised constituencies.

So domestically the political difficulty of structural reforms in my view is even greater than for budgetary discipline. If, on the other hand, we look at the help coming from Brussels, well, the help coming from Brussels in terms of constraints and pressures, is very, very strong. We may like it or not, but concerning budgetary discipline we have Maastricht Treaty, Stability Pact, Two Pact; Six Pact, Fiscal Compact. Instead, concerning structural reform, we relied on original Lisbon Strategy without any teeth.

Therefore, if a government, in achieving structural reforms, has to face even stronger oppositions domestically, and gets less help from Brussels, no surprise that structural reforms have made less progress than budgetary discipline. Hence, in my view, the big challenge for the new Commission on how to help Member states achieve structural reforms. I do not agree in this respect with the President of the ECB, President Draghi, when he says that there will have to be a further surrender of sovereignty. I think we should be very, very careful there, because in many countries it is believed that we should not surrender further sovereignty. I don't think that there will have to be a surrender of, or a sharing of sovereignty as if it were a new treaty. It can well be a bilateral contract between the European Union, the Commission in particular, and the individual Member state, the so-called contractual arrangements that were proposed but then did not make much progress at the Council. I hope that, under the impulsion of the new Commission, they might emerge again, specifying which targets a government should assume for structural reforms with a time profile, etcetera, and the Commission will monitor, will help, may even provide some financial incentives to cover the transitory costs.

I believe this will be a very important challenge for the Commission. The other big challenge, perhaps even more difficult ideologically, would be in my view to stick to budgetary discipline, but really to make it more rational. Here I go back to the difference between public expenditure on consumption and public expenditure on investments.

I like to think of the European Union as a friend of future generations, an ally against the abuses and the excesses of current politicians. In terms of respect for future generations, it is of course profoundly different whether a government borrows in order to cover current expenditure, or whether it borrows to finance public investment.

I believe that this is extremely structural, and this is particularly evident. So, we are at a time, and we are likely to remain in this situation for some years, in which governments, first of all the German government, can borrow at zero or little above zero interest rates. I would not, for example, if I were in a government position in a country of southern Europe, invoke "flexibility". I would invoke "rigour", and I would have a friendly discussion with my German colleagues about whether it is respect for future generations to refrain from borrowing at zero, or 0.5, funds that could be put into serious, well-defined, well-checked, restrictively monitored public investment with an internal rate of return of three, four, five percent.

So I would like to see a rigorous interpretation of the principle that presided over the foundations of the Stability pact and that would require, therefore, a sharper distinction between current expenditure and capital expenditure, and particularly in a situation like this. I was discussing in a very friendly manner with a high-ranking German Minister. I said to him, but maybe future generations of Germans in a few years may regret that you did not increase a bit the debt of the federal government to remedy the malfunctions of the transport system or to invest more in broad band, etcetera, in order to leave them with an endowment of public capital more conducive to growth and employment. I hope that as this discussion is gaining ground, this time around the ECB will be more supportive and not be an obstacle as it has traditionally been in the past when some debates have been taking place.

I hope that now in a way which I would see as consistent with their more and more growth-oriented policy stance, they would not object if the Commission were to take some initiatives here.

Let me finally say, concerning the ECB, I very much welcome the bold, courageous and necessary, I believe, steps taken by President Draghi, and that by the way concern growth policies in Europe, and I will close with this remark. I have maybe a minority view, but I do not believe that it would be good to change the mission, the mandate of the ECB to make it broader, as with the Fed, to include growth explicitly.

Why do I not believe this? For two reasons: one, I do not see that it is necessary for Europe to pursue an active growth policy; and two, I consider that dangerous. I do not see it necessary because we have seen on several occasions how the full respect of the independence of the ECB is not inconsistent with the ECB living in a broad context and not in a vacuum.

The best example there, I believe, is June-July-August of 2012, when, with a lot of effort, the political authorities of Europe finally agreed at the European Council - on the 28th, 29th of June - on a statement, unanimously subscribed to including by the heads of government of Germany, the Netherlands and Finland, saying that when a country meets all the requirements and recommendations of the EU, and yet its government securities are experiencing undue stresses in the markets concerning the spreads, it may be justified to have stabilising intervention. Never would the President of the ECB have dared to say "we will do whatever it takes", devising the OMT instruments shortly afterwards, had he not had this unanimous top-level political backing.

And why, finally, would I consider it dangerous if we were to have an enlarged mandate for the ECB? Well, because already now we see Europe's politicians, both at the national level and sometimes also the EU level, preferring to resort to the ECB in order to achieve goals, like economic growth, simply because they are reluctant to embark seriously on the hard work that, with other policies, they have to do in order to achieve growth. I would be very concerned if the little reference to growth were to appear explicitly in the mandate of the ECB because this would be a little word, but a gigantic further alibi for Europe's politicians not to act.

Finally, on the issue of whether a fiscal union is necessary. Yes, I believe that as phrased here, the achievement of successful monetary union requires a move towards a fiscal union.

Even before needing a fiscal union to complement the monetary union, we need to have, full in place, an economic union, the cake on which the single currency was meant to be the cherry. Speaking about the comparisons that are made with the US, it's very obvious that we do not have an economic union as there is in the US; this is the issue of the single market: completing it, extending it to new areas like the digital economy, etc. but also endowing the European Commission with enforcing the single market with adequate legal powers that the same Commission does have and use in the area of competition. Once there is a treaty change, it is also in this relateively minor but practically important aspect that I would like to see a change.

In the area of the single market if the Commission finds an infringment in the case of a certain member state, the European Court of Justice will pronounce its judgement after four or five years. But that obstacle to the single market will have remained in place for such a long time. In the area of competition, by contrast, the Commission issues its decision at once: this merger is allowed, that merger is not allowed; this state aid is allowed, that state aid is not allowed; and reality has to conform immediately with the decision of the Commission. Then the parties may go to the European Court of Justice.

So... I find it really historically understandable, but crazy, that in the area of budgetary discipline there are stronger instruments of enforcement than there are in the realm of the single market which is much older (the Rome Treaty precedes the Maastricht Treaty by thirty-five years) and, with all due respect for budget, money, etcetera, the Single market is even more fundamental.

The paradox is that if we look at concrete indicators of the extent to which the Single market is in place, is respected, we find on average that the countries not in the Euro zone, perform more respectfully regarding the Single market than some of the countries in the Euro zone. Then the countries in the Euro zone complain that in spite of having the single currency they do not have good employment performances. Yes, they do not have labour mobility, recognition of diplomas, qualifications, and we should have a much more perfect single market than the US do because we have to compensate for the non-singularity of languages.

But then of course also fiscal union is necessary and I am glad that this frontier territory for the European Union is the one where I've been asked to do some work; as the Chairman of the High-Level Group on Own Resources, set up by the European Parliament, the Council and the Commission.

J. DE LAROSIÈRE

Thank you very much.

I thought the debates were very interesting. We could say that at the beginning of the afternoon we had a very lively session on the related matters of monetary policy, fiscal policy, structural policies, deleveraging and the future of the economy, which is indeed sluggish and has a dramatic, high rate of unemployment, especially among the young people.

So, we discussed that, we recognised the boldness of the policies announced by the ECB a few days ago, which are characterised firstly by decisive action, rapidity, and hopefully will re-engage a mechanism of credit that is unfortunately stalled in Europe today. I think we will need more than the ECB announcement to achieve that. We have on our agenda several interesting topics on recreating a true market of securitisation, which is not guaranteed at all. Further measures have to be taken. A few measures in terms of unblocking a couple of, I would say irrational pieces of regulation that have to be reconsidered.

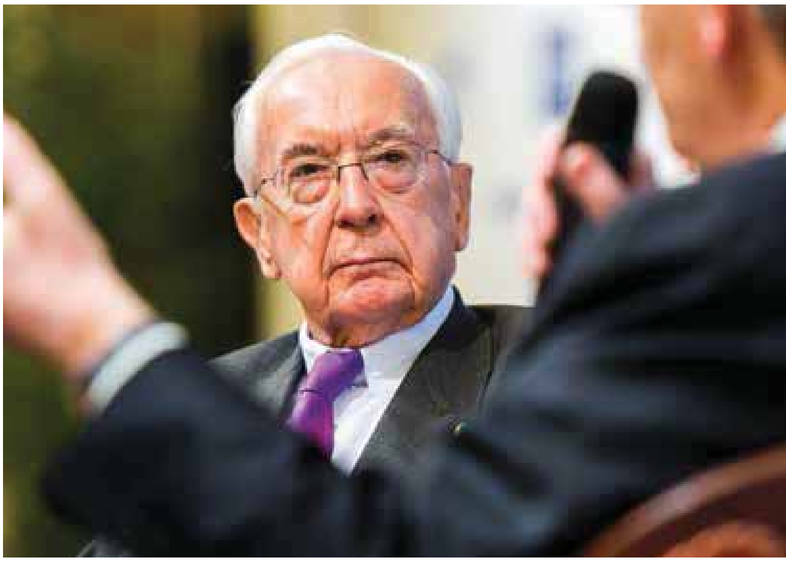
There was also an intimation that the base scenario in which we are all working, which is a gradual recovery, still sluggish but taking some momentum in 2015, there may be some indications that this relatively modest base scenario might have to be reviewed southward. If that were the case, there might, I don't want to throw cold water on the... session today, but I think it's better to call a spade a spade than to pretend things that there might be some beginning of a de-anchoring of price expectations which have been relatively stable and positive up to now, but they're moving incrementally, a little bit lower.

So we have to be very vigilant and what I would like to say, and this will be my last sentence tonight, is that we're going to have a new Commission. We have a dire economic situation, which is probably a little worse than we think and I think there is no time to play games, do mountains of reports on how we could launch investment, etcetera. I think we know exactly what to do. The name of the game is urgency. So I'm going to do all I can to impress the ministers, and in particular the very able Italian presidency of the union, that if there are indeed a few, not-very-numerous, but a few, let's say 10 measures to take, you have to take them before the end of the year. So, no time to study and consider!

So thank you very much for your attention.

Exchange of views: Challenges for EU banks in the context of on-going regulatory evolutions

Jacques de Larosière, President, Eurofi
Jean Lemierre, Senior Adviser to the Chairman, BNP Paribas



JACQUES DE LAROSIÈRE

I'm delighted to be this morning with Jean Lemierre, who is, as you know, Senior Advisor at BNP Paribas, and he has had a very rich and important career in the public sector, the French Treasury, the EBRD, and now he is a seasoned banker. I would like to ask him to start off, where do we stand now in the context of ongoing regulatory evolutions?

JEAN LEMIERRE

Thank you, Jacques, I'm very happy to be with you this morning. I'm not so sure I'm a seasoned banker, I've slightly reacted on 'seasoned' but not yet, huh?

J. DE LAROSIÈRE

You're moving towards it.

J. LEMIERRE

Yes, too quickly. A few remarks. Where do we stand? Well, I will not elaborate long, and so I think we have done a lot, the banking industry has done a lot. All the ratios have been increased, improved. I think banks in Europe are safer, to make it simple. I would say probably much safer, hopefully the Asset Quality Review will confirm that.

Regulators, supervisors, ECB, are extremely helpful doing this. But, at the same time, there has been a cost to this, and the cost is mainly deleveraging. The size of the balance sheets of the banks has been reduced probably since the crisis roughly by a third, which is significant, it was maybe needed, it has been done.

We are absorbing new regulations, I'm not so sure how we use the word tsunami but it looks like it, and we are absorbing it. And, Jacques, I think we have continued to do the job. Business was done over that period, banks have continued funding the economies, so, doing the two together was not easy, but it was done.

I will finish my answer to your question by a simple remark: I hope that trust is back. I hope that through both the remarkable job done by most of the banks, if not all the banks in Europe, and by the fact that, whatever people say, the economy has been funded, companies have been funded, trust is back, and trust is crucial for growth, and this is what we need now.

J. DE LAROSIÈRE

Okay. I have to be perhaps a little bit more nuanced on what you've just said. You can't really say anymore that in the Euro area all banks are lending and participating in the real economy. Because, t especially, in the southern part of the Eurozone, there are forms of credit crunch which don't exist in France, luckily, but are there.

Now, I'd like to ask you, there are some indications that the Basel Committee intends to qualify the EU implementation as significantly non-compliant with the Basel III principles. What do you answer to this?

J. LEMIERRE

Compliant to what? If the question is compliance to the Basel III regulations, we know we are not compliant because there are derogations and they have been accepted. So, if we take that point of view, yes, Europe is not compliant to a certain definition of Basel III.

I'm not so sure this is a useful question. The assessment which would be extremely useful is to understand if we are moving towards full compliance or not. That's a different question, and that's the real question we have. In my view, in a short time, we have started moving towards full compliance. I will take one example, which is probably a question to the ECB, but my guess is that after the Asset Quality Review, the ECB will review some specifics within the Eurozone. And, I try to say this in a modest way, but it's a huge task, and that will have a big impact on the way we are moving towards full compliance.

So, Jacques, I will try to make a comparison, hopefully we should not be the only two to understand the comparison. I followed you, some years after, as President of the EBRD. In the EBRD we have a challenge which is to try to make an assessment about the compliance with the countries with which the EBRD operates, with democracy. This is extremely difficult, and a very wise decision made by Jacques, I simply kept the system, is to say that, what we monitor and we make an assessment on, is the move toward democracy and that's key. Why? Because, it helps a lot to sanction, to put the finger on cases in which obviously they go backward. And, I would say we are probably in Europe in the same situation today. No, we don't comply, we know there were negotiations. Do we move forward? My guess is, yes.

So, hopefully, the Basel Committee, making such an assessment will have two paragraphs, one saying: no full compliance, but a move toward compliance. And, that would be a good incentive to continue to move forward.

J. DE LAROSIÈRE

Yes, that's certainly a good point, more important than the snapshot at one point in time is the film, is the evolution, the dynamics. Now, I'd like for the last question, to ask you, given all this, where should we be going in terms of banking activity?

J. LEMIERRE

Well, maybe on your previous question I would like to make one remark. When you look at what is happening from a bank point of view, you have regulations requirements, or Basel Committee requirements, and we have to be compliant with those requirements. But at the same time, you have EU regulations saying that within the EU there can be specificities country by country. And, I think we are in a very strange situation and we'll have to fix it. At least we shouldn't have this type of situation, at the moment when the resolution mechanism is fully implemented under the leadership of the ECB. So, maybe there is a transition period of a few years in which, at the end of the day, there's probably some legitimacy to some specific cases within the EU. But, at the medium term horizon we should have the same system, at least within the Eurozone.

So, regarding the point you have made about making an assessment, I think we're European; we need to think carefully about these types of exceptions. It's not because I don't like exceptions, it's simply because banking means a lot of money, a lot of capital, business plans are extremely difficult to build, and we need to understand as quickly as possible where we are going to, that's all.

On your good question, Jacques, because I like this question, which is not a negative one, which is, what should we do? Bankers are always constructive, never on panels, but in life they are constructive. On panels they are always negative, but in life they try to build up. The point on which I'm probably the more focused is the transition period in which we are changing to an economy which will be more funded by the markets. And, I think the time has come for everybody, including regulators, to be more focused on this. Because, we do the job but we deleverage. When I see all the new regulations ahead of us, they will have a cost, hopefully not too high, we have a lot of discussions but there will be a cost, and then it means further deleveraging. So, the market funding part of the equation is absolutely key.

So, what does it mean? If you allow me I would like to mention at least two examples. One is securitisation, we speak about this, but there are still a lot of difficulties. I know there is a panel later on securitisation, let's be clear that should be at the top of the agenda, we shall penalise the European economy, especially if growth is back, if we are not careful about securitisation, helping the balance sheet of the banks to dispose of some assets. So, securitisation is absolutely key.

The second point I would like to make quickly, relates to my former life in the official sector. I think public sector institutions within the EU have done a great job over the last years, and notably the EIB, the KfW, the Caisse des Dépôts. In all countries, public development banks have done a great job providing funding for SMEs, notably. A new paradigm is being built now by the ECB, hopefully the new policy of the ECB will channel liquidity and credit to SMEs. And, the pressure to continue to fund SMEs by official institutions, will probably, hopefully, be reduced.

That will be good, but the policies of these institutions were moving toward taking more risks, and especially helping the transition process toward a market funded economy, by more equity, and probably more long term infrastructuring. It's a big change, but it has to be done, with additionality, of course. Probably we're the only two to understand additionality, Jacques, but it's key. And, I think there is a good piece of thinking for governments and institutions, public sector institutions to help this transition process.

The last point I would like to raise, but this is maybe for a Eurofi forum next year. What is the business model of the banks tomorrow? I think nobody knows. Today in Europe banks are based on national ecosystems, and even if you have banks in various countries, in fact each of these banks operates according to the national ecosystem. We have the potential of growing a new model of banks in the Eurozone. I don't know if it will happen, I can see there is resistance, I can see there is an extraordinary opportunity to do it, and I think we need to work on this.

I think nobody has the answer, I don't have, probably, Jacques, if somebody has the answer you have the answer, but that's also a key positive challenge. Shall we be able to use the opportunity of a new business model across the Eurozone, fuelling liquidity, or using liquidity across borders, managing the risk in a different way? And, that would be probably, and hopefully, a good trigger for growth, at least, that could be part of our contribution to growth.

J. DE LAROSIÈRE

Well, thank you very much Jean. I think this is very enlightening, thank you for the candour of your remarks. One thing I'd pick up in your last intervention is the need to improve on the own funds of small and medium size enterprises. Because, I think it's very well to promote securitisation, to facilitate for the banks space for lending again to SMEs, but I also think that their balance sheets are often very weak, and that they need to be buffered in terms of own funds. And, I think that the public sector has a very important role in this regard.

So, thank you again Jean.


RELAUNCHING GROWTH IN THE CURRENT
CONOMIC AND REGULATORY ENVIRONME
eurofi
J. de Larosière
J. Lemier

Exchange of views: Impacts of EU regulations on the prospects of the EU insurance industry

Jacques de Larosière, President, Eurofi
Henri de Castries, Chairman & Chief Executive Officer, AXA Group

JACQUES DE LAROSIÈRE

I would like to draw your attention to the discussion we are going to have now with Mr Henri de Castries, who is Chairman and Chief Executive Officer of the AXA Group. I would like to thank him very particularly, because he has made the effort to come from New York, he just landed a few moments ago and we are very grateful to him for sharing with us a few thoughts on the subjects we have been touching upon, viewed from the insurance sector. So Henri, perhaps you could say a background word on how you see the insurance companies' role and challenges in the present general macro-economic and climatic environment, and then we could touch upon more specific questions regarding long-term investment through the insurance companies. So you have the floor.

HENRI DE CASTRIES

Thank you very much Jacques. Thank you for inviting me, I'm sorry that I wasn't here yesterday, but from all that I have heard, once more Eurofi has set the benchmark at a very, very high level. So, it's a privilege to be here this morning.

On the insurance sector, I think we are at a very interesting point in the history of the industry and looking at Europe, is an interesting observation point. The industry, of course, like all financial services, is in the recovery phase after the big financial crisis. I think it's not wrong to say that the sector has been less affected than banks by the crisis, and obviously so because the nature of the business model is a different one and I think we can be proud of the way the European insurance sector has got through the crisis.

Where are we today? We are in a phase where we observe the world, see the very, very powerful re-balancing between the emerging world and the mature countries, which I think is a challenge for Europe.

When we discuss at Board level, where do we want to allocate our capital, the case for European investment has to be very, very strong and it's going to be probably even more so in the years to come. This means, and I think it's not unrelated to what you've been discussing over these two days; it's not a given that Europe is an attractive place for investments going forward. Growth in other parts of the world, regulation in other parts of the world, can be more attractive or more friendly for good reasons, so I think when we look at that, as a company operating in a core business it's an important factor. It's true also as investors.

The second thing which is interesting is, I think we are at an inflection point, in terms of innovation, new risks, and sometimes, the next crisis coming not from the previous risks, but from the new ones. What is very, very clear to us (and most of us in this audience) is the fact that the impact of technology, of digital, on the economy in general, but on services in particular, is going to be much more powerful than what most people think, and we are probably at an inflection point there. It's going to transform very, very deeply our business models and probably sooner than what most of us expect.

For us insurers, it's a big opportunity because helping our clients understand their risks, understand the way they will have to cover them, understand what the challenges are; as an example, in the field of cyber-security, there is an opportunity to do business, but we should not under-estimate the impact of all these things on the way we operate on a daily basis. I think everybody is familiar with the impact it's going to have on the distribution side of our businesses. Less people are convinced of the depth of the change we will see in the upper side of the value chain, and this is going to have an immense impact on the way we identify risks, on the way we price risks, and the way we define jobs we will need for the future. So I think it's a risk we should not under-estimate going forward.

So that's, I would say in a nut shell, the landscape we are in. Of course, because our business is risk, we look at that with optimism, but also with the hope that Europe is going to wake up and adjust sooner rather than later.

J. DE LAROSIÈRE

Thank you very much, this is extremely interesting. I'll come now to the more specific subject which I wanted to touch with you and that is, insurance companies have a long-term framework, that's something rather tautological, but it's good to remember that, and despite the long-term nature of your business model the regulatory framework has a rather short-term focus, so how can regulation help insurers play, or regain, the playing of their key role in the long-term financing of the economy? We had very interesting sessions yesterday when we spoke of the buy side, we spoke of insurers buying long-term assets and we spoke of securitising credit to the economy because banks were not so capable now of holding these assets on their balance sheets, how do you see that? The role of insurance in participating in the financing of the real economy and given the disintermediation that we are observing in the banking business? Would you like to comment on this?

H. DE CASTRIES

Sure. I look at it now with a 25 years' perspective since I started in the business a quarter of a century ago. I hate to say that, but I have to admit it, it is a fact. The world has changed. Let's be clear, all sensible European companies are in favour of a strong and clear regulation, so the question is not about regulation versus non-regulation. We want a strong regulation, because we think that a strong regulation is helping to promote sustainable business and it's fostering growth, investment and so on. But, and this is the caveat, regulation has to respect the business model, the fundamentals; because if regulation ignores or distorts the business model, you can have very unintended consequences and there I think the picture is less rosy. Basically, to be very short, there are a couple of important pillars of the regulation which have an immediate impact on the way we allocate our assets, if not our capital.

One of these pillars is accounting. One of the other pillars is, of course, the solvency regulation and in the solvency regulation, the calibration, which is, put in terms of capital requirements, in front of the investments you are making. If you look at the substance of the business model of insurers, it's very, very, very clear that they are natural stabilisers of the economy for the very reason you've been mentioning, which is the fact that their liabilities have a very long duration. You have to admit that over the last fifteen years, say... to be short, regulation has started to stray from the fundamentals of the business model by shortening the horizons. This is something I've been saying for years now at all Eurofi conferences and the consequences are starting to become visible. It has led to European insurance companies progressively investing less in infrastructures, investing less in equities, investing less in some asset categories, which are the asset categories, which at the end of the day are necessary to finance the growth of the economy and jobs.

I think we are now close to a very, very fundamental point or to a very fundamental step. We are coming to the finalisation of Solvency II and we will have in the next month some important steps on the accounting side. On Solvency II, the substance of the delegated acts is something important. If it's the will of the Council and of the European governments to see insurers playing a more active role in infrastructure and in infrastructure financing, and in securitisation, well it's obvious that they have to give a very fast and very deep second look at calibrations, because if they don't do it, we will not invest. It has to be absolutely clear.

Let's be simple. The total balance sheet of insurers in Europe is six trillion, 1% in infrastructures means 60 billion. You see that it can be a very, very powerful

addition to what governments intend to do to re-generate growth. There is very little hope; no hope, let's be frank, with the current calibrations that anything significant is going to move on the insurance side if a second look is not given at these calibrations. You can wait until 2019. If you wait until 2019 nothing is going to happen before that. So I think the …choice is simple. As we say in French, 'the mason is at the foot of the wall' and we will see the way the wall is built in the next weeks.

The second thing which is important for us, is the way accounting norms are going to change. You know that we are in the process of discussing on IFRS 4 phase 2 for insurance liabilities and that the EU Commission is scheduled to adopt a new IFRS 9 standard on the asset side of the balance sheet that would apply to a broad set of financial institutions including insurers.. There I think it's very simple, Europe has the choice to re-make the mistake it did at the beginning of this century, which was to delegate powers regardless to the IASB without ensuring that there is a consistency between the accounting norms and the economic reality of the business models.

Many people speak of calibrations; that is s the train which runs at the risk of derailing now. The second train which could very well derail in the very near future is the accounting train. At the current state of the discussions, if the IFRS 9 standard were to be passed, it would imply that the accounting framework would foresee separate and disjointed standards for assets and for insurance liabilities. This is inconsistent with the insurance business that manages assets and liabilities conjointly. This inconsistency in measurement would also result in accounting mismatches and reinforce the artificial volatility of the P&L.

Consequently, we strongly believe that the standard for assets (IFRS 9) cannot be endorsed by the European Commission before we reach a meaningful result with the IASB on IFRS 4 phase 2 on the liabilities side. The whole industry has been saying that, IFRS 4 phase 2, as proposed by IASB, is totally inappropriate to the business model of the industry. So IASB must review its copy. Fine. Any other road is going to block once more the role the sector can play in helping growth in Europe and it's going to put the sector at a competitive disadvantage when compared to non-European players.

I have the hope that with the very strong political will we are now seeing, insurers will be in a position to contribute without distorting the fundamental elements of their models and that this will be helped by the appropriate political control of the regulation.

J. DE LAROSIÈRE

Thank you very much. These are very strong warnings and I very much hope that we're not going to re-make the mistakes of the past, in particular on the question of the accounting norms, which has not been really discussed over the past two days, but I think is one of the most important …drivers actually of the future of your business. We have sensed over the last two days among the regulators, but perhaps more so, among the ministers, willingness, or perhaps a will to change some elements of the calibration which you were mentioning. I think it is absolutely clear that if we want to be in harmony with what the ECB has just done in terms of purchasing Asset Backed Securities in order to re-start the credit channel, we have to consider that those who will eventually buy those Asset Backed Securities issued from the process of securitisation, cannot be banged on the head in terms of regulation and calibration, especially if these assets are high quality assets and there's no reason I think, to introduce a negative bias just because they are the result of a process of securitisation. You have to look at the intrinsic quality of the underlying assets and if they are high quality you have to treat them regulatory-wise as high quality assets, there's no in principle, stigma to be attached to the securitisation process.

So I think these things have been much better understood. I think the Council, the Ecofin Council, is aware of the urgency. I don't think we have a lot of time to ponder and to desiccate these things. It's probably something that has to be done in the coming weeks and I would like to thank you because you will be one of the major European players in this debate, and I don't think we can rely on the ECB to be the only purchaser of these assets. There has to be a market and if you want a market, you need to have investors with large balance sheets. It's as simple as that.

And now if you're told no, you're going to be penalised, I don't know, eight times more than on a similar other type of bond that you would be holding just because they are the product of a securitisation process, I think we can forget about it. But my feeling this time is that we're not going to forget about it, something's going to happen, probably, and thank you very much for what you've said and for the inspiration you are giving. We have a few more minutes so if you want to elaborate a little more on the subject, you're absolutely welcome to do so for five more minutes.

H. DE CASTRIES

Thank you Jacques. I agree to every word you've just been saying. After all, if the ECB is buying some categories of assets, you should expect other players to buy the very same. We are ready to play this role. The business model we have, justifies that. What we need now is a fast regulatory clarification, which to happen, needs to be provoked by a very, very clear and well defined political message.

Everybody in this room, I think, understands how difficult it is when you are outside Europe to explain to investors, competitors, other regulators, the complexity of the European framework. I think we are at a point where if the cost of this complexity is such that it prevents us from taking the necessary steps we have to take to get out of the hole we are in, we will be in real trouble two or three years from now. Europe has a sufficient number of challenges to address outside these ones, not to have the luxury to make this a contentious point, let us just do our business. Of course, from the supervisors' standpoint, they will have to accept some risk because infrastructure as an asset class does not have today a definition. Fine, but as insurers, we have learnt something in life; the only day where you have no risk is not the day you expect for yourself tomorrow, it means it's the day of your death.

So, you have to accept to take some risk. I think Europe has entrenched itself over the last years in a situation where risk avoidance has become excessive. We have to accept to take some risks, because without risks we are not going to have growth, we are not going to have jobs and at the end of the day, we will be held accountable for that.

So what I hope, this is far away from insurance accounting and far away from calibration, but it has a common factor. I mean, now we are at the foot of the wall and the months to come will be very, very decisive. If we cannot show to the European actors and also to the outside world that we are able to take the necessary steps, the risk I personally see is that capital is going to flow out, because people will turn the page, and it would be a very difficult situation for all of us. So since I am a deep... I mean in my blood, a deep European, I remain convinced that we will find a way to put in place the right solution.

J. DE LAROSIÈRE

Thank you very much Henri. I very much hope that your words will be heard and you couldn't make a better contribution to our debate. Thanks a lot.

The challenge of implementing market regulations consistently at the global level

Michel Barnier, Member of the European Commission, Responsible for Internal Market and Services

Good afternoon ladies and gentlemen. Many thanks to you Jacques de Larosière for inviting me once again to this Forum, perhaps for the last time.

At the Copenhagen Eurofi conference in 2012, I spoke about global convergence in financial services.

Two and a half years on, at the start of a new parliamentary term, and with - in a few weeks - a new Commission, where do we stand?

Today, the objectives of global convergence and deference to other jurisdictions are broadly shared. Because that is the only sensible way forward. If we want efficient financial markets to sustain growth and jobs, then global regulators must cooperate, trust and rely on each other.

Today, the EU legislative framework to implement G20 commitments is broadly in place, and the concept of third country equivalence is enshrined in it.

Now, we need to deliver on implementation. How rules work in practice on the ground.

Because that's what will allow us to reap the benefits of global convergence.

My message is simple: we must ensure rules are applied in a consistent and coherent way.

This is particularly true for the EU and the US, the markets of which are so closely interlinked - that is why it is a good sign that Michael Pedroni from the Treasury is on the Panel today. But this is also true for emerging financial centres such as Hong Kong – and I want to greet Ashley Alders, CEO of the Hong Kong Securities and Futures Commission.

Ladies and Gentlemen,

We have come a long way.

Capital requirements for banks have been strengthened around the world. We are now waiting for the results of the AQR. I don't need to remind you how important this exercise is.

The trading and clearing of derivatives has been made more secure and more transparent.

And on both sides of the Atlantic we have carried out reforms to end "too big to fail" banks. But there is still work to be done to deal with the structure of the biggest banks – banks which are not only too big to fail, but also too costly to save and too complex to resolve. We must continue to work and to act on shadow banking in a spirit of cooperation and convergence.

And we need to go further along this way when it comes to applying new rules to crossborder activities. Let me mention the five key challenges.

1. I have already mentioned derivatives.

The Path Forward, agreed in July 2013, sets the foundations, both for the EMiR and the MiFID rules. We are now in near daily discussions with the CFTC and its Chairman Tim Massad on the details. Let me reassure you: We want to find practical solutions in the coming weeks. It takes two to tango. The American side must also deliver.

2. Another area where the cross-border angle needs to be taken into account is bank resolution.

The FSB's work on loss absorbency [GLAC] is an important element. But we need to do more: we need a true cooperation framework for cross-border resolution.

Again, our objective must be deference to each other's rules. Not making foreign banks subject to double requirements.

3. Securitisation also needs looking at. We need common global standards for sound and simple securitisations. If we get this right, I am sure there is real potential for increased growth.

4. On international financial reporting standards – IFRS – I am much more pessimistic.

The prospects that these standards will be used by all major jurisdictions are even dimmer today than in past years, despite our efforts and the time I spent in IASB meetings. This remains an issue of major concern.

5. And finally, we need to converge regulation and supervision of the global insurance sector. Initially, and most importantly, by addressing the issue of reinsurance collateral.

Ladies and Gentlemen,

If we are to make progress in all of these areas, we need to do the talking where it can be the most effective.
Both in multilateral fora – such as IOSCO, represented by Chair Greg Medcraft today - and in bilateral talks.

We engage extensively in multilateral talks.

But I believe we could have even greater impact if we improved our coordination within the EU. So that we speak more systematically with a single voice. This is one of my messages to the new European leaders.

Bilaterally, we will continue with our useful regulatory dialogues with key international partners.

But experience has shown that these dialogues have their limits.

That is why the EU is pushing to include financial regulatory cooperation in the TTIP.

We want to put in place a transparent, accountable and rules-based process.

One that would commit the EU and the US to work together.

I am sure that the new Commissioners responsible for trade and financial services, Cecilia Malmström and Jonathan Hill, once confirmed by the European Parliament, will be able to convince our American partners that this approach will not lower standards but will achieve greater financial stability and a more efficient framework.

Ladies and gentlemen,

Consistent implementation of our rules will remain work-in-progress for the coming years.

I will certainly continue to work for increased trust between regulatory communities and workable common solutions until the last day of my mandate.

I count on you to do the same and to pursue that work in years to come in your roles as members of parliament, governments, regulators, supervisors and market participants.

Thank you.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SUMMARY OF DISCUSSIONS


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The Eurofi Financial Forum 2014

FINANCING OF THE EU ECONOMY

Challenges posed by the deleveraging of EU economies and the weaknesses of inflation and growth

Objectives of the session

This session sought to explain the deleveraging trends of different economic agents (states, banks, businesses, consumers) in the European Union's economies and their impact on growth. The tools that could make it possible to combine kick-starting growth in Europe with deleveraging the economies were also identified.

While member states are working to reduce their deficits and excessive debt levels, the first question asked was whether it is necessary for banks, businesses and consumers to continue deleveraging and if so, to explain the reasons and the economic consequences of this.
Speakers were also invited to indicate whether or not banks and businesses from the main countries of the Union are adopting a "good" or "bad" deleveraging approach, and to clarify whether this situation varies across countries.

Finally the lack of impact of the ECB's measures (rates close to zero, liquidity lines, TLTRO etc.) on bank lending to SMEs and the consequences of the weak growth of M3 money supply for the economic activity were also discussed.

Background of the session prepared by Eurofi

This session will seek to explain the deleveraging trends of economic agents (states, banks, businesses, consumers) in the European Union's economies and their impact on growth, in addition to identifying the tools that will make it possible to combine kick-starting growth in Europe with deleveraging the economies.

While member states are rightly working to reduce their deficits and excessive debt levels, the first question to be asked is whether it is necessary for banks, businesses and consumers to continue deleveraging and if so, it is important to explain the reasons and economic consequences of this, which may vary depending on the stakeholders and countries.

For a bank or business, "good deleveraging" means raising capital and quickly cleaning up impaired or inefficient assets. "Bad deleveraging" means reducing the size of their balance sheets indiscriminately, regardless of the quality of the assets concerned or their contribution to economic growth. Speakers will be invited to indicate whether or not banks and businesses from the Union's main countries are adopting a "good" or "bad" deleveraging approach, and to clarify how this situation varies depending on countries.

Participants in the session will also explain why the ECB's measures (rates close to zero, liquidity lines, TLTRO etc.) are not making it possible to kick-start bank lending in particular to SMEs. M3 money supply growth is still weak and this is significantly undermining economic activity. This plenary session will seek to explain this phenomenon (see also the paper of Jacques de Larosière on " Recent developments on monetary policy" prepared for the Eurofi Milan Forum).

The essential channel of monetary policy has always been the bank credit channel. It is important to explain how present monetary policy impacts the economy in the context of bank deleveraging. In this respect the role of bank regulation which has led to very rapid and significant increase of banks own funds as well as the role of low level of profitability of EU banks need to be assessed. Another issue to be discussed is also the role of the competitiveness of businesses in certain member states as well as their financial situation in this current deleveraging process. On this basis, the discussion will assess the priorities for member states to restore their competitiveness.

Participants will also be invited to touch on the consequences of rates being kept close to zero for a long time for economic agents, particularly retail savers or financial institutions that have long-term commitments, such as insurance companies or pension funds (asset allocation policy, etc.). The IMF and BIS are also concerned that the accommodating monetary policies that have been in place for several years are contributing to asset bubbles (real estate, speculative bonds, etc.) in many states. The speakers will be invited to clarify whether the central banks are making use quickly enough of the macro-prudential instruments available to them.

Lastly, this session will focus on the ways to combine efficiently monetary and fiscal policies to kick start growth in the euro area in the current economic and monetary context.

Summary of the session

1. Deleveraging goes hand in hand with high debt, which paralyses lending activity

A central banker based in the Euro area started his intervention by asking the following questions: Why are banks not lending in the euro area? Why are they deleveraging? Why are small and medium enterprises not borrowing? We are seeing discussions about the effectiveness of the non conventional measures decided by the ECB (LTRO, TLTRO, ABS purchase programme…). But according to this speaker, money creation is not the solution. "Banks are swimming in money and don't know what to do with their money". So what is the problem?

This speaker explained that his country was able to exit from the crisis through a credit less recovery. He pointed out that speed, ownership, commitment and solidarity were four crucial elements for this country's success. A credit less recovery can take place in the euro area provided that Member states pursue sound fiscal policies. As long as there are budget deficits, the outstanding public debts will not be brought in order, "there won't be any serious re-launch of bank lending taking place" he added. Moreover, he affirmed that structural reforms in order to raise the effectiveness of the labour force and the competitiveness of the business system are of the essence.

The fastest deleveraging is indeed taking place in the countries which are having the highest budget deficits and the highest public debts. High household indebtedness also matters. He concluded by specifying that large companies and SMEs are often waiting before lending in the euro zone, because they expect that government sooner or later will have to take decisions in order to get out of the crisis. They know that sooner or later taxes will be raised and the borrowers are afraid that their business plan may be screwed up. So they prefer to wait. Therefore, the answer to the question: why the credit growth is weak in the euro area? is very simple, he concluded.

2. The actions of the ECB over the recent years until now

Another central banker synthesized the actions taken by the ECB over the last years until now. Over the past years, the financial system has been severely shaken. Throughout the crisis, the ECB has indeed deployed a number of efficient instruments, conventional and unconventional.

In the aftermath of Lehman's demise, the ECB changed the liquidity allotment system from one where the quantity of liquidity lent to banks was fixed to one where the price of liquidity is fixed letting the market decide about the quantity that is needed to support that price.

In the aftermath of Lehman's default the ECB also extended the term at which liquidity was lent to banks from three to six months to one year (in June 2009) and we broadened collateral rules. By allowing banks to liquefy a larger share of their assets and by stabilizing the liquidity horizon of those banks in liquidity deficit, which had lost access to the money market, the ECB averted a major disruption in the first stages of the transmission mechanism.

In the face of the 2011-2012 escalation of the debt crisis (when the confidence collapse reached two systemic countries) the central banker reminded the audience that the ECB concentrated on banks' loss of access to the wholesale market to address a major roll-over risk. He stated that "we conducted two three-year operations (LTROs) that helped banks in a wide part of the euro area to do funding substitution. Without this relief banks would have had to shed assets on a large scale (given high leverage), with potentially systemic implications for the euro area economy as a whole".

Moreover, when a major tail risk emerged in the securities market in mid-2012, as more and more weight was given in the pricing of market debt to the risk of a euro area break-up, the ECB announced its decision to conduct Outright Monetary Transactions in the market for sovereign securities, conditional on the issuer submitting to strict multilateral surveillance.

In July 2013, the euro interest rate curve was very close to the US curve in terms of rates while the economic cycles were quite different. As a response, the Governing Council of the ECB decided to clarify the policy orientations then going forward, conditional on the outlook for inflation and weak economic activity in order to decouple the monetary conditions of the euro area from those prevailing in other major currency areas. Overall this guidance succeeded in securing our accommodative stance and promoting more stable market conditions.

At present, the recovery is weak, uneven and fragile in the euro area, inflation has remained low for a considerable period of time[1] and the geopolitical environment is also fragile which could have a further negative impact on business and consumer confidence. Credit weakness appears to be contributing to economic weakness in stressed countries. The speaker told the audience that there is a risk that disinflationary expectations might take hold and this is why the Governing Council of the ECB decided in June and September 2004 to provide additional monetary policy accommodation and to support lending to the economy. The packages included further reductions in the key ECB interest rates, Targeted

Longer Term Refinancing Operations, and the decision to start purchasing non-financial private sector assets. Regarding deleveraging, the central banker stated that we had a credit boom which is being corrected. He stressed that "this correction takes time and the longer time it takes, the more you have the issues of hysteresis. That means that the longer it lasts, the more people get long term unemployed, the more companies postpone investment, the longer the potential output lags behind and pessimism starts to feed on itself".

The fundamental question now is how to revitalise the European Union. Monetary policy can buy time. But most member states in the euro area have planned structural reforms for a long time. What is needed now is action. "These reforms have to be implemented in order to address the "secular stagnation" the euro area is facing. There are in particular clever ways to implement such reforms and getting rid of monopolies. This implies some budget costs and some creativity also. It is manageable. You have the time dimension but you need the credibility and you can use some budget leeway to get that done"he concluded.

3. In this uncertain economic environment, the recent monetary policy actions of the ECB are appropriate

A representative of an international public Institution indicated that "we are very supportive of the recent monetary policy actions by the ECB". Headline inflation is indeed worryingly low and short and medium term inflation expectation indicators appear to be drifting down. While he did not say that inflation expectations have been de-anchored, this is clearly a risk at this juncture, he acknowledged. We know that if inflation remains very low for a prolonged period, it is very difficult and costly to re-anchor inflationary expectations. In addition a prolonged period of low inflation will make this balance sheet repair that is still needed much more difficult, he added.

Otherwise, according to this speaker, there are risks that loose monetary policy pushes agents to take more risk and cause asset bubbles, but these risks are not very pertinent right now. Credit is still contracting in the Euro area.

The speaker also stressed that the Asset Quality Review is well under way and this will facilitate balance sheet repairs, but he thought that there is quite a lot of work still to be done at the national levels to strengthen national insolvency frameworks to facilitate debt restructuring.

He concluded by mentioning that "unless there is this strong political determination to pursue structural reforms, we are not going to have the political support in the longer run for active monetary policy. There are legitimate concerns, moral hazard concerns that loose monetary policy could reduce the reform momentum and so it's important from that perspective also to be sure that we have full political support for these measures."

4. The main question is how to make loose monetary policy more effective and to combine efficiently monetary and fiscal policy to kick start growth in the euro area

An economist from the private sector indicated that the Euro area is falling into a kind of "quagmire" made of zero growth, close to zero inflation and inflation expectations falling incrementally. So there is a situation of emergency and it requires bold action, and this is why he welcomes the bold decisions taken by the ECB and announced a few days ago. He added that to kick start the recovery, bold action about fiscal policy, about structural policies and about making the current loose monetary policy more effective are required.

According to him, a triple deleveraging explains this quagmire. It is indeed painful when governments, the non-financial private sector and the banking sector are all deleveraging at the same time. It is very difficult to have a strong recovery in such a context. So there is a need to go over these three dimensions of the deleveraging process.

Concerning governments, the euro area aggregate public debt is still increasing and therefore is not yet deleveraging. Only Germany has stabilised and even reduced its debt. According to this speaker, it would not be wise to accelerate the deleveraging of the government sector on an aggregate basis. He explained that there are countries such as France and Italy which need to do it, because this is very important in terms of the signal sent to investors and all economic agents about where we want to be in ten years' time. But he said that "it would be wise at the same time to ask Germany to avoid this full deleveraging of their government debt if we want to relaunch growth in the Euro area".

Turning to the private sector (consumers, non-financial companies), he specified that deleveraging is a good thing when it comes to over-indebted consumers or companies. Not everything has been totally repaired; it depends on countries. But in Ireland and Spain for instance who suffered from a big construction housing bubble, a good part of the way that leads to sustainable levels of debt is being followed.

Third, the deleveraging of the banking system is coming both from the capital markets, and mostly from regulation. "Regulators want banks to become so clean that there will be no crisis anymore" he indicated. Is it so wise to go that far? "The speaker really questioned the wisdom right now of continuing this process of deleveraging only on the back of we do not want the 2009 crisis to be repeated again.







His hunch was that there will be another crisis which will be different and which this time might come from totally different sources. But when that economic situation was examined he came to the conclusion that bank deleveraging is a double edged sword: "as far as it is part of restoring the capital credibility of banks, it's good. If it is something that is only done for the purpose of regulation, it has very bad side effects".

In such a context, the main question is how to make loose monetary policy more effective and to combine efficiently monetary and fiscal policy to kick start growth in the euro area without creating moral hazards.

5. Spain: Deleveraging or rebalancing?

Another representative of the industry focused his intervention on the deleveraging situation in Spain. The stock of total corporate financing in this country is now falling at a much lower speed (less than 5% year on year against 10% one year ago). The flow of credit is growing strongly and a strong rebound in business investment in Spain can be observed (11% year on year in Q1 2014). This speaker also stressed that, we are seeing in Spain a "good deleveraging" in the sense that it is concentrated in the sectors that are less productive (construction and real estate sectors) and not in those sectors that are driving the economy.

Then, this speaker identified one supply side constraint for lending in Spain and gave the following example: When Spain was rated AAA, most banks internal ratings for SMEs ranged between A and BB, more or less, leading to an average risk weight of around 70/80%. With the sovereign weighting at BBB-, no longer there now, but this was still the case six months ago, the internal ratings for SME loans ranged between B and below. In terms of risk weights, this means that the risk weights have gone up from levels around, as I mentioned, 70/80% to 150 or even 200%. So from the regulatory point of view, the regulatory capital requirements for Spanish banks who desire to lend to SMEs are really expensive.

Then the speaker explained that there are three ways you can overcome this regulatory constraint. First you can change the regulation, which was done but not sufficiently. There was a correcting factor of 25% which was introduced for new SME loans in the Capital Requirements Directive IV, but while regulatory capital is at 200%, going down to 175 is fine, but it is still too high.

The second way is upgrading the sovereign but this is not in the hands of the industry. Spain could be upgraded to the single A space over the coming months and, according to this speaker, this will actually free/unlock a huge amount of capital and banks will be able to lend over the coming months just because of this explanation.
The third way has to do with risk sharing, some entity removing part of this risk out of the balance sheet of banks. The European Investment Fund (EIF) and the European Investment Bank (EIB) have been working on that. The problem here is that EIF is too small; it has only a balance sheet of two billion. "In Spain every month we have thirteen billion in new loans for SMEs, so two billion for the whole European Union is a bit too low", he said. This is why the recent decisions of the ECB regarding the purchasing of non-financial private sector assets is key to re-launching bank lending in stressed countries".

6. Rates, demographics and regulation are very challenging

A representative of the industry pointed out that the interaction of low rates, the aging demographic profile of EU savers, the savings composition, the financial regulation and the bank deleveraging have altered market characteristics and the nature of the growth challenge. The collective impact of regulation and market developments across banks, insurance and pensions has been to align their asset base more tightly to their fixed income-like liability streams, reducing risk appetite and trading incentive.

The resulting illiquidity, unbalanced bank deleveraging and lower base volatility also imply greater disruption from episodic spikes, this speaker explained.

He illustrated his purpose by the following example: "if you just take only one simple rule, for illustration purposes, let's say the leverage ratio at 4 and you've got a 60% cost income ratio and a 10% cost of equity. Then your balance sheet has to clear for 100 basis points on a weighted average basis. But the vast majority of European banking balance sheets does not earn 100 basis points. The vast majority of the stock underpinning that balance sheet does not clear 100 basis points over their funding costs. So there is an awful lot of point of sale adjustment and what happens when you bring this point of sale pricing, that's what creates deleveraging, the clients don't accept it and therefore the economic activity dies out, and it impacts everything from revolving credit to mortgages to securities finance".

This representative of the industry also described 5 trends which can be currently observed in the financial area: the corporate investment rate bond space and the peer to peer space which are not yet very active, the direct lending funds (a new category of "shadow bank"), the sub-investment grade bond and loan space, which is very encouraging even if "the inability of our eco-system to match the US CLO market, partly due to our regulatory framework, partly due to our savings pools, is an inhibitor there". The fifth trend is securitisation. It is not a panacea, the speaker observed, but it represents an important mechanism to alleviate banks balance sheets and contribute to providing additional sources of financing.

7. The economic environment required unconventional policies. Securitisation can in particular play an efficient role in the re-launching of growth

Following the crisis we are facing a large public and/or private debt overhang, but more importantly there has been a sharp reduction in expected permanent income and more uncertainty around permanent income going forward. According to a public decision maker, this brings about structural changes in the behaviour of savings and consumption, which keeps consumption below the trend. It means that you have to move into unconventional space: "You have to be creative in monetary policy. You have to be a bit creative in fiscal policy within the constraints and you have to implement structural reforms", he said.

Concerning bank regulation, this speaker stated that the bulk of deleveraging has been on non-core assets and the bulk of deleveraging has come through capital accumulation. The speaker does not deny there is bad deleveraging, but we have to be careful not to lump all deleveraging into the bad camp. In addition, he specified that there's always a perception that the regulator and the regulated are the only people in this debate, but there are other parties in the debate and in particular there are investors and tax payers. So even if the regulator and the regulated come to a deal on what is the best level or the best phasing of regulation, if this is not perceived as credible by the market, it does not solve the problem. For example, Basel 3 was phased in over ten years, but the market did not accept this phasing.
Concerning securitisation, he noticed that it's a "win win process". Securitisation indeed allows banks to deleverage and credit to continue growing in the economy. Therefore the speaker was in favour of reviving a safe and sound securitisation market in Europe for

SMEs. He mentioned that there is a pretty heavy debate going on at the moment between the macro prudential and the micro prudential elements about securitisation. "It's the first time that macro prudential and micro prudential supervisors have engaged on a subject like this where, from a macro prudential perspective, you need to promote credit in the economy to get the economy growing, but when you talk to the micro prudential supervisors, they remember the crisis". Micro supervisors remember that securitisation was at the heart of the crisis. They accept that the stigmatisation was perhaps unfair, but they raise very valid issues. The speaker indicated that it is up to the macro prudential people, those who want to promote growth, to make the case and the micro prudential people to listen to the facts and perhaps get over a little bit the emotion that is attached to securitisation in the crisis.

According to him, work should proceed on regulation to promote securitisation, so long as it is on a sound and stable basis, but it is very important to define carefully what is a good securitisation.

8. Concluding remarks: Jacques de Larosière

I was very interested by this session. I fully agree with those who say that structural reforms are, in some countries, absolutely essential to kick start growth and I think you were right to say that in France credit is relatively abundant. The latest figures of French SMEs that state that they have difficulty in finding credit is only 27%. So you have 73% that are satisfied. This is relatively high, a bit diminishing nonetheless, but relatively high and still employment is not rising and the economy is very dull and it is absolutely clear that structural reforms constitute an immediate task to perform if we want to reduce the burdens that weigh on the enterprises, on their capacity to invest, to innovate and to continue their activity. On that I fully agree. In some cases structural reforms are not at all the old story that we repeat, it's an absolute immediate must.

I also think that the problem of deleveraging is relatively complex. It's not universal. It's not homogenous, but it is also true that imposing a more than doubling of the equity base on the banking system of Europe and to achieve it in, let's say, two to three years is something by definition traumatic. It took something like 100 years to achieve that in the period before. So doing it in three years is bound to have some structural consequences on the balance sheets of banks. We have studied those consequences. There may not have been an enormous amount of deleveraging, but if you go into the different countries and you disaggregate geographically this virtual European bank, you see that there is a lot of deleveraging and not only in the construction sector, and if you look at the rate of satisfaction of enterprises in terms of access to credit, you see that in some countries it's historically unknown. It's really a credit crunch.

So I don't think there's one solution to all these problems, but I believe you have to tackle the problems in a very specific and concrete way. When you see that the deleveraging is not the "good" one, to use the expression we used in the paper, you have to ask the questions on why isn't it? And what can we do to regain the credit channel that is more or less blocked in a large part of the area today? In that respect the idea of some form of high quality securitisation is something obvious, one has to do it.

Now, some say, as you have intimated Jose, that this is not going to free a lot of capital because it's high grade stuff and that quantitative easing should perhaps enter into a layer of less high quality assets. Of course, this would be a transfer of bad risks to the Central Bank and that is something that a Central Bank is very reluctant to accept. So one has to imagine some forms of support or enhancements which can involve public sector institutions specialised in long-term finance. That could help kick start those intermediary layers.

So I would like to finish by saying that we all say that we need action and we don't need more words because we're a bit fed up with words. And one institution that has taken action is represented on my right side. It's the ECB. Last Thursday they took decisive action. It's of course not sure that that action is going to change magically everything and cure all the evils in Europe. We know that that's not true and we all know that monetary policy should not be asked to do too much, because it's not the way it can act in a durable fashion, but it has taken action, forceful action. And I think we should help the ECB to build a success story.

I believe that it's not the role of the ECB to do all the buying of asset backed securities I think they can kick start things, but I also believe that there should be a true market and to have a true market, we have to get together with the buy side and the insurance side and the savers and try and develop a market. In order to do that, you have to look at the aspects of some of the regulations which are actually stifling the mere possibility of insurers or pension funds to buy some securitised assets because they are extremely penalised, not even taking into account the quality of the assets that are underlying. So we have to amend those rules. They're not very complicated. One is Solvency II, one is in the Basel regulation and that could help because I think the ECB policy would be much more credible if it were not the only one to do the job.

1. The speaker referred to the "three contingencies" that may lead to further monetary policy actions and which were developed in the speech of Mario Draghi delivered on 26 May 2004 at Sintra:" First the common effect of exogenous factors, including the exchange rate, on euro inflation. Second the asymmetric effect of endogenous developments, such as tight access to credit for parts and sectors of the euro area. And third, the risk that those effects combine to generate a more persistent regime of excessively low inflation.

Revitalising the market for securitised loans in the EU

Objectives of the session

The objective of this session was to clarify the conditions for an appropriate use of securitisation to address the reduction of lending to the economy, and particularly to SMEs. The potential benefits of simple and transparent securitisation were described as well as the conditions to achieve such characteristics. In this perspective the panellists were invited to comment on the proposal made by Eurofi for launching Prime High Quality Securitised (PHQS) products.

Finally another target of this session was to describe the drivers for revitalising the market of securitisation e.g. role of the public sector, impact of the ECB ABS purchase programme, necessary evolutions of financial regulations impacting the investors in such products (insurance companies, banks…) as well as the regulatory agenda required.

Background of the session prepared by Eurofi

There is an urgent need for a solution to address the reduction in lending to businesses, particularly in the Eurozone (-2.3% in June 2014 year-on-year). Naturally, this average includes some particularly difficult situations in the peripheral countries. Indeed, the bank-lending channel of the monetary policy has not been functioning properly since 2012.

At a time when Member States are justifiably working to reduce their budget deficits, with constrictive impacts notably on the Eurozone's economy, monetary policy is seeking to promote growth. However, many of the significant measures decided on by the ECB a few weeks ago are not likely to have a significant impact in terms of kick-starting bank lending. Bank lending is indeed being held back by several factors including the updated regulatory constraints of CRD IV (capital, liquidity, leverage) and the weak level of profitability of banks which is reducing their ability to attract fresh capital in order to satisfy these constraints. This interpretation is confirmed by the ECB's analyses.

In this context, as proposed by the Commission in its communication on long-term financing for the European economy a few months ago, it appears to be both essential and urgent to relaunch high-quality securitisation. Securitisation indeed appears to be the most promising instrument to help provide additional sources of financing to SMEs in particular, which are very dependent on bank financing, as it is a way of reducing banks' balance sheets and therefore of increasing their capacity to lend to the economy.

A relaunch of the securitisation market, which is sluggish in Europe, nevertheless requires strong actions to be taken quickly in order to restore sufficient confidence among policy makers and investors. This requires offering investments that are not only transparent and predictable but also positioned on assets with a low exposure to asset bubbles or to economic contingencies. This also supposes building in the E.U. a strong consensus among banks, investors, central bankers and legislators, on various issues: the necessity to eliminate potential legal risks, to align the interests of the banks (which are transferring their loans) with those of investors. Finally how to eliminate the risks associated with the modelling approaches implemented for structuring these products has to be discussed.

The precise ways to achieve the so-called high quality securitisation (e.g. reduced number of tranches, loan-by-loan information, extensive data history on underlying assets, retention by banks of a portion of each tranche, legal certainty concerning asset ownership, etc.) also have to be specified.

Consequently we are suggesting creating a new category of securitisation – a prime high-quality securitisation (PHQS) – based on loans to very high-quality SMEs and subject to requirements both in terms of securitisation process and of choice of underlying assets (see Eurofi proposals in the paper published).

We propose restricting securitised assets part of this new category, to SME loans of unquestionable quality conforming with criteria stricter than those set by the European central banks for accepting them as security for refinancing operations (e.g. companies with a three-year default rate of less than 0.4%).

Checking the quality of the businesses benefiting from the bank loans is a key point within this approach. It requires a common methodology under the control of the central banks. Some central banks of the Eurosystem already have the capacity to rate SMEs. Those that do not can rely on different instruments that they can validate (banks' internal models, external agencies...) in order to achieve the same results.

In addition, the potential investors for this type of product - insurers, pension funds, funds, banks - must be able to participate in such a market. For this their regulations and particularly the delegated acts of Solvency II must be calibrated based on the specific risks associated with these very high-quality assets, which have nothing in common with the financial products that were at the origin of the financial crisis, completing the first identification of high quality assets defined by EIOPA.

Provided that very strict requirements in terms of the securitisation process are met we believe that PHQS should be subject to a regulatory capital charge similar to the level that would be applied for the underlying assets they hold.

Similarly, European authorities must take into consideration the quality of these PHQS in the new regulatory approaches defining the capital charges required for banks investing in these securitised SME assets, being calibrated by the Basel Committee - BCBS – that currently would be around 7.5 times higher than the levels applied for unsecuritised assets of the same quality.

Summary of the session

1. Regulatory challenges related to the revival of the EU securitisation market

The representatives of the public institutions in the EU are very supportive of reviving securitisation in the EU. They consider that the securitisation market is one of the building blocks of the capital market union; securitisation indeed will help diversify the financing mix of the European economy and thereby will help to make it more robust. It also contributes to financial stability, as it has the potential to reduce risk in the Euro zone financial system. Yet they explained that the Capital Market Union should not be only about fixed income products, but should also address the development of cross border equity investments because having risk being shared across borders is a fundamental factor of resilience.

The panellists as a whole agreed on the fact that it is more about creating a market than reviving one. Furthermore, one panellist said that a stigma exists among EU citizens though the securitisation market was virtually non-existent in the EU. Consequently the challenge is to fight the stigma and deal with something that is actually quite new for the EU. A representative of the private sector stressed in that respect that to bridge the confidence gap - given that the reality of the product is not that dangerous and the perception of it that is much more frightful – requires a well regulated framework so as to drive a lot of things simultaneously. He declared that if in the EU we qualify a certain category of products, which will be given a specific regulatory banking, investors, insurance, etc. treatment, and finally those products are preferably bought by different public development agencies or bodies, this will create the conditions for having better confidence.

One aspect mentioned as critical to restore confidence, is the high quality securitisation label proposed by the EIOPA on the basis of a number of underlying criteria. This proposal, which takes into account the lessons learned from the past, is considered as a breakthrough. Several panellists however suggested further thoughts in that respect. In particular they stressed the need to be very careful that central banks or regulators do not remove responsibility from market participants. In this perspective they underlined the need for due diligence regarding the quality of securitisation to remain on the side of the market and not on the side of public authorities. Finally the panellists agreed on the fact that the definition of a label requires to be demanding.

Another panellist however stressed that to support this market we not only need action on the regulatory side but also a joint effort between regulators and market participants regarding (financial market) infrastructures, registers, templates, transparency, IT issues, etc. for information sharing. There is also a need for an economic model he concluded.

Many participants on the panel also stressed the need for anything done in Europe being included and consistent with the broader framework being built by the BCBS and IOSCO.

However a representative of the public sector, suggested that the EU be a first mover on the revision of the regulation regarding securitisation, as there is much less appetite in our US friends to tackle this, due to the very big difference between the markets on both sides of the Atlantic. He stressed that the EU cannot really afford to wait too long to start discussing that question. He suggested in particular that the EU should use the opportunity of the delegated acts on Solvency II to push it a bit further, provided in addition that one may fail to understand why as investors, insurers should have more stringent calibrations than what is currently discussed for banks.

A public sector decision maker insisted in that respect on the fact that the objective of the European framework dedicated to securitisation is to facilitate the channelling of financial investments to the economy, in the context of a six-year economic crisis. Consequently, mentioning SMEs and also infrastructures he proposed that whereas regulators should remain neutral, they should first look at those underlying assets that can be best leveraged to foster economic growth in Europe, even if related securitisation products are less developed or more difficult to analyse.

A panellist commented on a proposal tabled by France and Germany, which was inspired by different existing work streams such as BCBS, IOSCO, EIOPA, or Eurofi. He said that its key feature is to propose a European regulation based on principles common across financial sectors and neutral in terms of assets. Indeed he stressed the fact that from one country to another you can have a different situation, between SMEs and mortgages for instance, regarding the best economic model for securitisation. He acknowledged however, that naturally certain financial players might require some regulatory specificity as for instance for the LCR regarding banking regulation that is not needed for insurers.

2. The role of the public sector in the re-launching of the EU securitisation market

Regarding public intervention there are two different issues, one is the ECB as purchasers for monetary reasons, and the other one is the definition of the type of public intervention desirable to help reviving the market. The differentiation of the two is critical if in the EU we want to provide the appropriate incentives. In particular generating a blanket guarantee similar to what is enjoyed in the US is probably not the appropriate model for Europe.

The ECB ABS purchase programme

A panellist reminded the audience that the target of this programme is to support lending to the real economy and ultimately to bring inflation back to two per cent. It is primarily a credit-easing programme with two legs targeted one is LTROs, targeting liquidity provision, and the other is the ABS and covered bonds purchase programme which provided a relief on banks balance sheets.

To this end the ECB will buy a broad range of ABSs based on loans to the real economy originated in the Euro zone. He explained that the ECB will apply strict criteria in terms of risk, hence it cannot be said that the ECB is turning into a bad bank. Actually the ECB will limit risk very strictly in accordance with existing principles.

The role of public guarantees

Many panellists acknowledged that there is some confusion about the role of public guarantees in securitisation. Public guarantees are not needed for the ABS purchase programme to be a success. Actually the possibility offered by the ECB to accept guaranteed mezzanine tranches, was only a bonus in the general monetary easing engaged by the ECB.

Conversely some stated that targeted public guarantees can be useful to support the development of the market as a whole but have nothing to do with the monetary policy.

However, many panellists agreed on the fact that though actually the reason why the US securitisation market has expanded to such an extent is that it is massively publicly sponsored, in the EU we should not do that but rather remain within the boundaries of privately managed risk and limit the extent of public guarantees. They explained that it is better in terms of market incentives to have good risk management by market participants and limits to moral hazard, even if consequently the securitisation market will remain much smaller than in the US.

Why development banks like EIB are interested in securitisation

A public sector decision maker explained that securitisation as a pool of assets reduces concentration risks for those investing in the long term in the real economy. The purpose of public development banks is therefore to generate a catalytic effect, he said and he reminded them that in this perspective the European investment fund increased its capital last year to further enhance its activity in the SME securitisation world with the purpose of facilitating the risk absorption of the layer of risk that finds such difficulty today to be absorbed by the market.

Many were of the opinion that public intervention should be envisaged more in the form of either targeted guarantees or purchases by development banks of mezzanine tranches. In this respect the SME initiative of the EIF/EIB is meant to facilitate the use of public funds to enhance the credit risk of securitisation transactions in the SME space to attract private resources and contribute to the creation of a securitisation market in the SME space.

Finally representatives of the public sector explained that development banks' initiatives do not target eliminating due diligence by investors. In particular when development banks talk about high quality securitisation they actually seek defining labels to enable the customer to decide which kind of securitisation they prefer. The label - by defining different layers of quality or expected quality - brings simplicity and legibility but does not replace the due diligence for each single securitisation. In that respect provided that SMEs risks are very diverse, the banking sector and probably the SSM should standardise at the EU level, SME risk classes that should facilitate but not to replace due diligence by investors.

3. Simplicity, transparency and consistency to restore trust and confidence in this asset class

A lack of trust and confidence in securitisation as an asset class

A panellist informed the audience about the initiative of the task force of IOSCO and the BCBS to support the revitalisation of the market, which surveyed more than 100 regulators around the world and similarly 100 investors, issuers and market intermediaries around the world.

The issue revealed he said, really comes down to a lack of trust and confidence in securitisation as an asset class. Why? The negative perception generated by the crisis is only one factor, and there are another three important factors, which are regulatory consistency, regulatory certainty, and the fairness of treatment with the similar risk asset classes such as covered bonds. Indeed for investors, particularly non-bank investors currently the risk/return profile of securitisation products does not fit with what they are looking for and they find a better return in other assets.

A panellist stressed that having 25 years in securitisation in Europe, it is quite amazing that we have not really progressed a lot. To solve the issue he stressed that we need not only to define principles but it is important that we should stress that they are all endorsed and we can assert: "here are what we consider to be good principles for good securitisation, simple, transparent and consistent". Indeed the key is actually about restoring and - most importantly - maintaining a sustainable real money investor base that has obtained trust and confidence in this class, particularly the real money investors. What is important is to structure transactions not to attract current investors but to bring in new real money investors. Indeed simply making it easier for banks to buy the securities does not build a sustainable market with real money investors. This includes finally creating securities that are in fixed income indexes that actually you need to buy.

He concluded by saying that the public sector has a role to play there to define the features or criteria of those securitisations involving investors and issuers to define simple, transparent and consistent securitisation - STC. In this perspective, he said that within that framework public decision makers have focused on the three key areas of risk: asset risk, structural and servicing risk, and fiduciary risk.

Removing existing inappropriate regulatory de incentives imposed on insurance companies should enable the economy to leverage their long-term liabilities

Many panellists recommended an approach that is a principle based defining general condition to look through the securitisation and access to risk and returns of underlying assets. These principles should be around three aspects, they proposed: firstly the underlying pool of assets, which should be homogeneous to facilitate risk and return analysis, it should also be of good quality with a risk profile that we can measure, i.e. having historical data on performances. The second aspect is linked to securitisation structures, which should be standardised and simple and in particular not allow for over complexity and negative risk transfer. The third aspect is transparency both at the moment of the origination criteria, and also on an ongoing basis on the performance of the underlying pool.

In addition Regulation should not discriminate against the various tranches of a given securitisation (the proposal of EIOPA excludes from the A category non senior tranches). It should apply at the transaction level rather than at the tranche level, because securitisation is both a funding mechanism and a risk transference mechanism, and the mezzanine and junior tranches should not be penalised for allowing banks to use them to transfer risk.

The focus should be on soundness and transparency rather than quality of assets and simplicity

However an executive from the private sector warned that creating a whole new set of guidelines based on the concept of having safety is going to be problematic for what is already a misunderstood financial product. Firstly we have the risk of over complication and in addition this concept of prime or high quality securitisation is creating the wrong kind of perception, because by definition the concept of a regulation that would make you risk free is flawed. In particular in the case of SMEs, which are by definition not high quality.

High quality seems the wrong word, he suggested, the concept of sound and transparent seems much more interesting. In particular we completely agree on the need for transparency; the ECBs concept of a European data warehouse where you can actually centralise information and make it consistent, makes sense and avoids layering, increasing harmonisation. Finally there is no reason to have the government, the ECB, or any policy to come in and create an artificial layer that gives people some kind of comfort. You cannot allow investors to think they are buying a super triple-A type piece of paper. Another panellist added that maintaining a level of responsibility on the origination side is critical. He also explained that the secondary market is instrumental to creating the right condition for the product itself to thrive. Finally he was of the opinion that one should fear in the EU the situation where the ECB is the only buyer of ABS. The EU needs a real market.

The survey of IOSCO also suggests that real money investors are likely to be far more interested if we can reduce the product complexity, if we can improve disclosure and most importantly standardisation - the documents, etc. - making it easy that the last deal that they looked at will be the same as the next one. These features will actually help them to better assess the risks and the returns of the products and also to reinvest in the next deal. However a participant from the banking industry stressed that the concept of over simplification is not relevant: to oversimplify something that works - actually securitisation in 99 % of the cases has actually worked - is inadequate. Thinking that simple means three tranches in a securitised structure, is flawed.

Finally this representative concluded by saying that regulators have to factor in that the investor's knowledge at the moment is higher as a result of the crisis, higher than it has ever been and actually in Europe investor knowledge is akin to that in the United States, which grew up as a credit market. Consequently he said, we should focus on the origination and quality as opposed to regulating and getting over complicated.

Two different steps to improve the regulation regarding securitisation

In this context a panellist explained that regulators should take a two-step approach. One step is an overall framework defining a simple, standardised and transparent securitisation, which removes complexity and favours sound and sensible securitisation structures.









G.Bichisao

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The second step concerns the definition of capital requirements.

However one can also see some logic in going forward making a distinction among the assets securitised in Europe. In particular there is a question regarding whether all SMEs would be justified in going into high quality securitisation categories. Indeed some of these SMEs are highly risky.

4. Addressing inappropriate gaps in insurers' regulation between underlying asset capital charges and those applying to related securitisations

The real risk of securitisation

The cumulative default rate of European securitisations that were outstanding as of the middle of 2007 is only 1.6 per cent and for the SME it is 0.55 per cent. Looking at the securitisation market over the crisis there has been not more than 0.14 and even a zero per cent default rate. The US base of the securitisation over the course of time has also very similar numbers, the exception being sub prime.

Actually people are mostly focused on a very small line, which is the CDO item. CDOS are leveraged securitisations; they have actually got into difficulty. Yet within the European securitisation market, which has managed since 2007 $2.8 trillion, only $29 billion are CDOs. However this specific line is unfortunately creating a negative around securitisation. The whole idea here is to get money into the real economy; most of securitisation, 99.9 per cent of it, is actually real economy oriented.

Further neutrality of the calibration of insurers' regulation is necessary

Insurers are key in the provision of long-term investment and to help to provide financing for the economy. Because we have long-term liabilities we have an appetite for long-term financial assets and consequently for reviving, revitalising, rejuvenating the securitisation market and specifically creating high quality securitisation. However a panellist said, insurers currently face regulatory barriers to invest in securitisation.

Another panellist acknowledged that first moves towards specific calibrations for high quality securitisation are good in principle but they are however still too restrictive and punitive in terms of capital charges he concluded.

The panellists agreed on the fact that in this respect there is an issue regarding the concept of the neutrality of the calibration. According to this concept of neutrality capital charges of securitised products should be similar to those demanded for related underlying assets should investors directly hold them. Yet the proposed calibrations made for the two-labelled categories defined by the EIOPA stem from existing data available suggest that actually securitisation products did not perform in stressed situations similarly to related underlying assets.

Finally regulators consider that they have to address the risks embedded in securitisation techniques such as legal risk, counter-party risk, etc. They express the need to avoid a situation in which similar products to those that were widely sold in 2003/4/5/6 are again being offered to insurers with the rubber-stamping of regulators. However many from the public sector, acknowledged that in certain circumstances - senior tranches of high quality securitisations - the gap between the underlying asset capital charge and the securitisation is not logically credible. A regulator proposed to this end to leverage the Solvency II framework, which brings in the idea of a look through approach. It is worth considering for this type of assets, for this type of super high quality senior tranches, not mezzanine, not equity. It could be the solution to the problem that we all are facing.

Retention rule

The panellists agreed on the fact that the originator has to keep a substantial amount of the risk (retention of a portion of the securitisation) in order to align its interests with those of the investor. Asset managers and investors considered that the percentage of five per cent is not sufficient. For their part, when they create a fund of SME loans - which has the same objective as securitisation - they ask the bank who originates these loans to keep between 10 and 20 per cent of the risk of the loan. Indeed they said that the quality of risk for SMEs is very dependent on the quality of the entrepreneur and we can do all the analyses, but at the end of the day the quality intimacy of the bank with this SME is fundamental.

A representative from the banking sector objected that in fact the risk retention rule until now has provided a lot of flexibility e.g. you can retain risk at either a horizontal or a vertical level. Yet is the securitisation market better? He asked. He concluded by warning that trying to impose restrictions and put more risk retention in place at even higher levels is going to further deflate the market.

5. Liquidity issues of securitisation products

Insurance companies are, to a large extent, market-to-market investors. In this context the liquidity of the assets they invest influences their ongoing valuation. This is why many investors lost a great deal of money in 2007 and 2008, they did not because the underlying pools defaulted but because mark-to-market prices of securitisations were damaged.

It is necessary to create the conditions for investors to permanently access assets prices freed from pricing risks due to huge liquidity crises such as the one faced because of the subprime crisis. One condition would be the creation of an efficient market implementation of many of the regulatory principles already quoted – homogeneity of underlying assets, transparency, etc. that will help to permanently measure the risk and the value of the securitisation. The principles being identified to improve the transparency and the soundness will also help to improve liquidity and reduce the volatility of market risk if the asset is homogeneous. It is also very important that a few benchmarks help to orientate investors on the fair price of what they buy or hold.

However these products will not have sufficient liquidity; this imposes higher yields. This explains also the need for industrialising securitisation to reduce the cost of the structuring of securitisation in a context of limited yields. In addition there is still the issue about exogenous market risks impacting the asset class and how do investors deal with that?

6. The use of external ratings for calculating capital requirements

A panellist from the financial sector, stressed that we are currently experiencing a regional divide between the US and Europe, regarding the use of external ratings. Indeed following the crisis US lawmakers imposed not to rely on the ratings from rating agencies. Consequently in the US the use of external ratings for calculating capital requirements is prohibited i.e. US banks use the so-called simplified supervisory formula approach. Conversely in Europe for any transactions that banks have not originated themselves, the use of rating agencies is mandatory. This poses level playing field issues, he said.

This is the reason why the banks advocate in the EU allowing for a rating-free risk sensitive approach, based on sound models involving parameters controlled by supervisors, who allow the classification of the different types of securitisation products and define the appropriate capital charges. These approaches should also enable the supervisors to appropriately assess the risk of securitisation, he concluded.

However another representative of the private sector reminded the audience that rating agencies have learned the lessons of the crisis so when they make a rating they look at the underlying collateral, historical default rates, correlations and market structures. In addition he said, they have made criteria and assumptions more transparent and put them on the web so the market place people can do sensitivity analyses.

Stimulating EU corporate bond and equity markets

Objectives of the session

This session was devoted to discussing the regulatory and market-driven actions needed for further developing capital markets and more specifically corporate bond and equity markets in Europe in the context of a reduced availability and lending horizon of bank credit. The discussion put a stronger focus on the financing of small and mid-sized companies, but issues concerning larger corporate securities (e.g. the liquidity of EU corporate debt markets, the tax bias towards debt…) were also covered. Broader issues related to the objective of building a "capital markets union" were moreover discussed.

Background of the session prepared by Eurofi

Developing market-based financing mechanisms is a major objective in the EU

Developing alternative sources of financing in the capital markets is critical for EU corporates with the expected reduction of bank lending due to Basel III capital and liquidity rules. EU securities markets appear to still have a strong potential for growth and improved liquidity when comparing them with the US (or comparing between EU countries). Many measures have been proposed or adopted by the EU Commission and some Member States since the beginning of the crisis to facilitate the financing on the capital markets of EU SMEs and midcaps in particular. They build on recently reviewed and completed capital market frameworks which provide common rules for the admission to trading and publicity requirements of EU securities and for their trading and post-trading as well as EU investor protection rules.

These measures include EU regulatory regimes for venture capital (VC) funds and European Long Term Investment Funds (ELTIF) as well as a framework for crowdfunding. A specific label for growth SME securities markets has also been created in MiFID II to increase their visibility and reduce administrative burdens for SMEs while maintaining high levels of investor protection. Additional regulatory proposals include a proportionate disclosure regime for SME issuers in the Prospectus Directive and an extension of UCITS eligible assets to sufficiently liquid securities listed on SME growth markets and of ELTIF assets to listed SMEs. Actions have also been put in place on a domestic level to foster bond issuance for unrated companies: private placement regimes (e.g. in Germany or France), mini-bond or retail bond markets (e.g. in Italy, UK). Facilitating a central access to SME data at EU level and developing a uniform risk assessment or credit scoring methodology are also being worked on.

Actions proposed to further stimulate EU corporate bond markets

There has been a strong increase in the volume of corporate bond issuances in the EU since the crisis which has approximately matched the fall in bank credits to corporates.

The EU corporate bond market however still offers limited secondary market liquidity and is highly fragmented with sporadic issuance and varying characteristics and maturities. This increases spreads and transaction costs and diminishes returns for investors. MiFID II should contribute to developing transparency and liquidity and encouraging electronic trading of bonds, but such evolutions are still at an early stage. Some participants suggest that further standardising corporate bond characteristics and their issuance at set maturity intervals in order to reduce the number of individual bond issues would foster liquidity, although others are concerned by the loss of flexibility this could lead to.

Additional measures are proposed to stimulate the issuance at a European level of bonds by unrated large SMEs and midcaps. Setting up an EU private placement regime and/or a mini-bond platform is proposed by some stakeholders in particular for issuances ranging between around € 20 and 200 million, which are too low to absorb the cost of a public issuance of debt. Regimes for these products exist in different EU Member States but a more standardised EU approach, possibly completing the existing domestic regimes, could help to increase the scale and liquidity of the market and further encourage cross-border investments. Suggestions have also been made to develop a single harmonised framework for covered bonds as their issuance remains largely un-harmonised.

Actions proposed to further develop EU equity markets
Equity markets have not grown significantly following the crisis in Europe, unlike bonds. The number of Initial Public Offerings (IPOs) has however substantially increased since the end of 2013 in several EU markets (UK, France…).

MiFID II measures which aim at improving price formation and transparency should help to stimulate EU equity markets. Several issues however remain to be addressed.

A first issue is the bias towards debt that existing tax systems create in the financing decisions of companies which many stakeholders believe should be removed. More equity financing may indeed foster additional growth allowing companies to better diversify their sources of financing and increasing their ability to raise additional loans by improving their capital structure. Interest payments on debt are tax-deductible for issuers under most income tax systems, while the cost of equity capital is not, which may hinder equity financing, even if fiscal incentives on the investor side are usually more favourable to equity. The potential impact of the EU Financial Transaction Tax project on equity markets is also stressed.

A second challenge to be tackled is creating a more favourable market environment in the EU for SME and midcap equity trading and for IPOs. Many observers consider that MiFID I has led to a concentration of a large part of trading in the EU on blue chip stocks which has consequently damaged the SME equity market ecosystem (specialized or local brokers, analysts, lawyers, liquidity providers). The creation of SME growth markets in MiFID II aiming at stimulating these markets across the EU should help. Some participants stress that the priority is redeveloping local SME markets and providing support to SMEs wishing to raise capital, building on initiatives put in place in several EU trading venues. Additional measures such as tax incentives for IPOs have also been proposed, as well as incentives to encourage institutional investors to engage more in active investment rather than index investing. Other measures suggested include supporting venture capital and private equity funding notably with targeted actions from the European Investment Fund (EIF).

Going towards a deeper integration of EU capital markets is an objective ahead

A challenge ahead is achieving a greater integration of European capital markets potentially leading to a "capital markets union", as called for by JC Juncker, in order to "reduce the cost of raising capital and increase the attractiveness of Europe as a place to invest". There is still a strong home bias in the issuance and holding of securities which limits the appropriate allocation of capital throughout the EU.

Further integration of EU securities markets is hindered notably by a lack of harmonisation of the legal regimes applying to these securities. One area is laws relating to rights in securities (e.g. property rights) which differ across EU countries. A second area is differences in insolvency laws which may hamper the development of a wider cross-border private placement or mini-bond market for example. Yet another area is tax regimes with diverse regimes in the EU for withholding tax and relief collection procedures by non-resident investors for example. These issues are however quite contentious potentially because solutions impact national legal and fiscal systems. They are therefore usually viewed as a medium or long term project.

In addition some areas covered by existing EU frameworks may need further harmonisation. This is the case for example of exemptions from the prospectus regime which are not always applied by national regulators in a consistent way. Further harmonisation is also required in the post-trading area concerning e.g. corporate actions.

Summary of the session

1. The EU and global economic and prudential context

Stimulating corporate bond and equity markets in Europe is a major objective for regulators, enterprises and EU Member States given the current economic and prudential environment, a regulator stressed. Capital markets are indeed a "necessary alternative" that is needed in order to fill the financing gap that is likely to be created by a higher selectivity of banks.

Another regulator emphasized that growth is the main problem that Italy notably and more generally continental Europe are facing. Finance is a key instrument for fostering growth because it is a way to link up savers and the real economy by channeling savings into the real economy. A major problem at present is that European small and mid-sized enterprises (SMEs) which are essential for growth and job creation still have difficulty in getting appropriate credit and growing, six or seven years after the beginning of the crisis. This is not a problem of available liquidity but at least in part a problem of regulation e.g. of the financial instruments and of the trading venues that should be better adapted to the needs of SMEs. Also, at present, credit is shrinking not only because banks have higher prudential requirements but also because companies are refraining from investing in the current market environment, which is a broader economic issue.

An industry player offered a perspective on the attractiveness of Europe in terms of investment. There has been "a myriad of measures" to foster growth notably in the US including near to zero interest rates, credit easing policies followed by some form of quantitative easing (QE). "It is about time that the US FED starts trying to reverse or dis-accommodate easy monetary conditions", the speaker stated. There is also now "a lot of differentiation" across emerging markets and the big economies that used to drive large premiums in emerging markets are at present pretty much stabilized into "a more tepid growth path". In this context Europe is "squarely at the centre of the global investment arena" in the speaker's view. The challenges big sovereign wealth players in particular are confronted with are their large portfolios in fixed income and also getting higher return from their investments given their present liabilities. In Europe these players are going to look for three main things: whether there is more activity in private equity which would be a very attractive signal for many global institutional investors, the degree of confidence one can have in the EU financial sector (i.e. whether stress tests for example are properly conducted) and thirdly the degree of financial innovation. In terms of innovation the repo market has a strong potential. It is at present counteracting the reduction in unsecured lending to a large degree. Socially responsible investing is another area of interest for large institutional investors. The speaker finally emphasized that one of the biggest drivers of the financial crisis had been "the outsourcing from emerging markets to Wall Street". In many ways Europe could be a robust and broad platform to house such assets given the current appetite for risk and provided there is an appropriate development of capital markets. In this perspective regulatory reform should not just impede bad risk taking it should encourage good risk taking.

2. Needs of different types of companies and investors

Financing needs of different types of companies and obstacles in the use of capital markets

Several speakers stressed that the financing needs of companies mainly depend on their size.

The largest mid-sized companies want to be able to diversify their financing options and to have both equity and bond partners in order to preserve their independence, a market observer emphasized. Successful mid-sized companies need bonds and ideally convertible bonds for their financing, but they are very cautious about going to the market because they are afraid that the information they will be publishing on this occasion may be used by their competitors. For smaller SMEs capital markets are very difficult to access and these smaller companies will continue to rely mostly on bank financing. Some can however use venture capital or crowdfunding, which is why having a European approach of such instruments is very positive. For these smaller SMEs public banks such as the Caisse des Dépôts in France, the CDP in Italy, ICO in Spain or the KFW in Germany should also play a major role. An idea to attract more savings in the direction of SMEs could be to set up funds managed by the major European public banks offering some kind of guarantee to individual investors or a European investment savings fund which could invest in loans, equity or bonds according to the sectors concerned, with national quotas in order to maintain an appropriate balance across countries in the investments received.

An industry player agreed that the size of enterprises is a key determinant of their capacity to access the capital markets. It remains difficult for SMEs to access bond markets, even if the minimum thresholds to issue private placements are much lower than for the public bond market. € 30 million of turnover or sales seems to be a minimum size for issuing bond instruments such as private placements, although there might be some exceptions. Different instruments might be better adapted also to some types of companies. Mini-bonds which exist in Italy for example are considered to be quite helpful for the smaller mid-sized companies. Companies with a turnover of more than € 2 billion usually have access to the financial market but may also use private placement in order to get some experience on the way to call on the market for funding. For smaller SMEs with a turnover smaller than € 30 million bank financing will remain the main option and securitisation can bring a useful contribution in the financing of such companies.

A financial industry player explained that companies wanting to access non bank sources of financing (e.g. bonds and equities) and particularly SMEs have to meet at least three conditions: they need to become more transparent, to adopt a robust governance model and to be able to communicate a sound strategy. The problem is that most of the time SMEs do not comply with these three conditions and this reduces their capacity to access the capital markets. There are cultural factors that can explain this situation, particularly in Southern Europe.

Another industry player explained that the level of confidentiality asked by issuers was another constraint. For EuroPPs for example, a type of private placement used in France, there is a negotiation under confidentiality rules between the issuer and each investor usually through the intermediary structuring the deal (a bank normally). Asset managers investing in such instruments may keep the confidentiality agreement at their level or pass it on to the final investor, for example in the case of mandates or dedicated funds where end investors will quite often want to be informed directly. This will allow the investor to further negotiate the covenants in particular. For EuroPPs it is indeed possible to negotiate covenants in the same way as with banks that lend on their balance sheets.

Obstacles to the engagement of retail investors in capital markets

A retail investor representative claimed that the further development of European capital markets requires first of all a return of investor confidence because savers, and not the intermediaries, are the real buyers of stocks and bonds. The confidence of retail investors was undermined by the events of the financial crisis and has not improved since with the returns on equity and bond investments which have been "quite unattractive" over the last years.

A recent study shows that since the year 2000 investors in the stock market have lost on average 1% per year net of inflation, corresponding to a total decline of 13.4% over the last 14 years. And this period is very representative of the market over the medium term in the speaker's view because it includes two upswings and two downswings in the market. In bond markets, the situation is not very favourable either. The best signatures offer a long term return of about 1.5% corresponding to a real pre-tax return of about 0.5 to 1% and in most countries to a negative return after income tax. The performance of intermediated investment (i.e. investment funds) which has developed significantly in Europe at the expense of direct ownership has not been very strong either. According to the same study 59% of European equity investment funds did not beat the index of European equity over the last ten years. This is not the consequence of any lack of skills of portfolio managers, but of the "huge fees" that are taken by the portfolio management industry to cover its own costs and also to serve the distribution sector, the speaker claimed.

In the bond market, the share of individual investors is still far too low, the investor representative believed. The problem is that providing good access to the market, is difficult at present for retail investors. Buying a bond on the primary market is quite impossible for them because most issues are reserved for a limited number of institutional investors. The secondary market is also difficult to manage for retail investors due to the limited transparency of the issuance process and to liquidity problems, unless a sufficient market making capacity can be introduced. MiFID could help to improve the situation but this has still to be further assessed. The direct investment of retail investors in bonds (high yield or SME bonds) or securitized products also raises investor protection issues. The conditions under which retail investors could take on the risks that banks usually bear when they provide companies with credit still need to be clarified. Two issues need to be further determined in particular: the access that can be provided for credit-rating data and methodologies and whether market participants will be able to develop sufficient research on SMEs in the context of the proposals made by ESMA about inducements which are currently being consulted upon . Developing new types of bonds is not necessarily a priority according to the speaker. The focus should rather be on developing simple products that fulfill both the interests of investors and issuers.

A regulator agreed that transparency is an issue in the bond market if one wants to increase liquidity. The market is a buy-and-hold market mostly and the issuance process intermediated by banks is not always very transparent. The regulator added that more generally a difficult balance needs to be found between two objectives: rebuilding the confidence of the general public in the financial and capital markets and alleviating the administrative burden of small and medium-sized companies which means allowing them to go to the market with less legal and administrative constraints than larger companies. The key issue however is diversification i.e. for investors to diversify the risks they take when investing in equity, bonds or other types of credit and for issuers to diversify their investor base, even if it will be difficult to attract average retail investors to invest directly in SMEs.

An industry player explained that investments in bond instruments adapted to mid-sized companies such as mini-bonds, Schuldscheine, Euro Private Placement (EuroPP)… are at present only made by institutional investors, because of the lack of liquidity in these markets. But these instruments could potentially be extended to retail investors under certain conditions. Retail investors could for example put money in long-term investment schemes which would invest in such non-listed bonds.

3. Actions to be conducted for further developing capital markets in Europe

On-going actions to develop capital markets

The market is currently in a cycle of positive innovation a regulator believed. Market intermediaries and issuers are already exploring alternatives to bank funding with the development for example of private placements, new types of loan funds, green bonds and an IPO market that has become more dynamic. Corporate bond markets have also been expanding over the past few years. Worldwide they have almost tripled since the year 2000. Bond markets currently benefit from an "appetite for yield" in a low interest rate environment but they remain fragmented. This increase in volumes does not seem to have triggered so far a higher level of harmonization in issuance and trading practices.

Moreover, in order to develop different types of financing such as loans or bonds adapted to SMEs, buy-side players are partnering with banks that play an important role as intermediaries structuring such deals.

Capital markets need an appropriate regulatory framework that could be more favourable to long term investment and able to reduce the burden for issuers, a regulator added. Many actions have been launched or initiated both at the European and domestic levels to support the development of EU capital markets. There has been a focus since the outset of the financial crisis on improving the alignment of interests, transparency, resilience of products and of infrastructures, but now more sectoral rules are needed, the regulator believed. Measures are needed to make equity and bond markets in particular more open, liquid and competitive in order to attract issuers and long-term investors.

On-going regulatory actions at the European level

A policy-maker emphasized that, at the European level, the current topic is MiFID II and MiFIR for which implementation rules are being drafted and which are due to be implemented by the beginning of 2017. This implementation phase has to be completed before moving actively into new policy projects. MiFID II has the potential to make markets safer, to improve the price formation process and market efficiency and to enhance competition.

The EU Commission is exploring in parallel wider policy issues notably in connection with the communication published in 2013 on the long term financing of the EU economy, the policy-maker emphasized. The objective of this communication – which is not an action plan and involves very little legislation - was to identify the issues on which further work is needed in order to favour a sustainable financing of the European economy. Around thirty areas were outlined. Securitisation is one of them. Reviving these markets through the identification of high quality securitization in order to support the financing of SMEs in particular is essential. In addition, market segments which are successful in some Member States but do not yet benefit from a European framework should be further assessed. One example is covered bonds, which are a very successful vehicle in some EU countries even if they raise asset encumbrance issues. Private placement is another area where there are quite notable experiences at the domestic level and where a European framework could develop more cross-border activity. The launching of SME growth markets part of MiFID II is another important initiative in favour of SMEs. The right balance has yet to be struck between alleviating administrative burdens for SMEs and ensuring appropriate disclosure to investors. Another action is the revision of the prospectus directive which is programmed for 2015. This directive has already been modified in 2010 in order to implement a more proportionate disclosure regime for SMEs and further assessments will be conducted in order to decide whether additional amendments are needed in order to facilitate the access of SMEs to the EU capital markets.

On-going regulatory actions conducted in the Italian market

Many regulatory changes conducted in Italy to help mid-sized companies to find appropriate funding and benefit from a better environment for growth were underlined by a regulator. Simplifications have been made to the regulation of stock exchanges. Multiple vote shares have been introduced, as well as loyalty shares and the mandatory bid threshold was changed to take into account mid-sized companies. The minimum capital for creating a new company was reduced and specific domestic legislation was implemented for start-ups, mini-bonds and crowdfunding. The objective of all these actions is to provide companies with a menu of instruments from which they can choose according to their needs and specificities, avoiding a general one-size-fits-all type of regulation.

An official representative further detailed "Finance for growth", one of the flagship policies of the Italian government and also a priority of the Italian EU Council Presidency. In Italy an array of measures have been put in place over the last six to nine months in order to attract more foreign and private capital and increase

the recourse of companies and notably SMEs to the capital markets. A first objective is to increase the diversity of originators and investors alongside banks, strengthening the role played by insurance companies, pension funds and credit funds in particular. This has required changes in the regulation for example of insurance companies in order to allow them to lend directly to companies or new regulations as in the case of credit funds. A second action is to widen the range of financial instruments available to companies. Mini-bonds are an example. The experience has been very positive in Italy with 26 companies going for the first time to the capital markets in the recent months with mini-bonds and raising more than € 1 billion. A platform created by the Milan stock exchange to connect issuers, investors and corporate partners has also been very useful to help these companies better approach the market. Another interesting instrument is project bonds for which changes in regulation are necessary because such bonds of very long maturity are not regulated in a way that is appealing enough. Securitisation is another important element of this range of instruments. Another aspect is the use of public guarantees, even of a limited amount, provided e.g. by public development banks in order to leverage the private capital provided. The third objective is to widen the perimeter of projects or activities funded by private capital in order to compensate for the reduction of public investment. Beyond businesses, private capital should be used to finance infrastructures (for example though Public-Private Partnerships (PPPs)) but also the cultural and artistic heritage (for example museums which need to become more business viable). Not-for-profit activities also need to be incentivized through fiscal incentives.

Additional proposals to develop EU capital markets

An EU framework for private placement and / or mini-bonds

Several speakers on the panel agreed on the relevance of developing a European framework for bonds tailored to the needs of mid-sized enterprises i.e. private placement and/or mini-bonds.

Standardization at the EU level of the mini-bond or private placement type regimes that exist in different Member States would be useful, several speakers suggested, as it would favour more cross-border investment. A European approach could build on the criteria and standards currently used at the domestic level. An industry player believed that this should be a market-driven rather than a regulatory-driven initiative. The industry should first work on standardizing the current practices and best practices, which could eventually be recognized by a label and should be defined at the European level in a second stage.

Improving liquidity in the corporate bond market

Several speakers on the panel stressed the importance of improving the liquidity of EU bond markets.

An industry speaker emphasized that liquidity of bonds in the wholesale market is provided by market makers. Maintaining a strong activity for market makers in that area is essential and in that respect the new measures of MiFID II to increase pre-trade and post-trade transparency are a concern. Another industry player agreed that liquidity in SME instruments is very much market-maker based and that excessive transparency requirements in that area would actually hurt liquidity particularly in smaller countries and when the market is stressed which is when liquidity is most needed.

A regulator admitted that one should not go too fast in the direction of transparency in this area.

Further developing SME equity markets

SME stocks often face issues in terms of liquidity, a regulator emphasized. Liquidity of SME stocks is generally "evanescent and fragmented". In addition the access to appropriate financial analysis and to the resources needed to meet growing listing obligations is also problematic for such companies.

The speakers on the panel welcomed the creation of SME growth markets in MiFID II but some stressed that additional actions are required.



The key challenge some speakers stressed is developing an appropriate ecosystem to facilitate the raising of capital by SMEs and the appropriate allocation of capital to SMEs stocks.

The problem is that this SME ecosystem has deteriorated with the implementation of MiFID I, an industry speaker emphasized. A first issue is liquidity which has moved over the last years to large caps. It has become quite difficult for broker dealers to have a profitable market making activity in the SME sector. This is affecting the valuation of SMEs and their attractiveness to raise capital. A second issue is research. The research market has moved away from SMEs, which is a major concern because research is essential to attract investors to the SME market. A service is about to be launched by the Nordic stock exchange in order to promote the re-establishment of a research community for SME companies. The objective is for the exchange to provide data as a foundation upon which research services can be built. This has the advantage of pooling the information on SMEs in one central place without the stock exchange competing against the existing actors in this sector.

Another industry speaker did not see many additional improvements still needed in the regulation of capital markets for SMEs but many potential actions to be undertaken in order to create an effective ecosystem and informal business and financing network for SMEs. The example of a web platform created by the Milan stock exchange to support SMEs in achieving their growth targets was given. This platform proposes tools that SMEs can use to improve their transparency and visibility and a network of contacts with private equity and institutional investors, banks and experts as well as entrepreneurs and managers of listed groups. The platform aims at helping SMEs to find appropriate financing solutions such as bonds, public and private equity and also M&A transactions. More than 150 high quality companies have so far joined the platform as well as more than 100 investors and 100 advisers. These companies have on average revenues of under € 5 million, 15% EBITDA, 15% growth and very low indebtness. This has created a real ecosystem working in a very informal way, the speaker claimed. After 18 months there have been more than 11 bond emissions, 15 IPOs are under way as well as 29 M&A transactions and 10 private equity transactions, all within the group of companies taking part in the platform, which has helped to bring these SMEs closer to the capital markets.

Some other actions were suggested for developing SME equity markets.

One issue to be addressed, an industry speaker suggested, is the increasing proportion of institutional capital going towards index investment rather than being engaged in active investment. This trend is not favourable for SMEs which usually do not qualify for index investment. Institutional investors should be incentivized to develop more active investment strategies. They should also be encouraged to increase the share they have in their holdings and invest long term.

Another issue the speaker mentioned is tax neutrality between equity and loan financing. There is at present a tax bias favourable to loan financing. There is a stability aspect to this the speaker admitted but leveling the playing field between equity and loans tax-wise would encourage more long term financing into SME stocks.
With regard to the buy-side, although it cannot replace the banking system it could do more than today in some cases, the speaker believed. There could be an increase in the number of funds dedicated to small caps (there are almost 100 of these in the UK and only 5 in Italy for example). This requires efforts on the part of the buy-side but also of issuers as well as tax incentives and a political will to develop an appropriate ecosystem as mentioned previously.

The capital markets union project

A policy-maker explained that the next task down the line for the EU Commission, after the implementation of MiFID II / MiFIR and the actions following the communication on long-term investment, will be to work on the capital markets union project. This project is due to be set up by 2019 according to the letter of mission received by the Commissioner designate for financial services . The fact that EU capital markets are poorly developed and integrated compared to the US and that they may not be sufficient in their present state to avoid a funding gap if bank lending decreases in the coming years, is well known. Some "very serious" economic analysis has first to be conducted to understand the causes of this situation the policy maker emphasized. In addition the appropriate conditions for a further development and integration of EU capital markets need to be further defined. This may involve addressing some very complex and sensitive issues such as taxation, supervision and insolvency laws as well as the possible need for an EU securities code covering in particular ownership and disposition rights. This will require much work on the part of regulators and also of market participants. Some issues will need to be sorted out by the market such as corporate bond standardization which is important for developing deeper and more liquid bond markets.

A regulator believed that a capital markets union could help to create a better balance between equity and loans in the financing of SMEs. Until now loans have been preferred by enterprises for a number of reasons including regulation and taxation. This has created a near monopoly of banks in the financing of companies in many countries which is not necessarily the optimal situation from an economic standpoint. But for this situation to evolve a real competition between equity financing and loans has to be introduced with the help of regulation in order to encourage companies to make a stronger use of the capital markets. Taxation is an important element in this perspective. But a more appropriate fiscal environment can only be created at the European level in the context of a more integrated financial or capital markets union in which the regulation across countries is consistent as well as its implementation, in order to create a level playing field among the different Member States. If similar regulations and fiscal laws can be implemented across Europe this will create a real European market in which companies may experience better growth.

1. Note: Brokers' investment research which is made available to buy-side participants that undertake a certain level of execution business with them is often paid for by higher commission rates than those charged for simple execution. A ban on the use of dealing commission to pay for such research has been proposed, excluding research from the list of permissible inducements.

2. At the time of the Milan Forum the Commissioner had been designated but not yet confirmed.

Providing long term investors with appropriate financing tools

Objectives of the session

This session was held in a context where the G20 under the Presidency of Australia was putting a high level of priority on the development of infrastructure projects as a key driver for growth and employment. EU and national institutions, public banks as well as the private sector in the EU are also mobilised on infrastructure financing, which has led to the emergence of various innovative financing tools.

The session in such a context was first dedicated to drawing lessons from on-going initiatives to facilitate non-bank financing of infrastructure projects in the EU.

In addition, panellists were invited to clarify the specific needs of long-term investors (retail, institutional...) as well as whether infrastructure financing represents an opportunity for them, and to outline the critical success factors of existing or proposed long-term saving tools.

Finally the conditions for improving the access of small and medium infrastructure projects to financial markets and institutional investors were discussed.

Background of the session prepared by Eurofi

The G20 under the Presidency of Australia has put a high level of priority on the development of infrastructure (and SMEs) as a key driver of growth and employment. The support for infrastructure investment, and the long-term finance it requires, remains therefore a key priority.

The infrastructure and long term financing needs are now on such a scale that bilateral, regional and multilateral financial institutions can only make a difference if they succeed in attracting the private sector and leverage capital markets.

In such a context the EU Commission and the High Level Expert Group on SME and infrastructure financing encompass a wide and varied range of actions.

Increased information and transparency about investment plans and credit performances, harmonised approaches to impact assessments, and, where possible, convergence of regulatory and legal frameworks should help in that respect. Many issues however have been raised in that respect recently.

The support from regulators and governments to establish the adequate regulatory environment for more efficient long-term financing is naturally required. The preparation by the EU Commission of the delegated acts required to implement the Capital Requirement Regulation (CRR, for Banks) and Solvency II (Insurance) should offer the opportunity to address certain key and urgent aspects in that respect. There is a case for different treatment of infrastructure when compared to corporate debt given its different credit characteristics and lower default risks over time. The current EIOPA treatment of infrastructure will need to evolve over time as more data become available to justify a different calibration.

Finally making infrastructure investment a well defined "asset class" would facilitate a specific regulation for investors (pension funds, insurance companies, retail, investment funds, etc.) to enable them to allocate a larger share of their portfolios to infrastructure financing. A wider variety of projects will be funded as investors gain more experience and understanding of this asset class. In Addition given the potential for higher long-term returns from greenfield projects, we can expect over time an increasing allocation to them from the more sophisticated and seasoned institutional investors (e.g. the larger pension funds and insurance companies with experience of construction risk and credit risk management techniques).

Developing innovative approaches and instruments is also important. Many initiatives have already been launched e.g. EU/EIB project bonds, Bank/Insurance partnership for direct lending to infrastructure projects, etc. Some suggest also that carefully regulated and designed asset-backed securities as well as private equity funds targeting infrastructure should be developed.

In this context Multilateral Development Banks (MDBs) have or are expected to provide specific contributions through technical assistance and financing of Project Preparation and Financial Structuring, and other instruments such as partial credit guarantees and equity.

The choice of model depends on the size and experience of the investor as well requirements to obtain specific rate and maturity terms to achieve more efficient asset liability matching: direct lending by investors - usually big ticket operation -, intermediated financing through managed account platforms allowing co-investment on personalised terms or on a standardised basis through a debt fund, a system of credit enhancement similar to the EIB/EC project bond and lending partnerships between investors and banks.

All in all institutional investors - insurance, mutual funds and pensions funds – funded nearly 20% of debt in 2013, a significant increase on past records. In addition, institutional investors can invest for longer maturities than banks, 30 years (up to 45 years). Drawing the lessons on those initiatives and singling out the key success factors are necessary to maintain the momentum toward improving the financing tools of E.U. infrastructure projects. The issue there is to define progressively how to move swiftly from an ecosystem that relied very massively on banks to a more diverse financing architecture. However, the capital raised has also to be channelled toward smaller projects given that in particular projects over €500 million are relatively rare, and small and medium public projects represent about 70% of total investments. In this respect, aggregator vehicles where smaller projects of a similar nature are held within a pool are a welcome development especially if they benefit from credit enhancement from an entity such as an MDB.

These examples show that to facilitate the recourse to new non-bank forms of financings, MDBs should also more systematically advise local and national governments and bring their technical experience and market knowledge.

These political targets also emphasises positive impact expected from the synergies that should result from closer cooperation between the D20 and the MDBs. Given their size, their role and their considerable experience in infrastructure finance, MDBs can contribute to set standards and provide leadership working in close cooperation with Member States and National

Public Banks. At the same time the D20 bring substantial lending capacity, linkages to the financial sector and capital markets and experience and knowledge about local institutional and regulatory conditions.

Involving smaller institutional investors is also a very important issue to address, as many second tier players exist holding in aggregate a very significant share of the money. To the end the European Commission has proposed a new investment fund framework designed for investors who want to put money notably into projects for the long term i.e. the European Long-Term Investment Funds (ELTIF).

The benefits of good due diligence and risk management provided by a third party manager in an ELTIF structure –could benefit smaller institutional investors as there are a limited number insurance companies and pension funds in Europe which have the capability to analyse individually big infrastructure projects. The E.U. should consequently allow them to access to those assets indirectly through professionally managed fund structures. This could be particularly beneficial for infrastructure projects where complex issues such as construction risk, legal risk, political risk, etc., require specialist knowledge. The ELTIF should enable medium-sized companies and small institutional investors to invest in these kinds of long-term asset with appropriate professional oversight. However the solution should not be a "one-size-fits-all" structure but allow the ELTIF to adapt its investment objective depending on its target market.

The E.U. Commission expressed also the ambition to explore the ways to increase cross border flows of savings, including through the introduction of an E.U. saving account, offering a standardised framework to encourage savers to contribute to long-term financing. In that respect the Commission should also consider a form of ELTIF, which appeals to retail investors and not only to institutional investors.

Retail investors are however even less familiar with illiquid assets than institutional investors. This requires very specific disclosure and advice needs, particularly given the lack of liquidity and the fact that the ELTIF risk profile differs radically from that of a deposit in a bank account. This means also high standards of suitability and appropriateness to investment by retail investors to avoid the potential for mis-selling.

Adding capital protection to limit downside risk for retail investors is however likely to increase cost, as this will require the use of insurance company or bank balance sheets. Finally the question remains whether retail investors are the right type of investor for these types of long-term investments.

Summary of the session

1. Long-term investment policies in the EU

The general view of the participants on the panel was that the economic context requires long-term investment. Not only are these investments expected to alleviate recourse to public financings and contribute to kick starting growth, reinforcing European competitiveness, but also should represent much needed investment opportunities for investors, the long-term liabilities of which are badly impacted by the current low for long context. Indeed, a representative of the private sector stressed that - in a context of historical low rates - Investing today in government bonds does not make much sense as flat or even negative interest rates do not enable insurance companies to guarantee the promises that end clients should benefit from. He added that the situation was even worse as actually many insurance companies last year were invested up to 15% in cash at a time when Europe badly needs more investment consistent with the quest for sustainable growth.

However many participants from the public sector - considering the weakening of long term investment since 2007 - underlined the fact that in combination with the efforts being made to better finance long-term investments, the E.U. needs more consistent fiscal policies, as no financial instrument can work without a favourable economic environment. In addition many agreed on the need to create in the EU a favourable economic environment with structural reforms, which is considered as a pre-requisite.

2. A new regulatory phase is now required

Furthermore, a representative of the public sector then focused on the conditions that would attract investors. He said that long-term investment requires building additional confidence. In a context where the European financial system is stronger than in the past and able to face shocks, further improving confidence now requires entering in a new phase, he added.

Then he explained that this new phase supposes on the one hand working hard to creating a clear framework for long term investment providing the necessary harmonisation and clarity on taxation, projects, investments, the authorities to talk with, etc. It supposes also that the public sector will demonstrate its willingness to launch infrastructure projects. The plan that Mr Juncker presented is very important in that respect and should generate additional confidence within the system he concluded.

This participant added that this new phase also requires focusing on stopping the short-termism of European financial instruments and raising the level of long term ones. He concluded by explaining that the European long-term investment fund (ELTIF) is going in the right direction in that respect and is also the concrete means to foster long-term investment and open access to finance for small and medium sized enterprises.

More generally the participants on the panel stressed that the E.U. has to create a general environment for long-term instruments working on transparency, control mechanism, and checking that financial regulation frameworks do not penalise investing in the real economy and leaves room for manoeuvre for the non-banking sector, which is critical. In addition the participants acknowledged that Europe has to rationalise all existing long-term instruments e.g. the European Venture Capital Fund and the European Social Entrepreneurial Fund, and maybe put them together.

This representative concluded by underlining that to achieve this specific task a really new European Commission is an asset. He explained that the novelty comes not only from the fact that we have new commissioners but because we have a new institutional architecture for the first time with dedicated clusters each of which features in particular a portfolio focused on financial services.

3. Attractiveness of long-term investment to end investors

Participants from the private sector warned: it is very important that long-term investments should be attractive to the end investors. End investors e.g. pension plans, insurance companies, sovereign wealth funds, retail investors notably through funds, etc., are multiple and have different investment profiles and different interests within this sector. They insisted on the fact that before all we cannot be creating products that then nobody wants and that consequently savers and investors have to be at the centre of such a product development process.

All the participants agreed on the fact that Individual investors/savers are long-term investors, notably because their savings needs are long term e.g. retirement, financing for the school or education for children, a new home. A participant also stressed that Individual investors need long dated assets with stable cash flows, possibly inflation linked.

However certain participants stressed that liquid investments very much attract individuals. The issue there – they said - is that investments in infrastructure (or SMEs) are illiquid. And a participant warned in that respect that whenever you transform intrinsically illiquid investments into something, which promises liquidity, you run into problems. Finally he said that one


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can easily solve this liquidity problem by having individuals exposed to the specificities of infrastructure investment, through the intermediation of institutional investors like insurance companies and pension funds, investment funds.

A participant from the private sector stressed that more generally investors want an adequate return. Yet the return is rather thin – he said - quoting the figures included in the European Commission proposal for the long term investment funds, which show that US properties - the investments, which have the higher return – need 14 years on average to beat the S&P 500. Similarly US venture capital needs 20 years. All this in a context where the total US stock market over performed quite significantly the S&P 500 (large capitalisations) during the last decade! He concluded. In the context where the current Proposal of the European Commission for an ELTIF, allows up to 40% invested into other funds. Such funds of funds structures add layers of fees reducing further the return. Another panellist said in that respect that many clients are interested in infrastructure investing because they want assets that better meet their liabilities; however he said - they want to be rewarded for the illiquidity: they do need a return profile, a tax treatment and not just a legal entity that actually works for them he concluded. Another representative from the private sector stressed in that respect the necessity to get rid of all the existing long term packaged products which are tax incentivised; just adding another category of funds with no tax incentive, is not an option he said.

Another participant also reminded the audience that to make the politicians, public authorities, retail investors confident in these long-term investment products, you have to propose simple products. Another participant insisted on the necessity that distributors should be qualified enough and probably certified. The challenge is to systematically apply the common sense principle of Emilio Botin who used to say "I'm not selling products to clients that I don't understand myself". Finally he proposed to set a sufficiently high threshold to avoid investors, be they retail or institutional, investing in a business they do not understand. He proposed that policy makers should only target qualified investors.

4. The different areas to work upon

A public decision maker reminded the audience that the EU and the G20 are mobilised on the issues raised by infrastructure financing. Consequently they are trying primarily to propose an appropriate definition of the asset class and working to make infrastructure financings an asset class. These elements are considered as critical bedrocks, which should allow capital market instruments to develop, and (institutional) investors to come in. He explained that in this context many of the necessary actions, which are required, have been outlined in the communication of the EU Commission on long term financing. The way the EU needs to structure all these domains is what has still to be discussed more in detail. He concluded by stressing that the Juncker commission agenda sees that as part of the overall policy. In addition a public decision maker stressed that the organisational clusters in the Commission could provide a more holistic view looking at all the different pieces rather than a lot of silos each doing its own.

However the panellist stressed that in some areas e.g. tax, local regulations such as bankruptcy issues, one might not get responses very quickly at the European or federal level given that they would come under the subsidiarity principle. In addition a representative from a public promotion bank stressed that in the EU we are in a sort of urgency to find alternatives for sovereign and public money. Consequently he proposed working preferably on concrete aspects e.g. whether to get a better deal flow, how to finance smaller projects; etc.

The panellists easily agreed on the different areas to work upon to effectively improve the financing of infrastructure projects. This would help to restore confidence, bringing appropriate transparency:

- The removal of regulatory barriers in different areas that have still to be identified to develop the pipeline of projects in the E.U.,
- The transparency of the EU pipeline of projects. In that respect local and regional authorities have also to help building good, sustainable, investible projects in infrastructures in order to avoid a phenomenon known as the infrastructure bottleneck.
- The development of an appropriate and consistent regulatory treatment of infrastructure financial assets - legal, tax, accounting, - and notably in the area of insurance regulation i.e. Solvency II.
- The accessibility of data on infrastructure projects and financings for capital market investors given that in the EU infrastructure financing has a different and positive credit story than in other parts of the world, and this requires structuring the provision of such data and standardisation. The need for data regarding the yield was also mentioned.
- The form of the public support for infrastructure financings and the need for credit enhancement schemes, which requires the Commission to work together with the European investment banks and the national promotion banks.
- The appropriate avenues to aggregate smaller projects to enable them to have access to market finance. ELTIF is one way. Securitisation techniques were also mentioned.

5. Tax issues

Regarding tax issues, considering that infrastructure investments are very attractive and that there is much demand, a participant from the private sector concluded that investors do not really need, in general, tax advantages. What is really needed he said is stability, a level playing field and regulatory consistency.

In that respect a panellist rather stressed possible de-incentives weighing on infrastructure investments. He quoted in particular the BEPS project (OECD Action Plan on Base Erosion and Profit Shifting) addressing the issues raised by the opportunities ceased by Multi National Enterprises to greatly minimise their tax burden. This has had bad implications on alternative investment funds in a context where ELTIF for our European infrastructure projects offers a subset of alternative investment funds and a very minimum would to make this tax the same as for UCITS, etc.

A representative of the insurance sector also explained there could be a possible easy way to use the existing tax incentives linked to life insurance products, which only require slight modifications to improve actual specific returns and rewards benefiting to the clients. In this perspective it would suffice to add infrastructure assets within the eligible assets of our contracts,.

6. Solvency II

Many on the panel stressed the fact that generating good and investible projects in the EU requires an appropriate regulatory framework. Some stressed in particular the negative impact of Solvency II and systemic risk global regulations for insurance companies, which are creating regulatory uncertainty.

They said that the current regulation is in contradiction with critical policy objectives. They explained that Solvency II is not adequate for financing infrastructure projects (or securitisation) as they are not considered as a specific asset class. A participant from the private sector illustrated the point explaining that currently investing in a 20 years' bond with an A rating, for infrastructure yields about 4%, while the solvency capital charge is 15.5%. Similarly he said investing in the equity linked to infrastructure projects would yield about 6%, while solvency capital charge is 49%. This regulation is discouraging investing in infrastructure.

Yet – many panellists said - factoring in the positive credit and economic specificities of these assets would provide improved security and safety for the insurance sector and its customers altogether with the much needed long term financing of the economy.

In that respect the representatives of the insurance sector reminded the audience that life insurers, as pension providers, need to optimise our asset liability management better matching the duration of investments and that Infrastructure projects give them very long-term assets, which perfectly match such liabilities.

A representative of the industry insisted: the worst losses suffered in the insurance sector during these years of crisis came from the Greek debt (investing in sovereigns as encouraged by the insurance regulatory framework) not from Eurotunnel. Indeed explained another representative of the insurance industry, in the low interest rates environment, the regulatory framework is encouraging increasing the exposure to sovereign risk, so it is something for us to monitor very closely.

Many participants on the panel, from both the private and public sectors, said that it was not too late to review the calibration in Solvency II and that the implementing measures provide the appropriate opportunity to do it right now. However, though the last available studies coming from those currently involved in infrastructure financing show that infrastructure recovery rate is often much better than for other class of assets, the representatives of the private sector acknowledged the lack of academic evidence or research on the long run, on infrastructure investments (returns, risk) and declared that the profession is ready to participate in the requested studies to help reassuring the regulators about those facts. They also indicated that there were many initiatives in this perspective among which is the initiative the EFR, which is considering coming with something concrete to get the right data and harmonising them.

7. Securitisation

ABS might help to channel project financings toward investors.

Various panellists stressed the fact that they lack investment opportunities. Consequently they proposed to put on the market, aggregated, medium sized projects of infrastructure, in funds. Indeed they explained that big infrastructure projects are massively held back because of public finance constraints while it is actually easier to find public resources for smaller projects. Conversely they said, those small and medium sized infrastructure projects represent two thirds of the infrastructure needs. However they stressed that these projects are too small to access market finance while shortage and cuts in the banking financing strongly impact them. In addition they explained that the project bonds initiative mainly covers large and medium investment grade projects. In this context several panellists concluded by saying that more should be done on the demand side for also creating large pipelines of smaller, standardised PPP projects also encompassing the vast world of social and intangible infrastructures. In addition they explained that investors would be eager to take parts of that too in their investments.

Therefore the idea they outlined would be to bring small and medium projects together and package them to make them marketable in financial markets. Many panellists also said that securitisation ABS would help in creating infrastructure financing so as to channel PPP and project financings made by banks toward investors. They explained in that respect that at least some selection of small and medium infrastructure projects would be necessary to propose to financial markets to underwrite single bonds with consistent enough projects underlying. National promotional banks could help to gather such projects and securitise them.

A panellist pointed out the real estate market in the US provides us with a useful example. There, he said, investors can make intrinsically long term and illiquid investments invest in traditional real estate funds but also through the securitised market. Therefore one possibility in the EU would be to favour an efficient securitised market with listing, which requires essentially standardisation.

A cohesive set of securitisation rules is necessary

The panellists agreed on the fact that there are already a number of initiatives regarding securitisation. They observed in that respect that there is a need for a cohesive set of securitisation rules on the basis of some guiding themes among which the number one is the alignment of the issuer and the investor's interests. This encompasses things like transparency, not just up front but on an ongoing basis, on areas such as how projects are doing, what the cash flows look like, the emergence of any problem, etc. and also servicing standards. A panellist stressed the fact that simply taking a fund invested in these types of assets and making it available to the public with some provisional liquidity is potentially dangerous.

Finally one key issue stressed by many on the panel, is that in the 28 countries in the E.U. we have different rules, which make a pan-Europe type securitisation, very, very difficult. Bankruptcy, restriction of possible lenders – there is a lot of local level work that would need to be coordinated to make this a really robust and consistent market. One panellist explained in that respect that the UCITS framework has been extremely successful in Europe and increasingly globally because UCITS are all pretty much the same, subject to the same constraints, limits and regulations. What is really important in this framework is regulatory stability and consistency across countries, the more so when you are dealing with these (long-term) types of investment horizons.

8. How the public sector can help the private sector

Several panellists stressed the expected role of national promotional banks to facilitate non-banking infrastructure financing in the EU. The project bonds initiative was quoted as a successful experience in that respect; indeed the pilot phase shows a selection of a number of good projects in various countries and a large demand from long-term institutional investors. These experiences demonstrated that if the projects are good, credit enhancement could give a great booster to their "investability". Another panellist summarised by saying that having good and investible projects, requires an appropriate array of credit enhancement schemes such as monolines and the provision of credit and risk guarantees and first-loss absorption mechanisms. A panellist stressed in that respect that those mechanisms are also needed to alleviate the regulatory capital absorption required by financing projects and explained that they should also contribute to reducing the haircuts demanded by central banks for those financial assets when used as collateral, which should consequently reduce the mass of frozen liquid assets.

A panellist proposed an additional added value for the public sector. He said that what makes infrastructure attractive to investors, is notably stable cash flows. He explained in that respect that this is why most existing investments result from the privatisation of existing infrastructure assets as opposed to new infrastructures. The rationale he said is that those new infrastructures might take a very long period of time before they start to produce stable cash flows. Consequently he was of the opinion that the public sector has a particular role to play investing preferably at the green field stage - bridge financings - via direct loans – or possibly supported by governments, agencies and development banks - and then handing over the financing to the private sector when the infrastructure starts to mature. This is even more important for financing new infrastructures expected to increase productivity and growth in Europe as opposed to leveraging existing infrastructures he concluded.

A panellist from a public bank long-term suggested regarding infrastructure equity, infrastructure funds similar to Marguerite (European Equity Fund dedicated to transportation, energy and environment sectors) specialised is technology, R&D, local utilities, etc.

9. Bank financing of infrastructures and the role of the ECB

Though infrastructure financings are illegible to the TLTRO, a panellist proposed an "infrastructure LTRO" characterised by longer maturity in line with the horizon of infrastructure projects so as to reduce the subsequent re-financing risk. The panellist proposed that this refinancing mechanism be envisaged as a direct lending facility as such in the perspective of which the ECB should also envisage introducing an automated mechanism to collect the collateral taking the form of large EU infrastructure investment programmes e.g. NTNI, NCF etc., and projects co-financed with EIB loans or EU project bonds.


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FOSTERING FURTHER EUROPEAN INTEGRATION

Conditions for solving financial fragmentation within the EU with the implementation of the Banking Union

Objectives of the session

The primary objective of this session was to identify the segments of the banking market that are still affected by fragmented financial conditions.

The participants in this session were also invited to explain the factors behind this fragmentation and indicate whether, in their opinion, the implementation of the banking union would on its own be sufficient to eliminate them.

The speakers were also asked to comment on the expected benefits of the implementation of the banking union and the short and medium term changes in the banking landscape which may result from its implementation.

Background of the session prepared by Eurofi

Financial markets in Europe have stabilized markedly

The Eurosystem defines financial integration "as a situation whereby there are no frictions that discriminate between economic agents in their access to – and their investment of – capital, particularly on the basis of their location. This means that financial integration is achieved when there is equal market access, de facto and de jure. In such a setting one would also expect to see significant cross-border holdings of financial assets, along with a convergence of asset prices and yields across borders."

However, the trend of increased integration in the EU wholesale banking sector that had prevailed up to 2007 has been reversed since the global financial crisis and the euro area sovereign debt crisis.

During the sovereign debt crisis (2010 - 2012), as far as 10 years' governmental instruments are concerned, countries like Italy or Spain had to pay 250 to 360 basis points more than Germany (not to mention Greece, Portugal and Ireland). These high public spreads percolated into the real economies and produced restrictive effects on growth and thus compounded the difficulties of their fiscal adjustment effects.

The perceived risks of redenomination linked to the threat of a possible euro area break-up was successfully mitigated by non-standard Eurosystem measures, further progress towards the banking union and by the economic and fiscal convergence process in particular in distressed countries.

But in many market segments, financial integration has not yet returned to pre-crisis levels. Bank lending conditions in particular for households and SMEs, although improving slightly, remain highly fragmented, in contrast to other market segments, such as the sovereign or corporate debt markets where fragmentation has declined significantly.

The access to finance for SMEs is still fragmented in Europe. The last ECB survey (April 2014) shows that SMEs of some countries still meet with significant difficulties in obtaining credit. In Italy there are 43% of such companies that declare that they cannot easily find credit. In Ireland the percentage is 62%, in Greece 67%. On the opposite side, the percentage is 18% in Germany and 17% in Finland.

In addition, the cost of finance in the euro area also remains strongly based on national conditions. For example, according to the ECB , the average cost of borrowing for non-financial firms in Portugal is more than 5% per year, whereas the equivalent for French firms is around 2% per year.

As B. Coeuré stated in a recent speech , "part of the explanation is that banks' credit assessments are influenced by the health of the local sovereigns – rather than just the characteristics of the firm. But this is not the whole explanation. Even if sovereign risk were zero in the EU, most banks are not structurally set up to provide cross-border lending. One would imagine in this situation that a Portuguese firm would seek out a French or German bank, but the euro area banking market does not facilitate such arbitrage. Direct cross-border loans to firms account for just 7.5% of total loans to firms. And local affiliates of foreign banks represent on average only around 20% of national markets, and much less in larger countries". Thus, firms depend heavily on the health of their domestic banks.

The effects of location on access to finance are exacerbated by firm size. While firms are in general more credit-constrained in some jurisdictions than others, this phenomenon is particularly apparent for SMEs. For example, the percentage of financially constrained but viable SMEs – defined to be those with positive turnover in the last six months seeking a bank loan – varies from a minimum of 1% in Germany and Austria to a quarter of the total population in Spain and even a third in Portugal. The implementation of the Banking Union can help to mitigate several sources of this fragmentation and create the conditions for deeper retail banking integration.

The Banking Union means three things: first, it means a single supervisory framework that minimizes equally the threat that a euro area bank can experience excessive risk and run into failure. Next it means a single resolution framework, so that if a bank does still fail, it can be resolved in the same way, with a limited use of taxpayer money, irrespective of where the bank is located or the fiscal strength of its government. Lastly it means a system of deposit protection that provides depositors with equal confidence that their deposits are safe, regardless of jurisdiction.

The SSM is well on track to start operations in November 2014 and the EU Institutions approved in April 2014, three important measures which will bring the EU down the road towards the banking Union: the Bank Recovery and Resolution Directive (BRRD), which will provide common and efficient tools and powers for addressing a banking crisis pre-emptively and managing failures of credit institutions and investment firms in an orderly manner. Second the establishment of a Single Resolution Mechanism (SRM) aimed at setting up a Single Resolution Board and a Single Resolution Fund in its center. Third, progress towards a European system for deposit protection was also made

A single supervisor should enhance transparency, lead to the harmonization of rules and standards, remove distortions created by national borders and thus increase trust in cross-border lending, while supervisory ring-fencing or national asset-liability matching would no longer be relevant given the SSM's European focus. In addition, an effective single resolution mechanism would help attenuate the infamous bank-sovereign nexus. Sovereigns would have less ability to intervene in failing banks, thus allowing bank risk to be better separated from sovereign risk. This governance integration provides a more permissive environment for retail banking integration.

As until the crisis banks integrated mainly through wholesale markets, it is unlikely that they should gravitate straight from this to direct cross-border retail lending. More probable is an intermediate phase where cross-border M&A expands. The SSM nonetheless increases the potential to obtain economies of scale within the single market, for instance by allowing banks to optimize their internal management of capital and liquidity. As Benoit Coeuré underlined, "the mere presence of SSM could induce restructuring as banks seek to reduce margins in anticipation of increased euro area competition. This will be compounded with the competitive pressure created by the expansion of ebanking".

The Banking Union will not resolve on its own the problem of fragmentation

The implementation of the Banking Union will improve significantly the underlying conditions of this problem but not the problem itself. Because banks in a country are always capped by the rating of the sovereigns. And since sovereigns are one of the drivers of fragmentation. If we want to break the link between the banks and the sovereigns, the sovereign has to improve its own rating so that it can in a way elevate the quality of the ratings of the banks themselves. Therefore it is essential that the countries and sovereigns continue - or, in some cases, start- implementing structural and macro-economic reforms that will improve the competitiveness, the flexibility and the quality of the economies. That should be "the third pillar" of the Banking Union.

Summary of the session

1. The extent of financial fragmentation across Europe remains significant

The crisis of 2008 and the euro crisis which followed saw a complete decline in the previous five years' worth of integration and the move towards sovereign protectionism. Even if financial integration of money markets, bond markets and equity market has improved during the last two years, in many market segments financial integration has not yet returned to pre-crisis levels, which complicates tremendously the monetary policy of the ECB.

A representative of the private sector stressed that the effects of the financial crisis on the European Union's financial integration are statistically still undeniable and gave some examples related to the banking market:

- The level of cross-border debt securities held by euro area banks decreased by more than 20% in the past five years, while cross-border inter-bank lending positions within the euro area have halved.
- The last ECB survey published in April this year shows that SMEs in some countries still meet with significant difficulties in obtaining credit. In Italy, 43% of SMEs claimed that they cannot access credit easily. In Ireland, the percentage is 62%; in Greece, 67%. On the other hand, in Germany it is 18% and 17% in Finland.
- In addition, the cost of finance in the euro area remains defined on national conditions, so the average cost of borrowing for non-financial firms in Portugal is more than 5%, when the same rate for French firms is around 2%. Ultimately, getting lending going into the real economy will rely on tapping into broader pools of funding, particularly given the large deleveraging that is still under way.

Moreover, another representative of the industry underlined that the market based funding of EU banks is also still fragmented mainly because of their location in terms of sovereigns.

A public decision maker emphasized that financial fragmentation will have disappeared when EU cross-border banks will be able to decide what form of organisation they want to choose and transform for example their subsidiaries in the euro area into branches, and the fungibility of liquidity and capital within the groups will be complete.

Another participant explained that price convergence does not mean integration. Convergence is a welcome process but it does not in itself guarantee deep and resilient financial integration. Narrowing spreads in the first decade may have been a sign that markets were under pricing risk and that financial imbalances were building up. This speaker noticed in particular that "before the crisis, there was a price convergence in the euro area which relied on the presumption that a Banking Union was in place and on a perception where the European taxpayer would take care of the failure of a cross-border bank".

2. The multiple factors behind this fragmentation

The participants in this session explained the different causes of this fragmentation. The impacts of the location of borrowers and of lenders, the lack of competition in banks domestic markets, the lack of harmonization of legal rules in key areas of capital markets (collateral, insolvency…), the differences in the way supervision is performed across Europe were the main factors put forward by the speakers.

The location of borrowers and of lenders impact the allocation and the conditions of bank lending

Location impacts the allocation and the conditions of bank lending in the euro area in two ways: via the location of borrowers and of lenders.

The economic and social fragmentation still characterises the European Union. Many speakers assessed that the domestic economic environment differs from one country to the other and this affects the borrower's credit profile. One speaker told the audience that "if you compare two similar firms located in two different countries, you might say that they are the same but they are not the same because their working conditions, their economic environment differ". A participant of the public sector took another example: "An SME located in Spain, even if it is exporting all his production to Germany is facing Spanish taxes, the future for Spain" he said. A banker stated that this economic fragmentation contributes to explaining why the cost of risk and capital for banks differ across the countries.

Another speaker noticed that in Spain and in Italy, when sovereign spreads were moving up, the spreads in the pricing of loans to the private sector were going up in tandem. But the symmetry is not the same on the way back. "We can observe that the reduction of spreads between sovereign is not fully translated in the reduction in prices of credit. Domestic factors like the non-performing loan ratio or the level of banks profitability are in play. Competition between banks does not help in this regard because the big players are only "looking and fighting for the best risks", he said.

While the decline in bank lending is in part related to supply factors, a leader of the industry stressed the importance of "not giving over-attention to the offer of credit, because demand for credit, is also a key problem".

The credit assessments of the banks are also influenced by the health of local sovereigns – rather than just by the characteristics of the firm. One speaker indicated that banks have positions on their sovereigns which impact their lending conditions". Another decision maker stated that banks established globally but operating in the same area were facing different funding prices during the crisis depending on where they were located in terms of sovereigns". In other words banks in a country are capped by the ratings of their sovereigns and sovereigns represent therefore one of the driver of this financial fragmentation.

The availability and cost of credit will remain due to the weakness of direct cross border lending to firms

A public decision maker noticed that if sovereign risks were zero in the EU, most banks are not structurally set up to provide cross-border lending. Direct cross-border loans to non-financial corporations account for just 7.5% of total loans to firms. And local affiliates of foreign banks represent on average only around 20% of national markets, and much less in larger countries. Therefore firms and households depend heavily on the health of their domestic banks.

The financial fragmentation is also caused by the existence of different regulatory rules within the euro area

A leader of the industry emphasized that achieving more cross-border bank lending in the euro zone is quite difficult because collateral requirements and solvency rules are different across borders. He added that "proximity to the lender remains an essential element of the customer relationship, and this will not disappear soon because the majority of the clientele of the banks are not "digital-native", and want to "see" the bank. They want to go into the bank, talk to the people working in the branch, and even touch the money. They pay a premium for these proximity services".

According to another representative of the industry, the new macro-prudential toolbox (systemic risk buffer, countercyclical buffer, extension of the scope of pillar 2…) introduced into the fourth Capital Requirement Directive (CRD IV) might cause even more fragmentation in the future. He stressed that this may undermine the single market through the introduction of national domestic capital requirements that do not reflect actual differences in risk, but rather some regulators' ambition to introduce strict capital requirements. He said that "in Norway, the common equity tier one ratio was doubled for macro prudential reasons. If you double the capital requirement, that might be significant for the terms and banking conditions to the customers over time. This kind of local decisions should be avoided. International bodies like the European Systemic Risk Board (ESRB) and the EBA should play an active role in harmonising the use of macro-prudential measures and Pillar 2 requirements".

A speaker from the public sector replied that there is indeed an inherent tension between what is needed in terms of macro-prudential supervision and the need to preserve the single market. He also recognized that this tension is not managed appropriately at this stage and should be managed in a more structural way. He took the following example. "If you have a financial system which represents 500% of GDP, you may ask these banks to structurally hold more capital than if they are located in a country in which the banking system only represents 100% of GDP. There is a very intense discussion between the regulators in order to define the appropriate balance between the macro-prudential objectives and tools and the need to preserve the single rule book.

The significant differences in the way supervision is performed also generate financial fragmentation within the EU

A banking supervisor reminded the audience that the supervision has, until very recently, remained mostly national, and national authorities have operated in a national legal framework. He stated that "the supervisory authorities answer to national public opinions and national Parliaments. They have their own national supervisory culture. They have quite legitimately national priorities."

He noticed that "before the crisis, you observed a kind of convergence, and all have the appearance of a single market, because the market acted under the presumption that the banking union already existed. When the crisis struck, it was clear that the institutional framework was not there. Coupled with the fall of confidence in the sovereign debt, this made the abrupt shift from a situation where the market assumed that there was a complete Banking Union and then discovered, perhaps overreacting in fact to the situation, that it was not the case."

The European Banking Authority (EBA) well knows how these supervisory practices diverge. The differences are particularly visible in the colleges of supervisors of cross-border groups. The EBA has identified the differences in methodology which lead to difficulties in reaching joint decisions on the level of capital and liquidity needed. But there is a response to this question. A participant of the public institutions underlined that "by the end of this year, the EBA should adopt a common framework for supervision with a unique methodology to evaluate risks and therefore capital and liquidity. So this is a big step forward, and therefore supervisors will significantly contribute in removing this kind of fragmentation."

3. The implementation of the Banking Union will help to mitigate several sources of this fragmentation and create the conditions for deeper banking market integration

The Banking Union will contribute to weaken the link between sovereigns and banks.

The Banking Union has three pillars: supervision, resolution and deposit insurance. A number of speakers


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explained that the Banking Union will weaken the bank sovereign nexus. The single supervisor with a truly European mandate and a collective responsibility will indeed guarantee that all the institutions are subject to the same rules and the same oversight practices and will not be subject to national biases leading to national biases that can lead to the temptation of economic introversion.

Moreover, in a crisis event, the new resolution framework (Bank Recovery and Resolution Directive, Single Resolution Mechanism) will shift the costs away from sovereigns and on to the private sector. And through the Resolution Fund, those costs will be spread more evenly across the euro banking sector.

The Banking Union will revamp the cross-border banking model within the single market.

Many supervisors stated that the single supervisor will create a set of homogenous standards, reducing the compliance costs of operating across borders. It will be in a position to remove some hidden barriers to cross-border activities linked to national preferences. This will foster competition, increase the efficiency of the allocation of capital. And, because the single supervisor will take a European view, the fungibility of capital and liquidity within cross-border banking groups should increase. It will increase economies of scale and should encourage banks to resume their cross-border activities.

Establishing the SSM is a huge challenge

The ECB will directly supervise the significant banks, which account for approximately 85% of the assets of the euro area banking sector. The day-to-day supervision of these 120 significant banks will be conducted by Joint Supervisory Teams, which comprise staff from both the ECB and the National Competent Authorities (NCAs) of the countries in which the credit institutions, their banking subsidiaries or their significant cross-border branches are established. These Joint Supervisory Teams have already been formed.

The NCAs will be in charge of the supervision of the approximately 3,400 less significant banks, but we are a single supervisory system: all the banks (significant and less significant) will be supervised according to the same supervisory manual, and the ECB can, if necessary, assume direct supervision of any credit institution to ensure application of the highest supervisory standards. The new structure of banking supervision will enable the efficient and rigorous supervision of all the banks in the SSM area through close cooperation between the ECB and the NCAs.

A public decision maker underlined that the staff of the SSM (around 800 supervisors) has largely been recruited. The division of labour between the national supervisory authorities and the ECB has been laid down. Internal procedures have been set out in the Supervisory Manual. So the way these joint supervisory teams are going to be organised is a huge challenge. He emphasized that "the knowledge, the information, is local from the beginning, so we're in a process which is really a sort of revolutionary process. The challenge is also important in terms of human resources. For example, the way you remunerate teams which are largely local and centralised at the same time is challenging. The Single Supervisor has to deal with a multi-national project, like multi-national companies have to do in terms of Human Resources. If we want to have really a strong, integrated SSM, so we need the rules, we need the teams thinking European and not national."

4. Banking Union: Conflict or Companionship?

The SSM and SRM could create a new dynamic also for the non-SSM members

A representative of the EU authorities assessed that the implementation of the banking Union should create a dynamic for non SSM members. Another one noted that the non-euro area members are legally allowed to ask to enter the single supervisory mechanism, and in practice, are strongly encouraged to do so.

If banks are entitled to keep their specific business model and will not have to pay for mistakes from other banks, then a majority of politicians would argue for its country to join the Banking Union.

An EU public decision maker replied that the membership of the SSM will be decided by the SSM members. The question whether the SSM can find a way to reconcile this specific business model specificity with what is needed in terms of convergence of regulation and supervision is like any discussions related to the single market. It is possible to accommodate specificities but only to the extent that the single market concept is not watered down. "If you start accommodating everybody's specificities there's no single market, because we're all specific" he said.

Regarding the costs in the case of a bank failure, he added that "within a Banking Union, banks share a responsibility for supervision and for resolution".

The EBA has an essential role to play in order to preserve the single market

SSM and non-SSM members of the single market should work in a consistent way. The EBA must ensure that the single market does not stop at the euro area's borders. Most cross-border groups will indeed continue to have operations both within and outside the euro zone and as such will continue to be submitted to join supervisory decisions in EU colleges. A public decision maker reminded the audience that from 43 cross border banking groups in the EU, only five of them will disappear inside the SSM and the others will have a significant presence in the euro zone and outside of it.

So it is vital to preserve and reinforce the single banking market. And the EBA is the only Authority which can organize common supervisory methodologies. A speaker stated that the EBA will continue its efforts to promote a single Rulebook and common supervisory culture, for example rolling out the common SREP Guidelines[1] in 2015 and working with both supervisory and resolution authorities in colleges of cross border banking groups to ensure full and effective discussion and joint decision making.

5. The implementation of the Banking Union alone may not completely eliminate the fragmentation of the financial system.

There was an agreement among the speakers to acknowledge that the Banking Union is not the "silver bullet" and that some fragmentation will remain following the implementation of the SSM and the SRM. They stated that the current financial fragmentation is unlikely to disappear completely across countries due to their different credit profiles, legislatures and traditions, particularly in light of the ongoing macro-economic concerns across the EU. This situation may be called the "new normal".

A leader of the industry emphasized that "we don't expect to see full economic convergence between the Euro zone member states because that would require effectively a degree of harmonisation, and a degree of mutualisation and alignment across the economies, that we don't see happening in the short term. There are still structural economic differences, and those are here to stay".

Another one said that "although the benefits of Banking Union could, and should, be far-reaching, ultimately the critical factor will be in the implementation, and rules need to be applied consistently. If not, regulatory uncertainty, and a lack of consistent implementation, could have significant and disruptive effect".

6. Additional measures are required to overcome the financial fragmentation

Implementing structural reforms to improve growth potential of euro member states, diversifying the source of financing of the EU economy and establishing a single deposit insurance scheme are also required to overcome the financial fragmentation.

Addressing the underlying structural weaknesses that affect the economies of the euro zone

Some speakers also stressed that it is essential that member states continue – or in some cases start-implementing structural and macro-economic reforms that will improve the competitiveness, the flexibility and the quality of the EU economies. This will contribute to raise investment demand.

Towards more market based financing for the EU economy

During the session, it was also suggested that the EU economy should me more reliant on capital market financing. One speaker stated that "historically, the US economy has been much more reliant on capital market financing, and one can argue that this has eased the economic recovery in the US. "

It was also mentioned that reducing reliance on bank funding by improving the capacity of financial markets to finance the real economy should reinforce the stability of the EU financial system and provide additional source of financing to SMEs and households.

A single deposit insurance scheme should be created

Deposit insurance after the harmonisation brought by the Deposit Guarantee Schemes Directive remains a national competence. A speaker stated that we should not erase the single deposit guarantee scheme from the architecture. He clearly emphasized that "If banks have the same rules, the same supervisor, the same mechanism for resolution, depositors are still differently guaranteed, if they put their money in bank A or bank B inside the same monetary union. So for citizens, it's very difficult to explain that you still have the national budget as a backstop, if something goes wrong."

1. The Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP) will be applied in the supervision of all institutions across the Union and represent a major step forward in forging consistent supervisory culture across the single market.

Towards a fiscal union?

Objectives of the session

The main objective of this session was to discuss whether the time has come to work towards a greater integration of the Eurozone's economic policies and more specifically to consider putting in place a fiscal union.

The current weaknesses of the EMU and the expected benefits of deeper fiscal integration were addressed first. The second topic was the possible content and ambition of a fiscal union (i.e. a more significant common budget, an insurance mechanism against strong cyclical fluctuations, a common unemployment insurance scheme, an equalisation of interest burden via a European debt agency) and the process for implementing such a union.

The speakers were also invited to describe the key success factors of any reform of the fiscal architecture of the Eurozone and the short term steps required for progressing towards a deeper fiscal integration.

Background of the session prepared by Eurofi

Remarkable efforts have been undertaken in the EU to prevent future crises and improve fiscal discipline but there are doubts as to the sustainability of budgetary discipline

The review of the main areas of financial regulation following notably the G20 commitments and the gradual implementation of a true banking union within the Eurozone should reduce the risk that a financial crisis of the magnitude that we have just experienced will materialise again.

In parallel significant improvements to the rules-based framework for fiscal policies have been achieved in the past few years. The six-pack, the two-pack and the Fiscal Compact represent an important step towards providing the EU with tools to manage public finances in a sound and consistent way.

Moreover, with the European Stability Mechanism (2012) and the two-pack, both a permanent funding instrument and a governance framework, the euro area is endowed with instruments to respond to possible future crises.

These are key steps to reinforcing the European Economic and Monetary union. Indeed a monetary union is not workable without fiscal discipline. Sound fiscal policies are essential for growing out of the present level of public debt which is penalizing EU economies. The economic problems of individual Member States that share the same currency impact the whole union because this undermines the cohesion of the Union and the solidity of the currency. This has been shown by the recent examples of Ireland and Spain that have been affected by very strong asymmetric shocks which they were unable to handle on their own and which impacted the whole of the Eurozone.

However despite these improvements, economic and fiscal policies remain a national responsibility which does not guarantee a permanent stability of the Eurozone. In addition although budgetary positions in structural terms are close to balancing in many Eurozone countries this is not the case in the whole zone and several Member States do not comply with the requirements of the Maastricht treaty at present despite the implementation of the recent economic governance package. Moreover the euro area's debts remain at high levels. It is also uncertain whether these governance mechanisms will be strong enough to convince Member States to bring their fiscal policies in line with the Stability and Growth Pact and the Fiscal Compact in a lasting way. Liability and control need to be further reconciled.

The potential benefits and feasibility of a fiscal union are debated in this context

The President of the Deutsche Bundesbank recently stated that "the euro area has reached a kind of cross roads: either we proceed towards a fiscal union in the sense of establishing joint liability with centralised rights to intervene in fiscal matters at the European level, or we turn back to the original framework as specified in the Maastricht Treaty and reinforce the principle of individual national responsibility (which would require in particular to end the preferential treatment afforded to sovereign debt)".

Progressing towards a fiscal union would reduce the incidence and severity of any future crisis by providing an ex ante framework for enforced fiscal discipline and temporary transfers.

The Four Presidents Report "A genuine and comprehensive Economic and Monetary Union" (2012) outlines the economic rationale for such a fiscal capacity. "In a common currency area, the burden of adjusting to country – specific economic shocks falls on labour and capital mobility, price and cost flexibility and fiscal policy. In order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific shocks are less than perfect. This is clearly the case in the euro area where labour mobility is comparatively low, capital flows are susceptible to sudden swings that can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources... In this context, setting up risk-sharing tools, such as a common but limited shock absorption function, can contribute to cushioning the impact of country specific shocks and help prevent contagion across the euro area and beyond."

Deeper fiscal integration would also boost economic growth in Europe since it would reflect a dynamic community approach that would be able to restore confidence in the benefits of European integration, while reviving entrepreneurial development and investment in Europe.

This would however mean yielding a great deal of national sovereignty in fiscal policy matters since a significantly stronger element of centralised intervention regarding the definition of national budgets would be required. It can be considered that if the "new budgets" are admitted by a central authority as adequate, the new debt would be the object of a mutualised treatment (leaving aside the legacy debt). This raises difficult political issues. The confidence of the citizens is therefore needed, implying that democratic accountability must also be strengthened.

The various ways of progressing towards a fiscal union and the possible ways forward

The convergence process should imply the transfer of certain budgetary responsibilities to the European level with a view to strengthening risk-sharing within the currency union. But this can only occur once trust has been restored across countries and within countries. Mutualising legacy public debt created in the past is not possible at this stage. However once Member State governments have demonstrated for a certain number of years that their budgets are in accordance with requirements defined and monitored centrally at the Eurozone level, one may consider mutualising the new debt issued.

The economic convergence process within the Euro area could be complemented by joint European investments in public goods such as network industries and R&D, as a way to bolster Europe's growth potential and to even out drops in public investment in economies hit by shocks. Yet, this should be achieved by prioritizing spending and should not undermine efforts that remain necessary to bring down debt levels. This action would be consistent with proposals by the upcoming President of the European Commission who has proposed a €300 billion public-private investment programme to help incentivize private investment in the EU economy. There are however several different options for achieving deeper fiscal integration. Four main options for achieving deeper fiscal integration in the Eurozone have been proposed: a common budget, an insurance mechanism against strong cyclical fluctuations, a common unemployment insurance scheme, and an equalisation of interest burden via a European debt agency.

Deciding on the appropriate course of action requires thorough technical and public exploration before political decisions can be taken. A decent first step could be, as proposed by Paul Tucker in the Eurofi newsletter, to set up an expert commission to conduct such assessments, completing the work of the 1980s'Delors group on EMU.

Summary of the session

The moderator introduced the session by reminding the audience that the European Union was born in Rome in 1957 and its foundation was based on a very clearly stated principle of neutrality between the public sector and the private sector. And one "old and venerable but evergreen of policy course, competition policy, rests in fact on the total neutrality between public and private ownership, provided that companies do comply with the competition and stated rules".

When the single currency was conceived, the moderator emphasized that an entirely different approach was adopted. It deliberately discriminated profoundly between the public and the private sector, so that the Maastricht Treaty and the Stability and Growth Pact and all the myriad of subsequent instruments have been built up "with the concern of putting strings and straight jackets for very appropriate reasons to one component of the economy, the public sector". Then we have discovered a few years later that the fact that other financial flows, flowing into the private sector had been neither constrained nor in fact very much monitored has created a big problem, he added.

One peculiarity of the Maastricht Treaty and the Stability and Growth Pact that are being more and more reconsidered today, is the implicit assumption that expenditure originating from the public sector is more suspicious and more dangerous for the economy, even when it concerns an act of investment. Regarding expenditure originating from the private sector policy makers don't have apparently to have any particular concern.

After these preliminary remarks, the benefits, the possible ways forwards and the various ways of progressing towards a Fiscal Union were actively debated.

1. Monetary Union dangerously incomplete without some fiscal union: "Delors 2 needed"

A decision maker started his intervention by stressing the importance of moving towards a Fiscal Union. A focus on the long-term architecture would help to underpin confidence in the nearer term. He stated that "Fiscal Union represents a great issue that our continent faces and it is the great issue that the rest of the world wants our continent to face. Indeed, if a monetary union suffers from very big shocks that affect different regions/members very differently, there have to be mechanisms for adjustment. That should not rely entirely on migration and shifts in relative prices and wages".

Then the speaker gave the audience three illustrations of why it is so important to move towards a Fiscal Union:

- During a recent conference marking the 70th anniversary of the Bretton-Woods Conference attends by ex-Finance Ministers, ex-Presidents, Central Bankers from around the world, there was sharp criticism of Europe for turning to the IMF and hence the rest of the world for resources for the package for Greece when the euro area as a whole could afford to sort out on its own".

- Second, the ECB looked to be heading to provide stimulus to nominal demand by buying private sector paper. The speaker pointed out that "If you buy private sector paper you are getting into the distribution of resources across sectors and borrowers and taking risks that can only be covered by the taxpayer. That doesn't mean that the ECB has adopted the wrong measure. It means that in the absence of alternative mechanisms, the ECB is the only Institution able to combine monetary stimulus with quasi-fiscal stimulus. There is something wrong here."

- The third angle was about the Banking Union. According to him, without a common deposit insurance scheme, a complete Banking Union or even a complete and well-founded monetary union cannot be achieved. "A monetary union means that the money of the currency area must be homogenous. By definition the central bank money (issued by the ECB) is homogeneous. But the private deposit money which is most of the money people use, is not because the deposit- insurance regime in one member country is not the same as another, so that a retail deposit in one country is not the same as another. Without a collective deposit-insurance scheme, the monetary union remains fragile." In the US, the deposit-insurance regime is part and parcel of the Fiscal Union.

The speaker proposed therefore that the euro area should debate what kind of Fiscal Union it should have, and through what staged-process it could move there. The issues are profound, requiring thorough technical and public exploration before political decisions could be taken. Therefore he suggested as a first step that "an expert commission, completing the work of the 1980s'Delors group on EMU should be set up".

There were various ways of progressing towards a fiscal union.

One possible route would be a union of rules, where control over fiscal policy in a euro-area member country was transferred to 'the centre' if certain debt or deficit thresholds were breached. For this speaker, that seems likely to create political resentment and tension in the event of a country suffering a crisis that's not of its own making.

A second route would be mutualisation of debt, but that entailed moral hazard and blunted local incentives to be prudent.



A third possible route would involve some kind of collective catastrophe insurance against the costs of very large increases in cyclical unemployment. Under this approach, according to this decision maker, first, there would be no subsidy for structural unemployment, underlining the incentive for necessary supply-side reforms. Second, there would be no bailout for insolvent states. But third, the people of the euro area would help each other, and fourth, spending in the worst hit economies would get some underpinning.

The speaker noted that the US established in the mid-19th century that the Federal government of America would not bail out bankrupt State governments; "If California, for instance, were to go bust its state, the State of California, would default and the federal government would not be bailed out. But the people of California would get some help from the people of Massachusetts and Texas, and that helps to forge a common bond between the people of California and the people of Massachusetts and Texas. The euro area needs to establish the same kind of mechanism to help cushion the blow of really big asymmetric problems without diluting incentives to reform".

He concluded by reminding the audience that "it is absolutely vital that everybody understands that without some kind of Fiscal Union the Monetary Union will not be sustained in the very long run. That is not in the interests of anybody; it is not in the interest of the rest of the world".

2. Some progress has been already achieved to strengthen the Economic and Monetary Union

To overcome the financial and sovereign debt crisis, euro area Member States have further enhanced the economic and monetary union (EMU). Two EU decisions makers explained that the arrangements adopted to strengthen the institutional set up of EMU and address the budgetary and macro economic imbalances represent major steps towards a Fiscal Union.

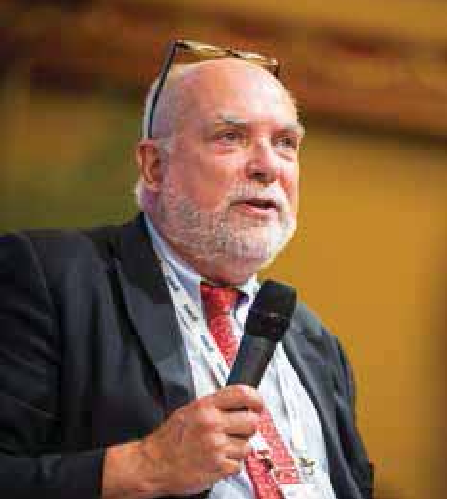
Member States have in particular pooled resources to establish a permanent euro area crisis resolution mechanism, the European Stability Mechanism (ESM) and have created a Banking Union, which includes a common supervisory structure, a resolution authority and a resolution fund. The speakers agree that this represents an effective element towards an element of Fiscal Union even if it has not been seen in this way from the outset.

The ESM was indeed established in October 2012 and since then has been operating as the euro area's crisis resolution mechanism. Together with the temporary crisis resolution fund – the EFSF –, the euro area countries have pooled resources to build up a common firewall of €700 billion, helping countries in financial trouble with an efficient set of support instruments. The ESM has a maximum lending capacity of €500 billion. It is a substantive central fiscal capacity that was created. So far, only €50 billion has been used. In other words: €450 billion is not tapped, which leaves plenty of room to address any possible future crisis needs. The ESM will also have a role as last line of defense in the banking union.

Moreover some speakers stressed that further steps towards fiscal union, as proposed in the report "Towards a Genuine Economic and Monetary Union", jointly prepared and presented in 2012 by the Presidents of the European institutions and by others, could support more growth in the euro area and increase its overall resilience.

Nonetheless, many decision makers emphasized that the environment of cheap and ample financing in financial markets currently sets little incentives to move towards more fiscal union. However, one decision maker assessed that "this calm may be elusive". Another one warned that "the euro area had a near death experience and the fact the bond yields are so low now doesn't mean that it couldn't come back. Do not think that low bond yields are a nice measure of high confidence, tragically they are not", he insisted.

More generally all the speakers acknowledged that that any further steps towards a Fiscal Union require a sufficient strengthening of the central euro area level governance power.

According to one of them, a first step towards a fiscal union could be an incentive-based arrangement of contracts with the Commission to support structural reforms. The arrangements would work within the European Semester, which was created to coordinate macro-economic policy. They are thought to be mandatory for euro area countries, and voluntary for others. The Commission would make suggestions for reforms, agree with the Member State and monitor implementation within a multiannual plan. The fiscal component is that the scheme could be supported through financial incentives. Member States with excessive structural weaknesses engaging in significant reforms could get a temporary transfer.

The speakers also agreed that significant structural reforms are the key priority to enhance growth prospects for the euro area.

One of them assessed why we are facing in Europe such an enormous debt overhang. He indicated that there is a high degree of correlation between the level of debt of a member state and the level of structural measures it has implemented to deal with globalisation. Member states which have adopted appropriate measures to face to globalisation are the less indebted countries. And those who are suffering from high debt are the countries which did not deal with the challenges of globalisation. He pointed out that "We cannot any longer deny that we have to make our economies more flexible in order for them to become more competitive at a global level. And if we continue to deny what needs to be done and continue to shovel debt on to the problems so that the politicians continue to be voted for, it will help for a year, it will help for two years but escapism is not a sound and stable solution".

In such a context, any incentive scheme which can be found to support reforms should be welcome. This is the reason why a speaker mentioned that adding positive incentives to the overall governance framework provides added value. From an economic perspective, some reforms may carry economic costs in the short run, such as foreclosure measures, and only longer-term benefits. Providing limited support in an area complementing structural reform such as funds for venture capital or project finance when business is deregulated may also multiply this positive effect. Politically, receiving financial support can help to break a political stalemate and create ownership.

In the long run, solutions that would lead to an even larger degree of fiscal centralization- based on a European or euro area budget, may gain some traction. The precondition would be that confidence in national and local government fiscal responsibility becomes fully anchored. The mutualisation of public debt indeed requires a relationship of trust among members states, based on a fiscal framework much stronger that the one we currently have This central budget could be limited and complement national budgets in areas with strong cross-border effects (such as networks, infrastructure or defense).

Today the euro area's fiscal capacity is limited to crisis resolution events. Euro area fiscal policy currently follows a rules-based approach and relies on policy coordination among Member States. This is very limited compared to any existing federal system, including the USA. But one needs to remember that the prevailing central government role in fiscal federations has been achieved over long periods and is based on a political union.

The lesson from existing fiscal federations is that a higher degree of Fiscal Union also requires a deeper Political Union. On this account, further steps towards fiscal union in the euro area have to be in tune with a more powerful euro area governance structure.

Fiscal Union means yielding a great deal of national sovereignty in fiscal policy matters since a significantly stronger element of centralised intervention regarding the definition of national budgets would be required

A speaker pointed out a paradox about the Fiscal Union: "People who want to move towards a Fiscal Union strongly object to sharing sovereignty'. And these two tenets are not jointly tenable" he said.

He explained that there are many different definitions regarding the fiscal union and gave some examples. "You can say fiscal union is about risk sharing or you can say fiscal union is about fiscal control and discipline. Or you can say that Fiscal Union is about a net transfer of resources that we could call solidarity. Or Fiscal Union is something in order to provide a buffer against/for anti-cyclical and asymmetric fiscal policy following asymmetric shock which could hit the euro area".

What is germane to all of these models is that "there is an element of joint risk taking". The speaker stated that this explains why banking union and fiscal union overlap. The Banking Union means a Single Supervisor, a Single Resolution Mechanism and a single Deposit Guarantee Scheme. The decision maker specified that a joint deposit guarantee scheme is part of a Fiscal Union; it requires loss of sovereignty, and presupposes elements of political union. "This is the reason why finance ministers are not ready to move forward towards such a common scheme" he added.

He also stressed that there are many circles who want a Fiscal Union but do not want political union due to the lost of sovereignty. But, according to this speaker, "this is the necessary debate which should be launched in Europe over the next one or two years trying to set out what the sometimes divergent views are and what possible solutions could be proposed".

He also expressed his own views on the different steps towards the Fiscal Union; the step number one should be a small one. It consists of a small treaty change which incorporates all the little piecemeal economic reforms done over the last years (six-pack, two-pack...). Then there is the possibility for larger reforms provided that there is a sufficient political leadership in favour of elements of fiscal risk sharing.

Under the present constitutional system, any further movement seems very difficult. "But the less political control and co-determination you have over its system the more complex the rules are because politicians then always believe, put in another screw, put in another element and we will have total control. Look at fiscal policy in Europe nowadays and it simply shows there are limits to total control", he added.

3. The democratic accountability must be strengthened

A decision maker explained that the European construction is dealing with three obstacles to move forward:

- Growth is Europe is very low growth and unemployment is very high.

- Europe is suffering from a lack of support from its citizens who do not understand economic decisions taken in Brussels and who are lost by EU politicians. The recent European elections have shown in particular the degree of disenchantment of EU citizens with the European Union.

  The speaker illustrated this specific obstacle by giving two examples:

  "it is not honest to explain to the citizens that following the battle for the EU elections between political parties, we are organizing at the EU Parliament a big coalition bringing together socialist, centre and centre-right political forces to defend either the socialist views or the ones of the European People's Party", he said.

  Otherwise, "nobody will fall in love with the Six-pack and the Fiscal Compact even if it is very necessary to have all the controls", he added. These measures are too complicated. Europe has to change our approach if we want that EU citizens agree to progress towards a fiscal union or more integration in Europe.

- Third, 20 years after Maastricht, economic cultures between members states are very different and this is the most difficult challenge to be addressed in the coming years. In Germany for example, the majority of people estimate that there is no growth because of the lack of structure reforms and the lack of budgetary discipline. Conversely in France, many people think that it is not possible to respect the common fiscal liabilities objectives because of the lack of growth. A chicken and egg question here. The most important challenge is to work on these divergences in economic culture, according to this speaker.

In addition this decision maker pointed that citizens do not really trust so much politicians but all the politicians are proud to have politicised the Commission and the European Council. He observed that unfortunately, this is not what the business community and public opinions are expecting. They expect from the politicians to deliver and to able to work together.

Concerning the Fiscal Union, the speaker confirmed that there is a consensus that we need a common budget. But this requires a political momentum and therefore the support of EU citizens. This is why the economic benefits of the fiscal union have to be clearly explained to public opinions of the euro zone and more generally from the European Union. "National debates are too focused on national and sometimes narrow-minded issues. The external dimension has to enter into the political debate, if not no progress towards the economic or fiscal integration of Europe will be possible", he concluded.

All the speakers agreed that a political consensus and leadership on a common vision is required to more forward a Fiscal Union. "We need to create a common economic culture; it will take time. It took a long time in the US and several crises. We probably don't have that much time but they are necessary conditions" a speaker said.

Another one deplored that a majority of the twenty-eight member states does not have a strategy of where and how they want Europe to be in ten years time. He added that it is clear that all elements of fiscal union require a political mechanism. "We cannot sneak in by the backdoor and fool the voter, and fool parliaments. National parliaments have a feeling that everything is done in the European parliament. They don't have any experience of Europe, no experience of Brussels, no experience of the legislative part of this world. Therefore, I think that the present distribution of democratic accountability with a very, very strong emphasis on the European Parliament, which is fine for the European Parliament, has contributed importantly to the way that the European people have distanced themselves from Europe" he added.

Another speaker confirmed that we have missed something in the legitimacy of the European Parliament but he replied that "do not draw the conclusion that it is a reason for giving again the power to the national parliaments because they are part of the problem too. If we have not prepared the future, if we are indebted, if we don't think long-term they have to take part of the responsibilities, so the solution is to improve at both levels the accountability and the scrutiny of the policies..."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EU BANKING REGULATION

Priorities regarding the regulation of the EU banking sector

Objectives of the session

The objective of this session was to outline the general consequences of the evolving bank regulatory landscape for the European banking sector and economy. The session helped to clarify in particular how far EU banks have gone in the implementation of Basel capital, liquidity and leverage requirements and the challenges raised in the EU by the implementation of Basel regulations. In addition the panellists were invited to describe the most significant impacts of the financial regulations being implemented on EU financing mechanisms, banks and the economy.

The aim of the session was also to identify priorities to be addressed by the renewed EU institutions in order to improve the financing of the economy, address certain unintended consequences of the new banking regulation (e.g. reduced provision of liquidity to financial markets or credit supply to SMEs and infrastructures, etc.) and reduce the current regulatory uncertainty.

Background of the session prepared by Eurofi

The comprehensive set of reforms developed by the Basel Committee on Banking Supervision - "Basel III" - have been defined in 2011 (Leverage ratio, minimum common equity capital ratio, capital conservation buffer, minimum Tier 1 capital, minimum capital ratio, a definition of capital instruments qualifying as non core tier 1 or tier 2 capital) and 2013 (liquidity coverage ratio, net stable funding ratio). The Basel III phase-in timetable started in 2013 and ends in 2019. Defined in response to the financial crisis these measures aim to improve the banking sector's ability to absorb shocks, their risk management and governance, including in the case of system wide risks.

Though large parts of related level one legislative pieces have already been adopted, the transposition of this global regulatory framework in the E.U. is still on the way in particular through the so-called delegated and implementing acts to give full effect to an E.U. single banking rule book.

This would give way to important – though level 2 - policy decision in the coming month (appropriate calibration of certain capital charges, definition of high quality liquid assets of the LCR and related haircuts, etc.).

Tighten bank regulation triggered a challenging adaptation process in the E.U.

According to the BIS banks in aggregate do not appear to have cut sharply the assets or lending growth due to higher capital standards. More recently however the IMF pointed out the ongoing deleveraging of banks. Indeed it found that the improvement on the Core Tier 1 of the Large European Union Banks (from 10.0% in Q3 2011 to 12.4% in Q3 2013) was due respectively to recapitalising (90bp), deleveraging (90bp) and de-risking (reduction of RWA (60bp). In particular the IMF pointed out that in the countries of the stressed euro area the main reductions of banks exposures were in the domestic private sector.

Credit supply constraints negatively interfere with the monetary policy

Though the regulators in particular in Europe anticipate no systemic impact, such tightening of banking regulation has triggered a challenging lasting adaptation process with deep consequences on banks and financing processes in the E.U.

In particular negative impacts are expected on the availability, the maturity and the price of bank loans. The involvement of banks in market making is also decreasing. In addition the regulation is impacting interbank markets, in which demand for collateral rises.

In addition, regardless the actual situations of banks regarding their regulatory capital or liquidity, from now on bank regulations are the bedrock of decision-making tools of banks networks. Consequently part of the deleverage observed is the consequence of the rapid rise in lending prices, which are more and more in line with the actual credit risk of bank counterparts even in highly competitive contexts.

Finally bank-money creation regimes are changing with huge consequences on monetary policy and tools. Bank deleveraging results in a very moderate money creation. Annual growth rates of M3 in the Eurozone are poor and moving down .

The reason is simple: credit to the private sector (which is the major counterparty of money) is falling and therefore cannot provide the necessary transmission channel to the real economy. Currently the increasing credit rationing of SMEs , which first emerged in periphery countries, is now touching other EU states.

The regulatory tightening happens in a context where E.U. growth is still fragile and deflation-risk exists. In this context Central Banks consider that credit supply constraints might negatively interfere with the transmission of monetary policy and reduce the impact of aggressive monetary policy.

The challenges posed by the implementation of banks regulation in the E.U.

According to the regulators the challenge for Europe is to succeed reinforcing banks so that they have high capital ratios or strong profitability to support lending. They highlight in particular the positive impact that an increase in the ratio of capital and reserves to non-performing loans, has on the level of credit.

In that respect data regarding the trend of the implementation of new bank regulations in the E.U. seem encouraging. The shortfall capital of Common Equity Tier showed a significant decrease in the middle of 2013 and the big banks have an after-tax profits before distribution of €456 billion. Europe is in addition very close to having implemented the Basel requirements regarding the LCR.

The EBA highlights also that the banks of the Euro area have risen over €80 billion in capital in 2013 and that they should rise additional €60 billion in 2014 benefiting from benign market sentiment.

However an important question is whether the reinforcements that the E.U. banks have already achieved were the easiest part of the efforts demanded to the banking sector. If it were the case the next steps might have an even more negative impacts on the financing of the economy in a context of already contracting credit supply.

Indeed the capability of E.U. banks to further strengthen their capital and liquidity depends in particular on their relative attractiveness (median price to book ratio is increasing but still inferior to 1, while no changes are witnessed in inferior tail). In that respect the specific situation of the banks of reduced size and of each country (economic recovery, perceived riskiness of domestic banks) is critical.

One additional issue is the form and feasibility of an E.U. process of consolidation and resizing of banks, which is expected in particular to address the case of weakest and less competitive banks, and its ability to maintain the necessary level of credit to the E.U. economy in the different Member States.

The profitability of E.U. banks is a concern

It is worth noting that European banks apparently operate in a highly competitive context, which is not favourable to a self-reinforcement of E.U. banks on the basis of their sole earnings, when resuming growth will require additional lending.

Indeed, before the financial crisis their net income amounted in average to approximately 0.58% of total assets. After the crisis it is 0.22%. In the United States these ratios are respectively 1.07% and 0.69%. Yet on average the operating expenses in the EU – about 1.35% of the assets - are lower than those of U.S. banks (2.81% and 3.15 before and after the financial crisis).

However European banks apparently did not widened lending spreads in similar proportions to American ones (respectively +22bp and + 34 bp).

The EBA stresses in that respect that the operating income of E.U. banks declined €10 billion in 2013 after a decline of €39 billion in 2012, and the fact that the flow of profits declined by 58%.

The ongoing calibration of certain key regulatory pieces raises additional and fundamental issues

Beside this, the regulators at global level are still working upon certain key regulatory pieces. In particular adjustments to calibration and definition to the Leverage Ratio as defined in Basel can be made until 2017.

In this respect according to certain observers, regional specificities of the banking sectors (e.g. the macroeconomic specificities of the regions in which the assets are held, the existence in the US of Fannie Mae and Freddy Mac, which absorb much of the housing risk, the fact that in the U.S. the loan book requires six times the provisions required in Europe, etc.) may require adapting the calibration at regional levels.

Furthermore the leverage ratio, the calibration of which depends on the capacity of the supervisors to restore the confidence in risk-based ratios, may finally become the binding regulatory constrain although it is supposed to just act as a backstop. Certain fear that this could eventually reduce the risk sensitiveness of the management of banks.

Finally the impact of this ratio on bank lending activity should also be carefully assessed. Similarly the expected impacts of the NSFR on banks lending ability raise a question mark (e.g. reduced maturity transformation capability of banks).

Summary of the session

1. Huge progress has been achieved

A representative of the public sector stressed that the amount of regulation brought about has been enormous and it has been done in a very short period of time. Huge evolutions have already been achieved in the EU: the banking union and the Single Resolution Mechanism, which help to foster financial stability, and boost confidence and investment in Europe. An EU public decision maker stressed in addition that in the EU we are very close to the finishing line of implementing the new regulation: we started he said with huge shortfalls with respect to Basel III standards - 230 billion only three years ago in terms of Common Equity Tier 1, trillions in terms of liquidity. Now the shortfall is basically zero in terms of capital, in terms of liquidity coverage ratio. He also said that even the shortfall related to the net stable funding ratio, which is not yet even in the legislation, is very small and manageable.

In that respect the participants from the banking industry asserted that financial markets are in a much safer place now than at the onset of the financial crisis. They were also of the opinion that significant progress has been made in terms of resilience. In addition they pointed out that one of the major achievements of the G20, is the degree of regulatory convergence, which has been achieved.

An EU policy maker also pointed to the fact that these changes had been very painful but had also been a condition to re-start lending. And he expressed the opinion that the banks that have completed the adjustments are the banks that lend more into the real economy.

However, he added that though a lot has been done on the liability side, now the necessity is also to check the quality of the assets and stress test to create much more confidence. The stress tests are a huge opportunity to improve confidence talking about how all the regulatory things that have been done so far have contributed to a safer system. A tough AQR, which is almost finished, showing what kind of risks are in banks and how the provisioning is done, will also represent a positive input into the economy and the banking system, as it will also add to investors confidence in the banks.

2. However leverage has continued to increase

Though a panellist from the public sector stressed that debt has continued to increase but in different places and formats, which continues to be a concern. Actually the leverage is not that much in the banking sector but in businesses in the emerging markets and in Sovereigns in the advanced economies. Another public decision maker agreeing on this point said that the level of leverage in the private sector remains very high particularly in those countries where there is less growth and where the situation has been particularly fragile recently.

He concluded by stating that increasing bank capital has created lending capacity, but we also need to act to reduce the leverage in the private sector notably helping banks to work out bad quality assets. The Asset Quality Review is a major contribution in that respect he said as the banks included in the sample of the EBA stress test have raised €120 billion of capital, and have taken additional provisions for 120 billion. This has created capital capacity allowing banks to do write down ailing assets, which is also beneficial because it also reduces the debt of the private sector.

3. Completing and implementing consistently existing regulatory projects should be the priority

However an executive of the private sector explained that despite all the stuff that has been done for banks to de-risk the system, the premium over the risk free rate is wider than it has ever been. He stressed in particular that the risk free rate is now about 1%, while banks are required to give returns on capital of 10% plus. Why do investors want a higher premium than they have ever asked for in the past? He asked. The answer is regulatory uncertainty: what the rules are going to be, no idea on how much capital banks will require, no idea if banks are going to be allowed to make a profit, etc. Actually he concluded though much has already been done in terms of capital, in terms of the resolution, in terms of the shadow, OTC, all the different blocks but it is not complete.

Another panellist said it was not true that the markets request higher capital constraints on the banks. What markets want is, either you return equity to the shareholders or you invest it in new activities. He stressed finally that markets ask for a higher capital ratio when the regulator hints that new rules will be implemented, and this creates regulatory uncertainty.

Another representative of the industry stressing that among the recent 56 pieces of bank regulations, 19 are not yet finalised, stated that this questions the ability of a banking system to operate efficiently with so many moving parts, and so many remaining uncertainties. One of the problems, said a representative from an EU bank, is that there are only 52 weekends in the year. We have to switch systems off to be able to test them that means you can only do it at weekends. Regulators have to understand, the sheer number of projects that are now being worked on, the strain that that is creating, and help us to prioritise within that burden.

Consequently in terms of regulation, the priority shared by most of the panellists is now completing what is on the table. Regulatory pieces like the stable funding ratio, the calibration of the leverage ratio, GLAC, etc., need to be completed. Consequently the private sector stressed also the need for regulators and policy makers to refrain from adding new layers of regulations that will introduce additional constraints and costs on financial institutions and their final users e.g. the financial transaction tax; level 2 rules or technical standards fully in line with the spirit of the Level 1 framework registration.

Finally a participant suggested not to 'widen' regulation, which means increasing it, but to focus on 'deepening' it, which means only Level 2 action. Another panellist also reminded the audience of the importance of having a level playing field, which requires having a consistent implementation. Many participants on the panel stressed in that respect that in Europe the move towards the banking union is absolutely impressive and the final test will be when a bank is analysed and judged only by its business model, risk taking, portfolio, etc., and not depending on where it is located.

In addition a panellist proposed that new global resolution standards be based on a detailed feasibility study and impact analysis due to serious constraints on the banks' financial market. In addition regarding the crisis and resolution frameworks being discussed at both the European and the global level, the definition and calibration of bail-in instruments (MREL and GLAC) should take into account existing and ambitious Basel III capital requirements as well as the limited liquidity of the subordinated-debt market. In addition the final calibration should not simply be a combination of the stricter features of both EU and Global proposals.

However a representative of the public sector reminded the audience that the fundamental objective of the regulatory process underway, is to make the system safer and reallocate risk on the owners' and investors' sides; a system, which is not underwritten by an unlimited guarantee of the State. He acknowledged that the transition is in full swing and that at the same time it is already enforced. He quoted in that respect that we had in Portugal the first resolution this summer in August, de facto under BRD rules, though the BRD is not yet in force. Consequently some 40% of the costs were borne by shareholders and junior debt holders. In Slovenia, in 2013, State Aid rules on bail-in were strictly applied which led to a 20% reduction of the cost for the State. He asserted as a conclusion that actually the markets reacted positively, with enormous volumes, historically speaking, of junior debt being raised in 2014. Up until May, in Europe, 22 billion Euros of CoCo's were raised. In 2013, that was 1.8 billion Euros.

4. Remaining issue: securitisation to improve SME lending

An EU policy maker proposed specific issues regarding the interplay of bank regulation and economy recovery, stressing that the monetary easing has not reached certain segments of the productive economy – for SMEs, for instance, in some countries, the cost of financing remains too high he said – which means, that these firms are too fragile, and that it is difficult for the banks to lend to them.

He also stressed the key proposal that the ECB has put forward to see whether a revamp in the securitisation market can help and acknowledged that the calibration of bank requirements for securitisation was wrong as it was mainly made on default history in US markets while European securitisation has a different performance. He finally proposed in order to correct the situation to differentiate securitisation capital charges according to the quality of securitisation.

He concluded the point by saying that capital requirements have not a magic wand that solves all the problems in the world. In particular regarding SMEs securitisation, he said that the lack of standardised information is probably an issue, as well as the sovereign caps that credit rating agencies are imposing, which require uneconomical credit enhancements and

are significant impediments probably damaging this segment of the market. (Rating agencies justify rating caps by the risk that ABS face in case of country defaults or other major macro country events.)

5. More on supervision as the financial system is evolving very rapidly

A panellist stressed the fact that the emphasis should now be much more on supervision as the financial system is moving very rapidly. Supervisors have to reassure people that regulation continues to be applicable to the new financing mechanisms, which are less bank-intermediated and more capital-market intermediated. We need to prepare for the next crisis.

In particular in this new world we need to understand where new risks are. In that respect the behaviour of the asset managers, yet less leveraged institutions, is going to be very important. Actually it could be "leverage-like" behaviour and cause "leverage-like" tensions that could bring new stress to financial markets. Perhaps we are moving to a financial system in which liquidity is going to be the critical factor and it may be that less leveraged institutions behave very pro cyclically in very non-linear ways. These behaviours may result from competition among asset managers, their "index chasing", etc.

The though pillar one regulation on bank resolution is complemented by a Single Resolution Mechanism. This is crucial to having market distortion and moral hazard removed. In the EU we will have the BRD come into force in 2016.

Confidence is not yet fully restored; it will not be by piling up new layers of regulation.
Regulators need to fully recognise the critical importance of governance, culture and behaviours. Governance will not stem from excess regulation.

Consequently the official sector has to understand the operational risks that exist within major financial institutions at the moment.

6. Monitoring the multiple possible effects of the regulation put in place

A panellist asserted that at this point in time we are in a post-regulation phase, which requires monitoring the effects of the regulation put in place and in particular checking how regulations work over time.

One participant on the panel illustrated the issue explaining that though liquidity regulations impose more securities on bank balance sheets, which is a good thing by itself, if the economy were to improve a bit and interest rates were to move up say an additional 1% we would see the value of those securities going down, and symmetrically the value of the equity basis at the expense of the lending capacity. He explained that a 100 bp increase of interest rates would reduce the value of the 22 hundred billion of liquid assets held by European banks by 22 billion, and reduce subsequently the regulatory capital basis of the banking sector. In the context of a 4% leverage ratio this would mean a 550 billion reduction of the lending capacity in the EU (3% of our total lending) taken away, in a context where the current 2½%, raises significant concerns for growth.

He concluded by saying that Individual liquidity rules and capital rules are good but, we still need however to look at how things are interacting with each other. The objective should be that banks become a sort of stable lenders able to increase their lending capacity not subject to all this potential volatility.

More generally a panellist was of the opinion that one should monitor the interplay of all the new financial regulation - prudential regulation as well as MiFID II, EMIR, etc.

In the context of the "tsunami" of regulation experienced another panellist suggested paying attention on a two-fold damaging process and pro-cyclical effect on the economy. One effect he said is a de-leveraging, sometimes unhealthy de-leveraging e.g. changes in total assets but also in risk re weightings and


insufficient write-offs. Another effect is an increase in the costs of funding of banks- both equity and debt – as banks' risk premiums have increased by more than 400 basis points. One participant added that the prescriptive nature of regulation is clearly providing wrong incentives. For instance **the leverage ratio is creating a disincentive to lend** to the SME sector, in particular for good quality SMEs. An executive from the private sector concluded the point by saying that the financial system is there to be at the service of the economy, effectively support monetary policy and ensure a sustainable supply of credit; it has to be adequately supported by properly remunerated investors. However it is a matter of fact that after the crisis in the UK people were not taking credit, credit facilities were withdrawn, as **banks de-risked** to solve their capital deficiencies. Similarly the pricing of the facilities they had went up to help re-building bank balance sheets. In the event that the rules change again, facilities will be withdrawn and will be re-priced upwards. Finally the participant concluded by saying that the targeted role for the sector is not consistent with actual regulation. We have a vision of the future that says that we really want to encourage the system to look at credit to SMEs, to think about infrastructure, and we build a regulatory system with strong incentives to focus on short-term risk-free assets.

Another participant on the panel also stressed the returns on equity which are very low because the banks are asked to raise more equity in the period of economic depression that the European Union is experiencing, and they do not cover the cost of equity. Consolidation is the way out he concluded. The process of balance sheet repair and exit of inefficient banks should lead to consolidation at the Eurozone level. It is important that this process of consolidation and exit should take place immediately after the AQR and that it does not enter into contradiction with the 'too big to fail' regulations and potential ideas of regulation which have to do with the structural separation of activities within bank groups.

Finally a representative of the private sector said that in the long run we have to rebalance the source of funding for the European economy. However he stressed that the EU has to deal with the existing situation in which banks play a significant role in financing the new economy in particular for SMEs. He concluded by stressing that consequently we have to strike the proper balance between further increasing the resilience of the financial system, and promoting sustainable recovery

An executive of the private sector also stressed that the impact of a regulation on banks is not only a strategic issue but it goes down to the very operational level as regulations need to be embedded deep in internal policies and procedures, and each employee in a bank has to change his behaviour and the way decisions are made.

Moreover he said due to the number and the complexity of regulations the staff has been under significant pressure for a number of years and in painful work conditions; the IT systems need substantial change.

Furthermore he stressed that now few individuals would say that they face uncertainty as they may be criticised a few years later. We risk creating a compliance driven system, a threat to judgement, and common sense. It is also a threat to financial innovation he concluded. Finally it carries the risk of potential excessive risk aversion embedded deep in the banking culture with unintended consequences. Another panellist agreed explaining that there is a tremendous amount of risk aversion being built into financial institutions today because of the conduct agenda. There is a risk tolerance of zero. Policy makers need to help regulators they are defaulting if doing nothing.

Another panellist suggested the point to monitor was the multiple new authorities, which carry a risk of policy conflict and inefficiency in particular in the context where financial activities are moving to the non-banking sector we do not fully understand.

A representative of the private sector also stressed the need for implementing a smart single rule book enhancing regulatory harmonisation but taking into account

national specificities, which have demonstrated prudent conduct of business, proved to be in the interests of clients (e.g. French Real Estate Lending Market, which imposes loan to income ratios and proposes fixed interest rate borrowing solutions

Another constraint, faced by banks in the wake of the reform of bank regulation expressed by an executive from the private sector, is the difficulty of recruiting people dealing with data, privacy and cyber issues, which are amazingly valuable to the defence industry, the tech industry, the telecoms industry. He explained that now because of the level of the remuneration and the European rules under which we tell them they will get their money in five years' time the compensation package is out of sync with what they can get in other industries.

7. Balancing growth and resilience

Growth is what we need: a better balance between the need to secure a safer financial system and, on the other hand, the need to promote sustainable economy growth. In this perspective regulators and policy makers should pursue their efforts to move away from a purely constraints based financial reference, towards growth oriented measures.

However a representative of the public sector reminded the audience that if we want to have growth prospects in the Euro area, you need to have tough regulations and a growth prospect requires a healthy banking sector, financing the real economy.

A representative of the private sector stressed that despite the projects to enhance the contribution of capital markets to the financing of the economy, traditional bank loans still remain a major part of them. He said that in this context the announcement by the Commission in the Communication regarding long term financing, of an assessment of the appropriateness of the new prudential requirements to long term finance is welcomed as policy makers have to check that regulation does not hamper the capability of banks to provide finance for SMEs.

He quoted four specific priorities in this respect

- Liquidity coverage ratio: the definition of liquid assets should be broadened; covered bonds have been given a better position now, which is an appropriate step in the right direction
- NSFR strongly reduces maturity transformation and increases the burden of banking regulation on SMEs
- The leverage ratio: would have negative impacts on market making of Government and corporate bonds. In addition it counteracts attempts to develop capital markets
- Finally non-risk based measures favour the substitution of low risk assets by risky ones, as
- Any review of the standardised approach for credit risk should neither increase capital charges for loans to SMEs, nor entail new administrative burdens for banks.

8. Preserving the diversity of the European financial landscape

Finally an executive of the banking sector suggested that regulators and policy makers have to preserve the diversity of the European financial landscape and in particular the European bank led financing model in which universal and co-operative banks have a key role. Regulators in addition have to bear in mind that as banking structures were not at the root of the financial crisis, additional reforms shaping the structure of banks are not necessary.

A representative of the private sector stressed that the level of profitability of banks today is minimal due to direct costs of additional regulation (costs of funding, operating costs burdened by compliance costs: and finally the board of directors spend most of their time addressing compliance issues, rather than addressing strategy.

A public decision maker mitigated however the description saying that the performance of the banks followed under State Aid rules in Europe, which represent 25% of the total banking system. Historically the profitability of the banking sector in Europe is at a dreadfully low level. 2% ROE versus 9% in the United States. This used to be 10% versus 16% in 2003, and 17% versus 21% in 2006. However if you de-aggregate, you would see enormous variations and quite a few banks, actually having very high returns. I think we also need to let the banking market function in the context of an enormously difficult transition.

However a representative from the public sector asserted that there is still a need for the banks to improve their profitability and further diversify their financial sources. He considered a condition for this to happen is to focus on their core businesses and increase the non-interest income rather than focusing on lending.

Policy makers also assist banks by making sure that the EU returns to a solid growth. Indeed the economic environment in the US is the reason for the profitability of US banks. This requires fostering the necessary reforms in particular looking at labour markets and public sectors.

Finally, in particular at the global level we need to discuss how can we have long enough transition periods so that banks can still fund themselves and so that banks can return to profitability.

9. The impact of regulatory reform on market activities also requires attention

Much has been said about the impact of regulation on bank lending. However given that the interaction between regulation and market activities is in many ways more complex to understand, more indirect and more difficult to quantify, the impact of regulatory reform on market activities triggers less comments though there is potentially a broad range of regulatory initiatives, which are going to affect market activities, that include both prudential and market regulation.

The participant took the repo market as an example. There, he said, there are at least five significant regulatory initiatives which are outstanding at the moment, whether you are talking about the calibration of the leverage ratio, the liquidity coverage ratio, the NSFR, the Fundamental Review of the Trading Book, or the new Central Securities Depositories Regulation, that could all have a very significant impact.

However a representative from the industry underlined the fact that the industry does not feel that we are in a post-regulatory reform phase just yet. On the contrary he stressed that assessing where we are going is very difficult, because there are still so many quite significant moving parts outstanding, which are still, at this very moment, being finalised

Europe must not create regulations that are risk adverse and should really encourage entrepreneurs and society to take risks.

In a global context where you have very young countries, Europe's aging societies tend to be very prudent, and in the end will die.

10. Improving the legitimacy of international financial rules

The panel also discussed the legislative process. One issue raised in this field was the need for an international level playing field regarding financial regulation. The panellist pointing to this issue recognised in that respect that it is perfectly clear that we need places at the global level where we can discuss matters with other constituencies.

However this panellist stressed that the outcome of global fora has to be backed by a very sound democratic accountability in order to sell the rules to the citizens. He explained that these regulatory decisions must be accountable like those elaborated by Parliament where you have public and democratic debates. This panellist concluded by questioning the democratic accountability of the decisions taken at the G20 level and was of the opinion that they lack a parliamentary dimension and public discussion. Finally he suggested defining a global government for taking decisions in the area of global financial rules for global banks and global markets. We do not have it yet, he said.

Yet another panellist reminded the audience that committees of national authorities define global regulations in Basel and these regulations result from processes, which are public and not binding as such. Actually he said it is the group of national authorities, which decides to agree and to respect what they have agreed.

This panellist also pointed to the fact that the G20 is a useful instrument for international co-ordination. It is when the States are gathered at the G20 meeting, that the different countries agree and decide that they want to have a peer review of the agreements that they are taking. He insisted on the fact that in the end, in each country, it is parliament that approves the regulations. He concluded by stressing the fact that it is a sensible way of getting international co-ordination, respecting the need of international rules and, at the same time, respecting each parliament letting decide what it thinks is best. In addition, he said, it is good for parliaments to think that the best is what has been internationally agreed.

Finally a representative of the public sector pointed to the fact that the EU on several occasions has taken the political responsibility to adapt the rules to the European context because it was absolutely necessary.

Regulatory challenges regarding electronic financial and payment services

Objectives of the session

A first objective of this session was to clarify the main trends regarding data protection and retail transactions (e.g. emergence of new distribution channels or service providers, evolutions of the payment value chain…) in the context of the proposal made by the EU Commission to revise the Payment Service Directive (PSD2) and to evaluate the appropriateness of the compromise reached in the context of the Greek EU Presidency.

The session also helped to clarify the complex issues and stakes related to the definition of a fair remuneration of the banks involved in card transactions, in the context of a proposed EU regulation on interchange fees and the possible consequences of on-going evolutions of the regulation in that respect.

Background of the session prepared by Eurofi

Digital innovation raises new challenges for banks and E.U. regulators

Technology continues to impact banks. Controlling costs or mitigating risks systematically involve processing data and analytics. But simultaneously banks have to deliver to differentiated customers the same level of service through the channels they select, what requires major processing and support investments. In addition technological innovation creates new commercial contexts which demand innovative answers to traditional needs (payments, financing, security, etc.). In parallel big data and cloud computing are becoming critical for better understanding customer needs and providing them.

These challenges imply far-reaching changes for banks, as their systems are complex, with reduced connectivity among different applications. Conversely new entrants are exempt from such legacies.

Those issues are raised against a background of increasing fraud in particular in card transactions. Although only 2% of all card transactions were acquired from outside SEPA, these accounted for 25% of all fraud in 2013. In addition with €794 million in fraud, payments via the Internet, post or telephone, were not only the largest category but also the one with the highest growth (up 21.2% from 2011). More generally security researchers estimate that cybercriminals attempted to steal between $75 million and $2.5 billion.

Moreover, many new payment operators are now competing in the market after the implementation of the "Payment Services Directive 1" (600 authorized Payment Institutions and 2100 "small" Payment Institutions).

In such a context regulators need to ensure security, privacy, consumer protection and systemic stability introducing online identification procedures, and harmonized electronic identification and authorization tools, and to become more tech-savvy in applying modern technologies to AML-KYC procedures. At the same time, they should leave space innovation but maintain fair competition. This must be completed in a fast changing digital world.

By facilitating the access to payment accounts by Third Party Providers (TPP), the revision of the Payment Service Directive (PSD 2) aims at the fact that the EU market for cards, Internet and mobile payments remains fragmented hindering its development and slowing down the EU growth potential.

However the PSD 2 has also to address the fact that TTPs, which are the embedded in innovative products, obtain sensitive private and secret credentials of a consumer and use them to impersonate the consumer, enter the bank account and initiate payment orders.

There the banks even question the existence of business models based on the transfer by the consumers of their personal credentials. They also demand a level playing field imposing the same safekeeping, security, privacy and transparency obligations to TTP as those imposed on APSPs, and claim a fair distribution of the responsibility between TTPs and APSPs, and a fair cost sharing whenever a TTP generates activity within the account-holding APSPs. Finally the banks consider that no "market failure" has been evidenced, which would justify legislative intervention and the related compliance costs.

To address those difficulties the compromise reached by the Greek Presidency has notably introduced a definition of the service provided by TPP, defined what payment data are critical and sensitive, and introduced various safeguards. It also adjusted TPP liabilities regarding in particular unauthorised payment transactions. Finally the compromise further defined the role of the EBA for settling disagreements and the powers of host member states regarding the compliance of business activities with national laws, information to be made available by TPPs to payers or the obligations of the TPP regarding the accessibility of information related to payers' account.

However, beside Data Protection rules, or new Security Requirements and despite the much-needed harmonization brought about by the PSD1, Anti-Money Laundering rules should also further contribute to deepen Single Market approach.

Overall in a rapidly changing market, regulators have also to clarify certain guiding-principles e.g. i) legal certainty and regulatory consistency; ii) proportionality and technological neutrality; iii) the fostering of financial inclusion, and, importantly iv) the effective promotion of the Single Market for retail payments.

Improving competition conditions in the E.U. in the card payment services

In parallel fair competition and the business model of card payments remain controversial in the E.U. The Commission considers that cardholders are encouraged by banks to use cards that generate higher fees, as card companies compete primarily to attract issuing banks by offering higher interchange fees. Consequently they are of the opinion that new and innovative providers of mobile or online payment services cannot enter the market and (low fee) domestic operators cannot expand.

In such a context National and E.U. competition authorities have been looking at these issues. However given that the European card market remains fragmented and interchange fees vary widely across the E.U. the Commission considers that a regulation is necessary as the market, due to its nature, is unable to address existing imbalances and obstacles for a level playing field to emerge, in a comprehensive and timely way. The Commission seeks in addition to guaranee the legal certainty of the card payment business case.

Finally the E.U. Commission has proposed 0.2% and 0.3% caps on interchange fees. These levels are those proposed by certain schemes in competition proceedings and stem also from data on the cost of payment instruments used to estimate the fee at which a merchant would be indifferent between being paid by card or in cash. Consistently, "three-party" card payment-schemes using issuers would also be covered by the caps on interchange fees.

However Banks stress the fact that limiting interchanges impedes a fair remuneration for actual services. Others insist on the fact that an important function of interchange fees is to balance the demand of cardholders and merchants for the cards. Indeed if interchange fees are too low, acquiring banks will find it easy to sign merchants up to accept payment cards, but issuing banks will have less incentive to issue the kinds of cards cardholders want at the price they are willing to pay, and will be discouraged to undertake the considerable investments necessary to market safe payment card products.

Finally the risks associated with regulating interchange fees, whether this involves capping or prohibiting them, would entail higher costs for card, usage by consumers, more cash transactions that gives a helping hand to tax dodgers, fraudsters, money launderers and other criminals, less payments innovation, security and efficiency. In addition banks fear that regulating inappropriately interchange fees may inadequately favour three party payment schemes, which is detrimental to competition.

Many banks oppose in that respect the situation observed in Australia, where interchange fees were capped and where there has been a slowdown in the growth of card payments. Moreover, they say that there, the resulting cost saving for merchants did not benefited to consumers. Instead, it resulted in their paying more to use cards with no detectable reduction in the prices of goods and services.

On the other hand, smaller networks claim not being included in the scope of any IF regulation. They consider in particular that that it would dramatically undermine their economic viability and their ability to act as a counterweight to dominant schemes. In addition they consider that the proposed rules do not acknowledge that in some circumstances territorial restrictions are the appropriate counterpart of the investment made by a licensee.

In parallel digital wallets warn against any attempt to assimilate them to card schemes with respect to such caps, as they do not engage in card-based transactions and are users of card schemes and pay interchange fees to the four-party scheme acquiring banks.

Summary of the session

1. Ensuring safety in the payment area

A representative of the private sector explained that one of the challenges faced by the payment industry was security. In this perspective he said, the policy intent behind the current payment market reforms is ensuring safety, transparency, but at the same time innovation and competition.

He pointed out that in that respect the first critical evolution to be foreseen is the oversight of all market infrastructures. It is in this context, that the new payment regulation will implement the so-called CPMI-IOSCO principles and that the ECB will monitor overtime that the four systematically important payment systems that they have identified, are resilient and will be able to recover quickly. The introduction of five such criteria for critical service providers is welcome because they will ensure high standards, a level playing field and also support the strengthening of the system across the board. It is therefore critically important that these criteria should be implemented by Clearing Service Providers (CSPs), he concluded.

However, he stressed that beyond these five criteria for CSPs, implementing the 24 principles addressing operational risks and communication needs was also important. In this field he quoted a recent project - Market Infrastructure Resilience Services - developed with a number of central banks for the TGS systems operated by SWIFT, which provides a clear example that regulation also means steering innovation.

He explained that there is also a regulatory demand for further transparency in the context of financial crime. In that respect the Financial Transfer Regulation, FTR, will provide the EU with a wide set of rules to further reduce money laundering and terrorist funding conforming to the Financial Action Task Force (FATF) requirements. He also stressed that beyond these requirements, SWIFTs services and standards are expanding the range of anti financial-crime tools - sanction screening, sanction testing, a new Know Your Customer register (KYC), etc. - to provide the industry with utilities like anti-money laundering tools.

2. The payment area is witnessing service breakthroughs

Another panellist explained that another revolution, which is supported by the second Payment Services Directive - PSD2 - is the opening up of access to payment systems and the widening of consumer choice through new payment service providers entering the market. He was of the opinion that the resulting regulatory changes and these new payment service providers are actually encouraging financial institutions in many countries to innovate. He quoted to illustrate the recent global innovation trend, the creation of domestic real time retail payment systems. He concluded by explaining that these initiatives are addressing several policy concerns regarding the immediacy, easy access to payments, and the reduction of their riskiness. They are also intended to address some consumer needs.

He concluded by stressing that however we must ensure that all these players play by the same rules and deliver the same security levels and that therefore the financial industry and the supervisors need to work together to find the right balance between facilitating access to new providers and protecting customer data as electronic payments are going through a very thorough transformation process; related changes are very demanding for all parties and regulations. A representative of the private sector summarised the changes currently witnessed. We are now facing three critical changes, he said.

He explained that the first transformation is in e-com, which does not exist any more as it was two years ago. What is happening he said, is that now customers can browse the web to choose the goods, identify in which store they can go to pick them out, then in that store they can choose the size, change the colour, take them back home and even go online to give them back and finally pay at any moment in this process.

The second evolution concerns mobile payments. He was of the opinion that this is the most dramatic change of the financial industry. The revolution is not about paying at the point of sale. He stressed in that respect that the real change is that this is an interactive process: currently when you are paying with a card you just get a ticket; tomorrow when paying with your mobile you will get a lot of information e.g. an online alert, how much you have got left in your current account, ask online for an instalment, you will even get a discount and possibly cash back and take part in a loyalty programme. The mobile phone is changing the way you shop. He stressed the fact that when you are browsing on your mobile it is impossible to say whether it is either e-commerce or physical buying; and consequently it is difficult to assert that it is a "card present" transaction or a non-present one... Finally he stressed an additional evolution to come, which is geo-localisation. It will allow you to receive offers from the shops around and even communicate with some intelligent devices in the shop.

The latest big evolution is related to the smart use of data, he concluded. Though data will raise important security issues, they offer compelling opportunities. Data analysis could help retailers to sell more and whenever they sell more their margin reaches may be

8% or 10% and not the 20 basis points they try to spare when negotiating rebates on interchange fees with their banks. So if banks can help them by analysing data they will receive remuneration for an effective precious added value not just for a payment. Indeed banks can tell them to which segment of the population they are selling, they can compare it with the growing buying segments and even help them to sell. Finally instead of bombarding the customers with discounts for everything, big data allow retailers to better target offers to customers so as to provide them with what they want, when they want and where they want.

A representative of the public sector explained that in such a context the intent of the Commission is to combine answering the demand for innovation and for diversified payment instruments and providing safety for the related data. He also stressed that now what is critical is the use of passwords on Internet and the PIN of the chip on a card. In this context today consumers are afraid to buy anything as a Third Party Provider (TPP) could use these critical identification data.

3. The key success factors of the regulation of the payment area are consistency and a level playing field

The payment business is a cross border business meaning that the harmonisation of such requirements is key and the EU is making important progress with these new regulations. New service providers are finding their way. They are introducing many innovations into the market and this is welcome. But it might be at the expense of consumer protection and security of the transactions. The paper of the Commission issued on 25 July is very welcome in that respect because it mention many of these issues.

A representative of the banking sector explained that innovation and security have to go together so that the consumer may feel comfortable with innovative products. Consequently he suggested these issues must be regulated by addressing them with activities, not only by type of actor (bank, non-bank), to make sure that the level playing field is respected.

Another representative of the private sector said that it is worth noting however that beyond banks and non-bank financial institutions, payments are also being made within social networks and other areas that have no connection with the financial world and that are not regulated as financial institutions are.

Imposing equal rights and equal duties whatever the provider of payment services

A speaker on the panel explained that under the impulse of the Commission the regulatory framework should accommodate these coming innovations and at the same time ensure safety. Finally competition should give safety priority. The issue we have with radical innovation is that they are insisting on efficiency, and for the time being safety issues are totally forgotten.

Another panellist explained that the appropriate approach is to impose equal rights and equal duties and fair competition whoever the provider of payment services may be, and stricter control on TPPs to avoid possible fraud and abuse, stressed a representative of the banking sector. In that respect he acknowledged that the changes brought by the Greek presidency in the wording of the proposed directive regarding the access to payment account are very appropriate since such access has been narrowed. Similarly welcomed is the initiative of the EU Parliament to limit the type of information and data to which service-providers can gain access.

However this representative stressed that there is still one major concern not yet covered, which is the introduction of the concept of "indemnity coverage", which imposes reversing the burden of proof onto the keeper of the payment account. Indeed he explained that it is inappropriate putting on the banks the onus of restoring the payment account, which has been debited fraudulently, just because banks are naturally the first point of access of the customers, and imposing on the banks the burden of proof to have the possibility to be refunded by the TPP through which the fraudulent payment was actually initiated. He was of the opinion that such an approach is particularly inappropriate when no contract exists between the third party provider and the payment initiator, and even more so in the case of non-registered TPPs. This has to be tackled even if it has to be accepted that these are very difficult issues as banks play a central role in clearing payment transactions.

A representative of the public sector stressed that provided that the issues are linked to the fact that innovation and technology, as well as the institutions are stepping in and addressing specific segments of the payment value chain and bringing efficiency gains i.e. new attributes for payments. That is positive. But in doing so they also bring risk into the payment value chain. He proposed consequently that a key principle would be that those who are coming and contributing to this industry do not weaken the payment value chain.

But he stressed also that another type of innovation that is coming - totally different from the existing value chain - is also fundamentally challenging the payment chain he quoted virtual currencies, which provide a valuable example of such a phenomenon.

He explained in addition that certain providers do not offer any payment service but only manage information. The choice between including or not such payment account permission services in the scope of the regulation will therefore critically influence the safety of the payment value chain in particular the security

of the customer but also the safety of the functioning of on-line banking platforms themselves. He proposed in conclusion a possible approach, which would mean defining a lighter regime for those services than those related to payment institutions.

4. Payment is by essence a risky business in particular in the context of a rapidly evolving technology

The payment value-chain involves more and more actors. This offers customers a new framework of simplicity, fluidity and flexibility, more consistent with the growing online economy. However a participant from the industry explained that a payment is by essence a risky business for banks but also for customers and merchants. This is why regulation affects banks in particular. The challenge is to outwit thieves though they have always existed and will always exist, he concluded.

Actually cyber criminals attempted to steal up to $2.5 billion in 2013. Thieves look for a weak link and the more links there are, the more they are likely to find one weak enough. He explained that the reason why banks are legally responsible for ensuring banking secrecy is that it is more or less possible to read an entire life from banking data. Sharing these data that banks collect with anyone cannot be envisaged. Therefore banks have created vaults to ensure the integrity of customers' data. Provided that many of us now deal with such data it would be wise to ensure that we all keep the vault hermetically locked. That must be the purpose of regulation, he stated.

Another panellist explained that in the digital world thieves evolve as quickly as technology. This is why the amount of fraud on online is rapidly growing, 25% in two years. A representative of the public sector quoted the report published by the ECB, which highlighted two main issues in that respect. The first one is "card not present" payments, which represent 10% of the payments and 60% of the fraud. This demonstrates that there is a weakness there he said. The other issue we have is cross border payments - 5% of the transactions and 25% of the fraud he stressed. Finally he was of the opinion that the rationale behind this is that for the time being the strategy of the industry has been to adapt to the Internet or dematerialised space the payment instruments and processes, which were formerly very effective in face-to-face transactions.

The panellist explained that this first issue reveals a core fragility, which is related to data. When you initiate a payment what is crucial is the authentication i.e. you know whom you are talking to. This means that we collectively need to move from the static data used for that in the current process to dynamic ones. Though we may overestimate them many technologies are available to achieve that, whatever media you use, Internet or mobile. This leads to a reflection on the role for regulation. Though Central Banks have been pushing very hard toward this, at some point, only a regulatory provides the appropriate incentives or constraints, and is therefore necessary.

The other critical issue is related to cross border payments. Indeed whenever you do the right thing in your

jurisdiction on a standalone basis, then fraud moves away, crosses the border and the problem moves to another place or somewhere else within the payment value chain. This requires coordination and a level playing field. You can admit variations but only as far as there is a base line that everyone has to observe. The move towards chip and PIN provides an illuminating illustration of this principle. He explained there that the adoption of chip and pin technology by single countries made fraud move across the border and imposed coordination at the European level and even at the international level. It is a global issue though in the United States they are only just starting to use chip and pin technology.

5. Imposing more security and tracking fraudsters across the borders

A panellist proposed two ways for fighting against fraud. One is prevention thanks to imposing more security on the system and a regulation on all actors within a given country but also consistently across the borders as 50% of fraudulent transactions in Europe come from cross border transactions, which only represent 7% of all transactions. The second is to cure when attacks succeed: in this perspective it is vital to be able to track down the problem and the fraudster by identifying the origin of the fraudulent operation. Yet this is currently impossible in the case of actors operating in the name of customers.

Another panellists stressed that we have – notably in Europe - developed in clusters somehow: how many transactions are made outside the SEPA? 2% only. What's the fraud of those 2%? Very high, 25%. And he concluded by saying that there is a global dimension on which we should concentrate more. This is probably an issue for the FSB or something global, he suggested. The cross jurisdiction issue is much more about security than efficiency, because cards work basically across the globe.

A panellist of the public sector stressed that however in Europe, a difficulty behind all of this is the European legislative process, which is so complicated. In a field like the payments system or innovation you would want regulation to be up-to-date and you feel the need to revise it almost every year, he concluded.

There is a big cost here said another public sector decision maker, and one wonders whether those costs would not be better invested into reinforcing security ex-ante.

6. Multilateral Interchange Fees - MIFs

Providing appropriate incentives for favouring innovation

A public decision maker in the context of a strong demand for innovation, stated that the EU legislator has also to address the question of what is the incentive for banks to offer other instruments than the simple payment card provided that Multilateral Interchange Fees (MIFs) generate a great deal of profit? He stressed that the situation would be inappropriate if there were no incentive to develop additional payment forms: that is what the PSD 2 is trying to address, he explained: in the PSD 2 the move on MIF has to be understood as an intent to make sure that we in the EU develop as much as possible every potential demand. Simultaneously the proposed directive increases security.

Lessons learned from various jurisdictions having regulated interchange fees

One panellist quoted the case of Spain: there he said, they already have had - since 1st September – MIFs set at 0.3% for credit card transactions and 0.2% for payment card transactions, whereas in reality they are on average at 0.27% for credit and 0.1% for debit, because a cap on MIF of seven cents has been defined for lower value payments. The lesson learned is that retailers of course are now paying very low interchange rates while not one cent has gone to the consumer. In a context where the penetration of cards among the different payment means remains at 19% since the last six years this ceiling will not help as consumers have to pay now more for the card given that banks have to keep investing in innovation. Similarly in 2011 there was a drastic reduction of the level of MIFs in France. Consequently some banks charged the withdrawals made at the ATM of other banks, which were previously free of charge. MIFs are also necessary to enable issuing banks to maintain affordable prices in particular for vulnerable customers and achieve financial inclusion.

Another panellist warned that the proposed levels for the MIFs are supposed to make the cost of card transactions for the merchant or for the retailer, similar to the cost they incur for cash transactions. Yet we have read and heard about this rationale but in fact we have never seen the numbers. Consequently we suggest having in Europe a common place where this has to be talked about in a transparent manner so as to set the MIF limits at the right levels.

A representative of the banking sector said that the MIF issue is first of all, a dogmatic stance by DG competition that has decided once for all that MIFs were anticompetitive by objective and by effect. The problem is that the case has never been evidenced, he said; the numbers are nothing but a compromise. He concluded by stressing the fact that the Court of Justice in Luxemburg issued two very important decisions at the moment of the Eurofi Forum. One by which the Court said that the EU Commission was wrong to deny MasterCard access to its study comparing the cost of cash with the cost of cards. The second was the decision by which the Court of Justice ruled out a lower Court decision saying that the French interchange fee modulation-mechanism - the famous MERFA - was anti competitive by its objective.
A public decision maker pointed out in that respect that the level of MIFs is a compromise. This is true for any piece of legislation. In addition as far as MIFs are concerned, finding the right amount is particularly challenging, as there is no model that gives you a concrete answer. He also stressed that furthermore the academics from various universities are far from agreeing on the optimal level of MIF. According to some they might be zero positive or in some cases even negative… And some countries in the EU complain that the levels proposed by the Commission initially were too high… Finally no one says that the fees should be zero but it should be somewhat lower than they are in certain cases, with some exemptions… he concluded.

A representative of the public sector explained that from a Central Bank perspective given its mandate to promote safety, MIFs have been an effective funding model for investment in security in a number of jurisdictions. However he concluded by acknowledging that it does not say anything about the appropriate level of MIF and whether it is an appropriate economic mechanism. There might be different perspectives in this issue. However he warned that though you might move to other models for funding security investments, this is a sensitive issue and serious attention should be paid to the overall effects of any possible change.

Another representative of the public sector explained that one issue is that the situation, especially for debit card schemes, is very different from one member state to another. These schemes are already very efficient. He stressed that in particular in certain member states specific programmes exist for micro payments making this criterion of 0.2 or 7 cents unworkable. He concluded by suggesting introducing more flexibility in the regulation allowing member states to define alternative solutions.


eurofi

EU CAPITAL MARKETS REGULATION

Completing the EU regulation of asset management and shadow banking


Objectives of the session

This session covered the priorities for the appropriate regulation of asset management and shadow banking activities in the EU.

The panel first discussed the possible systemic risks associated with asset management and the approach required for addressing such risks. The pending issues regarding the proposals made by the EU Commission to further regulate Money Market Fund (MMF) and to improve the transparency and reporting of Securities Financing Transactions (SFT) were also discussed as well as additional issues that may need to be tackled by the EU Commission in the asset management and shadow banking areas.

Background of the session prepared by Eurofi

EU investment fund regulations (UCITS and AIFMD) mitigate many risks that investment funds and their investors are exposed to such as leverage, liquidity and operational risks. Assessments related to the "shadow banking" initiatives of the FSB and the EU Commission however showed that these regulations do not directly address potential systemic risks which may be amplified by factors such as the interconnectedness of funds within the financial system and their exposure to significant redemption or "run" risks.

Following these assessments two legislative proposals were made in Europe before the European elections: first, a proposal to further regulate Money Market Funds (MMFs) and secondly, a proposal to regulate the transparency and reporting of Securities Financing Transactions (SFT) such as securities lending, repo and rehypothecation.

MMF proposals are more advanced with a report drafted by the Econ Committee of the EU Parliament in November 2013. The decision on this report, which recommends going further than the EU Commission's proposal on certain points, was however postponed to the next EU Parliament. Many issues remain controversial and notably the proposal to impose minimum capital requirements of 3% on Constant Net Asset Value funds (CNAV), which would be very detrimental to such low-margin products, according to the asset management industry. The industry also argues that Variable Net Asset Value funds (VNAV) are less attractive to institutional investors for tax and accounting reasons.

In parallel MMF rules adopted in the US in July 2014 by the SEC differ to a certain extent from EU proposals. The rules require prime institutional MMFs (which mainly invest in non-government securities) to abandon their fixed $1 share price and adopt a floating NAV. Prime funds sold to individual investors and government MMFs (defined as investing 99.5% or more of their total assets in cash or government securities) can however keep a constant NAV. The rules also allow all MMFs to temporarily block investors from withdrawing cash in times of stress (gates) or allow funds to impose liquidity fees for investors to redeem shares. The SEC ruling also increases disclosure to investors and enhances transparency and diversification. These rules provide a two-year transition period. The introduction of a capital buffer was examined in the US previously but rejected by the SEC.

SFT proposals have not yet been formally examined by the Econ Committee but they appear to be more consensual and are generally considered to be adapted to the mitigation of the risks that materialize in such activities. Some issues remaining to be addressed relate to collateral rules including: the distinction that may need to be better made in regulations between re-use and rehypothecation, the variability of collateral rules across regulations (e.g. with regard to eligibility or asset segregation) and their possible impact on securities lending. These issues are not specific to investment funds however.

Existing EU investment fund regulations and the additional EU proposals made covering MMFs and SFT, once they have been finalised, should help to mitigate most of the systemic risks associated with asset management. Extensive assessments of the possible vulnerabilities that asset management activities might create in the financial system have been conducted by international (FSB and IOSCO) and US regulators (Office of Financial Research (OFR) of the US Treasury and the Financial Stability Oversight Council (FSOC)) in particular, in the context of the work on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs). There is a broad consensus on the main sources of systemic risk in the asset management sector that may amplify "swings" in the financial system (i.e. excessive leverage combined with inappropriate funding or investment features, interconnectedness and liquidity issues in stressed conditions...). There is also generally an agreement that the specificities of the asset management "agency business model" need to be taken into account and that possible systemic risks materialize mainly at the fund level or in relation to certain activities conducted by funds, rather than at the management company level. The objective of such assessments has however been debated. Industry participants believe that it should be to identify potential stability issues and propose appropriate remedies and not necessarily to designate certain firms or funds as G-SIFIs. A FSOC statement on 31 July 2014 indicates that this is the way the overall debate may evolve in the US. The US public body stated that they would "undertake a more focused analysis of industry-wide products and activities" rather than focusing on asset manager entities per se. Whether the size of funds might be a factor for identifying systemically important players possibly in conjunction with leverage is also disputed.

Some additional areas of improvement have been suggested regarding investment fund rules. Improving and harmonising data collection and reporting appears to be the main area of improvement at the EU and global levels with the objective of providing supervisors with data that can be easily aggregated and analyzed and that are meaningful. Areas that could benefit from improvement in addition to SFT include for example alternative funds, swap data, threshold reporting and separate accounts. From an international standpoint, the need to assess the compatibility of UCITS rules with the fund passport rules being defined e.g. in Asia has also been emphasized.

More broadly, the FSB is currently monitoring the implementation of policy recommendations on shadow banking in coordination with the standard-setting bodies. These recommendations include actions to mitigate spill-over effects between the regular banking system and the shadow banking system (banking prudential regime, supervisory framework for banks' large exposures), measures related to MMFs and SFT, recommendations regarding securitisation and the development of an information-sharing process to activate the high-level policy framework for strengthening oversight and regulation of shadow banking entities. National authorities are currently reviewing their regulations in the light of these recommendations (as is the case in the EU and US). The FSB is due to report on overall progress to the G20 in November 2014.

Summary of the session

1. Systemic risks associated with asset management and shadow banking activities

A macro-prudential approach is needed for assessing the systemic risks of asset management and shadow banking activities

The non-bank financial sector is now worth around $70 trillion globally. This is nearly as much as the banking system and about 100% of the global GDP. This sector is growing fast and is quite concentrated. Assets under management by investment funds, insurance companies and pension funds doubled to $60 trillion over the recent years. Five firms now manage around $13 trillion of assets globally.

Regulatory reforms have so far been concentrated on the parts of the financial system that were most connected with the crisis, a regulator stressed. This is the case of the banking system in particular where capital requirements have been raised and additional rules imposed. This is expected to trigger a move into more market based forms of financing.

A macro-prudential approach is the right answer for assessing the potential systemic risks created by such activities and evolutions, the regulator believed, because it means "looking at the risk top down from the system perspective and how the different parts of the system influence each other" and what can be done to mitigate the risks, rather than looking at risks bottom up from a firm specific perspective. Macro-prudential regulators moreover need to analyze how risks could manifest themselves in the future once the exceptional or extraordinary emergency monetary policies put in place in the major economies over the last five years normalize. These measures put in place in order to stimulate lending to the real economy and economic activity have indeed led to a search for yield. Investors might find out, when monetary policy conditions normalize globally, that they have been underestimating risk to a certain extent.

But it is wrong to think that the macro-prudential approach should sort out all the problems encountered during the crisis, the regulator believed. Macro-prudential supervision is about mitigating tail risks, which do not often happen but when they do are very damaging and may cancel out the benefits of many years of stability. Macro-prudential regulation is different from micro-regulation, it is prospective and "is not about fighting the last war".

A specific approach is required with a focus on activities rather than entities

Macro-prudential approaches have so far been primarily concentrated on the banking system and on domestic asset markets like housing (in order to detect housing bubbles), a regulator stressed, leading to the use of tools such as capital buffers in particular. Shadow banking and asset management are a "new frontier" for such an approach and the issues to be addressed are quite different. For example leverage is a very big issue in banks but is not necessarily so present in the above mentioned area. The international regulatory community started off by trying to identify systemic institutions in this area, which is an approach imported from the banking and insurance world. This approach is providing some insight but the regulator believed that the agenda needs to move to an assessment of the activities within the asset management and shadow banking sectors which may cause systemic risk and of how risks are created in a period of stress, since looking at the big institutions operating in these sectors does not allow the capture of all the main risks.

One should start by "identifying the problems" that need to be solved before proposing new rules an industry player stated. It is difficult to see what problem the designation of some asset management companies as systemic entities could solve. Some asset managers might seem very large but all asset managers in aggregate only represent 25% of the assets under management in the world. 75% of assets are managed "internally" mainly by entities such as insurance companies, sovereign wealth funds, pension plans, family endowments, family offices… If the problem that one is trying to solve with additional asset management regulation is herding or the search for yield the question is what can be done about the 75% of assets that are managed internally.

If the largest asset managers are the starting point of the analysis, as was the case in the first consultations about systemic risk, then one ends up with several misconceptions or "false positives and false negatives" the industry player believed. On the false positive side, many of the largest investment funds are US registered index mutual funds that are limited in the leverage and the illiquid securities they can use. It is difficult to see how such index funds can be a source of systemic risk. On the false negative side, the point is that asset managers did not fail during the financial crisis and actually they very rarely do so. They used no public support such as the Troubled Asset Relief Program (TARP) in the US. Asset managers were actually a source of strength during the crisis, the industry speaker argued. When looking at the individual fund level, problems have been caused in the past by relatively small asset managers such as the company managing the Reserve Primary Fund, a money market fund which caused a "tremendous" amount of dislocation in the market. This is because larger firms tend to have more resources in risk management and in technology and they are also more concerned about keeping the reputation of their firm intact, whereas smaller or emerging firms might be more interested in growing market share and ready to take risks to get there. This is why the speaker believed that the "size approach is quite flawed".

Another industry player added that the largest asset managers tend to offer the lowest costs because they are largely index managers managing very broadly diversified portfolios. These products are of great value for investors because they enable them to accumulate wealth for retirement. Any additional costs imposed on asset managers particularly in the low cost index segment would be passed on to the investors in the fund and impact their long term savings.

A regulator however pointed out that the fact that asset management and the broader market finance universe did not create particular problems in the last crisis does not mean that the interconnections the sector creates in the financial system do not have to be addressed.

Another regulator agreed that the debate had started with a "banking lens" focusing first on bank risk and this had naturally led to the notion of "shadow banking". The key concern is the interconnectedness of the different parts of the financial sector and being able to understand how risks are moving from one part of the system to another, how interconnections work and how the related risks can be mitigated. The debate has consequently moved from looking at entity-specific measures to activity and interconnection risks.

A market observer stressed the benefits of diversity in the regulatory approach. When "looking through the same lens" i.e. the banking lens there is a danger of applying the same solutions and inciting all types of activities to move the same way. One danger would be to force all investment funds to all hold certain amounts of sovereign debt for example because that is liquid, when other types of securities need to become more liquid.

An industry representative stressed the importance for financial stability of having strong fund depositories. These third party financial institutions which safekeep the assets of investment funds and oversee the activities of the fund are a specific feature of the European market. They are an integral part of the risk mitigating system in the asset management sector and therefore asset managers should not be looked at in isolation but together with the depositories. This combination makes asset management completely different from the banking world.

Areas requiring further attention or assessment in the asset management sector

Liquidity risks, herding and search for yield

A regulator believed that one of the most "obvious" issues in this area is liquidity risk and the impact it may have on the system as a whole. The question is what would happen if significant parts of the asset management, insurance and pension fund sectors all moved in the same direction at the same time and what that would mean for the system as a whole. It is true that such entities carry very different risks from banks since they manage assets on behalf of investors, but many of them have quite important liquidity mismatches which are not dissimilar to banks. Many offer a daily or short term liquidity promise to their investors which they might not be able to honour in times of stress. Another issue is that the search for yield is driving investment into the less liquid and less well known parts of the market. Investors might discover that the investment strategy of the funds they invested in is not as good as they thought it was and that they cannot liquidate their assets. They might therefore suddenly lose confidence in these funds with the risk of this loss of confidence rippling through the system and possibly impacting the banking system through a re-pricing of assets. Yet another element is that market making which traditionally contributes to absorbing shocks in the market is said to be diminishing. And at the same time liquidity premiums are "incredibly compressed" the regulator thought which means that either investors are very complacent about liquidity or have no choice, which is more worrying.

When thinking of herding and search for yield in the liquidity risk management area, some issues "warrant additional attention", an industry speaker believed. Not all investment managers use appropriate risk management techniques. There is therefore room for regulators to "raise the bar" based on best practices existing in different frameworks and fund structures. Interesting features can be identified for example in the EU UCITS and the US 40 Act[1] structures which could potentially be adopted more broadly. These include for instance the stress testing that is part of the UCITS framework or the ability of 40 Act funds to use emergency borrowing powers in case of run. At present the topic "du jour" in search for yield is bond funds. Average bond funds have a tremendous amount of liquidity with a very high allocation to US treasuries and other sovereigns which are not the assets for which there is the most concern. Regulators are currently mainly worried by three asset classes according to the speaker: bank loans, high yield and emerging market debt. But in each of these categories only 25% of the assets are held by funds meaning that about 75% are held directly by investors. So unless there is a way of regulating those end-investors it will be difficult to solve the issues relating to herding behaviours. In the asset classes where there is less liquidity, bond managers are taking steps to put liquidity in their funds.

A regulator however pointed out that the portfolio decisions of most of the entities managing the 75% of assets that are not handled by asset managers, notably pension funds and insurance companies, are closely supervised. In addition the level of similarity of the trading strategies of asset managers which might lead them to act in the same way in a period of stress needs to be further assessed.

Another industry player added that regarding herding concerns figures show that in times of market decline the flows related to redemptions are actually quite limited. For example between October 2007 and February 2009 the stock market in the US went down by 50% but there were only 4% of redemptions as a percentage of assets under management and from May 2013 to December 2013 when rates went up significantly and bond returns strongly declined investor redemptions amounted to 3.5%. In this context the industry is trying to provide solutions such as "target-date funds[2]" in order to rebalance portfolios automatically, the industry speaker mentioned. Such funds which represent as much as 25% of the cash flows of some managers will rebalance back into stocks if stocks are underperforming and rebalance the bonds if bonds are underperforming. They will sell the asset class that has performed well and buy the asset class that has done poorly. This counter-cyclical approach adds stability to the economy in a very low cost way for investors, the speaker claimed, and increases liquidity to asset classes that are lacking liquidity.

Leverage

The "leverage approach" makes sense when looking at financial crises over history and the companies that failed such as Drexel Burnham Lambert, Lehman Brothers or LTCM an industry speaker emphasized. Problems "almost always start with leverage". A leveraged institution usually has short term funding. If there is a crisis in confidence it loses its lines of credit and funding sources and is forced to sell assets and often ends up needing some sort of government support. Traditional asset managers however usually do not use leverage: they do not borrow money, are not counterparties to any derivative transactions and all of their assets are owned by their investors, the speaker claimed.

Another industry player emphasized that the vast majority of the traditional asset management industry, including most funds managed by very large asset managers is unlevered, unlike the banking industry or hedge funds. An analogy was made with an individual holding €500,000 in cash, leveraged investment means making a down payment of €500,000 and borrowing €4,500,000 to buy a €5,000,000 house whereas a non-levered investment approach such as the one adopted by traditional investment funds is buying a house worth €500,000 with the cash. Secondly, because the fund industry is mostly unlevered it is not viewed as a counterparty risk in the market. The trades are with the fund and not the manager and all monies are segregated with a custodian bank.

A regulator however stressed that asset managers and banks cannot be opposed on the grounds that the former are presumed to be unlevered and therefore safe and the latter not. "It is not a question of either or". The objective is to understand what activities give rise to systemic risks and how to trace them through the system. Leverage through derivatives and margin lending also needs to be considered.

Substitutability and resolvability

Using a "bank lens" does not work either when looking at substitutability or resolvability, an industry speaker believed, because there is a "tremendous number" of asset managers in the market "able to step into each other's shoes" if clients decide to change managers.

Another industry speaker agreed that managers can easily be substituted. As for a large apartment complex the manager of the complex can be changed if he does not perform well and this does not affect the value of the property of the different owners. Changing asset managers is normal business for an investment fund the speaker emphasized and does not create counterparty risk because the trading is being done by the fund itself.

CCPs

Actions need to be taken in some other areas outside the asset management sector an industry speaker suggested. CCPs are "at the top of the list". Asset managers are not counterparties to CCPs but their clients are. CCPs have been created as a result of the crisis in order to take risk out of banks but they have no capital, have no stress testing so far and are not transparent. This is a "fundamental flaw" the speaker believed.

Concerning CCPs a market observer believed that one should be careful not to create systemic risk by concentrating all derivative flows into centralised clearing. Developing sufficient knowledge of derivative flows and more generally of lending activities is essential. Monitoring CCPs is also very important. CCPs should not be allowed to go into any "wrong kind" of fee competition. This is a potential concern because they are hybrid entities; they are mostly private entities with a public duty and therefore have to behave in many ways like utilities even if they are in a competitive sector. Margins should be looked at in particular in this context as well as the collateral and securities lending activities.

A regulator agreed that ensuring that CCPs do not compete with each other on risk is essential and stressed that CCPs not only help to increase transparency but also contribute to improving netting and shrinking risk.

2. Proposals to further regulate Money Market Funds (MMFs) and improve data and reporting

Proposals to further regulate MMFs

The proposals made respectively by the EU Commission and the US SEC to further regulate Money Market Funds (MMFs) were commented on.

The proposal of the EU Commission has been subject to some criticism, a policy-maker explained. A 3% capital buffer has been proposed for Constant Net Asset

Value (CNAV) funds in order to complete the liquidity requirements already part of UCITS rules, instead of mandating CNAVs to float and become Variable NAV funds (VNAV) as has been proposed in the US by the SEC for non-government or "prime" CNAV. The divergence between these two approaches can be explained by the structural differences between the EU and the US MMF markets. In the EU almost all CNAV funds are prime institutional funds (investing in a combination of corporate and sovereign debt), retail MMFs do not exist (unlike the US) and government MMFs are a niche product. In addition the impact of floating CNAVs on the funding of banks and on the wider economy would be much greater in the EU than in the US, the policy-maker claimed. Moreover additional liquidity fee and gate requirements do not seem necessary in the EU since stringent liquidity requirements are already part of the UCITS framework together with the possibility to suspend redemptions on a discretionary basis when MMFs face liquidity bottlenecks (as has already been the case in 2008 and 2011). What is important in the speaker's view is that both jurisdictions achieve the same objectives, notably in terms of financial stability, even if the tools used are slightly different. The same should be true at the global level and particularly in jurisdictions such as China or South Africa where there have recently been problems in the MMF market. The IOSCO-FSB peer review will be "extremely important" in this regard in order to achieve global standards.

An industry player agreed that the EU does not need to follow the same rules as the US regarding MMFs since the jurisdictions are different and the products are used for different needs. But what needs to be looked at are the problems that the MMF rules are trying to solve and whether the EU proposal to impose a 3% buffer is the right answer. If the objective is to limit runs on MMFs and reduce systemic risk a 3% buffer will probably not achieve this, the speaker believed. This was shown in the report released by the SEC in June 2013[3]. Yet a 3% buffer would make CNAV MMFs which are low margin products quite uneconomical at the risk of "killing" many of them. Regulators need to make sure that the new provisions proposed will not kill the product and the purpose it serves. Moody's has indeed estimated that with the provisions proposed the one trillion euro MMF industry will probably dwindle down to half of that amount causing destruction both of jobs and liquidity in the market, the speaker believed. Liquidity provisions are another issue. There are already liquidity provisions in UCITS which should help from a liquidity perspective but if investors are prevented from moving monies on a same day basis for cash management purposes this might make the product useless.

Another industry speaker agreed with the potential negative impacts of the proposed MMF rules in the EU but stressed that besides these structural features there are other positive measures in the proposal, concerning the portfolio in particular, which could enhance MMFs. These include greater diversification rules, minimum credit and maturity standards and liquidity buffers. There are also other interesting measures related to stress testing, know your customer requirements and transparency. The proposal to remove credit ratings however does not seem appropriate. If there is an independent rating for some funds and if for others the judgment of the quality of securities is made by the fund manager, there might be a "race to the bottom". Oversight might not be sufficient to prevent this and retail investors cannot be expected to perform their own credit analysis. It would seem preferable to reform the way credit rating agencies operate rather than eliminating them altogether from the process because they perform an important role for clients. A final point the speaker made is that asset backed commercial paper which is currently the object of many discussions in the EU in connection with securitisation are assets that fit well with MMFs but which will not be allowed in the current proposal. A regulator however believed that developing such products sufficiently in Europe for them to have a real economic impact would "take a long time".

Improving the reporting and data on Securities Financing Transactions (SFT) and other shadow banking activities

An industry speaker commended EU regulators for positioning the proposals made concerning SFT[4] mainly on transparency rather than on restricting activities. Some of the definitions made in the proposal however need reviewing. The text covers repos and reverse repos but also other financing structures with equivalent economic effects, which is too broad a definition as it could be interpreted in many different ways.

Also, in this case more alignment with the SEC and FSB recommendations would be welcome, the speaker suggested because of the global nature of these activities. A global framework would also be welcome more generally for the reporting on capital markets activities in order to eliminate the current differences and duplications which are very complicated to manage, the industry player claimed. In addition such differences make it difficult to have an overall view. In Europe there is dual reporting from intermediaries as well as market participants whereas in the US there is only one side reporting. In the US reporting concerns transactions and daily values but in Europe there is also reporting of collateral and valuations. The timeframes also differ with some reports required at T+1, some in real time and some others near real time.

A regulator added that the data available for capital markets is insufficient and of a lower quality than in the banking sector in particular and that this issue still needs to be addressed.

An industry player agreed that the new reporting standards proposed in the EU for Securities Financing



Transactions (SFT) are a major step forward and that there should be a harmonised approach at the global level. If there are different regulatory regimes across jurisdictions this will take away the whole point of having data available and lead to many data gaps. Making data available reduces the speculation on the risk created by certain products or activities and helps to get to the right conclusion by understanding better how the industry actually works. This was the case for example of separate accounts which were suspected of investing in illiquid assets and having much leverage but a survey actually proved that almost all the assets (99%) of the sample analyzed were in long only portfolios.

A regulator confirmed that data and reporting are essential. Getting a consistent global picture is "very tough" but it is a worthwhile objective because that is necessary in global markets and one can never get a correct understanding of the market with data that cannot be reconciled. There was an attempt four years ago to implement a common reporting for hedge funds at the global level but collecting data globally that is consistent is a very challenging task. The same has been done in the derivatives area for EMIR working closely with different regulators around the world. The same approach is needed for securities financing transactions.

A market observer argued that the financial industry should be able to furnish regulators with better data than at present, particularly with the technology and big data capacities that are available nowadays. Detailed data is available in many industries such as the energy industry which might have less economic impact from a systemic perspective than the financial industry. The problem is that the ambition regarding the provision of data is generally insufficient. When regulators want to introduce a new piece of reporting the industry usually negotiates in order to reduce the proposal to the minimum and one then ends up with little sub-sets of data that are difficult to consolidate and much fragmentation. Improving data should be a priority. If it is too difficult to do at the global level because of legal problems for example, it should at least be done regionally, the speaker believed. The proposal to improve the reporting on SFT should help to have a consolidated view of this area in the EU but one should start thinking ahead about what type of data will be needed in the future. For example in the perspective of setting up a capital markets union, as called for by JC Juncker, one should start looking at the number of legal boundaries that are crossed in SFT transactions and the laws that apply. In order to move towards a capital markets union the different securities laws that exist in the EU indeed need sorting out. Having a clearer mapping of where assets go and what could be the presumptive path in case things go wrong will also help to explain better to clients where the risks reside with SFT.

3. Future regulatory priorities in the asset management and capital markets area[5]

Regulatory priorities for the asset management sector

A policy-maker stressed that although the debate about the potential systemic risks posed by the asset management sector and more broadly by shadow banking is relevant, the "positive story" about the role asset management plays in the financing of the EU economy should not be overlooked. Much work is being done at the European policy level to encourage asset managers to play a strong role in the financing of the economy.

When considering regulatory priorities for the asset management sector, the European Long Term Investment Fund proposal (ELTIF) is a key element. The trialogues are about to start between the EU Commission, the Council and the Parliament on the ELTIF proposal and one can hope that an agreement can soon be found. The asset management industry and more generally pooled investments are indeed expected to play a major role in encouraging a shift towards more capital markets financing and in implementing the capital markets union project. ELTIF funds have been proposed to make it easier for infrastructure projects in particular to raise capital across borders through the creation of a well regulated and easily recognisable EU scheme. Such vehicles could in the future become "the UCITS of the alternative sector" the speaker believed.

Further proposals could also be made regarding the UCITS framework the policy-maker stated. The framework has already been reviewed several times since its creation and most recently in 2014 in order to enhance investor protection and ensure that the investment strategies allowed are suitable for retail investors. UCITS distribution is however a remaining area of concern for the EU authorities because retail investors tend to continue purchasing financial products and UCITS funds in particular from a single supplier which is usually their bank. This may not always ensure the best choice for investors in the authorities' view. This is particularly the case in the 13 new EU Member States where investors on average have a choice of investment funds that only amounts to 10% of the choice available in other EU countries. This translates into higher costs, with management fees that are 40% higher (e.g. in Bulgaria) compared to the UK which is the usual benchmark in the EU for this market. At the same time retail fees in the UK are again 40% higher than in the US on average. This means that the single market for UCITS is not as efficient as it could be. The UCITS product is well regulated and recognised around the world but more needs to be done to broaden the access of retail investors to a competing range of such funds. Different ideas that need further assessment and political discussion have been suggested to address this issue. One is to encourage the creation of cross-border electronic platforms for the distribution of mutual funds, covering several or all Member States. This might however be difficult to set up, the speaker believed, as it involves dealing with very different consumer protection rules across the EU Member States. Another idea is streamlining the rules that apply to the marketing of funds which is at present a host supervisor's responsibility. There are probably good reasons for such differences in rules, but they currently impede the proper functioning of the single market.

A regulator stressed that many legislative proposals are already on the table or are in the process of being implemented in the asset management sector: AIFMD, the latest review of the UCITS Directive, the ELTIF proposal but also the regulation of social entrepreneurship funds and of venture capital funds. The focus should be now on implementing these proposals, on ensuring sufficient supervisory convergence and on a stock taking exercise of the actions put in place.

An industry player agreed that implementing the legislative proposals already on the table should be the priority. Developing a more positive message of trust and confidence is also important because a solid asset management industry is needed in order to foster growth. In that respect terms such as "shadow banking" or "Securities Financing Transactions" are not very helpful as they give clients the impression that these activities are very risky, which is not necessarily the case.

The capital markets union project

The greatest novelty in the capital markets area, a policy-maker believed, is the focus on the capital markets union which should be implemented by 2019 i.e. by the end of the current Juncker Commission. This project is a very positive move as it aims to avoid a funding gap in Europe where capital markets are insufficiently developed and integrated, compared to the US in particular. Building a capital markets union should help to rebalance and diversify the funding of the EU economy, reducing the share of banks. A difference with the banking union is that the capital markets union is a project covering all 28 EU Member States. The City should be part of it otherwise the project would be "pointless" in the speaker's view. Building such a union means looking at "very sensitive and complex issues" such as taxation, insolvency laws and the possible creation of an EU securities code covering e.g. ownership rights. This is not an easy task as there are many structural and historical factors that explain the present situation. Supervision might also need to evolve, although there is no intention to centralise supervision in the same way as for Eurozone banks. The first step is to try and define collectively an end-game and then to determine the tools that need to be put in place in order to improve the functioning of EU capital markets.

A regulator emphasized that having sufficient diversity in the European funding sources is essential from a macro-prudential point of view. In case of stress the shock to the real economy will be smaller if there are several channels of credit intermediation than if the economy is very dependent on one single channel of intermediation (i.e. bank credit). This is one of the reasons why the US came out of the banking crisis faster than Europe, the speaker believed. Diversity of financing is also important for risk sharing reasons because risk can be shared across borders that way. The "real way" of sharing risks though is through equity because in times of crisis, and again from a macro-prudential point of view, bond markets can transmit stress sometimes as much as bank lending. Therefore when designing the capital markets union there are some potential downsides that need to be dealt with. The speaker added that the capital markets union is about integrating EU capital markets, it is a single market initiative. This means that the institutional element does not need to be as strong as for the banking union (where the Eurozone countries have decided to share supervision).

1. The Investment Company Act of 1940 defines the responsibilities and limitations placed on open-end mutual funds, unit investment trusts and closed-end funds that offer investment products to the public in the US
2. Target-date funds are a type of mutual fund that automatically resets the asset mix of stocks, bonds and cash equivalents in its portfolio according to a selected time frame that is appropriate for a particular investor. A target-date fund is structured to address some date in the future such as retirement, but its returns are not guaranteed.
3. Note: The SEC economic analysis concluded that a capital buffer would allow individual MMFs to continue to operate, which could help in times of moderate market stress but it would not be sufficient in crisis situations like the ones experienced in 2008 (source Eurofi Vilnius Forum summary – 2013).
4. Securities Financing Transactions as defined by the EU Commission in its proposal for a regulation on reporting and transparency of SFT (29/1/2014) include: securities lending, repo and rehypothecation
5. Note : At the time the panel took place Lord Hill had been designated as Commissioner for Financial Stability, Financial Services and Capital Markets Union but not yet confirmed

Achieving greater safety and efficiency in EU securities and derivative trading and post trading

Objectives of the session

This session covered the main pending issues related to the implementation of EU trading and post-trading frameworks (MiFID II / MiFIR, EMIR, CSDR) and of TARGET2-Securities and the implications of the discussions under way on key Level II standards. The possible additional actions that should be on the agenda of the incoming EU Commission and Parliament regarding EU securities and derivative markets in order to enhance the safety and efficiency of these markets were also discussed.

Background of the session prepared by Eurofi

Regulatory frameworks covering the trading and post-trading of securities and derivatives markets (MiFID II / MiFIR, EMIR, CSDR) have been adopted in the EU and are now in the implementation phase together with TARGET2-Securities (T2S). The objectives of these measures are to improve the efficiency and safety of trading and post-trading processes in the EU while improving investor protection and facilitating the integration of EU capital markets.

Trading requirements

A political agreement was reached in January 2014 on the MiFID II / MiFIR package, which is planned to take effect in late 2016. A consultation on Level II requirements was launched by ESMA in May 2014. Several measures which have been controversial during Level I discussions remain to be further specified.

The volume caps that have been decided on dark pool trading are one of them (a 4% cap per month per venue and 8% across all venues in the EU). The caps are designed to limit the negative impact of pre-trade transparency waivers other than the large-in scale one, on price formation happening in lit venues. The 8% cap raises the most issues from an implementation standpoint as there is concern over how ESMA can collect and examine data from many different venues across the EU in a central manner.

The implementation of post-trade market data provisions is a second topic that needs further examination. The EU authorities want market participants to create a consolidated tape of market prices and a log of the best bid, offer and execution prices from the main trading venues operating in the EU, but defining and enforcing such a system on "a reasonable commercial basis" as requested in Level I measures of the legislation is challenging and complex in the view of many observers.

Another area to be further specified concerns the open access measures, which are designed to encourage competition in derivatives markets particularly, by allowing users to process trades through a clearing house of their choice irrespective of where they are traded. ESMA is required to specify the circumstances under which access can be granted or denied and the related factors.

The implementation conditions of measures pertaining to High Frequency Trading (HFT) activities also need further specification. MiFID II involves a licensing regime which notably requires ESMA to agree on a definition of HFT (as a subset of algorithmic trading). The obligations in terms of liquidity provision of investment firms that engage in algorithmic trading in order to pursue a market-making activity also need to be precisely calibrated.

Specification work is being undertaken by ESMA in many other important areas for the final outcome of the MiFID II / MiFIR legislation: liquidity characteristics of the non-equity products concerned by pre and post-trade transparency obligations; the thresholds of proprietary activity for defining systematic internalisers; the trading obligation for shares and derivatives; circumstances for entering into a market making agreement…

Post-trading framework

The EU post-trading frameworks (EMIR and CSDR) have also been adopted.

CSDR was approved by the plenary session of the EU Parliament in April 2014. The agreed regulation defines the role of the CSDs operating in the EU and provides harmonized rules for such infrastructures including a shortened settlement cycle (T+2) and market discipline rules. In addition, TARGET 2-Securities (T2S), which is due to be implemented between June 2015 and September 2017, will transform the environment of CSDs and custodians by centralizing the settlement of securities trades in central bank money in the Eurozone (and some other jurisdictions) and triggering an evolution towards a single set of rules, standards and costs for all settlement transactions across T2S markets. CSDs which will be outsourcing settlement to T2S are expected to develop ancillary services as a result, such as collateral management and custody services, which will compete against those provided by regional and global custodians, together with settlement services for securities issued in other CSDs. Draft Level II standards are due to be proposed by ESMA and EBA for the CSDR by the end of 2014. Significant issues to be addressed include the definition of appropriate settlement discipline and buy-in standards and the specification of a capital surcharge for those credit institutions that have been designated by a CSD for commercial bank money settlement. The former subject being considered the most challenging one as it is expected to have potential wide impacts on market liquidity and on repo markets.

Concerning EMIR, most implementation standards developed by ESMA have now been adopted by the EU Commission. Two key sets of standards are still missing: those determining the clearing obligation of derivative trades and the technical standards on bilateral margins for uncleared trades. EMIR also involves the authorization of EU CCPs by their competent authorities which is a process under way.

The reporting mandate to TRs was implemented in the EU in February 2014. Work is proceeding to improve the quality and aggregability of the data reported and the access to data by regulators as well as its reconciliation across multiple TRs (six operating at present in the EU).

Additional issues to be addressed regarding securities and derivatives trading and post-trading

Further harmonizing EU securities and derivatives markets, which remain very fragmented across Member States, is a major challenge ahead. Fostering further integration of EU capital markets could improve the financing of the EU economy, but also enhance the efficiency of trading and post-trading processes. Although the harmonization directly related to clearing and settlement processes is well engaged this is not the case for other areas such as the legal regime applying to securities (e.g. ownership rules). Improvements are also under way in the corporate actions area. T2S is playing a major role in fostering further harmonization in some of these areas but additional actions are needed to achieve further integration of EU capital markets. Some stakeholders are for example in favour of pursuing the project of a common EU Securities Law legislation initiated by the previous legislature. This latter issue is however quite contentious because solutions impact national legal systems and it is usually viewed as a medium or long term project.

Collateral, which has been playing an increasing role in the financial system since the beginning of the crisis is another major topic. The proposals to regulate the transparency of Securities Financing Transactions (SFT) should allow supervisors to have a clearer picture of the market and to implement some requirements on asset re-use in particular, but a better horizontal view of collateral requirements and of the effects of regulations adopted or proposed (such as CRD4, Financial Transaction Tax, etc…) on collateral efficiency is needed to ensure an appropriate balance between transparency, safety and efficiency.

The possible need for regulating foreign exchange (FX) markets is also currently being assessed by the EU Commission. Concern has been raised about the lack of harmonisation between the EU Member States on where the boundary lies between what is an FX financial instrument (in the ambit of MiFID and EMIR) and what can be considered as a spot FX contract. There are also certain investor protection concerns.

Summary of the session

1. Challenges related to the implementation of MiFID II / MiFIRtrading requirements

A regulator explained that a discussion paper had been issued by ESMA in May 2014 in order to seek stakeholders' views on key elements of future MiFID II and MiFIR technical standards and that responses were currently being processed. In some cases there are quite clear proposals on the table whereas in other cases it is still an open discussion. The next steps for ESMA by the end of 2014 are to provide the EU Commission with advice on areas such as investor protection and requirements for investment firms and to publish a consultation paper with clear legal proposals for the implementation of MiFID II and MiFIR requirements.

Concerning trading requirements the focus of ESMA is currently in two areas for which implementation challenges are very significant for market players and for domestic and EU regulators: transparency requirements for non-equities and trading requirements for OTC derivatives. The regulator emphasized that the definition of rules was however not the end of the story. A great deal of the actual cost and effort will go into the implementation of these rules and this involves achieving a sufficient level of harmonisation and putting in place the appropriate human and IT resources.

Transparency requirements for non-equities

Specifying the transparency requirements of MiFID II is quite challenging a regulator stressed. MiFID I pre and post trading transparency obligations currently apply to about 6,000 shares. MiFID II will extend these obligations to a whole range of other products such as bonds, derivatives, ETFs, etc…,amounting to several hundred thousand if not millions of products for which an appropriate transparency regime will need to be defined taking into account the different liquidity characteristics of these instruments. This evaluation is quite challenging and doing so in legislation is difficult as markets as well as the liquidity characteristics of instruments change.

An industry speaker was generally supportive of MiFID II and MiFIR which should help to reposition capital markets in Europe as a key channel to finance the economy. A large proportion of SME CEOs have understood that diversifying their financing resources and using capital markets to a larger extent is critical. They are however asking for more transparency and stability, which should normally be provided by MiFID II and MiFIR. Some question marks were however stressed by the speaker. A first question is the statute of systematic internalisers which should remain bilateral in the speaker's view. A second one is the criteria proposed for defining liquid markets for non-equity instruments which could be improved the speaker believed. Using the criteria proposed in combination could be too rigid and thus excessively narrow the notion of liquid markets. Using such criteria successively in sequence would seem a preferable solution.

A regulator agreed that the MiFID II and MiFIR regulations currently being implemented are about making sure that capital markets are able to support the economy adequately and that capital support is effectively brought by investors to the firms that need it. Improving transparency is a challenge in this context as a "difficult judgment" has to be made about how far transparency should go in order to support capital creation and create more certainty without hindering the effective flow of liquidity in the market. The market making model for example is very important for certain parts of the capital market but if taken to the extreme it may create very untransparent markets, so the balance needs to be right. The concept of SME growth markets in MiFID II can be an important contribution to the financing of SMEs, the regulator believed, as it would help SMEs to use the capital markets in a more efficient and cross-border way.

Trading requirements

The second area where there are important implementation challenges, a regulator stressed, are the trading requirements imposed on sufficiently standardised instruments. The G20 requirements mandate OTC derivatives to be traded when possible on centralised trading platforms in order to ensure an overall transparency of the system and to facilitate the monitoring of these markets by regulators. MiFID II will ensure that information is available in a central place and that investors get the best information available. Trading requirements for OTC derivatives will be implemented in a second stage because clearing obligations need to be put in place first.

Another regulator stressed that venue based trading is not always appropriate. This is the case for example of instruments that are not liquid orof large-in-scale trades for which appropriate definitions are needed. There are also synergies between the definitions of what can be centrally cleared and what can be traded on platforms which need to be taken into account. Some lessons can also be learned from the implementation of similar requirements in the US.

An industry player emphasized the diversity of instruments that MiFID II will apply to. MiFID II notably aims to tackle the issues related to the lack of transparency of complex derivatives which was one of the problems at the origin of the financial crisis. Moving products into organised marketplaces which provide improved price discovery and post-trading risk management seems the right way forward, but some of these instruments are not attuned to such a degree of transparency and cannot be moved in a matching type environment, because of their limited frequency of trading or liquidity. The key challenge is defining which instruments can be moved onto electronic platforms.

The vital importance of the central clearing of derivative products was stressed by an industry speaker. Independent evaluation and the collateralisation of risk will strengthen the system. Much preparation work has already been done to make sure that CCPs are sufficiently strong and well-governed to manage the new risks coming from OTC derivatives. The next stage is to define which products should be brought into CCPs initially. Once central clearing is widely implemented there is then a diminishing return in driving OTC products into the electronic trading environment, the speaker believed, and actually there is an economic benefit in enabling certain products to continue to be bilaterally traded. In dealing with the implementation of the MiFID II trading and transparency rules and post-trading requirements the authorities should focus on the products which are systemically important and likely to threaten the system in the future in order to de-risk it, while allowing other instruments that serve a useful economic purpose to continue to be traded in the current way.

A regulator confirmed that deciding precisely which products have to be mandatorily centrally cleared still remains to be done. There is a definite recognition by the different parties in this debate that central clearing makes sense for some products which are sufficiently standardised and liquid but does not for some others which are bespoke and are not sufficiently liquid for the CCP to be able to close its positions quickly enough in case of default and to be able to remain a sufficiently "strong and safe node" at the heart of the system.

Another industry player agreed that moving some derivative products to electronic platforms is a good idea but for some others this is not possible. Some requirements need reviewing in this perspective. The status of market makers is one of them as there seems to be some confusion in the rules defined between market making and high frequency trading which are two very different approaches. For many instruments such as fixed income, OTC derivatives or swaps there is an RFQ market model (Request-for-Quote) for which market making is needed. Thinking that banks could be replaced by the buy-side in such a context is not a good idea because these are different businesses.

Market research and market data

Some issues raised by the rules currently proposed for market research were emphasized by two industry speakers. Brokers' investment research which is made available to buy-side participants that undertake a certain level of execution business with them is often paid for by higher commission rates than those charged for simple execution. A ban on the use of dealing commission to pay for such research has been proposed, excluding research from the list of permissible inducements. If such a measure was applied, market research, particularly for SMEs, would disappear these speakers believed because it would be too costly. This would affect the liquidity of SME stocks. This raises issues for asset managers and brokers but may also create level playing field problems with US players who are not subject to such rules.

More generally an industry representative argued that the purpose of regulation is to help to improve the transparency, stability and liquidity of capital markets in order to help finance the economy and not to "shift profit pools" as in the proposed measures concerning market research. Market data is another example where the proposals made in the EU do not seem to be appropriate. "There is no market failure" in market data, the speaker believed. Stock exchanges only represent a small proportion (8 to 15%) of the market data used and sustaining their current business model, which is very much challenged in the market, is "incredibly important" for them. Such requirements are not consistent with the "spirit" of MiFID II and MiFIR the speaker thought.

2. The global dimension of derivative markets

A market player stated that there is no such thing as an EU derivative market. Although there is an EU securities market for raising capital across the EU this is not the case for derivatives. The derivative market is global. Derivatives do not compete in the EU, they compete on a global level and although the US tends to be the focal point in many cases, one should also consider Asia where the market is progressing albeit at a different pace. In order for this global market to operate healthily rules must be as consistent and common as possible across all the providers.

Another industry representative agreed that derivatives constitute a global market but stressed that two years ago the NYSE Euronext / Deutsche Börse merger was blocked by the EU Commission because of the high market share the merged group would have reached in the European exchange-traded derivative (ETD) market. This means that at the time the ETD market was considered in isolation (compared to the much broader OTC market) and as a European market[1]. The speaker moreover emphasized the impact on market models that differences between EU and US rules may have. For example on swap platforms there is a "flat model" in the US with sell-side and buy-side players around the same platform whereas in Europe there is a two-tier model with the sell-side first and then with the buy-side. This means that there could be different prices for more or less the same product. Such differences in rules will lead to the fragmentation of what is a global market in the speaker's view.

3. Post-trading challenges

Post-trading will see major changes taking place in the coming years with the implementation of EMIR and CSDR regulations and with the launching of TARGET2-Securities (T2S). These changes however raise several challenges that the speakers on the panel commented on.

Clearing houses in particular functioned well during the financial crisis an industry speaker stressed and clients appreciate the capital efficiency of such infrastructures. One should therefore be careful when making any changes that could affect these infrastructures.

An industry player emphasized the importance of looking at trading and post-trading evolutions in combination because traders, buyers and sellers need both sets of solutions. Many of the issues mentioned on the trading side also apply to the post-trading area. The data and transparency challenges in post-trade are comparable to many of those on the trading side. Prudential banking reforms also affect post-trade players and the specificities of post-trade providers are not always fully taken into account in this context, the speaker believed. The global dimension is also present in post-trading since EU settlement systems for example offer post-trading services to global players and participants located in non-EU jurisdictions.

Implementation of T2S and further harmonisation of post-trading rules

An official explained that T2S is planned to go live in June 2015[2] and that the opening of the platform for user testing will start in October 2014. It will integrate securities settlement across Europe with 24 CSDs joining the platform. This platform which will deliver major benefits for securities markets and in particular for the organisation of collateral mobility across the EU is a concrete step towards building the Capital Markets Union called for by JC Juncker[3] the official emphasized. It will allow banks and financial institutions to have an easier access to their liquidity and to make easier use of their collateral across the EU and will facilitate the access of investors and issuers to the pan-European market.

Much effort has been made to further harmonise the rules applying to EU capital markets in order to facilitate a greater integration of these markets. This has been done in particular in the context of the development of secondary legislation for the CSDR on which the ECB is in close contact with ESMA. One of the main elements of harmonisation is the implementation of a harmonised T+2 settlement cycle which will help to facilitate the circulation of securities in the EU.

Some challenges still lie ahead though, the official believed, for example in the area of settlement discipline where an objective is to harmonise best practices. An effort is being made to leverage new technologies and a new generation of standards in the context of T2S and also to use them across different financial products. This is the case in particular of ISO 20022 which is being used for delivering T2S and which will soon be implemented also in the field of large value and retail payments through the SEPA.

An industry spokesman agreed that the T2S project is contributing to the integration of EU capital markets and notably to eliminating some of the so-called Giovannini barriers. However although the private sector barriers have mostly been eliminated this has not been the case of the public sector ones related to differing regulations and rules. Although eliminating the public sector barriers was a priority at the start of the Giovannini barriers project the financial crisis brought a new series of issues which delayed this effort.

Another industry player stressed that achieving the potential of T2S is a key objective. Further harmonisation is needed in some "problematic" areas such as corporate actions, tax and securities legislation. The insufficient progress with regard to the public Giovannini barriers can be explained in part by the fact that important stakeholders such as national securities regulators have not been involved directly in the day to day work on the T2S project. They therefore have not made so far the necessary progress and changes in the way they approach their task. But such evolutions should be part of the "core agenda" for T2S.

Trade repository implementation

Trade repositories (TRs) are one of the most important innovations in the global financial system, an industry speaker believed, and one that has "tremendous potential". During the financial crisis there was a lack of information on the positions held by the different participants in the derivatives market which created huge "information externalities" distorting participants' behaviour and leading to "risk retrenchment". The information kept in TRs should help risk managers to have a better view of the exposures of their institution and therefore to eliminate such information externalities in the future. Some implementation issues however remain to be addressed. A huge effort has been made to launch TRs and start collecting the data with a very tight timeframe. But the rules set down to access these TRs have been defined with a national focus. This means that every authority has a certain access to the data pertaining to that country. The speaker argued that such access rules are useless for the purpose of assessing systemic risks because OTC derivative markets are global. Putting a national border around a number of counterparties in order to determine how much risk concentration there is among them is not the right approach because the big picture is being lost and this may lead to mistakes. The local access rules that have been defined limit the public use that can be made of TRs.

A regulator agreed that these access issues need to be reconsidered. A better balance has to be found between what is needed for the supervision of a global market such as derivatives and regulatory approaches that are still national. The OTC Derivatives Regulators Forum (ODRF) is a good forum for doing so the regulator believed and progress has already been made in the right direction. Regulators however need to have information at hand to make the right choices at a national level taking into account the risks that the institutions based in their jurisdiction are exposed to also at European and global levels. The quality of the information held in TRs is however a more important issue than access, the regulator believed, because if the data is not of a good enough quality and cannot be reconciled nothing can be done with it. The launching of TRS was a "big bang approach" in the EU which the regulators knew would not be perfect. Six TRs have been authorised so far in Europe. Much work has been done to connect counterparties and also the users of the data and the remaining on-boarding queues are now quite limited. But the issue now is making sure that the data held by the TRs is of sufficiently good quality and that it can be compared and analysed. This requires efforts on the part of ESMA that is supervising the TRs but also of the national competent authorities that are overseeing the entities inputting the data.

Unintended consequences for the repo market of prudential requirements and of proposed settlement discipline rules

A market participant stressed the potential impact that the mandatory buy-in provisions of the CSDR could have on repo markets. Repo markets are important for the functioning of capital markets because they provide a safe and low risk source of assets for investors looking to invest their reserves, they allow primary dealers and market makers to offer financing and investments to fund managers and issuers of securities such as governments and corporate and finally they are the primary way for central banks to manage short term interest rates. Consequently repo markets are a prerequisite to the successful implementation of monetary policy. It is therefore critically important to maintain the integrity of the European repo markets due to their close links with the government bond and money markets.

However there have been reports in recent weeks, the speaker emphasized, that repo markets are starting to experience trouble in Europe and also around the world. Dealers and market-makers have significantly reduced their activity in these markets during the first half of 2014 due to the new prudential requirements. The mandatory buy-in provisions of the CSDR could further impact these markets by requiring dealers to hold higher levels of inventory across all bonds in which they transact, increasing transaction costs. The combined effect of these requirements needs to be looked at holistically. This is a major issue in the speaker's view because dealers play a key role in the government bond market which accounts for nearly 80% of the 5.7 trillion euro repo market according to ICMA figures. If dealers retreat from the repo market, liquidity in the secondary market for government bonds is likely to dry up, potentially increasing the cost of financing for governments. The calibration of the narrow exemption from the mandatory buy-in provision should be reviewed the speaker suggested and one proposal could be to define short term securities financing transactions, which correspond to the scope of the exemption, as a transaction with a maturity of less than six months. This would address the negative impact of the provision on the repo market and its functioning whilst keeping the exemption narrow enough to reflect the spirit and intention of the legislators.

Another industry speaker agreed that the impact of prudential and post-trading requirements on the repo market needs to be carefully analyzed because of the potential consequences for collateral management which is an "absolutely critical" risk mitigation tool. The proper calibration of the settlement discipline measures of the CSDR, which are a key element of how settlement systems work, is essential because otherwise these requirements may be inefficient. Although the Level II measures of the CSDR have not yet been decided, some concerns were expressed. There is major confusion, an industry player stressed, about the objectives and the capacities of the specific tools that are proposed to improve settlement efficiency i.e. mandatory buy-ins and late settlement fines. Agreement is difficult to achieve because different stakeholders have different needs and interests. The buy-in process works well today for CCPs but extending it to CSDs and therefore to different types of activities and participants might not be appropriate in some cases, as has been shown by the example of repos. The issues raised by the mandatory buy-in provisions could however be possibly corrected by an appropriate calibration. Late settlement fines raise other issues because the objectives behind this tool have not been clearly defined yet and this needs to be done because the objectives decided will affect the calibration and technical features of the tool.

A policy-maker agreed that the impact of the reforms adopted and the interactions between them need to be more precisely assessed in the future. So far there has only been an ex-ante evaluation but this evaluation also needs to be made ex-post. Such an ex-post analysis is however premature and needs to be conducted in two or three years' time.

An industry player agreed that there would be "unpleasant" unintended consequences of prudential requirements in the post-trading area and that the correct functioning of the repo market in particular was in


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jeopardy because of the leverage ratio. It is not possible to wait for three years until this is addressed and this can be solved quite easily by proper calibration, the speaker stated. The repo market plays a key role in the liquidity of sovereign bonds, the safety of inter-bank liquidity and the money base of the non-banking sector. The only money base a non-banking player can use is high quality collateral which can be instantly exchanged for cash through a repurchase agreement (repo). To make this market work market makers and dealers need to be willing to run high volumes of such instruments with complex netting positions in order to provide the market with liquidity. If netting is constrained with the leverage ratio the repo market will get smaller as is already the case in the US and this will hinder the development of non-bank financing to the corporate sector which is called for by the EU authorities. Central banks are starting to become major dealers in the repo market but that is not necessarily what is needed.

Securities law legislation

There was disagreement among the industry speakers on the panel about the need for a European law legislation which could potentially harmonise securities legislations across the EU and in particular ownership rights. Some considered that such a legislation was a necessary starting point or a key building block of a single capital market alongside MiFID II / MiFIR, EMIR and the CSDR. Others were concerned by the difficulty of harmonising existing legal regimes and the time it would take.

1. Note : The Commission recognised that the exchanges industry is global, and should include the CME Group in particular. But it argued that non-European exchanges actually have a minuscule presence in European derivatives trading, and so do not currently compete with Eurex and Liffe. DB and NYSE Euronext would jointly have had a 90% market share of the EU ETD market (Source: The Economist – February 2012)
2. Note: TARGET 2-Securities (T2S)is due to be implemented between June 2015 and September 2017 in four successive waves., The platform will centralize the settlement of securities trades in central bank money in the Eurozone (and some other jurisdictions) and trigger an evolution towards a single set of rules, standards and costs for all settlement transactions across T2S markets
3. Announced by JC Juncker as a key objective for the EU Commission for the coming 5 years

Defining an appropriate recovery and resolution framework for Financial Market Infrastructures

Objectives of the session

This session was devoted to discussing the objectives and main features of an EU framework for the recovery and resolution of CCPs, as well as the tools that could be used in this context.

Background of the session prepared by Eurofi

Defining an appropriate recovery and resolution (R&R) framework is the main forthcoming legislative challenge for Financial Market Infrastructures (FMIs) in the EU after the adoption of EMIR and the CSDR. Following a consultation paper published in 2012 by the EU Commission on the R&R of non-banks and proposals made at the global level in 2013 by CPSS-IOSCO regarding FMI recovery and by the FSB regarding FMI resolution, the Commission is expected to publish a proposal for the R&R of CCPs in the coming months. The EU Parliament adopted a self-initiative report covering the R&R of non-banks at the end of 2013. Measures have also been proposed in the UK.

The proportion of centrally cleared OTC derivative transactions is expected to strongly increase in the coming years with the implementation of EMIR. This will provide many benefits for the market in terms of risk management and netting, but it will also increase risk concentration within CCPs. Interdependencies will also expand in the financial system between CCPs and their members and among interoperating CCPs. The failure of a CCP is a very low probability risk but it is not to be fully excluded and would have extremely severe consequences for the market.

EMIR already requires the implementation of risk management policies, capital requirements, disaster recovery arrangements and the establishment of a default waterfall including pre-funded loss-absorbing mechanisms. Most EU CCPs have additional rules in place such as “rights of assessment” which are an unfunded obligation to replenish the default fund similar to a bail-in tool. But since ordinary bankruptcy rules, which focus on creditors, are not adapted for such entities that provide critical services for the market, these EMIR measures are due to be completed by a specific recovery and resolution (R&R) framework providing additional crisis prevention and management tools in case the resources mandated in EMIR are not sufficient. Several key questions remain to be solved in this perspective.

Distinction between ordinary risk management procedures, the recovery and the resolution phases

A first question is clarifying the measures that should be part of the recovery phase of a specific R&R framework, in addition to the ordinary risk management actions already mandated in EMIR. Suggestions have been made that the recovery phase should be triggered when the collateral posted by the defaulting member is insufficient to recover losses and when the viability of the CCP is threatened.

A second issue is how far recovery should be pursued once the ex ante agreed loss-absorbency measures are exhausted before triggering resolution. Many stakeholders believe that ensuring the continuity of the critical services provided by the CCP should be the main objective of an R&R process. This means first attempting to recover a CCP in financial distress (unless it is clear from the outset that this is impossible) and if this is not successful, transferring positions to another entity. When the market considers that losses are too high and that there is no point in continuing certain business segments then this is a resolution situation. Defining clearly when this move should happen is a key challenge.

Other participants, mainly from the buy-side believe that once the ex ante agreed loss-absorbency measures are exhausted the best course of action is to resolve the CCP, with a fast liquidation of positions, in order to return remaining margins to non-defaulting members and avoid penalizing them or their customers, rather than using additional resources (e.g. customer margins) to support a failing CCP. Two factors are put forward by these participants: (i) first the loss of confidence there is generally in a failing CCP, making its recovery unlikely beyond a certain stage as participants may leave the CCP in such a case, (ii) secondly the difficulty of transferring positions to another CCP or bridge entity in a short period of time. Augmenting pre-funded and pre-agreed loss-absorbency tools in order to strengthen the defences of CCPs has been proposed as an alternative to recovery instruments, although the effectiveness of such approaches is questionable in the view of some participants.

Finally, some participants think that a distinction should be made between the different types of products cleared by the CCP i.e. tools may vary depending on underlying cleared products and it should be possible to isolate products from each other in case of recovery as it could facilitate the effective implementation of the recovery itself.

Loss allocation tools in the recovery phase and the extent of the commitment of participants

Another issue is defining the tools that may be used for allocating losses and possibly continuing the core activity in a recovery context and the extent of the commitments of different participants. Recovery plans should provide the right incentives in order to increase the likelihood of recovery and be sufficiently predictable and transparent.

Haircuts on variation margins (VM) in order to distribute losses to a large participant base and buy time for an orderly reorganization of the CCP are favoured by many stakeholders as they can be implemented fast. The procyclical effects of VM haircutting are however stressed as well as the fact that the possibility of such haircutting might deter clearing members from increasing their exposure to CCPs. Some have also suggested using additional cash calls and partial tear-ups but such tools may be more appropriate in a resolution phase as they are not so predictable. Haircutting the initial margin of non-defaulting members has been rejected in the consultations recently conducted and drawing additional funds on shareholders seems unlikely at such a stage.

Moreover stakeholders generally suggest that recovery regimes should not give rise to open-ended liabilities that would potentially create incentives for participants to leave the CCP, which means defining precise triggers for activating the resolution process. The degree of flexibility that might be left to CCPs in the design and implementation of recovery plans in order to potentially adjust tools to specific circumstances also needs to be defined.

Resolution tools and authority

Two main options are envisaged for resolving a CCP: transferring the positions to another CCP or bridge entity or liquidating the positions. Many observers argue that transferring positions is difficult to achieve in a short timeframe particularly in a cross-border setting unless it is prepared in advance. Suggestions have been made that a CCP resolution could contain a recapitalization plan to potentially re-start the operations of the CCP on new grounds once positions have been liquidated.

Another issue is the nature and the role of the resolution authorities of cross-border CCPs given the speed of reaction that is needed when executing a resolution process and the possible fiscal implications. The way to handle the R&R of a cross-border CCP operating in countries with different rules also needs defining.

Whether central banks should play a role in the recovery or resolution of CCPs, either as a liquidity provider or as a backstop, is another issue that needs to be decided, taking into account the possible moral hazard this may generate and whether this may create obligations in terms of the supervision or location of the CCP.

A further issue is the coherence that is needed between the R&R frameworks of CCPs and of their clearing members - many of which are likely to be G-SIFIs.

Summary of the session

1. Update on the regulatory proposals concerning CCP recovery and resolution (R&R)

The speakers on the panel stressed the importance of defining and implementing an appropriate recovery and resolution (R&R) framework for CCPs. There has been a "dramatic increase" over the recent years in the number of transactions funneled through CCPs and the rules mandating the central clearing of standardized derivatives trades progressively being put in place around the world will continue this trend, an industry speaker believed. CCPs are at the centre of the EMIR requirements and should help to make the financial system safer but CCPs also accumulate risks and this makes them systemically important institutions.

Proposals regarding the R&R of CCPs are due to complete the default waterfall measures present in EMIR. The waterfall should hold in most cases but maybe not in all, a public representative emphasized, and the more flows are concentrated in CCPs the higher the probability that one might need to go beyond the waterfall into a R&R process.

A regulator emphasized that the global regulatory bodies are taking CCP recovery and resolution "very seriously". This issue is considered around the world as one of the most important risks to be tackled in financial markets at present.

There is a CPMI[1] – IOSCO workstream on the recovery of CCPs and the related planning process. There is also an FSB workstream on the resolution of CCPs, as an application of the "Key Attributes of Effective Resolution Regimes for Financial Institutions" also defined by the FSB. Recommendations made for CCPs indeed need to be consistent with those made more broadly for financial institutions, a regulator stressed. Both of these workstreams published guidance on the recovery and resolution of CCPs on 15 October 2014. A decision has also recently been made by CPMI-IOSCO to work on the stress testing of CCPs and to define consistent rules for such tests at the global level.

With regard to the EU, a policy-maker emphasized that a CCP R&R framework is the main piece of legislation following the G20 Pittsburgh commitments that was not covered during Michel Barnier's term. The proposal was left purposely for 2015 in order to be sure to make the right decisions. At present the EU Commission is working on an impact assessment covering CCPs but also other Financial Market Infrastructures (FMIs) and insurance companies, CCPs being the priority. The objectives of a CCP R&R framework are to maintain financial stability and confidence in CCPs, minimize losses for society and taxpayers and also to strengthen the single market for CCP services in order to ensure a level playing field.

Different issues are being looked at by the EU Commission in the impact assessment, the policy-maker explained. (1) Preventive measures to make sure that CCPs and the competent authorities have the appropriate contingency planning in place that can be implemented in a safe, swift, transparent and predictable way. (2) The triggers that should be used for deciding to move into recovery or into resolution. (3) The measures needed for a CCP to restore its viability in order for it to continue providing its critical functions. (4) Resolution measures. (5) Who decides on resolution, who should act as the resolution authority and what are the arrangements that are needed to ensure effective cross-border cooperation between the competent authorities concerned, both within the EU and at the international level.

A regulator agreed that these questions need to be addressed and thought that different situations need to be considered in doing so in order to put in place a credible recovery and resolution strategy that could gain the confidence of the market. Some additional issues have to be addressed including: whether keeping a CCP refinanced and open is the only avenue; whether bridge bank tools are appropriate; should activities be separated out in some cases; how to handle difficulties in a cross-border CCP, in a CCP that uses several currencies or in an integrated FMI where central clearing is only part of the activity.

A public representative stressed that much work has been done over the last two years. Work has been done in particular by CCPs in connection with the competent authorities to put in place recovery planning. Decisions however have to be made now regarding the toolbox needed because "the longer we wait the more risk there is in the system". This was confirmed by an infrastructure operator who emphasized that resolution planning had started two years ago before there was any regime in place to consider this issue. An industry player however believed that although much thought has gone into recovery planning, more work remains to be done.

2. Priorities, definitions and triggers of the recovery and resolution processes

Priorities for a CCP in a situation of stress

The speakers on the panel generally agreed that the priority should be given to recovery. A strong emphasis should be put on recovery planning and making sure that CCPs can withstand a crisis in case one of the clearing members defaults in particular. A regulator however stated that planning for recovery is not sufficient and unless resolution is credible recovery will not work.

An infrastructure operator emphasized that for the market it is very difficult to imagine that the critical services CCPs provide are ever going to disappear. Payment services are going to need to continue as well as settlement for any systemically important CCP. Putting a resolution plan out for such entities might in fact put doubts in the minds of the stakeholders concerned and give credit to the fact that the potential risks identified are realistic.

A regulator agreed that appropriate recovery planning and an effective execution of recovery are the best ways to ensure the continuity of critical services and to avoid trouble for the financial system at large. In a resolution situation "continuity is not guaranteed".

Many lessons can be learned from the debate about ending too-big-to-fail in the banking sector, another regulator believed. Recovery planning should be performed by the private sector institutions and thoroughly assessed by the supervisors at the same time as resolution planning is being prepared. An industry representative agreed that the private sector should be able "to find a solution as much as possible before the public sector comes in". This should be easier with more robust and safe CCPs following the implementation of EMIR.

Main characteristics of R&R processes

Three main characteristics were suggested by the speakers on the panel for defining an appropriate R&R approach: transparency, credibility and flexibility. An industry player added that a very important principle that should some way be enacted in the legislation is that there should be no possibility for a public bail-out of a CCP, in order to eliminate moral hazard. This requires finding solutions for R&R that are not dependent on any public support. A regulator also stressed the importance of ensuring legal certainty in such a context and doing as much ex ante planning as possible.

Transparency

Full transparency is required about the recovery plan and the possible resolution mechanisms of CCPs a regulator stated. In a context of recovery market participants need to have as much transparency as possible about their exposures with the CCP and about the risk management processes of the CCP. The types of tools that are available for the recovery of systemically important FMIs should also be shared and understood by all stakeholders although it should be up to the management to decide when and how to apply them.

An industry player added that transparency is all the more important for users of the CCP (clearing members) that they have to evaluate the level of risk associated with a CCP in order to be able to calculate the capital needs to be put in place to cover the exposures they have to the infrastructure.

Credibility

Credibility is another key aspect of recovery a regulator emphasized and in particular the credibility of the loss allocation rules and of the tools that can be used at the bottom of the waterfall and whether they are sufficient to ensure the systemic stability of the CCP. The credibility of the contingent claims related to assessment rights[2] and whether they would stand up if they were needed can be questioned for example. In the same way the credibility of different recovery options such as various forms of haircutting may also be challenged.

From a resolution authority perspective there is a "tension" between the waterfall described in the loss allocation rules and the creditor hierarchy, the regulator added. It is critical that the two should be aligned and to avoid being in a situation where the resolution authority finds out, when a CCP goes into resolution, that its hands are tied by a warrant officer or some insolvency measures in the loss allocation rules. Also, the further one gets down the default waterfall the less the loss allocation rules may be credible. This raises questions about the right moment for a CCP to enter into resolution, the risk being that if a CCP does so too late there might be insufficient resources to cover losses and for the CCP to be recapitalized because of its liability structure. In such a context pre-funded loss absorbency resources could be "conceptually attractive".

Flexibility

An infrastructure operator added that while ex ante rules are important in order to provide transparency and predictability in times of stress, the value of providing the management of the CCP with sufficient flexibility should also be recognized. There should be flexibility, notably in the application of tools meant to address losses and operational issues of a CCP in a manner that allows for the continued provision of critical services. Another issue is that the local resolution regimes such as Chapter 11 bankruptcy rules in the US do not take into account the specificities of systemic FMIs and therefore may not work in a way that achieves an orderly wind down or that supports the principle of continuing the critical services of such infrastructures. It is essential that the steps taken by the R&R process do not interrupt the continued availability of liquidity at the CCP and maintain the non-discriminatory treatment of all its members relying on previously existent loss allocation and risk management practices, the speaker believed.

Definitions and dividing line between the recovery and resolution phases

The speakers on the panel agreed on the importance of having clear definitions of each phase and also of the dividing lines between the default waterfall process defined in EMIR, the recovery phase and the resolution phase.


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Several speakers suggested that the dividing line between recovery and resolution was when the public authorities took over. Recovery planning is primarily the responsibility of the private sector and resolution planning involves the public sector, but normally only as a last resort solution a regulator added. A reason why recovery is part of the responsibilities of the private players is that it can be considered as "the extreme end of the risk management process of a CCP" therefore recovery is still part of the CCP's risk management, a regulator emphasized.

The EU Parliament's position in the self-initiative report on the recovery and resolution framework for non-bank institutions (published in October 2013) is that any actions that involve end-client assets and allocating losses to end-clients who have no control over the management structure of a CCP should be considered as resolution, a public representative mentioned. Such an allocation indeed requires the intervention of a public authority.

An industry player added that whether the waterfall process is part of the recovery plan still needs to be further clarified. Another issue is that while the objective of the waterfall process is to cover the default of the two main clearing members of a CCP, it might be necessary to start putting in place some contingency measures when a first clearing member is running into difficulty in order to limit the loss of confidence in the market.

An industry player stressed that there should also be the possibility to terminate (and basically bring into resolution) a certain asset class if it is no longer viable, with the objective of ringfencing losses and allowing the other services of the CCP to remain a going concern.

Triggers for launching the recovery and resolution phases

The speakers on the panel believed that an appropriate balance needs to be found between the use of quantitative triggers and the judgment made by the competent authorities and the management about the viability of a CCP.

Quantitative triggers can be envisaged, a policy-maker stated, because they have advantages in terms of transparency and equality of treatment but soft triggers relying on the judgment of the competent authorities are also necessary because institutions may fail in many different manners that do not necessarily meet the "hard conditions" of quantitative triggers. There is the same situation in the banking sector. Many banks that failed in the past did not have problems in terms of capital requirements. The judgment of the competent authorities should play an important role in deciding whether there is a need to launch a recovery or a resolution process. Such a decision depends on whether the CCP is failing or likely to fail and whether there is sufficient confidence in the fact that the actions that the operators of the CCP can take are likely to succeed; if this is not the case, then the CCP should enter into a recovery or a resolution phase. Another factor to be considered is whether resolution is in the public interest rather than liquidation. Sub-triggers will probably also be needed in this context coupled with guidance from the competent authorities to market participants as to how these triggers would be activated.

A regulator believed that most of the factors that need to be assessed in order to decide whether a CCP should move into recovery or resolution cannot be quantified and that the public authorities cannot be bound to any forms of quantitative triggers in such a matter. Flexibility is needed around this with different options both in terms of recovery and of resolution. Credibility is also needed about how these tools would actually be deployed. There needs to be sufficient ex ante clarity about when these tools should be applied and the impact that they can be expected to have on market stability. Another regulator agreed that precise triggers are difficult to imagine because in the end it is always a "judgment call" about whether the CCP is still in a viable situation. Different stakeholders having different views and interests also have their say including the CCP, the market participants and the public authorities, making it a "triangular sort of game" a regulator added.

An infrastructure operator believed that FMIs should retain primary responsibility for designing and applying rules for their individual recovery and for identifying the most appropriate triggers for resolution, in discussion with their regulators and based on an analysis of potential stress scenarios. Allocating these tasks principally to the FMI is necessary the speaker emphasized, given the diversity that exists among FMIs and the variety of their ownership, governance, loss allocation processes and exposures to credit and other risks.

3. Recovery and resolution toolbox

Many different tools are available for restoring the viability of a CCP including variation margin haircutting, assessment powers and contract tear-ups, a policy-maker explained, that all have their pros and cons. For the moment the conclusion that can be drawn is that none of these tools are optimal and that there needs to be flexibility for CCPs in the use of these tools with adequate oversight by the competent authorities. There should also be sufficient flexibility in the application of the tools and the powers of the resolution authority because CCPs can fail in many different ways depending on the origin of the failure and the economic environment.

Different tools depending on the cause of the problem and the specificities of FMIs

Several speakers on the panel stressed the need to adapt the tools used in R&R processes according to the origin of the problem encountered by the CCP (i.e.

clearing member default, operational issue, market failure…) and to the specificities of the CCP and of the instruments cleared by the CCP.

A public representative suggested that a different toolset is probably required depending on the cause of the problem in the first place. The default waterfall mandated in EMIR is to do with the failure of the main or of the two main general clearing members of the CCP. But operational issues within CCPs which are potentially going to increase as CCPs become more important and systemic probably require a different toolbox.

An industry player agreed that the tools that should be used depend on the cause of the failure. If it is the market that is no longer viable, this will affect other CCPs and it will then no longer be possible to sell off positions because nobody will be willing to take them up. It would have been for example difficult to establish a market price for Collateralized Debt Obligations (CDOs) some time ago, had such assets been cleared. In such a case allocation tools would be the right ones to use since they would allow coming to a quick and predictable resolution for a certain market. On the other hand if a CCP experiences an operational failure, then a bridge institution could be a solution because in such a case the market would remain viable for the operator, either within the same institution under a different ownership structure or in a different entity.

An infrastructure operator added that recovery planning should not be a "one-size-fits-all" approach. Not all FMIs are alike and therefore R&R objectives, approaches and tools should also be adapted to the specificities of each FMI. For those that have systemically important operations the goal should be to ensure a continuity of the essential functions of the FMI and notably of payment, clearance and settlement services.

The different characteristics and features of the instruments that are cleared by CCPs also need to be taken into account in the definition of recovery plans and of the tools to be used: for example the clearing of cash equity products is not the same as OTC derivatives and Exchange Traded Derivatives and OTC products are also different.

Recommendations made regarding resolution tools

When it comes more specifically to resolution "there are only two prevailing thoughts" at present, an industry speaker claimed, none of which seem "practical" at the time of a crisis, especially if there are only 24 or 48 hours to implement a solution. One involves the tear-up of positions and the other liquidation. Although these approaches offer the advantage of providing some immediate crystallization of losses to the counterparties they also have major potential downsides. Liquidation may result in the fire-sale of many assets used as collateral and might create systemic instability particularly if replacement services are limited, unreliable or long to put in place. Liquidation and tear-ups also create asymmetry of risks across market participants, unpredictability of the levels of gain and loss and uncertainty until the process is achieved. The underlying principle in any resolution should rather be to allow a failing CCP to continue as a going-concern, the speaker claimed, in order to be able to be open for business on the Monday following a failure. This requires a credible recapitalization strategy in particular in order to avoid either a liquidation or a bail-out.

Five basic recommendations were made by the speaker in this perspective. (1) The first recommendation is to mandate regulatory-driven stress tests for all systemically important CCP in order to size total loss absorbency resources, including both initial margin and the default fund. There should be a standard stress test framework in order to allow sufficient transparency and comparability across CCPs. Some micro scenarios could however be customized for each CCP, based upon its portfolio and the asset classes concerned. (2) The second recommendation is that the entire loss absorbency resources of CCPs should be fully pre-funded and that unfunded assessments be eliminated. At present most CCPs depend upon tens of billions of dollars of assessment powers on clearing members should their default fund be depleted, but there is a high probability that those assessments will not be available at the time of greatest need, particularly if several CCPs call assessments upon the same members. (3) The third proposal is to require the development of predetermined resolution plans for each CCP. This means deciding which authority may trigger a resolution, identifying in advance where the funding to recapitalize the CCP would come from and defining the procedure that should be used to bail-in the funds needed. (4) The fourth principle would be to create a recapitalization fund distinct from the existing default fund, possibly only for systemically important CCPs. This fund should be outside the control of the CCP and probably within the remit of a central bank or government agency so that there is an assurance that the funds are available. (5) The fifth principle proposed by the speaker is that the CCP should contribute to the guarantee fund and to the recapitalization fund at least on par with the largest clearing member. This would force CCPs to have appropriate amounts of "skin in the game" and would better align their incentives with those of the participants of the CCP, which is important at a time when many CCPs are for-profit organizations.

Implementing these different proposals will probably increase the upfront funding obligations for many market participants but may not strongly impact their total potential liability (measured as the current guarantee fund plus future assessments). Such an increase in costs should however be manageable, the speaker believed, and will be offset in any case by the "invaluable benefits" they may bring in terms of systemic safety.

Several regulators on the panel welcomed these proposals. For the private sector to propose such solutions is the "right signal" to give, a regulator believed. The private sector should be caring for itself as much as possible and the public sector should be appealed to in last resort. Another regulator added that such tools could add credibility to the R&R process with a stronger assurance that there would still be resources to cover losses and recapitalise a CCP entering into resolution. A policy-maker agreed that the funding element is key: i.e. whether the default fund is sufficient and whether a recapitalization fund is needed. Another public figure however stressed that such actions may not be that easy to put in place when going into the details and numbers.

The cost of the R&R of a CCP to the system as a whole needs to be assessed in advance also, a public representative believed. A resolution authority needs to assess in advance the levels of capital that will be needed for the on-going operations of the CCP and what form it should take i.e. a recapitalisation fund, pre-funded assessments… Some clients might assume that paying a fee to a clearing member acting on their behalf provides them with a "layer of protection", but clients are now generally more doubtful that this may be possible.

An infrastructure operator stressed that assessments are at present just a loss allocation tool and that there is a cap on the liabilities for the clearing members of a given CCP. If assessment rights become pre-funded, one would have to determine how to evaluate the size of the prefunded part and what should be paid for and by whom in each default scenario i.e. only clearing members or also their clients. The issue is defining the scenarios that a pre-funded line of defence is expected to cover. But in the end if a resolution authority takes over it should have the power to allocate losses among all the stakeholders and to make sure that no public money is needed.

Another industry speaker however pointed out that there is not a cap on liabilities per se at present. Liabilities are naturally limited by capital requirements and potentially exposure limits. Assessments are real liabilities the speaker emphasized but the issue is that they are not accounted for or capitalised properly.

4. Resolution authority

A public representative stressed that not all Member States have resolution authorities in place or the necessary legislation that would allow a resolution authority to operate. A first step is to ensure that such measures are quickly put in place. Once a resolution authority is in place, it should identify as a priority the tools (including possibly pre-funded tools) that are needed in order to maintain market stability.

A regulator believed that the home supervisor of a CCP, who performs the day-to-day supervision of the entity and is involved in the recovery planning, is well equipped to at least have a say in the resolution planning of the CCP. There is at present a debate at the FSB about whether independence is needed between supervision and resolution. In any case there needs to be at least a very strong link between the two. The question of a possible single supervisory mechanism for EU CCPs, as for banks, is also on the table. From a national perspective the regulator believed that "those that potentially have to bear the burden should have a say". The regulator was favourable to a national system that would be able to take into account colleges when they exist, as well as the major stakeholders of the CCP.

1. CMPI: the Committee on Payments and Market Infrastructures is the new name of CPSS

2. "Rights of assessment" are an unfunded obligation to replenish the default fund similar to a bail-in tool. The size of this obligation is usually capped and the level of the cap varies.


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FINANCIAL REGULATION AT THE GLOBAL LEVEL

Feasibility of bank crisis management at the global level

Objectives of the session

The aim of this session was to discuss the relevance of Gone-concern Loss Absorbing Capacity (GLAC) for banks and, if applicable, the criteria, amounts, location and appeal of these GLACs for investors. The question of the level playing field between different types of bank organisations (Single Point of Entry- Multiple Points of Entry) and the impact of the holding company on the way senior debt is considered was also examined.

Speakers were also invited to consider why the European bail-in rules and the Minimum Requirements for Eligible Liabilities (MREL) introduced by the Bank Recovery and Resolution Directive might not be sufficient and equivalent to the GLACs for handling the resolution of major international banks. The speakers were also asked whether the GLACs should be introduced exclusively in the regions around the world that have not already put such recovery and resolution schemes in place.

Background of the session prepared by Eurofi

With the Dodd-Frank Reform and Consumer Protection Act of 2010 in the US and the recent adoption of the Bank Recovery and Resolution Directive in Europe, policy makers have indeed made significant strides firstly to ensure that taxpayers will not be called on again to bail out failing banks and secondly to foster greater market discipline.

Dodd Frank explicitly bans the bailout of an insolvent bank and drastically limits the Federal Reserve's ability to provide liquidity support to a failing bank prior to its holding company being placed into receivership under the Federal Deposit Insurance Corp. (FDIC) as part of its orderly resolution authority.

In Europe, the BRRD requires prior haircuts of a bank's equity holders and creditors up to 8% of adjusted liabilities and equity , before a potential call on the resolution fund can take place. This means that in the absence of a sufficiently large buffer of equity and junior debt, senior creditors may need to be bailed-in prior to any bailout. At the same time, policy makers are making significant efforts to put in place credible resolution plans for large systemically important banks.

This attitude contrasts with developments in Asia and Latin America, where the dominant view is that policy makers should keep the ability to bail-out senior creditors and only a minority of countries is contemplating enabling senior creditor bail-in as a toll to recapitalise banks. One consideration often made is that senior creditor bail-in could trigger contagion risks, lead to a significant reduction of funding access for their banking system, and ultimately hamper the financing of the economy.

All the jurisdictions of the G20 should be committed to incorporating the Financial Stability Board's (FSB's) Key Attributes for Resolution into their domestic legislation. Two broad approaches have been identified to operationalise the resolution of large cross-border groups: a single-point-of-entry approach, where bail-in is applied at the holding company level, or a multiple-point-of-entry, where resolution tools are applied separately to different entities in the group. These approaches rely upon coordination between home and host authorities. The approach should be chosen and organized beforehand according to the specificities of each international financial group.

The Financial Stability Board is currently working on recommendations concerning "Gone-concern Loss-Absorbing Capacity", or "GLAC" for global systemically important banks (G-SIBs), with conclusions due to be presented to the G20 meeting in Brisbane in November 2014.

It is argued that further loss-absorbing capacity is needed, to be called on, so as to allow vital functions to continue and non-critical operations to be wound down in a controlled way. Generally, this loss absorbing capacity is to come from a bail-in of certain classes of private creditors, so as to avoid calling for a bail-out.

There are several important issues to consider. Among them are the questions of which instruments count towards any GLAC, how far GLAC may be appropriate and what measures can be taken to mitigate risks of contagion from GLAC holders incurring losses. On the matter of which instruments should count, a key question is whether or not equity capital above regulatory minima should qualify.

The direction taken by the FSB appears to be fundamentally based on 3 premises:

- G-SIB's therefore need massive loss absorbency and recapitalisation capacity in order to allow them to survive failure.
- This capacity must be made up of instruments that are contractually or structurally junior to senior liabilities and to the claims of retail investors.
- This capacity should allow for an extensive recapitalisation of the bank, to cover minimum capital requirements at least, but reaching potentially higher levels in order to restore confidence in the resolved bank.

Such an approach can be a workable answer to the undisputedcomplexities of G-SIB resolution. However this creates a choice.

- Either "Too big to fail" is to be ended by creating the possibility of orderly failure, through resolution planning and instruments (notably bail-in) that appropriately share losses among a wide base of unsecured and uninsured creditors, backed up by resolution funds and other back-stops
- Or "Too big to fail" is to be replaced by "Too safe to fail" in which G-SIB's are protected from failure by an extensive tranche of specific GLAC instruments, eliminating the possibility of a market exit, and obviating the need for resolution planning, and bail-in of anything other than GLAC. This option amounts to a complete internalisation of the resolution process based on the internal resources of the bank, limiting the role of authorities to the declaration of entry to resolution and the decision on the extent of GLAC conversion.

Maintaining in certain jurisdictions a "belt and braces approach" the approach of both options is inconceivable on grounds of cost and the knock-on impacts on the economy

Therefore GLAC may well be a workable solution for the resolution of G-SIB's in jurisdictions that have not created a resolution regime including resolution funds and their financial backstops as the complete internalisation of losses becomes essential in order to avoid recourse to public funds.

In EU jurisdictions, BRRD already provides the confidence that a failing EU GSIB meeting in particular its individual Minimum Requirements of Eligible Liabilities (MREL) can be successfully resolved without needing to be "resurrected" over a resolution week-end. The question is whether needs to be a global standard for a minimum requirement.

The recent doubling of the capital base of the major EU banks has already had major consequences in terms of deleveraging. It is important to assess the impact of any "extra layers" of capital through GLAC.

Beyond the amount of GLAC potentially required, the requirement for GLAC to be structurally or contractually subordinated can also be questioned. Whilst it is clearly essential that GLAC-holders be fully aware that their instruments are clearly ear-marked as bail-inable, is it essential that they should form a separate population distinct from, and junior to, senior unsecured liabilities? If GLAC is expressed to necessarily require either contractual or structural subordination, this would be a major "entry barrier" for a number of large EU banks who do not benefit from non operational holding structures or who have not chosen to issue large quantities of "Co-Co's". Statutory subordination, via an appropriate change to insolvency legislation, and which could be achieved in the EU via a regulation, may be a way to reconcile GLAC with the options taken under BRRD.

Summary of the session

In 2010, the US established a resolution framework for systemic financial institutions under the Dodd-Frank Act.

A speaker pointed out that in the United States, the crisis management framework is probably the most sensitive political issue of the entire regulatory reform agenda. "The dividing line remains on whether the resolution mechanism inside Dodd-Frank perpetuates too big to fail and creates moral hazard and implicit subsidies by virtue of the authorities that are granted to the FED and the FDIC in terms of triggering and ultimately carrying out resolution" he said.

Similarly, in Europe the Bank Recovery and Resolution Directive (BRRD) adopted this year will also allow authorities to put banks into an orderly resolution. Both regimes are broadly consistent with the global standard for resolution promulgated by the Financial Stability Board.

As part of fleshing out regulatory requirements underpinning that regime, the Financial Stability Board is expected to publish a proposal around the time of the Brisbane G20 summit in November 2014 to require G-SIBs to issue additional loss absorbing instruments.

1. Loss absorption capacity for Global Systemically Important Banks (G SIB): Gone-Concern Loss Absorbing Capacity (GLAC) or Total Loss Absorbing Capacity (TLAC)?

Definitions and differences between TLAC and GLAC

The recent Financial Stability Board (FSB) discussions have focused on the advisability of Total Loss Absorbing Capacity (TLAC) compared to Gone-Concern Loss Absorbing Capacity (GLAC) in order to solve the problem of too big to fail and to avoid calling for taxpayer bail-out.

As stated by a public decision maker, the differences between GLAC and TLAC can be explained in the following way: the G is talking about instruments that will absorb losses within resolution when an institution has failed, whereas the T means Total Loss Absorbing Capacity where the gone element is part of it.

According to him, TLAC interacts in an appropriate way with the Basel 3 framework: it does not affect how the minimum capital requirements work; it does not affect how the buffers work. Moreover the Basel 3 framework already makes the distinction between going concern capital and gone concern capital. He indeed reminded the audience that the Basel III framework requires banks to increase their minimum levels of tangible common equity tiers 1 (CET1), which is the highest quality form of capital and to improve their capital buffers. In addition the Basel Committee took further steps to ensure that if a bank fails, all classes of capital instruments fully absorb losses at the point of non-viability (PONV) before taxpayers are exposed to loss. In essence the PONV requirements ensure that all non CET1 capital and Tier 2 capital will be written off or converted into common equity upon the occurrence of a decision of the relevant authority.

So the TLAC/GLAC concept recognizes that the bail-in mechanism extends the PONV concept (which could be thought of as consistent with bail-in ideas) to other forms of bank funding and seeks to address the problem that, when a bank fails, losses could exceed existing levels of regulatory capital.

The TLAC approach seems more appropriate than the GLAC concept

An EU public decision maker stressed that TLAC has to be consistent with the Basel III framework and argued that the TLAC approach is better than the previous GLAC. He explained that "the GLAC envisages a recapitalisation capacity that is entirely separate from the capital level a G-SIB holds. Under the TLAC concept, capital instruments and qualified financial instruments count towards the requirement. In that regard, an institution is allowed to accumulate capital instruments to cover the TLAC requirement. In this framework, when an institution begins to incur significant losses, these would impact both capital levels and TLAC levels. Supervision and resolution authorities could simultaneously activate their intervention measures in a coordinated manner to address the situation; and this is expected to be more effective than a sequential intervention".

He also underlined that calibration is fundamental. "Anything we decide will have to be based on a very rigorous causative impact study". This speaker preferred a calibration based on leverage metrics not on risk weighted assets, but "this is still open to discussion" he added.

The opacity of the decision making process is worrying.

"2 months before the Brisbane G20 summit, there is no document that discusses T-LAC and the degree of opacity in this area since the autumn of 2013 is worrying" a speaker said.

Another participant added that this opacity which is also due to the complexity of the crisis management mechanisms, contributes to the suspicions of political decision makers on this subject. He also noted that the living will process is an iterative process between the banks and the supervisors in terms of what the plans would look like and essentially a process by which over time, the plans would be refined and improved. And he thought that this approach contributes to an element of opacity, which then plays into the broader political sensitivities.

A participant underlined that "we are only six weeks before the Brisbane summit but we have not had any papers on it in terms of being able to think about the practical implications and how these different things may land. I think this is causing a certain degree of angst in the middle management within institutions".

Are we sure the market exists?

A leader of the industry emphasized that when we are discussing the calibration of TLAC "we are speaking about 20-25% of risk weighted assets: Such a calibration would represent huge amounts of layers of sub-debt that we will have to raise and this should generate a further deleveraging of banks, in particular in Europe, and reducing lending to the economy; that must be underlined, because that will hamper our efforts to revive the economy".

He added that the average amount of sub-debt that a major bank would have to issue if the average T-LAC is 20% would probably be in the range of 20-40 billion Euros. Then such a figure is in itself the total amount of issuances in the European sub-debt market in one year. "And if you multiply this figure of say 30 billion, by the number of European SIFIs you come to a figure which is over the existing outstanding of this European sub-debt market, which his 300 billion. Moreover many major banks should come in at the same time to a very quickly saturated market. So he concluded by asking two questions: are we sure the market exists? Who will be the investors?

Another representative of the industry agreed with these observations and hope that the calibration of the loss absorbency rules will allow global investors to assess and price their risk at a level that works for the diverse bank business models across Europe, but more importantly allows them to support economic growth. He worried about the fact that politicians do not understand the impacts of the calibration of loss absorbency rules on the structure of the banks' balance sheets, on the supply of credit into the real economy and on its cost" he said.

Bank loss absorbency rules need to reflect diversity in markets and business models

"Is it possible to have one size to fit all approach?" a leader of the industry asked. What's the risk appetite of individual nations for contingent risk? Do people actually have legal frameworks in place that could give effects to what other countries would wish to do? Do they have resolution frameworks in place? Do regulators trust each other? Do regulators trust each other's policy makers? Do policy makers trust each other and how can they get certainty if they ever could on that? he also asked.

This speaker explained that it is not possible to have one size fits all approach concerning the crisis management framework of global banks. They are indeed different legal systems across the world, different cultures around resolution. He stressed that the willingness to absorb pain through the public sector also differs and depends on the shape of the financial system: the views of Europeans and Americans differ from those developed in Asia and Latin America where the dominant views is that policy makers should keep the ability to bail-out senior creditors.

He underlined that "ultimately, when people say we are solving too big to fail, I think that is a very misleading statement, because by definition if we are in resolution something has failed. More generally the crisis management framework is not about avoiding too big to fail, this is about pre-distribution of losses. So one of the main questions is, where are these losses going to fall, who's going to hold the instruments that take pain beyond equity and possibly a subordinated debt? Because if those destinations themselves end up in trouble, then all we have done is shift the problem to another place that can't afford it."

This leader also argued that he did not believe that "a resolution framework will ever work for systemic failure: individual institutions, yes, systemic failure, no" he said. He concluded his intervention by reminding the audience that it is important to recognize that "loss absorbing capacity is not free and the benefits to stability need to be balanced against the economic consequences of raising the cost of credit. Trapped capital and liquidity either at individual or consolidated level, cannot by definition support growth.

2. Reconciling TLAC with EU rules

There are similarities between the TLAC and the Minimum Requirement for Eligible Liabilities (MREL) but there are also important differences.

Similarities between TLAC and MREL

The objectives of TLAC and EU rules are to avoid use of public funds for loss absorption and to allow resolution strategies to effectively be implemented while ensuring the continuity of the critical functions of the failing bank. For this purpose authorities will need to ensure that GSIBs hold sufficient resources at all times. In that sense, as stated by a public decision maker, "TLAC and the European MREL concept share the same objective".

Another representative of the public authorities agreed that the shared objective is making banks resolvable. He



underlined that the FSB and the EU authorities share in particular the same approach in terms of ensuring that there are well defined resolution authorities with well-defined legal powers to impose losses within bank liability structures as far as they need to cover losses and re-capitalise banks. "T-LAC is not a substitute for resolution planning process", he added.

Nonetheless a representative of the industry emphasized that the T-LAC and the MREL concepts are completely different. The MREL approach is mainly to ensure that a failing bank can be resolved in an orderly manner whereas the other one is to ensure that a failing bank could survive failure. A speaker from the public authorities noted on this subject that "the TLAC is not about too safe too fail, because if it was about too safe to fail the regulators would not worry about the gone concerns elements but just focus on common equity Tiers 1".

It is difficult to compare the global approach and EU rules

A speaker stated that with the Bank Recovery and Resolution Directive (BRRD), European decision makers have tried, on the one hand, to improve the preparedness for the point of resolution and on the other hand to set up instruments, such as the Minimum Requirement for Eligible Liabilities (MREL) for when the moment comes.

He added that it is difficult to compare MREL and TLAC because we know precisely what MREL is, because MREL has already been approved by all the European member states. This case by case decision can be based upon another rule which is precisely defined in the BRRD: 8% of total liabilities (or 20% of RWA) of a bank needs to be bailed-in before resolution authorities can access to the resolution funds. "But we do not know at this stage what the T-LAC exactly is", this speaker noticed.

Differences between TLAC and EU rules

There are differences between the T-LAC concept and the MREL concept: the European concept covers all banks while the international concept only concerns the so called "too big to fail banks". A public decision maker stated that this is something difficult to understand "because if you look at what happened in Europe, most of the banks that were saved by governments (e.g. Northern Rock) are not in the list of the 29 G-SIBs established by the FSB. He also emphasized that "the question is what will happen to all these institutions if they fail and is the tax payer supposed to come? The European answer is the MREL. It covers each bank, but the international answer is not that one."

Several public decision makers pointed out that the MREL, defined in the BRRD, is a Pillar 2 requirement. In other words, resolution authorities will set MREL for each bank on a case-by-case basis depending of the size, the risks characteristics and the business model of the banks. MREL is tailored to each bank while the international discussions have not gone so precisely linked to each individual plan. So one speaker stated that "the international approach is more a Pillar 1 approach, but there may be a combination of Pillar 1 and Pillar 2 in order to adjust this new requirements to specificities and this profile of institutions, we shall see", he said.

Another participant noted that the MREL, as precisely defined in the BRRD is broad and permissive and there's flexibility to tailor loss absorbency instruments to the different resolution strategies of EU banks. But he added that the global GSIBs which are headquartered outside the EU and operated inside the EU, or which are headquartered here and then operated in the US or in Asia, need the concept of loss absorbing capacity to make cross-border banking work because it could be difficult to impose loss on long-term debt. "My hope is that a T-LAC standard will forestall what we see at the moment in terms of the fragmentation of the international banking system where host regulators are ring-fencing businesses because they have no assurance about how the losses would be distributed during the resolution process".

Otherwise, a representative of the industry told the audience that there is a possibility with the MREL to meet the requirements on a consolidated basis while the notion of LAC could contribute to fragment the major banks, adding constraints to the fluidity of capital, liquidity debt.

The institutional collaboration between supervisors and policy makers in different countries remains the main stumbling block

MREL and TLAC are not sufficient to ensure an orderly resolution worldwide. The participants all agreed that the crisis management framework can only work in practice if a highly collaborative process between home and host supervisors is put in place. One leader of the industry observed that "If you are constantly trying to protect your own issues, then it is unlikely that you are creating the foundations for a more collaborative approach when you get to really a very difficult situation, and we are seeing this all over the place. Home regulators are showing in their actions that actually they are more interested in the issues related to their home market."

This leader also clarified that in practice the way that resolution is going to be executed is profoundly influenced by the nature of the problem that led to the failure of the bank. "The idea that the resolution approach would be independent of that cause, is an extremely strong assumption and I think more needs to be done in thinking through the linkage between different scenarios of failure and how that would influence the resolution approach" he said.

Another representative of the industry focused in one of his statements on the need of a global co-ordinated and trusted Resolution Plan (RP) which requires effective trust among the supervisors of the global bank. "If a local resolution plan is required it should not conflict with the group one" he stated.

3. The location of TLAC should not be confined to holding companies (holdco) in a home country. During the session it was suggested that the group's home and host authorities need to have agreed in advance to the existence of an intra-group debt strategy

The distinction between the Single Point of Entry (SPE) and Multiple Point of Entry (MPE) approaches

This distinction between Single Point of Entry (SPE) when a group is resolved top down and Multiple Point of Entry (MPE) when it is resolved in different pieces is absolutely profound: an institution either is going to be resolved as a whole or it is going to be resolved in parts.

A speaker reminded the audience that some banking businesses lend themselves to an SPE type approach because the underlying business, even if conducted in different legal entities, is completely joined up (e.g. trading business, wholesale businesses), and there are some businesses that are conducted fairly separately (e.g. retail banking). He also pointed out that "with multiple point of entry, if you have a global group with three great regional sub-groups, each of those regional sub-groups could be subject to SPE resolution. But if you are going to use SPE for regional sub-groups, then they need to be not only financially separate, they need to be operationally separate as well. It is not appropriate if the regional operation in Europe suddenly has no access to IT or has no employees because all of that is contractually in a US entity that is now completely separated", he added.

The crucial issue is about effective cooperation and trust between home/ host authorities.

According to a leader of the industry, under a single point of entry strategy, there is clearly a superior solution that all T-LAC or G-LAC should exclusively be issued by the parent company, ideally a strategic holding company that would issue all the debt. But this is not enough. There are concerns that the single point of entry resolution would fail if an international co-ordinated and commonly recognised system of resolution based on common rules is not set up. It is essential to overcome concerns about ring fencing, concerns about trust among supervisors of financial groups.

There is indeed some doubt among the regulators whether they should trust each other in resolution. There is also a need to mitigate the regulators mistrust regarding banks on resolution. He clearly mentioned that "If we are not able to overcome this mistrust a lot of additional capital requirements will be placed locally just to match it but this would not be sufficient to resolve a systemic crisis of a GSIB".

The holding company and the group's home and host authorities need to have agreed in advance to an intra-group instrument in order to force home and host authorities to hard wire up front how they will coordinate the resolution of a global group

A binding international Treaty would be useful in principle to commit home and host jurisdictions to cooperate in the resolution of a globally active bank but this is not going to happen as a speaker stated. But the effects of a Treaty could be synthesized via intra-group financial contracting and, according to him, it would be important for Brisbane to deliver that.

This is why a leader of the industry proposed the creation of financial arrangements within a cross border group which force host country supervisors to contribute to fill the holes in case of difficulty. This proposal was endorsed by several public decision makers.

In a single point of entry resolution he explained that you need to pre-place some of the G-LAC or T-LAC. He emphasized that the solution is for overseas subsidiaries to issue super-subordinated debt to their parent group. This enables losses exceeding a subsidiary's equity to be transmitted up to the holding company, without the subsidiary itself going into default".

He added that if we take a group as a whole and it issues MREL or G-LAC or T-LAC from the top of the group, and then you have intra-group contracts between subsidiaries and the pure holding company that allows losses to be pushed up to the holding company, then something profound has happened.

Another speaker took the following example to illustrate this proposal: "So let's take a US Group, I can name names. Citi Group and Russia. For this structure to work, Citigroup's Russian subsidiary would issue super-subordinated debt to the Citi Holdings company that could be triggered by the Russian supervisors in conditions where the Russian subsidiary would otherwise go into local resolution.

Four parties have to agree to that: the board of the Russian subsidiary, the board of Citi Holdings, the Russian regulator and the US home regulator. And they may not all agree. And if they don't all agree, they have signalled to each other ex-ante that they are not prepared to co-operate in a resolution. Therefore, the US authorities say "we're not prepared to have this". Then it would be perfectly reasonable for the Russian authorities to say in which case "we would like a ring-fenced subsidiary please" and then it would be perfectly reasonable for City Holdings to say, "That is absolutely fine, it's going to be a smaller business". It is much preferable have these debates ex-ante rather than in the thick of the crisis" this speaker added.

So, by framing the trigger for "converting" intra-group debt into equity, home and host supervisors can hard-wire cooperation; or if they fail to agree on a trigger, they at least discover ex-ante rather than ex-post that they cannot rely on each other. This would usefully give a harder edge to discussions amongst home and host authorities in supervisory and crisis-management colleges.

As stressed by this speaker, an SPE resolution of a complex group/subgroup has two phases: in the first stage, losses in a subsidiary exceeding equity would be transferred to its holding company (holdco) by way of writing down/converting into equity a super-subordinated debt instrument held by the holdco. The trigger would be something like: if the conditions for host authorities to put the subsidiary into local liquidation or resolution were met, they could instead trigger the intra-group debt/conversion transfer. The second stage is typically for holdco bondholders to be bailed-in by the group's home authorities, thereby restoring the solvency of the group so that it restructured in an orderly way. According to him, all the G– SIBs and in particular the European ones should be restructured in a way that enables such an SPE resolution model, observing whether or not that happens would be an important test in the months to come.

Structural banking reform projects in the global context

Objectives of the session

This session was devoted to discussing the objectives of the structural banking reform proposed by the EU Commission, the rationale for proposing such a reform at this stage of the EU and global regulatory processes and the possible impacts that may be expected from this reform for the European financial system and more generally for the EU economy.

Summary of the session

1. Objectives and key measures of the reform proposed by the EU Commission

Main objectives of the reform proposed by the EU Commission

A policy-maker set out the main objectives of the structural banking reform proposed by the EU Commission[1]. The objective of the reform is to tackle the issue of the systemic risk associated with the largest banks, taking into account their contribution to the real economy. A large number of reforms to improve the transparency and stability of the financial system have been made in the last five years. However, some issues have been raised with regard to the size and complexity of the banking system and in particular of some banking institutions, the policy-maker emphasized. An interesting report recently published by an international regulatory organisation indeed shows that the increase in the assets and the size of banks does not always translate into an increase of the flow of funding to the real economy and that there is, of course, a part which is due to that but there has also been a significant increase per se.

The policy-maker also explained why the EU Commission was proposing to take action at this stage, after structural reforms have been put in place in four Member States and when a fifth EU country is about to move. Inevitably those initiatives – although they are going in the same direction to a certain extent – have a degree of diversity that could at some point have an impact on the single market. This may be an issue for banks operating across borders. "We would be much better off" having a common European text, the policy-maker believed.

Main features of the EU Commission structural banking reform proposal

The proposal for a regulation recommends banning proprietary trading in financial instruments and commodities from credit institutions and entities within the same group, using a very strict and narrow definition of this activity, the policy-maker stressed. And then for all other trading activities, what the proposal does is essentially to empower supervisors to look into the banks concerned using a series of indicators or metrics defined in the proposal. The supervisor is then empowered to make a decision.

A key feature of the EU Commission proposal is that there is no automaticity in terms of enforcing separation and that there is a strong empowerment of the supervisors[2]. This is different for example from the recommendations of the Liikanen report where there was a one to one correspondence between passing a threshold and then enforcing some sort of separation. In the EU Commission proposal, the only automaticity is that, passed a certain threshold, there is a requirement for the bank to be analysed by its supervisor . This is very important, the speaker believed, because ultimately, the responsibility and the judgment must remain with the supervisors of the institution. Now that many regulatory reforms have been undertaken, "it is important that supervisors can really act".

The reason for this supervisory discretion is very clear, the speaker explained. Banks need to have the ability to continue to serve a broad spectrum of clients and to continue to be able to offer them a broad range of products and services linked to their activities. The universal banking model which works particularly well in Europe should be preserved in particular. That was one of the most evident points that came out from the hearings about the Liikanen report: the way in which the real economy in Europe – i.e. companies and firms – leverage on the universal banking model.

2. Main features of the existing domestic structural banking reforms

A regulator outlined the objectives and features of the structural banking reform that has been put in place in France and the main differences with the other domestic reforms implemented in Germany, Belgium, the US and proposed in the UK.

Objectives and main features of the French structural banking reform

The objectives of the French reform are very close to those of the EU Commission proposal, and probably very close to what has inspired other pieces of legislation in the US for instance, the regulator stated. The objectives come from two observations made during the crisis. One is the risk of conflict of interest within banks between activities they manage on their own account and activities conducted on behalf of their customers. That is particularly a risk within large banking groups. The second observation is that there is a risk of excessive risk-taking in some trading activities that has to be taken into account. The whole idea of introducing some degree of separation is to protect financial stability, protect deposits and also remove conflicts of interest, being careful at the same time to encourage lending to the real economy and to ensure that the appropriate level of funding is available, the regulator added. In the banking legislation in France there is the objective of safeguarding the universal banking model, preserving all the activities that are useful for the financing of the economy and restricting only the activities that pose a threat to financial stability.

The French law passed in July 2013 distinguishes between what is called speculative activities and other trading activities, especially market making. There is no a priori ring-fence for market making activities, because the feeling of the legislator was that this could have negative consequences for the financing of the economy and for the service to clients.

The legislation does not prohibit proprietary trading, but mandates its ring-fencing if the proprietary trading activity goes beyond a certain level, due to the risks that need to be contained, and in that case, those activities have to be put in a subsidiary. Some activities such as credit exposures and guarantees to hedge funds with substantial leverage must also be included in the ring-fenced subsidiary. And finally, there are some prohibited activities in trading, such as transactions in forward financial instruments with an underlying exposure in agricultural commodities and certain high frequency trading activities.

However, the most important issue, the regulator believed, is the treatment of market making which should be allowed to continue within universal banks, certainly under enhanced supervision, and not in a ring-fenced subsidiary. Market making is a key activity aimed at providing liquidity for secondary markets and offering immediacy to investors in buying and selling. This means that it reduces, in fact, the cost of access to market funding for corporate and for sovereign issuers. It is also important for investors, who are more likely to buy securities if they are assured that they will be able to sell those securities when they need the liquidity. This is the case notably of insurance companies or pension funds that may be confronted with the need to make part of their assets liquid for reasons such as an outside event and that need to be sure to find the operators in the market that will take care of the market making, if they have no immediate counter-party.

There is some judgment to be exercised by the supervisor to distinguish between proprietary trading and market making; the dividing line is clear in theory, the regulator believed, but in practice this is not always the case. There are also three main types of exceptions to the limitation of prop trading that are provided for in the French legislation. First, when prop trading transactions are conducted to hedge risk resulting from transactions with clients. Secondly, transactions for the prudent management of interest, currency, liquidity and credit risk require banks to have liquidity buffers which mean banks having sufficient securities and the corresponding risk on their balance sheets. And finally, some transactions are performed for the purpose of conducting business, which is the case of market making investment services for customers.

Differences among domestic structural banking legislations

The French reform is very close to the German and Belgian structural banking legislations, the regulator stated. In the German legislation there is no prohibition of prop trading either, because it was felt that the distinction of these activities is not always clear cut and that they can help market liquidity, but if the prop trading activity is sizeable – above a certain threshold – then it has to be ring-fenced, in order to avoid putting these risks on the bulk of the banking group. In effect, the treatment of market making in the French legislation is also the same as under the US Dodd-Frank Act, where market making is allowed within banks, as are the various prop trades mentioned further up to hedge positions and manage the risk of a bank, the regulator pointed out.

The rules of the French legislation are however somewhat different from what has been proposed in the Vickers reform in the UK, which does not distinguish between "bad business and good business", in the speaker's view. No activities are prohibited in the Vickers proposal, but all market activities have to be put in a different entity from the traditional deposit and credit activities. The EU Commission's proposal is trying to bridge a divide between the Vickers and the Volcker rules, an industry player suggested.

In Switzerland, there was a deliberate choice not to have a structural requirement for banks, an industry player explained. The main measure was to massively increase capital, in particular CET1[3].

3. Issues raised by the EU Commission structural banking reform proposal

The potential unintended consequences for banking groups and the European economy of the proposal of the EU Commission and particularly of structural separation were stressed. Some speakers also considered that although the option chosen by the EU Commission is understandable in theory, such a proposal does not address the issues raised by the financial crisis and does not seem to be "the right way to proceed" in the current European context.

The need for structural measures for banks in the EU

An industry representative pointed out that neither the Basel Committee nor the Financial Stability Board have pursued ideas at the international level such as structural separation (of for instance investment banking and retail banking activities) or bans or stricter constraints put on proprietary trading activities. This should be read, the speaker believed, as an indication that these organisations which "are the collections of the most expert people across the world on these issues" do not think that either idea "is a very good idea".

Moreover, there are already many topics on the agendas of both policy makers and bank management teams, the industry speaker stressed: i.e. completing Basel III; sorting out all the issues with resolution; revitalising credit markets; developing capital markets in order to support


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economic growth and job creation in Europe. The time and effort involved in delivering structural separation proposals "just seems to be a huge distraction that we can ill afford at this moment". This looks like a rather "bureaucratic" response, a market observer added, which "is complicated, will take time and will be circumvented anyway". Another industry spokesman agreed that at a moment when everybody is talking about growth and about the need for credit and for banks to concentrate on the real economy and to initiate concrete actions in this perspective, introducing "additional uncertainty" for the industry - and consequently for the market – with such a reform is not appropriate. Rather than initiating "another big change" in the industry, the speaker suggested that the EU Commission should "finish the work on harmonising rules in Europe" and ensure their consistent enforcement and application, which is important for better controlling risk.

An industry representative stressed that the two approaches of separation and of constraints on proprietary trading should however be distinguished. Constraints on proprietary trading are less of a concern in the speaker's view, particularly the kind of "measured and carefully thought through rules" that the Bank of France has put in place for example. The logic for tightening constraints around "true proprietary trading" is understandable. The speaker however considered that the risk raised by prop trading activities "is largely a red herring". Proprietary trading by banks is not a major source of systemic risk, had very little to do with the latest crisis and is not a very significant part of any bank's business. The main own-account risks that most banks face are actually a result of liquidity management. All banks indeed run very large ALM (Asset and Liability Management) books which have expanded given the new liquidity rules. This means that in some ways most banks bear more own-account risk than in the past, but that is "a natural consequence of being well-managed and very liquid banks". And in any case, supervisors already have the powers to put Pillar 2 add-ons and to add "all sorts of constraints on banks' activities, if they think it is necessary", the industry representative emphasized.

The relevance of structural separation in terms of managing systemic risks

The structural separation of activities is "largely irrelevant" in terms of managing systemic risk, an industry representative argued. In addition such reforms may add to idiosyncratic risk by leading the way to financial institutions being less diversified. Most retail banking institutions in Europe might end up looking like the Spanish Cajas or Northern Rock which "did not do so well during the latest crisis".

Ring-fencing does not address the main issues of the crisis, another industry speaker agreed. Many of the banks that had problems during the crisis, were actually mono-liners, or had mono-focused businesses and ring-fencing will have no impact on the risks of such entities. Another industry speaker agreed that the ability for separation to reduce systemic risk in the market is still unproven. Risk would not disappear anyway, if at all.

A regulator added that the universal banking model has relative benefits for financial stability, because a banking group is able, in such a case, to diversify its risk portfolio between business lines and between products and is in a better position to weather negative shocks that may affect one of its activities. The "good resilience of this model" was witnessed during the crisis. It was even "instrumental in weathering the financial crisis". Any reform of banking structures should therefore neither weaken this business model nor hamper its positive externalities in terms of financial stability, the regulator believed. This was one of the objectives of the reform that was enacted in France for instance.

The universal banking model "all in all" proved to be resilient during the crisis and moreover proved to be capable of reinforcing itself following the crisis, an industry player concurred. Going in the direction suggested by the EU Commission, would also disregard the dramatic improvement that many European banks have made with regard to their capital ratios, leverage ratios and so forth. In the last years €700 billion capital has been raised in the market, the speaker emphasized.

The proposals made by the EU Commission "probably would have been great to have ten years ago" when banks were much more weakly capitalised, an industry speaker added. But now capital requirements have been significantly increased and common tangible equity is the best tool for resolution, as was said in another session of the Eurofi Milan Forum. A market observer agreed that the tool to avoid problems in a bank is having sufficient capital, rather than imposing an ideal business model or structure.

A policy-maker commented on the links between systemic risk, resolution and capital requirements. While capital requirements and resolution powers are essential and necessary instruments to reduce the probability and impact of bank failure, they can fall short of fully addressing the systemic risks arising from the trading activities of the subset of the largest banks. First, it is inherently difficult to accurately measure the risks associated with trading activities, which is a prerequisite for applying effective capital requirements. Second, the increased size, leverage, interconnectedness and complexity resulting from market-based trading make it more challenging to resolve large, systemic banks in a smooth and effective manner. "This is something to be integrated", the policy-maker emphasized.

Possible issues raised by supervisory discretion

An industry player stressed that the way the Commission's proposal is framed now, with different supervisors being able to come up with their own ways of conducting the reform, would “unambiguously” add complexity to the system.

A “useful move” was made by the EU Commission from a rigid system applied to all in a mechanistic way towards a system based on the intelligence, good will, and wisdom of different supervisors a market observer added. Such an approach however carries “the seeds of enormous diversity, fragmentation and complexity”, the observer warned. What appears as a good idea could in fact be “a terribly bad idea” if it creates further fragmentation.

Supervisory discretion is a key element of the proposal of the EU Commission a policy-maker stressed. It is important to give space to supervisors’ judgement. At the same time, there needs to be consistency and reasonable clarity with regard to the situations for which separation decisions are likely to be taken. That is why framing discretion by means of metrics has been proposed. While giving supervisors discretion, supervisors should nevertheless benefit from guidance from the legislators about when separation decisions should in principle be implemented. But of course, it will be very important to be able to discuss with the supervisors in charge, how and if they want to exercise this discretion.

Risk of regulatory arbitrage and lack of consistency of rules at the global level

An industry player claimed that structural separation could actually increase systemic risk, because it creates opportunities for regulatory arbitrage and increases complexity. The history of such structural separations is that they are “a massive opportunity” for regulatory arbitrage. One example is the growth and development of money market funds in the US as a consequence of the Glass-Steagall Act.

An industry player added that differences in rules at the global level would also create regulatory arbitrage across jurisdictions. The complexity generated by “multiple uncoordinated regulations” across major jurisdictions including Europe is becoming “a regulatory nightmare”, another industry speaker added. A bank operating mainly in the UK, the US and Germany for example would face four regimes in these three countries, because the EU Commission is proposing to put a European regime on top. This has a major impact for banks even if their investment banking activity is relatively limited.

A policy-maker pointed out that improving the coordination and consistency of these legislations within the EU was precisely “at the root of the proposal of the EU Commission”.

Extra territoriality arrangements and third country provisions are another issue, the industry representative emphasized. The US system mandates the creation of an intermediate holding company for the larger foreign banks operating in the US and there are connections with the single point of entry resolution regime. If one looks at the way the European Commission’s proposal applies to third countries, there is one exclusion clause. Supervisors have been granted the power to exempt from EU separation measures foreign subsidiaries of groups with autonomous geographic decentralised structure pursuing a multiple point of entry resolution strategy, so those that have a single point of entry strategy will have to apply the EU ring-fencing requirements.

Expected impacts of structural separation on the universal banking model

An industry representative claimed that universal banking “is still the best model for Europe”, in order to provide credit for the real economy. That is “what is needed” for the European economy and the differences between Europe, especially continental Europe, and for example the US or Anglo Saxon economies in general should not be overlooked in this perspective. The way credit is provided and the need for a certain kind of relationship with customers are completely different in Europe.

The universal banking model is “beneficial for the economy” a regulator agreed and market making activities in particular need to be preserved within universal banking groups. The idea that one could have the same service if market making is put in a ring-fenced subsidiary does not seem valid, the regulator believed. If the subsidiary is ring-fenced, this means that its cost of funding might be huge because outside investors will consider that it cannot offer the same level of security as a large banking group. “Everybody will consider that this ring-fenced subsidiary may fail and be left alone”, so that its cost of funding will probably be very high. One therefore cannot expect the same market making service to be offered at the same price in a ringfenced subsidiary. This could jeopardize the whole idea that is currently being pushed forward in Europe in particular by the ECB of the need for traditional credit channels to be completed by an increasing proportion of market financing in order to finance the economy, in the regulator’s view.

A policy-maker argued that the EU Commission shares the objective of preserving the universal banking model. This is clearly part of the proposal of the EU Commission.

Impact of structural separation on the competitiveness of the European banking system

Another issue is that “at the end of the day” separation would create a competitive disadvantage compared to other non-EU banks, an industry player claimed. “It is a fact”, the speaker emphasized, that the European proposal is stricter than the Volcker rule for example.

A market observer deplored the fact that the question of the impact of financial regulations on the competitiveness of the European industry is rarely taken into account in regulatory debates and in this case "there is clearly a negative impact" for the competitiveness of the European banking system.

Another industry player added that structural separation "unambiguously" increases costs and reduces the efficiency of the financial industry. "One of the really shocking facts" is the difference between the estimated cost of implementing the ring-fencing of retail activities in the UK, when the proposals were first made, and the actual costs that banks are now evaluating. The real costs are about 100 times more than people estimated in the first place. Another concern is that in a dynamic industry that is being transformed by technology, structural separation would be freezing "a definition of something" that is certainly going to change and will be rendered irrelevant by the way products and services will be reinvented in the future.

The different provisions that are being proposed in structural banking reforms could also play a role in the location of trading and banking activities and therefore in the competition at the global level between jurisdictions, an industry player emphasized. The additional structural rules that are being put on the table will not encourage the location of trading activities in Europe, and these activities will go where they are welcome, which is the new emerging markets, the Asian economies, where there is not yet a banking structure debate and also the US, despite the measures that are in place, the speaker believed. This will lead banks to re-optimise their global trading operations. The speaker added that the current time frame which does not even allow having a solution before 2015 or 2016, is moving forward too slowly to have any influence on the type of decisions that are now being made. This does not incentivise investment activity to be located in the European area, and probably is driving activity somewhere else.

Taking customer needs into account

Another critical point is the opinion of customers about such a reform, an industry player emphasized, which is unfortunately rarely asked by policy-makers. The experience of different client meetings in Italy or Germany for example shows that customers "are not really looking in a positive way at such structural evolutions", the industry speaker argued. European customers want to have one entry point; i.e. one bank that can provide them with the solutions they need. They want to have capital market products, lending and transactional banking "in front of them all at the same time"; and they want to talk with one bank, not with several banks.

A regulator agreed that there is a risk of reducing the quality of service to clients with a structural separation reform. Clients, notably large corporates, want to be offered a complete range of services, and the range of services they need is provided at present by banks in the EU. Some of these solutions are market-based, for example helping corporate clients to issue securities in the market, providing them with different hedges for their risks, be it in the foreign exchange market or in the interest rate market, and providing these services globally. If a corporate has to go to different providers to get all these services, it will never get this global approach and there may be a huge loss in the efficiency of the services provided. This is why it is extremely important not to break up the provision of this comprehensive range of services, the regulator believed.

1. Proposal for a regulation on structural measures improving the resilience of EU credit institutions – 29/01/2014
2. Note: Banks will be able to continue to engage in non-proprietary trading activities and investment banking activities, including market making, lending to venture capital and private equity funds, investment and sponsorship of risky securitization, sales and trading of derivatives, etc. subject to the discretion of the competent authority who will be obliged to review trading activities and will have the power (as well as an obligation under certain circumstances) to separate a subset of activities (market making, risky securitization, complex derivatives) if certain metrics are exceeded. This aims at avoiding the risk that banks would circumvent the ban on proprietary trading by engaging in hidden proprietary trading activities and that the non-prohibited trading activities become too significant or highly leveraged. The basic principle of the proposed regulation is that "deposit taking entities" within banking groups can only engage in these activities as long as the competent authority does not decide that they need to be performed within a distinct "trading entity". Source: Detailed explanation of the proposal of the EU Commission. Explanatory memorandum.
3. CET1 : Common Equity Tier 1

Next steps regarding the regulation of the EU insurance sector in the global context

Objectives of the session

The first objective of this session was to depict the main challenges currently faced by the insurance sector in the context of multiple regulatory evolutions at the regional and global levels.

In this perspective panellists outlined the issues raised by the definition of a global insurance framework for EU insurance companies. Systemic risk factors and the conditions for factoring in global regulations, the lessons learned from the financial crisis and the specificities of the insurance sector were identified. The consequences of the specific approach implemented in the US which aims at assessing the systemic relevance of insurance companies on the basis of their activities was also pointed out. Finally the panellists were also invited to identify the possible impacts of global insurance standards on Solvency II.

The remaining issues to be tackled in the context of the definition of the Solvency II level 2 measures were also commented on as well as those related to the definition of accounting standards for insurance undertakings at the global level.

Background of the session prepared by Eurofi

With the implementation of Solvency II in Europe and related regimes in, for example, South Africa and Mexico, in addition to existing regimes such as US RBC and the Swiss Solvency Test (SST), insurers face potential increased geographic, structural and operational regulatory silos and overlapping and conflicting review and reporting requirements and prudential rules with the attendant negative consequences:

- The supervision of international groups remains insufficiently effective, consistent and efficient, and the cooperation between supervisors is reduced,
- Regulatory compliance is costly,
- Level playing field is constantly challenged, and
- The cross-border provision of insurance services and products is hampered.
- Finally one cannot ignore the impact of this state of play on the ability of insurers to engage in investments that spur and sustain economic growth.

In addition, following the 2008/9 financial crisis there has been a marked increase in focus on the interconnection of financial institutions in a global financial market place. Consequently, discussion of insurance company solvency regimes must include discussion of insurers' potential systemic relevance. As a result, the FSB, through the IAIS and the global standard setting agenda, is implementing G20 objectives of addressing systemic risks in insurance.

This is in this context that the IAIS has begun to develop global standards both for Global Systemically Important Insurers (G-SIIs) and Internationally Active Insurance Groups (IAIGs).

However new global standards are expected to avoid being the genesis for additional and inconsistent layers of requirements, over local regulations. The challenge is also that the new standards be risk-based - it is in particular key to address emerging risks - reflect the true economics of the insurance business and take a total balance sheet view to ensure that all risks are captured.

Global standards must in addition address the current economic challenge, which is to combine sufficient resilience of insurance companies, financial stability and the contribution of the insurance sector to economic growth in particular to the benefit of infrastructures, businesses and real estate is critical. This requires that regulation reflect the unique insurance risk profile and business model.

Key issues arising out of the current global standard setting agenda.

In practice the developments of first iterations of basic capital requirements (BCR) and higher loss absorbency (HLA) for G-SIIs, are to be complete by November 2014 and December 2015 respectively. A Global Insurance Capital Standard (ICS) – the capital component of Common Framework for the Supervision of Internationally Active Groups (ComFrame) - is to be developed by December 2016. It is understood that the ICS will eventually replace the BCR as the basis for HLA but at what point this will be feasible is as yet unknown.

The current proposals for a BCR calculated on a consolidated group wide basis, developed to reflect very broad categories of risk impacting G-SIIs are largely in line with expectations.

However due to the overall simplicity of the BCR and the short timeline, it would not fully capture the complexity of the insurance business model (e.g. Asset-Liability Matching). In addition the current absence of information material to determining the actual impact of the BCR makes it very difficult to comment on its overall appropriateness.

The consultation also explicitly leaves open a number of key areas, which create ongoing uncertainty regarding BCR specifications e.g. the structure and application of HLA, the level of the alpha factor, the "tiering" of available capital and the treatment of the Margin Over Current Estimate (MOCE).

Furthermore, there is significant concern regarding the interaction of BCR and HLA as the consolidated groupwide capital standard for G-SIIs, with existing or anticipated prudential regimes to which G-SIIs are or may be subject in the future.

More generally the timeframe proposed for development of an ICS framework is considered as unrealistic due to significant technical and practical barriers especially if it does not leverage and accommodate existing or evolving home jurisdiction regimes to which IAIGs are currently subject.

Comparability and consistent application is an important objective. Absent a common valuation method and accounting standards, a means of comparability company to company and jurisdiction to jurisdiction, will be very difficult if not impossible. Currently while the current IAIS capital standard setting agenda appears to be moving in the right direction some consider that key elements that would permit fair assessment of the structure and application of capital requirements are still absent.

Beside this, it is critical that implementation requires not only changes in regulation within the powers of supervisors, but also changes in law to authorise amendments to national regulation that are the sole purview of governments and legislatures. However national policy makers and supervisors may use discretion when implementing standards to ensure the standards meet jurisdictional requirements and specific market concerns. This means that political acceptance of the need for capital standards must also be early in the process.

Another important issue raised by regulators relates to the location of capital e.g. at group or subsidiary levels, which suggest that capital is being considered as fungible in a global context. Here also lies one of the potential opportunities of an international standard: the development of a clearer global framework for group wide supervision.

One must avoid being « bank-centric » when addressing systemic threats in the area of insurance

One of the challenges underpinning the regulation of GSIIs is that stacking backstops on top of other backstops does not make supervision better or more effective to address unregulated businesses. In that respect in the industry some consider that at this point in time the focus is too exclusively on the BCR and less so on the the other tools foreseen by the FSB, recovery and resolution, effective supervision.

The regulators on the contrary should take into account the specificities of the business model of the insurance sector that is not comparable to banking. Indeed the insurance products are less global than banking and asset management. In addition insurance companies are not "institutionally" interconnected through secured and unsecured interbank lending. Furthermore insurers do not face liquidity risk; they are paid up front, and are actually liquidity rich. Insurers' business model is to invest the premiums paid by the customers in assets, which match the maturity of related liabilities. In addition the bulk of their liabilities are subject to events the policyholder does not control. Finally insurance companies do not create money nor handle the payment systems.

Finally the insurance community primarily needs incentives to focus on what insurance really is. In addition HLA capacities should be related to the activities that create systemic risk. In that respect a better and clearer definition of the NTNI (Non Traditional Non Insurance activities) deemed to be systemic is needed.

EU regulation for pension schemes still raises concerns to insurance groups

The new European Commission's draft revised directive issued in March 2014 contains diverse proposals: a new set of competence and scheme-governance requirements; new standards governing the information to be sent to scheme members; measures to help workers transfer their pension savings across national borders; changes to its regulations on investment. However it has given up insurance-style funding requirements, though pension schemes have to disclose to the clients their finances valued as if they were an insurance company and pension schemes that operate across borders have to maintain full funding at all times.

Finally the general issues that the regulation for pension schemes in the E.U. poses to insurers remain: will it create an effective level playing field with insurance companies and in particular in the area of life insurance? Will pension funds receive sufficient incentives to respond to long-term financing needs of the economy by matching them with their long liabilities?

Summary of the session

1. Regulating the true systemic risk factors.

All the representatives of the private sector warned: systemic relevance has to be regulated on an appropriate basis, not on what was been developed for the banking sector. Yet currently the concepts used for insurance are quite similar, they asserted.

One of these executives explained that it is appropriate to distinguish the two concepts of systemic risk and systemic relevance as it could influence the development our regulation. He explained that the systemic relevance of insurers is when they may be impacted by a crisis triggered by some banks participating in financial markets. These risks should be addressed by the regulation of banks, he said. Indeed we should really address the source of possible crises. Banks are exposed to liquidity problems, while on the insurance side, there cannot be liquidity problems as the insurance sector is not interconnected, insurance companies have nothing similar to the inter bank market; in addition insurers are not involved in money creation; they do not get money from the central banks.

Another representative of the insurance sector stressed the fact that whenever it comes to addressing the consequences for insurances of market instability, we have to check first their normal regulation; in the EU it is Solvency II. Yet the systemic riskiness in the insurance sector is addressed through a list of nine insurers mainly chosen for being global, he concluded. Actually he was of the opinion that the indicators used to identify them - even if it is not expressed in this way - are mainly based on their size and their global activity, not that much on their interconnectedness with financial markets and their substitutability in the markets in which they operate.

Another executive from the private sector expressed the opinion that Insurers would agree to be regulated whenever they carry out systemic activities. They would even be punished by some additional capital. But it should just be the single activity, which is systemic, which should be regulated and looked at in order to mitigate related systemic risk. It is on this basis that the basic capital requirements (BCR) and subsequent higher loss absorbency should be built up, he stressed. What is needed is that systemic activities should be regulated. And it only make sense if the normal prudential regulation - in Europe Solvency II - is not adequate or has some weaknesses and especially if it is not based on a fully risk based system. Finally he concluded by proposing that BCR and HLA should not lead to add-ons on the regulatory capital defined under Solvency II.

However a representative of the public sector reminded the participants on the panel that the IAIS also considers that insurers are not as systemically relevant as banks are. This is the reason why the methodology - which maybe should be improved - actually focuses on non-traditional and non-insurance activity (NTNI) and interconnectedness as well. He concluded by saying that therefore the challenge would rather be to appropriately calibrate any additional regulatory capital effectively depending on the degree of systemic importance of the insurance group.

However a representative of the private sector was of the opinion that a process for defining BCR should be completed and approved by FSB and G20, this year. Afterward the HLA process should be finalised by the end of 2015. Then the ICS should make achieving a balanced international capital standard in this short timetable very challenging.

He also stressed that defining HLA that will only apply to systemic companies and ICS that will only apply to internationally active insurance groups, will raise concerns regarding their capacity to maintain an effective level playing field.

2. Factoring in global regulations the lessons learned from the financial crisis and the specificities of the insurance sector

Yet many panellists agreed on the fact that the specific business model of insurance companies is not sufficiently factored in. One of them explained that there are two similarities and four differences with banks. Insurers, like banks, are financial intermediaries; they have financial assets and liabilities on the balance sheet. In addition insurers, like banks, are large financial investors in financial markets. The total balance sheet is six trillion compared to the 30 trillion of banks.

Conversely, he said, banks operate in a system to which they are institutionally linked through the interbank market. It is a five trillion market. The fact that there is a central bank shows there is a system. Insurers, by contrast, are standalone operators with no direct lending or borrowing going on. Further more banks face liquidity risk. Insurers do not; insurers are liquidity rich: that is a huge difference from a crisis management point of view. Finally banks are engaged in a maturity transformation; they lend long and borrow short. Insurers try to match assets and liabilities in terms of duration. Finally the most important difference is that by providing credit, banks create money; consequently they are part of the boom bust cycle of the credit cycle.

He concluded by asking the question - do we collectively have the right approach for capturing systemic risk in insurance? The answer is no, not quite. After this global

crisis there was a need to deal with powerful players in the financial system. Indeed there was the AIG case. We have to ask ourselves, whether we are drawing the right lessons from the financial crisis. Rather than focusing on the size of insurers we should understand the impact on risk and financial stability stemming from having sufficient diversification among the various business models of financial institutions and the implications regarding the necessary specificity of their respective regulations.

We should also understand the sources of systemic risk in insurance, the transmission channels: not enough progress has been made on these questions while the regulatory debate is advancing on the basic capital requirements and higher loss absorption capacities. Indeed the definition of the concepts underpinning what is systemic risk in insurance has not advanced much.

Another representative of the private sector said in that respect that the Financial Stability Board is asking for the right thing for the wrong reason. Indeed, he explained, today global groups provide various capital ratios, which are not comparable to the ratios that their peers are publishing. Analysts are confused and investors are confused. A globally consistent capital standard for the insurance industry is therefore necessary. He also stressed that customers also need this consistency: we currently have to explain to global customers that prices are different depending on the different countries because of different regulatory levels of capital. However he pointed out that the global standard could not be the BCR, which is just too crude, too simple. It is therefore absolutely necessary to get the ICS right. The international capital standard has to replace eventually the ones that we have. However it needs to be sufficiently credible so that policy makers can rely on it and give up existing regulatory frameworks. That will probably be a long journey. But we need to start on that journey.

There is little evidence for the systemic relevance of the insurance industry. The criteria and the decision-making process defining who should be on that list, is not fully thought through. Indeed the designation process appears to be a relative game with similar results even if the nine designed SIFIs had all de-risked their systemically risky activities.

3. A necessary step toward an international standard

However a representative of the public sector asserted that it should not be forgotten however that insurance lacks global capital standards. In this context he said, though BCR are rough and have nothing to do with the risk sensitiveness of a regulation like Solvency II, they are at least the first steps toward a global standard. He insisted on the necessity to take BCR for what they are: just a first step toward an International Capital Standard (ICS). In particular they should just serve as a temporary basis for HLA until a more risk sensitive ICS can be established.

He added that it is not envisaged that systemic risk will be tackled only by the HLA; it should also contain resolution measures and more intense supervision. However he concluded, in the end only a global capital standard that quantifies the risk a company is subject to, will sufficiently limit systemic risk. Consequently the goal of IAIS should primarily be to develop an ICS from the basis of what happens to the BCR.

4. The US will assess the systemic relevance of insurance companies on the basis of their activities

An executive of the private sector informed the audience that since in the US, the Dodd-Frank Act has set up a domestic systemic risk assessment process and regime, the Geneva Association at the beginning of 2010 proposed that the focus of regulation should really be on activities – the potentially systemically risky activities (PSRAs), before we came up with Non Traditional Non Insurance (NTNI) activities. However he acknowledged that insures have not done the job well enough to really drive home the message that it is the activities the insurers can engage in, that threaten the system, while firms as a whole are not systemically risky. Conversely he said that the asset management sector has been more successful. Indeed on the 31st of July 2014 the Financial Stability Oversight Council (FSOC) in the United States in charge of assessing US firms came




out with the statement that they would look at asset management companies on an activities basis only and not as complete firms. He concluded by saying that the FSOC will also revisit how insurance firms are assessed from a systemic risk perspective.

5. Improving the accountability of an international standard setter is urgently required

A representative of the public sector reminded them that many MEPs have always been supportive of a stronger convergence and coordination in international regulation, and international capital standards generally receive a positive attention. Indeed he said they certainly all agree on the necessity to address systemic risk and foster possibilities for supervisory intervention in that respect. In addition he said, an international capital standard offers opportunities to enhance global financial stability as well as global trade in insurance services.

However MEPs remain rather cautious regarding the regulatory procedure at the global level, as on the content there has not been much information or transparency. The governance structure of international negotiations remains unclear, he said. Consequently the Parliament requests better transparency and regular information from the Commission especially and the EIOPA, who are directly involved in the definition of the global standard. He concluded by saying that there will be a important demand from the new European Parliament to establish an appropriate system of accountability and participation in the international standard setting bodies, that will take into account the European legislator. Overall he said that the Parliament is requesting a stronger involvement in the definition of global regulations and standards.

Another public decision maker stressed in that respect that the Commission would like to give you more transparency, however it is beyond the power of the Executive Committee of the IAIS and this is different from the Basel Committee. It is an issue that the Commission is trying to fix because it is important and significant for the EU, and because the Commission needs to have the ability to give more transparency.

Finally they all agreed on the potential burden of a rash and incoherent development of international capital standards, which in addition puts the competitiveness of the insurance industry at stake, especially if there is a rush procedure without a comprehensive consultation and little democratic accountability. Indeed the timeline of the FSB and the IAIS seems to be too ambitious. They also stressed that a comprehensive impact assessment is also necessary to be able to appreciate the risk and sensitiveness of the European insurance system. They also stressed that it would be also wise to elaborate global standards for the insurance sector on a basis clearly differentiated from international bank regulations, with a view to the insurance long-term business model. Growth cannot be induced by prudential rules, but growth might be hampered by regulatory burdens and inconsistencies in regulation, concluded one panellist. Finally it is also important to better integrate the European stakeholders i.e. the EU insurance sector, while European institutions are demanding they should increase their contribution to the long term financing to reinforce sustainable growth. In addition it should be factored in at the global level that in Europe the implementation of Solvency II is the response to the lessons learned from the financial crisis. It is a very sophisticated piece of legislation that establishes a risk-based system.

6. Before and after regulation i.e. research and supervision

One panellist emphasised an important need of the regulatory process. He stressed two important things to take into account before and after regulation i.e. research and supervision.

We are in a situation he said, where we are at the global level improvising on the regulatory area - we are trying to make it in three years – and trying to define insurance international standards in a hurry, while it required 20 years in the banking sector. Consequently though it is extremely important to catch up, in particular regarding the issue of the resolution of insurance companies, research is extremely important as well as gathering data about interactions and interconnections within financial markets and within financial groups. He reminded the audience that in this respect in Europe we



have an advantage because we have the conglomerate directive, which already provides a really global view of groups. Consequently he stressed the need for a better interaction between the regulations we have in Europe and the forthcoming global ones, which has nothing like the conglomerate directive. He concluded by saying that this explains why the Danish compromise is questioned at the global level.

Regarding supervision the panellists explained that one of the lessons learned from the AIG case is the complete lack of consolidated supervision. This explains why the Office of Thrift Supervision has been suppressed, as this tiny office was supposed to look at the whole of AIG in the whole world. Supervision so that the group really looks at interactions inside the group, is extremely important and should impact internal practices of insurance groups.

Furthermore said another panellist, the consistency of the implementation of Solvency II is also a supervisory challenge. We should avoid being in the same situation bank supervisors are in now i.e. in the banking system they built up a very good risk sensitive framework but unfortunately it was too divergent. Consequently they are now going back to something crude, simple and dirty, like the leverage ratio and throwing into the bin ten years of experience devoted to models. An important thing also is the interaction and integration of supervision of consumer protection, and prudential supervision.

7. Possible impacts of the global standard on Solvency II

A panellist explained that in his opinion the central logic of any international negotiation is to offer a minimum on which you can improve. For once why we have gone through the painful process of changing a sophisticated and risk based multi factor in the interest of a rough insurance regulation (the global regulation being worked upon) is totally unclear. Regarding the Basic Capital Requirement (BCR), we are already well above it in terms of sophistication and quality of the operation so the interest fades. The Commission therefore would be unlikely to foresee any amendment on the basis of whatever comes down from this rough work – the BCR - before 2019. Afterwards, it might be more open.

8. The need to recalibrate Solvency II

A panellist explained that the calibration of Solvency II was done some time ago; since the world has evolved in particular regarding infrastructure, financing assets and securitisation. In particular the ECB's announcement to purchase outright such financial assets, has caused a complete change of the environment. This suggests - he said – we must look again at related calibrations.

9. Accounting

One of the most important regulatory issues is related to accounting pointed out another executive from the private sector. Accounting, though being about conventions, is ultimately deeply political. In that respect at the moment, we have the IFRS proposals; for insurers, there is a specific problem regarding that question. The proposed standard is only on the asset side and the insurers do not have the corresponding standard on liabilities so far. Two things would follow he stressed. You would introduce volatility in the profit and loss statement for insurers, and consequently they will have to choose between either going toward long-term investment or toward stable earnings. The likely consequence is that insurance companies that should be long-term oriented and counter cyclical, would become shorter oriented and pro cyclical.

10. What is beyond Solvency II

A representative of the public sector was of the opinion that though there are some aspects that need to be further defined such as the equivalent countries, the risk-free rate curve, etc. after Solvency II, we need now to stop regulating. Indeed he said both companies and supervisors have to use this new system and learn from it. No doubt Solvency II will provide supervisors with better tools for an earlier understanding of risk. But all those tools are more complex and difficult to use, and need interpretation. For example depending on the level of asset and liability matching, the exposure of a specific company to a given spread risk will have different regulatory consequences. Furthermore the risk sensitiveness of Solvency II should not just be on the Pillar I, it should also concern the Pillar II of the regulatory framework. Indeed in certain insurance businesses the standard formula does not reflect the actual profile of the company and capital add-ons are required. Supervisors need to learn how to interpret better and need to do that consistently. Directing this convergence is a role for EIOPA.

In addition, he said, though Solvency II is theoretically very sound, it will be nothing without good governance within the companies. The supervisors should therefore control the governance of insurance groups in a more intensive way so as to assess the fitness and appropriateness of board members, foresee how key functions are allocated to them and finally avoid the key people in a company not even being in Europe: this should not happen anymore, he concluded.

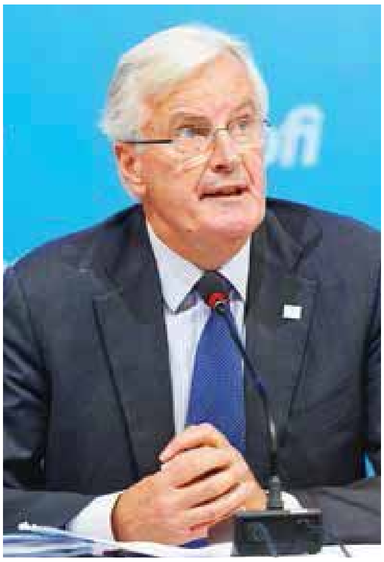
A representative of the private sector said that given that Solvency II will be here in about 15 months, we have to take decisions, close things off and avoid any new debate on how to interpret or how to implement certain things. We might have to re-open discussions two or three years down the road, he concluded. He said in addition that Solvency II is a complex system, which will require also from regulators to take responsibilities in particular regarding the approval of internal models. In this area there is no clear right or wrong answer.

However another representative of the public sector widened the area for further legislative work in the EU. Most of the suggestions the Commission receives he said, have to deal with private insurance: motor insurance, disaster insurance, health insurance. Related issues concern a dis-synchronisation in domestic rules within the EU. They highlight things, which are obviously against fundamental principles, like free mobility within the internal market. The Commission might take a good number of people to look at all these suggestions and all the legislation and simply harmonise all of it.

He also mentioned two initiatives that have been taken in the banking area, which could be considered in the insurance sector. The Insurance Union - a centralised supervision mechanism – makes sense he said even though insurance companies are free from liquidity risk and do not contribute to money creation. Resolution is the other area that we have centralised in Europe in the banking sector: the so-called non-bank resolution. He said that there is much work that could be done in the insurance sector, ex-ante before starting thinking about the "bad weekend", regarding recovery and resolution plans. Indeed it could be very helpful to understand how each company works.

He concluded by saying that there is also the vast area of consumer protection e.g. pre-contractual information, that in the EU we should try to simplify and make sure that all the appropriate information is brought up to date. The professionalization of selling practices was also mentioned.

Conditions for implementing market regulations consistently at the global level



Objectives of the session

The first objective of this session was to discuss the progress made five years after the Pittsburgh summit in the global implementation of the G20 commitments pertaining to derivative markets in particular, the main remaining issues to be addressed and whether the current bilateral cross-border approaches can ensure an appropriate implementation of requirements at the global level.

Proposals to improve the global consistency and cross-border implementation of market regulations was also discussed taking into account the findings of the IOSCO taskforce on cross-border regulation and of the outcome of on-going bilateral negotiations to implement OTC derivative rules, as well as the progress made in the global approach concerning uncleared derivative trades.

Background of the session prepared by Eurofi

The implementation of G20 commitments related to OTC derivatives is progressing at the global level. By the end of 2014 most FSB jurisdictions should have reporting obligations in place and a majority of them should have implemented mandatory clearing obligations also. Less progress has been made at the global level regarding the use of trading platforms for standardised derivatives except in the US but the EU is moving forward with these recommendations following the recent adoption of MiFID II / MiFIR requirements.

Shadow banking is another area of financial markets where common standards and monitoring tools have been developed at the global level by the FSB and IOSCO with an internationally-coordinated implementation. National authorities are currently reviewing their regulations (e.g. regarding money market funds or securities financing transactions) in the light of these recommendations.

The OTC derivatives rules that have been defined in different jurisdictions are broadly similar but their details vary to a certain extent (e.g. differences in the product scope, in the exemptions applied to non-financial corporations, in the types of transactions or the counterparties reporting requirements should apply to, etc...). These differences can be explained by the lack of granularity of the initial commitments and the fact that jurisdictions have been working in parallel on the drafting of the requirements within the parameters of their own laws and following in some cases national objectives. There are also differences in the timing of implementation (for example between the US and the EU). The rules of different jurisdictions therefore need to be reconciled when they are applied in a cross-border context (which often happens for OTC derivative trades that frequently involve counterparties based in different jurisdictions). Otherwise participants might end up being subject to two different sets of rules creating potential overlaps or contradictions.

Another area where coordination is required, some believe, is exchange-traded derivatives (ETD) for which there is at present no international agreement on margin requirements, since they are not part of the scope of the G20 commitments. Some stakeholders however point out that ETD margin requirements are part of the IOSCO-CPSS Principles for Financial Market Infrastructures (PFMI) requirements and that it is questionable whether they should be standardized on a global level, since the risk models might vary across products and jurisdictions.

These differences across jurisdictions raise a second set of issues. There is no formal guidance at present with regard to the tools and processes that should be used by regulators to implement in a consistent way reforms that concern global markets. The tools that are used in different jurisdictions for managing the cross-border implementation of rules differ: for example the EU uses "equivalence" assessments whereas the US use "substituted compliance". Although the general intention of these two approaches is quite similar – allowing foreign firms to operate under their domestic rules when regulations are considered to be equivalent – they differ in their application. One of the discrepancies being that the EU equivalence approach applies to jurisdictions whereas US substituted compliance is applied on a firm-by-firm level. Some steps forward have however been made since the end of 2013. Declarations were made at the G20 Saint Petersburg summit that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identical outcomes". Moreover multilateral common "understandings" on cross-border issues were published in August 2013 by a group of regulators covering the largest OTC derivatives markets, following a joint understanding published by the US CFTC and the EU Commission. How these general approaches and commitments to facilitate the cross-border implementation of rules will work in practice however still needs to be specified.

Regarding the practical implementation of these coordination principles, progress was made in the trading area at the beginning of 2014 when an agreement was reached between US and EU regulators to exempt from US trading rules European-approved derivatives trading platforms until equivalent rules come into force in the EU. But new contentions have since emerged between the EU and the US in the clearing space about the recognition of foreign clearing houses and about conflicting margin requirements and segregation rules for CCPs in particular.

Going forward, several areas of improvement are being considered to facilitate the implementation of requirements at the global level, a common element being the objective to build more trust between regulators and reaching more legal certainty in the cross-border application of rules concerning global markets.

A first option is defining when necessary and possible in an ex ante way sufficiently granular rules at the global level that can then be implemented consistently by each jurisdiction. The work currently under way on margins for uncleared derivative trades which has been conducted internationally from the outset is considered as a litmus test for such an approach. Globally agreed standards were published in September 2013, but their implementation is not expected to begin until the end of 2015 in most jurisdictions. Some observers are however doubtful as to the possibility to force regulators to implement rules in a consistent way even with a more detailed common template, particularly in the derivative field which is very complex and where it is very easy in their view to introduce specificities in domestic legislation.

A second avenue is reaching an agreement at the international level on the appropriate tools and processes that should be used by jurisdictions for implementing on a cross-border basis rules that are equivalent. This issue is currently being assessed by the task force on cross-border regulation set up by IOSCO, based on an analysis of the challenges jurisdictions are facing in dealing with cross-border implementation. Moreover at the transatlantic level a proposal was made by the EU Commission to establish within the EU-US TTIP process (Transatlantic Trade and Investment Partnership) a framework for regulatory cooperation in financial services with the objective to achieve consistent regulation across the Atlantic (which would not affect regulatory frameworks currently being implemented). But no agreement has yet been found with the US authorities.

A third possibility that has been suggested but considered by many observers to be difficult to implement, at least in the short term, is moving towards greater international coordination of policy-making and enforcement at the international level possibly with a sanction system (in the same way as the World Trade Organisation) for jurisdictions that depart from a consistent implementation of rules.

Summary of the session

The speakers on the panel stressed the importance of coordinating at the global level the definition and implementation of capital market rules and particularly of derivative rules.

A regulator stressed that a consistent approach to the regulation of capital markets is "absolutely critical" to ensure efficient flows of capital across countries, that are needed to finance the global economy. Developing market based finance is indeed critically important in a context where bank funding is likely to be restricted, a regulator added. An international diversification of the sources of capital can also be expected in the coming years for example with the possibility granted to Chinese investors to invest across the world.

1. Progress made in the implementation of derivative rules at the global level

Several speakers stressed that significant progress has been made in the implementation of the G20 commitments following the Pittsburgh summit notably in the derivatives market.

A policymaker stated that the EU legislative framework for implementing the G20 commitments "is broadly in place" including rules to make the trading and clearing of derivatives more secure and transparent. Now implementation needs to be delivered. Rules need to be applied in a consistent and coherent way and this is particularly true for the EU and the US, but also for more emerging financial centres.

Another policymaker agreed that "tremendous progress" has been made both by the EU and the US in the implementation of the G20 roadmap. This effort was compared to climbing a mountain. It is not a climb of two parties (the US and the EU) but of all the jurisdictions of the G20 that need to "throw each other ropes and make sure that they are supporting each other" in order to get to an outcome that is similar across jurisdictions and that shows an improvement compared to the situation five or six years ago. Although the US and the EU missed the initial deadline set by the G20 for implementing derivative rules, progress has been strong in many areas. In the US the CFTC which covers the grand majority of OTC derivatives trading has now rolled out central clearing, trading and reporting rules while the SEC has begun finalizing its rules. The notional value of the derivatives that have been centrally cleared in the US since 2010 has nearly doubled to $ 223 trillion and the CFTC has registered 102 swap dealers to date. The policymaker however reminded the audience that the US is currently awaiting an equivalence decision on CCPs from the EU following the recommendation put forward by ESMA to the EU Commission for a "conditioned equivalence".

The EU has also made significant progress but the implementation of OTC derivative rules is taking longer. The reporting to trade repositories (TRs) was implemented in the EU in February 2014. Clearing rules are due to take effect in the first quarter of 2015. Trading rules are programmed to go into effect under MiFIR by the first quarter of 2017.

A regulator agreed that good progress has been made notably on the clearing determinations. One can be optimistic that the products that will be cleared in the EU and the US will be "reasonably similar". And the same should be true for margins on bilaterally cleared OTC derivative transactions for which there are granular standards at the global level.

2. Remaining challenges in the global coordination of OTC derivative rules

Issues related to specific areas of the OTC derivative reforms

Several industry players emphasized the differences in the derivative rules that have been defined across G20 jurisdictions, the issues such differences raise and the impacts of the resulting fragmentation. Fragmentation reduces cross-border flows of capital that are still significantly lower than they were before the crisis, a regulator considered.

An industry player explained that the impact of having differing rules for financial institutions involved in the processing of cross-border orders is similar to a building company having to work for the same project with two different plans that keep changing. Global consistency issues have been identified in all areas of derivative regulation i.e. trading, clearing and reporting requirements. A future big issue for which a global approach will be welcome is cyber resilience, the industry speaker added.

When considering regulatory consistency in the OTC derivative market it is important to make assessments on specific areas of the reform rather than on its totality, given its breadth and extent, a regulator suggested.

Implementation of Trade Repositories (TRs) and data requirements

The implementation of Trade Repositories (TRs) at the global level is a key recommendation of the G20 Pittsburgh summit in order to provide the regulatory community and financial industry with data for understanding the $ 700 million OTC derivative market, an industry player emphasized. The good news is that TRs have been implemented in 15 jurisdictions out of the 20 of the G20 and are now up and running. This is quite a feat given the magnitude of the number of transactions concerned (DTCC for example manages about 100,000 accounts and 250 million weekly transactions with its TRs which is 4 times the data processed by Twitter). The bad news is that reporting standards are inconsistent across jurisdictions. There are many inconsistencies for example between US and EU standards regarding e.g. the scope of derivative contracts that should be reported (with regard to forward exchange contracts or exchange traded derivatives for example), whether a deal needs to be reported by one or two sides of the transaction, whether data should be provided in real time or at T+1. This inconsistency of data standards around the world means that in times of stress regulators will not be able to have a useful dialogue because it will not be possible to reconcile properly positions and exposures on a macro level as well as on a firm-by-firm basis.

Another industry player agreed that the multiple sets of overlapping and potentially conflicting regulation, for example in the reporting area, are an issue, with trades now having to be reported in up to three different versions: the DTCC TR version, the CFTC version (which swap dealers have to report) and the EMIR version (if the client has delegated the reporting task to the clearing member). The speaker considered that this combination of three sets of reporting which all together cost tens of millions of dollars to implement does not bring any additional value and hinders the diagnosis of systemic issues across the industry at an international level.

A regulator stated that there are no major "philosophical" differences between regulators on data reporting, the problems to be solved are "practical issues" and one can be fairly optimistic about this. There are data quality problems on which regulators are currently working, which are understandable given that the process launched in February 2014 is still at an early stage. There are also access problems across various jurisdictions, which regulators are trying to get round, searching for better legal solutions. Discussions are under way at present for example with the US CFTC to find a solution by which the EU could get access to data through the CFTC and vice versa. Some issues with TR data however stem from the hard legal text of EMIR rather than from the technical standards, which is very difficult to change in the short term.

A policymaker confirmed that there is very good collaboration at present between regulators to try and iron out some of the difficulties encountered in collecting the data and making it useful.

Clearing requirements

Clearing is a second area where the consistency of definitions and rules across jurisdictions should be improved an industry speaker suggested (concerning for example clearing requirements and whether foreign exchange products are affected or not). There is still work ahead to implement the G20 requirements consistently with the margin rules for uncleared trades coming up in 2015 and the need to ensure the consistency of clearing rules as well as the recognition of foreign CCPs, an industry player added. There has to be sufficient trust among regulators to do this and the appropriate tools to allow them to cooperate on an international basis.

Trading rules

Trading rules are another area of concern, an industry player believed. Derivative trading rules remain regionally fragmented, which will limit the level of transparency that can be achieved in the marketplace.

The US SEF rules (Swap Execution Facility) have a territorial scope extending to subsidiaries of US banks in Europe which account for about 50% of the liquidity in EU markets. Applying these rules in the EU could potentially damage market liquidity, an industry player believed. Relief from the US rules was eventually granted for EU trading venues subject to MiFID at the end of 2013[1] but this was too late and the actual relief proved to be unworkable between the European and the US regulators, the industry speaker claimed.

Another industry representative was concerned by the differences in the terminology being used across jurisdictions. Some rules that are being issued in Asia for example use some very unclear terms such as trading, booking and place of business which are very difficult to define legally.

Challenges raised by cross-border cooperation processes

Cooperation among regulators

Some challenges remain to be addressed, a policymaker believed, with the implementation of the rules derived from the G20 commitments. Following the adoption of EMIR and MiFIR rules in the EU there are on-going discussions between the EU and US public authorities about finding practical and concrete solutions for implementing derivative rules, but "it takes two to tango" and the US side "must also deliver" the policymaker claimed.

Another policymaker emphasized that the differences in the implementation timing notably between the EU and the US are the main reason for the fragmentation hitting the market at present. This is problematic because derivatives are a global market place and differences in rules can create arbitrage. The US CFTC is very much committed to making progress on these rules, as is the EU Commission, and much interaction is happening behind the scenes. Substituted compliance proposals have been made by the US on the basis of comparable entity and transaction level requirements in some key jurisdictions. The process is going on but the staggered implementation of the rules is making it harder for US and EU regulators to find an agreement, the policymaker emphasized.

A regulator stressed that the problem with cross-border issues in the capital markets area is that there are several jurisdictions concerned and that it is more than two "tangoing". While the coordination of policy making and supervision works relatively well in the banking sector thanks to the Basel Committee, the area of capital markets is more complex to coordinate because there is a multiplicity of players, infrastructures, products which all have specific national regulatory frameworks. The coordination among market regulators has progressed since the beginning of the crisis but so far has not eliminated fragmentation. This fragmentation will not halt cross-border flows but it will make them sub-optimal. An IOSCO task force on cross-border regulation is attempting to create the foundations for a better global regulatory architecture, but this is an "uphill struggle". The problem is that there is little incentive for a jurisdiction to cooperate when it feels it can project its own regulation extra-territorially. There is also some confusion between trade issues, protectionism, systemic risk and investor protection when addressing these questions. Host jurisdictions that do not export financial services are at a disadvantage in negotiations. For the EU and US the issue is "incredibly complex" because they are both hosts and homes for each other's financial services.

Following statements that discussions between EU and US regulators were progressing notably through private bilateral discussions, a regulator believed that such an approach "is not tenable at the moment". The need to keep certain discussions private in order to reach agreement is understandable, but doing so when the industry is facing "looming new capital rules" on the 15 December and that those rules have "very direct implications" for how the market needs to react to where it places its trading exposure beyond that date (depending on whether an equivalence decision is achieved or not) is not the right approach, the regulator stated. Both the CFTC and the EU authorities need to clearly indicate to the market what outcome can be expected. In addition in such a case it is the detail that matters and not the general principles because trading markets should locate on the basis of where the best services are provided and not where the lowest regulatory standards are available.

An industry speaker acknowledged that some progress has been made and that regulators are speaking together but was concerned that the fragmentation of rules at the global level is not considered as a major risk and that there is insufficient trust among regulators. As a result progress is limited and slow. In some areas fragmentation is even increasing in the speaker's view with new regulations coming out without real coordination. Even when there are IOSCO standards there is no guarantee that rules will be applied in a consistent way and IOSCO has no real power at present to solve such issues unfortunately. This is the situation for money market funds for example. Such a situation is bad for liquidity and growth, the speaker concluded.

Mutual reliance and equivalence assessments

The objectives of global convergence and deference to other jurisdictions are broadly shared, a policymaker believed, "because that is the only sensible way forward".

A policymaker stressed that the concept of third country equivalence is "enshrined" in European derivative regulations.

Mutual reliance and mutual recognition of foreign systems are necessary to support trust in each other's regulatory and supervisory systems, because trust cannot be ordered. Mutual reliance is also a rational way to optimise the use of limited public resources a regulator emphasized. It involves an assessment by the supervisor of the regulatory system of the other jurisdiction and following this there are continuous supervisory actions to check whether the regulatory system of the other jurisdiction is still functioning in the same way. An evaluation of whether the third country has a similar way of relying on the European system - which is not the case at present for the US in the derivatives area in the speaker's view - is part of the equivalence assessment conducted by EU supervisors. This does not necessarily mean reciprocity and it is reasonable to have this as a part of the assessment, the regulator believed. CCPs are an area in particular where relying on each other's equivalence is really difficult, as shown by the pending equivalence decision concerning US CCPs, the regulator added. US regulators should show that they are willing to rely on the European system. EMIR is indeed "a really high quality piece of legislation" in the speaker's view and foreign regulators should be ready to rely on that system.

A policymaker emphasized that while mutual reliance is "absolutely critical" it should not slip into "a world of reciprocity" because experiences in the past have shown that this is not the right way to achieve goals and is not permissible. Evaluating each other's systems is fine but there should be no reciprocity principle. The implementation of clearing rules in the EU (expected for the first quarter of 2015) should make it much easier for the CFTC to work on equivalence efforts. The policymaker more generally claimed that the US perspective on the implementation of the G20 requirements is very much in line with the following statement of the G20: "We agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes based on similar outcomes in a non-discriminatory way, paying due respect to home country regulatory regimes".

An issue, a regulator pointed out, is that there is at present no agreement at the international level on the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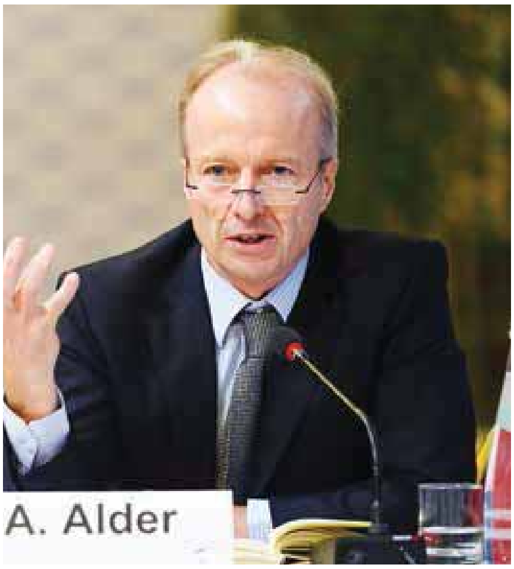
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criteria and the processes to employ when relying on a home regulator to deal with imported financial services. A regulator suggested that the current EU system of equivalence assessments could be improved with the experience of the implementation of OTC derivative rules. There is at present a pass or fail judgment of equivalence on the whole scope of the regulation, which is very broad. It would probably make negotiations easier to have a more granular or progressive approach, allowing the possibility to be equivalent in certain areas and non-equivalent in others for example.

A regulator emphasized that one of the major issues that needs to be solved is when jurisdictions have different traditions, with one jurisdiction being used to setting up equivalence assessments and cross-border passporting and the other not. This is a difficulty in the derivatives market, although much progress has been made, but also in other financial areas.

Cross-border legal tools

A regulator was not convinced that all the right tools were at the disposal of regulators for implementing regulations on a cross-border basis. The reality is that some "Level one" legal texts are making the work of regulators problematic and much effort is spent repairing these issues. If the wording of the G20 statement about jurisdictions and regulators deferring to each other (quoted further up in this summary) was entered into the legal texts of different jurisdictions, including the US, this would make the base case for coordination much simpler because there would be an obligation to coordinate with other regulators.

An additional problem is that regulators do not necessarily have the legal tools to act upon and handle certain situations cross-border in an effective way, a regulator emphasized. For example burden sharing is virtually impossible for regulators to achieve without legislative change. There are no international treaties governing this area and it is likely that in a resolution context jurisdictions will seek to ringfence activities if a bank defaults.

Coherence of rules at the European and global levels

More coherence is needed generally in the financial regulations being implemented both in Europe and at the global level, an industry representative claimed. There are conflicting objectives for example in the area of collateral. On the one hand collateral is increasingly required to secure transactions but on the other hand it will be more difficult to have sufficient collateral in the future because of the likely impact of the Net Stable Funding Ratio (NSFR) and the leverage ratio rules on repurchase agreements (repos). Nobody seems to be in charge of reconciling these objectives and actions and of achieving sufficient coherence among the rules being developed, the industry player believed. This issue is getting more and more important within the EU. The objective of further developing financial markets is put forward but at the same time requirements for separating out market making activities and additional taxes are being introduced. The same is true for the objective to develop securitization, when at the same time the investment in securitization instruments is penalized by insurance and banking prudential requirements. There are conflicting objectives also between the ambition to grow investments and the proposal for banks to put in place new standards for "gone concern loss-absorbing capacity" (GLAC). There might however be an objective to improve the coherence of EU financial policies, when looking at the new organization proposed for the incoming EU Commission, the speaker acknowledged.

There is always a balance to be found in financial market regulation between the conflicting targets of building safe and robust market standards, which also costs money, and promoting growth, but probably not at all costs, a regulator answered.

3. Possible ways forward for improving coordination and consistency at the global level

There are three key elements for ensuring international consistency a regulator stated.

The first element is to have international standards that are sufficiently granular and designed in such a way that they can be implemented in a consistent and coordinated way. The second element, which is often the most challenging as seen with OTC derivative rules, is harmonized implementation. This is because, understandably, legal and regulatory frameworks, as well as civic laws and needs, are different at the national and regional levels. This is the reason why a taskforce on cross-border regulation was established in 2013 by IOSCO. Much progress has been made by the taskforce, picking up on the lessons learned in the definition and implementation of OTC derivative rules. A consultation paper is due to be issued in the final quarter of 2014, setting out the toolkit of measures that can and are being used by national and regional regulators to regulate foreign firms and their activities across borders. The toolkit will consider in particular measures such as substituted compliance, equivalence, unilateral recognition, mutual recognition and passporting. At the end of the day the most important thing in order to achieve consistency is for regulators to focus on the outcomes and assessing whether different regulations may produce the same result. The third element of cross-border cooperation is about ensuring that international standards are operating in a consistent way. This is a question of cooperation over the enforcement and supervision of rules. Enforcement is a very important part of consistency. In this perspective IOSCO's Multilateral Memorandum of Understanding (the MMOU) covering consultation, cooperation and exchange of information is an essential tool for facilitating international cooperation in the context of enforcement and investigation activities. Much more cooperation is going on at the global level at present, the regulator claimed. The MMOU has been signed by regulators from over 100 jurisdictions and last year there were 2500 requests globally for cooperation under the MMOU, a 7 fold progression over the last 4 years.

Definition and implementation of global standards

More detailed or granular standards are needed at the international level, a regulator agreed. Such an approach has worked well for the margin requirements on uncleared OTC derivatives but this is less the case for the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI) which are too high level for CCPs in particular and therefore open the way to differences across jurisdictions, with national regulators introducing variations in the detailed rules. There is also a question of timing, because sufficiently granular international standards need to be available before individual jurisdictions start developing their own rules. This is the way ESMA proceeded in the EU for margin requirements for uncleared derivatives, deliberately waiting until the global standards were available before starting to work on their transposition at EU level. Such an approach has also worked well in the area of credit rating agencies (CRAs). Supervisory convergence is also important. This is not necessarily needed across the whole scope of regulation but convergence should be ensured in areas where it is important to maintain a level playing field. This is the case for IFRS accounting standards for which there have been discussions with other regulators about how they should be enforced and supervised on a day-to-day basis in order to achieve sufficient consistency. The same is happening for the larger CRAs for which there are now worldwide colleges, which is quite an innovation.

One lesson that can be learned from the past, another regulator added is that one should start with the "big picture" and defining international standards first before going into domestic implementation. The reverse process which was used in the case of TRs in particular with jurisdictions starting with the same intention but developing slightly different solutions is not desirable because it is very time-consuming, requiring in the end at least twice the work in order to converge.

An alternative solution, an industry player suggested, is for jurisdictions to adjust their requirements in order to meet international standards, when rules are still being developed. This is what is happening for the rules on margins for uncleared swaps. The US issued their proposal before the international recommendation made by IOSCO was available, but the US are now trying to tailor the rules they have proposed in order to meet the international IOSCO standards. Another example is benchmarks which is a new area where much good work can be done. Such an approach is more difficult to achieve when rules are already in place. Substituted compliance and mutual recognition can be solutions in this case but agreement on these approaches will probably continue to be "a major battlefield".

Going forward, a policymaker suggested that the process for implementing market regulations at the global level should be guided by the following five premises. (1) Regulators and supervisors should focus on prudential activities since their first responsibility is to protect national financial stability. (2) Financial markets are global and the EU and US cannot expect other jurisdictions to just follow the rules they set. Other jurisdictions "want a seat at the table as well". (3) National regulations are always going to differ to a certain extent because jurisdictions have diverse traditions, laws and cultures. (4) In order to promote robust consistency and convergence of regulatory regimes, countries should implement rules at home that follow the global standards and that is the whole point of the Pittsburgh agenda. (5) There cannot be a one-size-fits-all approach to financial regulation because what works in one jurisdiction might not work in another and what works for some financial activities might not work for others. This means that the aim is to reach comparable outcomes but the way to achieve them might differ.

Cross-border cooperation

When looking at what can be done to solve the remaining issues related to the cross-border implementation of derivative rules, an industry player suggested that there are three key elements that can be worked on: agreement, collaboration and trust (ACT) and this is in line with the new charter of the CPMI[2] recently presented. Agreement is the first condition. Regulators need to agree on the scope and content of regulation e.g. with common definitions and data standards in order to achieve consistency. This however requires that regulators go into a certain level of detail e.g. negotiating data sharing agreements so that they can coordinate approaches in periods of market stress or navigating differences in privacy laws. Some encouraging steps were made recently with the request made by the EU Commission to the EU Member States for permission to launch bilateral negotiations with several G20 states in order to secure international agreements on the sharing and exchange of information. These negotiations should be the opportunity to pinpoint the issue of differing data standards. Collaboration is the second condition for improving cross-border consistency. Regulators need to collaborate to a greater degree to pursue policies that may benefit the global community instead of a more national interest. Preserving home markets is of course important but this can be done using global tools or data sets. It is much more efficient to start with a global view first before focusing on the national market, the speaker emphasized. The third element is trust which is the underpinning issue in efforts to improve consistency. Regulators need to agree on a common understanding of the intent of regulation and progressively build mutual trust.

The EU countries engage at present extensively in multiple bilateral talks with key international partners, but experience shows that these dialogues have their limits, a policymaker believed. The EU could have an even greater impact if the coordination was improved within the Union and if the EU spoke systematically with one single voice. This is why the EU Commission is pushing to include financial regulatory cooperation in the Transatlantic Trade and Investment Partnership agreement talks with the US (TTIP)[3] in order to put in place a transparent and accountable rule-based process in which the EU and US can both work together. Such an approach will not lower standards in the speaker's view, but can on the contrary help to achieve greater financial stability and a more efficient framework.

An industry player thought that the approach to global recognition and deference questions is overly complicated when starting with concepts such as equivalent outcomes. What is needed is to "start with something small and build out from there", such as a basic matrix defining who (home or host regulator) regulates what (the head office, subsidiaries, branches, etc...).

A regulator stressed that in the context of bank resolution, be it with single point of entry or multiple point of entry approaches, the only way to deal with the cross-border aspect is using contracts established within financial groups because otherwise it will not be possible to get the agreements to support cross-border resolution. Another regulator however believed that although contracts can be useful there is a risk of permanently "chasing after them" which is why having a statutory or legal way of addressing this issue seems preferable. The different challenges underlined with regard to the global implementation of derivative rules call for even larger and probably more upfront international coordination than at present, which can hopefully be agreed upon and implemented. There is however no "United Nations of capital markets" at present. A question though is whether a capital markets union for Europe as called for by J.C. Juncker could help to improve the coordination of regulation and supervision with third-countries.

4. Challenges in the global coordination of banking rules

"Fragmentation between the EU and the US is a reality", an industry player stressed. Progress needs to be made on this because the cost of fragmentation on market participants is "enormous". This is happening in the capital markets but also in the banking sector. Foreign banks are for example required in the US, above a certain threshold, to place a large part of their US activities under a capitalised US Intermediate Holding Company (IHC) structure[4]. Some evolutions might also be required for operating in other regions of the world such as Asia in the future. Setting up and ringfencing these entities will increase capital requirements by tens of billions of dollars the speaker thought. Although there is an intention to move towards more market based funding, bank funding is the reality at present in the EU and such regulations keep adding costs into that sector.

1. An agreement was reached between EU and US regulators to exempt from US trading rules European-approved derivative trading platforms until equivalent rules come into force in the EU
2. CMPI: the Committee on Payments and Market Infrastructures is the new name of CPSS
3. The Transatlantic Trade and Investment Partnership (TTIP) is a trade agreement that is presently being negotiated between the European Union and the United States. It aims at removing trade barriers in a wide range of economic sectors to make it easier to buy and sell goods and services between the EU and the US.
4. Foreign banking organizations with U.S. non-branch assets of $50 billion or more will be required to establish a U.S. intermediate holding company over their U.S. subsidiaries. The foreign-owned U.S. intermediate holding company generally will be subject to the same risk-based and leverage capital standards applicable to U.S. bank holding companies. The intermediate holding companies also will be subject to the Federal Reserve's rules requiring regular capital plans and stress tests.

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SPECIFIC CONTRIBUTION

Specific contribution

Recent developments on monetary policy

Jacques de Larosière
President of EUROFI

1. Some thoughts on recent developments in monetary policy issues

As we have observed, there are two major lessons that we can draw from quantitative easing.

i. The first one has to do with its efficiency in terms of interest rates

Evidence shows that the US policy of quantitative easing which started end 2008 and has, as of now, led to more than a doubling of the Fed's balance sheet (from 1500 Billion US dollars to 3600) contributed to a significant fall in US interest rates.

Indeed, QE1 from end 2008 to mid- 2009 was accompanied by a fall of 96 basis points on 10 year Treasury instruments.

After the market tensions stemming from the Eurozone crisis in 2011, the Fed announced, in the summer, its "twist operation" consisting of buying long term instruments. This was followed in September 2011 by an extension of its QE programme.

The effects of these actions on long term interest rates have been significant : yields on 30 year Treasury Notes came down by 150 basis points from September 2011 to May 2013 (from 4,5% to 3%).

So, in terms of US interest rates the policy has worked.

ii. But there are drawbacks and unwanted consequences

First, markets have proved extremely sensitive to any sign of a "tapering off". The announcement in May 2013 of a possible reduction of Fed's purchases resulted in an immediate increase of 50 basis points on 10 year Treasury yields. After Mr Bernanke stated that the Fed purchases could end by mid-2014 if the unemployment rate was close to 7%, 10 year yields went up further by another jump of 50 basis points.

Second, these swings in interest rates have had significant negative consequences on a number of emerging markets that had received earlier huge inflows of dollars (carry- trade operations). Brutally, things changed. Outflows brought local exchange rates down and destabilized the equity, debt and exchange markets of those economies. Even if one has to recognize that some emerging countries had relied too much on capital inflows and were all the more impacted by the outflows so that they had delayed necessary adjustments, it remains that the Fed's policy – decided on purely national grounds – has had problematic international consequences.

More generally, monetary policy "forward guidance" is a double-edged sword. It can either lead investors to believe they will be warned about any interest rate change and therefore can encourage them to accumulate excessive risks, or it can precipitate selling as markets often overreact to any hint of a change in forward guidance.

2. The Eurozone : a very specific environment for monetary policy

i. A significant credit reduction is taking place

As you know, since 2012, credit to non-financial enterprises has been continuously reduced in the Eurozone. The yearly rate of reduction has been:

2012: -2,3%
2013: -2,9%
1st semester 2014: -1,05%

These average figures mask the credit crunch that is observed in countries like Italy or Spain (respectively -5,5% and -9,8% yearly reductions as of February 2014).

Of course, after a period of excessive leverage before the crisis, it is natural to observe a process of deleveraging whereby financial and non-financial enterprises reduce their debt and repair their balance sheets.

But, while this process takes place, one has to be careful not to compound "normal" deleveraging by over strict regulatory measures.

In this perspective, it may be observed that the entire regulatory framework put in place under Basel 3 has:

- doubled on average the equity base of the European banking system in a very short time span;

- discouraged risk taking (by inducing banks, through the new liquidity requirements, to hold "0 risk rated" Treasury instruments to the detriment of lending to the real economy);

- reduced the lending capacity of banks (through the increase in capital requirements and leverage ratios) as well as it has shortened loan maturities.

Furthermore, the return on equity of most European banks is low (because of capital constraints) and thus makes the raising of fresh capital more difficult. Therefore the reduction of the denominator of capital ratios (i.e. loans) is the normal consequence of regulation. Eurozone banks have indeed reduced their balance sheets by some 10% over the last years.

At a time when the European economy is particularly weak, it seems questionable to hamper the lending capacity of banks with too rapidly applied regulatory constraints.

ii. This deleveraging results in a very moderate money creation

Annual growth rates of M3 in the Eurozone are poor and moving down.
Annual growth rates:

2012: + 2,9%
2013: +2,4%
1st Semester 2014: +1,05%

The reason is simple: credit to the private sector (which is the major counterparty of money) is falling and therefore cannot provide the necessary transmission channel to the real economy:

2012: -2,3%
2013: -2,9%
1st semester 2014: -2,7%

So, in fact, in an environment of slow growth, low inflation (negative in some periphery countries) and fiscal contraction, we have – because of credit reduction – a sagging money expansion. Is that the policy mix we should be aiming for?

iii. We, therefore, need a pause in regulation

Doubling on average the equity base of the European banking sector in three years (instead of the initially decided "phasing in" period of six years until 2019) is unprecedented. It has a high macro-economic cost. Of course the competitiveness and the quality of balance sheets of corporations may also explain their deleveraging but bank regulation is also part of the problem.

I believe it would be unwise to add to that effort new, additional, layers of constraints at this point in time. Some sitting back and reflexion is called for. We certainly need "de-risking" through appropriate "asset quality review" but not more capital constraints. We must also eliminate the present uncertainty regarding future regulatory measures: indeed such uncertainty is adding to the "wait and see" behaviour of lending institutions.

i.v. A sensible initiative to allow SMEs to be financed through the markets is important

There are a number of SMEs that are requesting credit, that are on the up side, starting to re-export....but those companies have difficulties in finding credit. Looking at the monthly surveys on the ability of small and medium sized enterprises to access credit, we see that in Italy there are 43% of such companies that declare that they cannot easily find credit. In Ireland the percentage is 62%, in Greece 67%. These figures are high. And when you look at historic comparisons you guess that there must be something wrong and that it's not only the bad quality of the enterprises that is in question. If you look at it in a granular fashion, you observe that there are SMEs of good quality that cannot find credit because of the general regulatory environment that I have just described concerning banks.

So I think it would be a good idea to extract from the credits provided by banks to SMEs the best ones, those that have prime ratings from the central banks themselves. We must remember that in 2004 the central banks of Europe became eligible to rate SMEs for collateralization purposes, and I think it would be a good idea if those central banks who know how to rate SMEs were to rate those that are first quality (by first quality I mean those who would have a maximum probability of loss, let's say of 0,40%, on a period of three years). And then we would have to find a market.

Of course, you need to get the investors, and to get the investors you need to have simplicity, safety, confidence in the quality of ratings as well as sufficient returns. My understanding of the market is that we might not be very far from that equilibrium point provided that : a) there might be a form of public guaranty, a very limited one, on the first thin layer of losses and that such a guaranty could be provided by organizations like the European Investment Bank or national institutions whose job is to do precisely that; b) the second prerequisite would be to reassure the market that in case of liquidity tensions, the European Central Bank, as it has recently announced, would be there to buy, not only to accept as collateral, but to buy some quantum of these first class assets. I think this would give confidence to the market; and c) we would have to assure ourselves that these high quality instruments would be treated by the regulators, in particular the regulators of the buyers - as insurance companies,- as prime quality. I'm not asking for any "SME privilege" but just equality and not penalization.

We must be aware that the existing rules - as well as the regulatory changes that are being contemplated - constitute a major deterrent to any revival of sound securitization.

So it is an idea that we are working on at Eurofi and are discussing with a number of officials as well as with the private sector. It's not the solution to the problem that I have stressed a moment ago but it's at least a light in a very dark tunnel.

I will conclude with four remarks:

1. Many believe that low interest rates lead necessarily to stronger investment. It may be true in some cases, like real estate markets. But I do not think it is the case in general, especially in highly intermediated economies.

   To finance investment, banks traditionally need a spread of 3 to 3,5% between their lending rates and their deposit (or funding) rates. But when Central

Bank money is at close to 0% and when interest rates on long term funds have been squeezed (or "twisted") at 2% or less, the natural tendency for well rated large corporations is to finance themselves directly on the bond markets. That leaves banks (and in particular the smaller ones) with riskier loans, in particular to SMEs. Given the regulatory disincentives described above, SME lending becomes more problematic and more expensive all the more so if "prime" selection methods for securitization – based on reliable data – have not been put in place and been recognized by regulators and Central Banks.

2. Secondly, the crisis resulted from an excessive expansion of credit in an environment of low interest rates and scarce equity. Inflationary targeting was a misused tool and the fear of deflation has proved to be excessive. Low interests are still there and don't seem to generate much growth at least in Europe. As far as equity is concerned, it is continuously being discouraged by taxation and financial regulation. Loans to SMEs were in no way the cause of the crisis. Nonetheless, they are among the first victims of the new financial regulatory system (although SMEs are the main creators of jobs). A world of sophisticated, complex and opaque financial products chased by the originating financial institutions themselves for the sake of higher yields with no consideration to risk has been the nexus of the financial disaster. Are we sure that the new stringent capital rules combined with ultra-low interest rates, are not pushing banks and non-banks into the same appetite for riskier – but more profitable – assets? The question cannot be escaped.

   More generally, a very accommodating monetary policy can reduce the appetite to clean up balance sheets and lower the opportunity costs of holding doubtful assets.

   In an environment of great uncertainty, low interest rates can incentivize companies to increase dividends and share buy-backs instead of investing.

3. Low interest rates have a distribution effect: they favour debt to the detriment of savings. In particular, low interest rates affect the profitability of pension funds and insurance companies that have to deal with the requirements stemming from their long term liabilities. Derivatives as well as a generalization of defined contributions can help to deal with this issue. But the risk is only transferred and does not disappear. And the market and accounting effects of the possible bursting of the bond bubble are ominous.

4. Lastly, it may well be that in a highly intermediated economy, like the European one, QE is less efficient than in the US (where the economy – financed 80% by markets – is more sensitive to market interest rates and where wealth effects are higher).

Be it as it may, we have now reached a situation where some form of QE by the ECB seems essential.

Indeed monetary conditions in the Eurozone are far from being expansive (which should be the case given the restrictive nature of fiscal policies). Inflation is falling rapidly and the growth of M3 has been declining since 2012. This is because the Eurozone banking system is not passing through the monetary base into credit and broad money. Therefore the expansion of M3 is completely dependent on the banks' behavior in terms of lending.

But in fact, banks are reducing their lending to a great extent for regulatory reasons. Without a change in bank capital regulation, we need to encourage simple and high quality securitization, notably of credits to SMEs.

The indication given by the President of the ECB at his press conference (September 4th 2014) that the Central Bank will consider purchase "simple and transparent asset-backed securities with underlying assets consisting of claims against the euro area non-financial private sector", is, in my view, the most important and encouraging policy statement issued by the ECB.

But in order to launch a true and effective securitization market (with ABS "deconsolidated" from banks balance sheets) you need to treat – capital wise – the buy side (banks and insurance companies) in a neutral way with no regulatory penalization of securitized holdings (versus direct bond holdings of equal quality).

In this respect I heartily welcome the statement by Mr Draghi on June 5th that the move would take into account "desirable changes in the regulatory environment, on which the ECB will work with the relevant institutions".

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EUROFI BACKGROUND PAPER

Conditions for revitalising securitisation based on Prime High Quality Securitisations (PHQS) of SME loans

This document was drafted by Eurofi with input from its members. It does not engage in any way the Italian EU Council Presidency or the Italian Financial Authorities.

1. Context

Tougher financial regulation has made European banks more resilient, but the adjustments to this strengthened regulatory framework and the balance-sheet repair still ongoing in many parts of the European banking sector are hampering the capacity of banks to lend. The insufficient credit, which is now confronting even sound businesses in some parts of Europe is making the continent's economy more fragile and weighs on its recovery.

Improving the profitability of EU banks is not feasible in the short term. Thus, fresh investment capital is not easily available for banks. Therefore, stringent liquidity and capital adequacy ratios can be met only through a reduction in assets, including loans. Fixing the problem of the rationing of credit is an urgent task given the present sluggish recovery conditions.

One avenue is for companies to gain direct access to financial markets through equity or bond instruments. But this is not an option for smaller companies.

An appropriate answer for such companies is to revitalize the market for securitized loans, in order to support bank lending. However this market, which never really took off in Europe before the crisis, has all but vanished since the financial crisis.

Before this can happen, confidence needs to be rebuilt and the memories of opaque subprime securitisation structured in the US before the crisis must be dispelled by adequate measures. This requires that both the quality of underlying bank loans and the securitisation techniques be beyond question.

Eurofi is therefore proposing to develop a Prime High Quality Securitisation (PHQS) asset class with a specific label in order to encourage SME lending.

In addition a recalibration of bank and insurance company regulations, factoring in the true risk of PHQS, is necessary to enable them to invest in such products. Finally in certain E.U. countries it is also necessary to address possible issues regarding the returns of SME loans, which may threaten the economic attractiveness of related securitisations for investors.

Such a project offers a way forward to repeated calls by the European Central Bank, for loans to small and medium-sized enterprises (SME) to be repackaged into standardized products that are easy to assess and rate and simple for investors to price.

2. Revitalizing the SME loan securitisation market requires to issue in priority securitized products underpinned by a high quality securitisation process and prime underlying assets

In the perspective of revitalising SME securitisation the challenge is to stabilise at the E.U. level a common set of simple and sufficient criteria, in order to define Prime High Quality Securitisation (PHQS).

<u>Securitisation process</u>

Everybody admits at present that a high quality securitisation process is necessary to guarantee that securitized products are transparent, predictable and raise no conflict of interest among the various participants in the value chain (i.e. originator, rating agency, structurer, servicer and buyers).

Providing investors with sufficient transparency is also necessary, so that they can comply with their internal and external disclosure requirements.

We agree with EIOPA that a distinction between securitized products categories is necessary to reinforce confidence in securitisation. EIOPA has indeed proposed a set of criteria defining a specific category of High Quality Securitisation (HQS) - the A category - in the perspective of the Solvency II delegated acts due to be proposed by the E.U. Commission. The European Central bank has also defined certain conditions to improve the transparency of those securities, as a condition for their eligibility (loan by loan information, data base…). These are critical steps forward in the right direction.

To make the securitisation process sufficiently reliable, Eurofi however proposes to complement these criteria in certain key areas. We believe in particular that the simplicity of the approaches for tranching is critical (true transparency and predictability) and would therefore suggest limiting the HQS label to securitisation with 3 levels of seniority as a maximum (Equity, Mezzanine and Senior).

We consider that there is also a need to increase the requirements related to the data involved in the risk assessment and the tranching of the securitisation (e.g. data covering both SMEs and SME loan performance in general and data relative to the securitized assets), which in particular should include sufficient long series encompassing stressed periods.

Lastly we consider that the most appropriate way to reduce the conflict of interest on the side of the originator is to go beyond the usual "skin in the game" rule and to impose a vertical retention rule obliging originating banks to retain a portion of each tranche.

High quality underlying assets

In addition, restoring the confidence of investors in securitisation requires securitizing underlying assets of unquestionable quality. Indeed, an appropriate - simple and transparent – structuring of the securitized product is not sufficient to eliminate the risks of the underlying loans.

We propose focusing within the asset classes selected by EIOPA, on assets, which remain sound even in the event of a deteriorating economic context and are less exposed to bubbles or economic cycles.

This is the reason why we propose to start the efforts to relaunch securitisation with bank loans to "prime" SMEs. We can also envisage extending the list of these prime assets for example towards consumer or auto credits whenever objective data exist (e.g. positive consumer credit databases) but also to mortgages provided that central banks consider such mortgages are not exposed to real estate bubbles.

Prime SMEs would be defined as enterprises with a 3-year probability of default lower than 0.4%. This is more demanding than the one used by the Eurosystem to accept SME loans as eligible collateral (1-year probability of default less than 0.4%) in order to effectively reassure the buyers of those securities including potentially the ECB.

According to the Banque de France, which rates SMEs, the number of SMEs which have a 3 year probability of default lower than 0.4% encompasses in France around 40.000 SMEs and represents €150 billions' worth of loans, which is quite a significant segment of the market.

Moreover, we propose that this "prime" label be attributed by, or under the supervision of, neutral institutions such as central banks or supervisors rather than by originating banks or rating agencies. The ECB accepts 3 methods for assessing the quality of collateral: first the rating by central banks - certain EU central banks rate SMEs -, next the rating by a rating agency and lastly the outcome of the internal models used by banks as far as this outcome is validated by the banks' supervisors and follows a commonly agreed methodology.

In a context where the Single Supervisory Mechanism (SSM) is expected to rapidly reduce existing discrepancies between modelling approaches (RWA) run by the banks of the Eurozone and between supervisors' validation practices, and given that at the E.U. level the EBA has undertaken[1] a critical task to improve the confidence on the validation process of internal models by supervisors, using internal models should be acceptable for investors and market participants.

In summary, combining the criteria imposed on the securitisation process and on the underlying assets is the way to define a "Prime High Quality Securitisation" (PHQS) that should be the bedrock for a revitalized SME loans securitisation market.

This requires however that the financial regulation as a whole – bank and insurance prudential requirements in particular – fully factors in the low level of risk of such a Prime High Quality Securitisation asset class. It is not asking for a SME privilege but for an equal treatment with other securities bearing the same risk.

Regulators today do not dispose of historical market data that could be relevant for such PHQS instruments of the nature we would like to propose. Indeed until now, the criteria defining HQS were not explicitly used in financial markets as an investment factor to trade securitized products and securitisation issues did not focus at that time on prime assets.

Consequently, regulators have to devise a dedicated methodology to calibrate regulatory capital charges, based on a relevant projection of the risk and liquidity of such brand new assets.

3. Addressing possible issues regarding insufficient returns of certain E.U. SME loan securitisations.

To attract investors, products need to generate sufficient returns. Depending on market conditions, insufficient mark-up by banks on SME loans might affect the economic attractiveness of securitisation products compared to other possible investments. This would be the case for example, whenever SME loan portfolios yield 150 bp (prime SME loans) on average to originating banks while markets demand 200 bp for similar risks. Indeed competition conditions and commercial practices (cross-subsidies) in certain countries, may lead banks to apply reduced marks-up on SME loans.

However, this situation is expected to improve. Increased costs imposed by regulations on banks are likely to increase lending prices over time. In addition, in certain EU countries, average market yields have been reduced significantly due to the "flight to quality". This reduces the gap between the anticipated yield of SME securitisation and the yield of alternative investments presenting similar risks. Moreover investors should be attracted to this new asset class for the diversification effects it can offer.

Mapping possible situations in the E.U. where loan yields may be insufficient to attract investors to securitisation products is necessary.

In the case of a country in the Eurozone where existing loan yields are insufficient, one possibility to facilitate the securitisation of prime SME loans would be that organizations like the European Investment Bank or national development banks should provide a form of guaranty, though very limited, on the first thin layer of losses. This should help investors to accept a lower yield than the actual average mark-up of the portfolio until the market picks up.

In addition the fact that the European Central Bank would be there to buy, not only to accept as collateral, but to buy some quantum of these PHQS at least for a certain period of time, would give confidence to the market and reduce yield demands.

4. Calibrating capital requirements for insurers building on the proposals of EIOPA

Launching Prime High Quality Securitisations (PHQS) as defined in paragraph 2 entails appropriate capital charges for insurers in order to make the business case of such investments sufficiently attractive.

Although EIOPA recommended in December 2013 decreasing the charges for less risky issues to 4.30% (type A) while increasing them for riskier ones to 12.50%, and even if those calibrations were further divided by 2 as envisaged by the EU Commission, insurance companies observe that such capital charges are significantly higher than those required to hold directly loans of similar quality and therefore still consider that their ROI will be negative with such calibrations.

Therefore a major issue to revitalize the SME loan securitisation market, besides the definition of the relevant criteria for defining a PHQS, is to achieve a calibration of capital requirements for insurers, taking into account the real risks of such products.

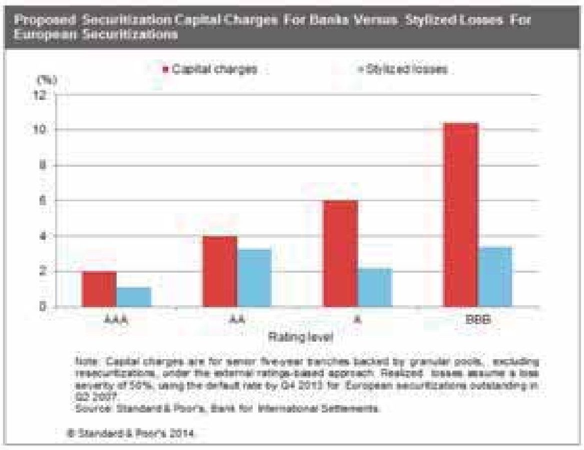
The risks of the underlying assets that are well known and can be easily reflected in the calibration represent a sufficient basis to define such capital requirements for insurers. Indeed, though we share EIOPA's views that the specificity of the risk profile of a securitisation is that it combines the risk of the underlying assets, with the risk specific to securitisation techniques - e.g. information asymmetries, legal risks, conflicts of interest, servicing risk, etc. –, we are of the opinion that whenever the securitisation process effectively uses criteria such as those mentioned in paragraph 2 (vertical tranching, availability of appropriate data...) in particular in the case of assets of unquestionable quality, the risks specific to securitisation techniques are actually sufficiently mitigated.

5. Banking capital requirements for securitisation tranches also need to be reviewed

The Basel Committee has introduced a risk sensitive approach for the calibration of investments by banks in securitisation products. But this Committee has also proposed setting a 15% risk-weight floor for all approaches. Consequently, according to many observers, the proposed risk weights resulting from this approach are still far from being consistent with the credit performance of securitisations (see table below).

In particular, the high level of the floor proposed will overwhelm the risk sensitiveness of the framework up to the point that such a floor becomes a binding constraint. This should discourage banks from securitising or holding securitisation tranches. Indeed this floor (15% risk-weight) would impose capital charges 7.5 times higher to a bank holding a AAA credit exposure through a securitisation vehicle, than the charges requested (2%)[2] when it holds it directly.

In addition S&P based on very prudent loss assumptions, estimates that AAA securitisation tranches would receive a risk weight the double of their expected losses[3] (see table below).



Addressing this issue is important because banks would be submitted to such excessive capital charges for the mandatory retentions of the securitisations they originate.

Another issue is the proposals made by the European Banking Authority (EBA) in the context of the delegated acts for enforcing the LCR, which only consider a limited number of RMBS as Liquid Assets (these RMBS do not include SME securitized loans even if they are of high quality), and require excessive haircuts.

This would deter banks from investing in these prime high quality securities (PHQS), as they would be considered as poor liquidity financial assets. This would be in contradiction with the ECB aim to possibly buy outright such financial assets.

The inappropriate calibration of these proposed measures is due to the fact that Basel and the EBA have not at this stage distinguished between PHQS and the securitisations of lesser quality in the same way as what has been previously mentioned for insurance calibration, and that existing data on the historic performance of ABS does not reflect the risk specificities of PHQS because this category has never been observed.

To achieve a more appropriate regulatory calibration - required for reviving the securitisation market – the Basel committee as well as the European Commission /EBA should therefore consider PHQS as specific products, in particular more reliable and predictable due to the new criteria proposed, and consider them as a new asset class.

1. Third interim report on the consistency of risk-weighted assets - EBA - 17 December 2013.
   EBA has in particular targeted to improve the definition of defaults, to harmonise at the E.U. level data sources, the length of the time series and the approaches used for calibrating the models predicting the probability of default. In particular the EBA is addressing the issue of the possible absence of available time series of stressed conditions. In parallel the EBA is encouraging more rigorous and comprehensive model validation processes and back testing frameworks, and is promoting the exchange of experiences on the validation and ongoing monitoring of internal models notably through joint work in colleges.
2. According to default data produced by Fitch in its document "1990-2013 cumulative default rates", the ten year probability of default of such a AAA credit exposure is 0; therefore a notional 2% risk weight is applied.
3. For calculating "stylised" losses S&P assumes a lossse verity of 50% and applies the default rates observed in Q4 2013. According to the ECB, European ABSs' defaults range since the start of the 2007/08 financial crisis, between 0.6-1.5% on average. In addition the Central Bank states that European SME ABSs are far below broader EU securitisation default rates, with defaults occurring on about 0.1% of instruments.

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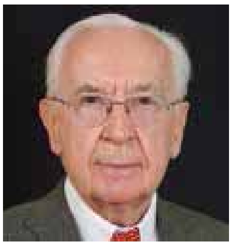
Time has come to revive a sound and safe securitisation market in Europe

Jacques de Larosière - President, **EUROFI**



At a time when Member States are justifiably working to reduce their budget deficits, with constrictive impacts on the eurozone's economy, there is an urgent need to address the reduction in lending to businesses, particularly in the eurozone (-2.3% in June 2014 year-on-year) following 2 and a half years of decline.

Yet the bank-lending channel of the monetary policy, which is seeking to promote growth, has been held back since 2012 by several factors including the updated regulatory constraints of CRD IV and the weak level of profitability of banks.

As it reduces banks' balance sheets securitisation appears to be the most promising instrument to help provide additional sources of financing to SMEs, which are very dependent on bank financing.

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Can structural reforms relaunch economic growth in the EU?

Pier Carlo Padoan - Minister of Economy and Finance, Italy

Growth remains very low or negative and joblessness is despairingly high in most EU countries. Expected recovery fails to materialize, with risks of growing divergences between and within Member States. Establishing the conditions for an increase in potential growth becomes a key strategy to exit stagnation and make progresses in terms of social cohesion, financial stability and fiscal sustainability. We are at a turning point. What can be done?

The focus on structural reforms is the cornerstone of a new policy agenda that requires looking at both demand and supply issues. Reforms are the key drivers of supply and they are the responsibility of national governments. Reforms and the innovation they spur are the major driver of growth, and productivity especially if the reform effort is wide-ranging at national

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Regulators at a crossroads

Henri de Castries - Chairman & Chief Executive Officer, **AXA Group**

Public authorities have moved expeditiously to reform the financial sector over the past five years. While the focus has been primarily on banking, progress has been made in other areas too. Examples include the Solvency II framework, which should result in even greater financial soundness of European insurance firms, and the new Insurance Mediation Directive, which will help policyholders get best value for their money.

But despite such major breakthroughs, regulatory momentum shows no sign of slowing down and is entering more questionable territory. In particular, the push on systemic risk for insurance by the Financial Stability Board and the International Association of Insurance Supervisors might do more harm than good, especially if there is no clear understanding of what systemic risk might entail in the insurance industry.

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Setting new priorities for EU financial sector legislation: target growth!

Jean-Paul Chifflet - Chief Executive Officer, **Crédit Agricole S.A.**

The regulatory reforms adopted in the wake of the 2008 crisis have radically changed the European and international banking landscape and financial system. Banks have largely anticipated these changes by substantially increasing their level of core capital whilst at the same time boosting their liquidity reserves and reducing their exposure to risky activities. They have also developed more solid risk management policies and markedly improved their crisis prevention tools. Combined with the implementation of the *Banking Union*, these unprecedented changes are today significantly contributing to making the EU a robust international financial place.

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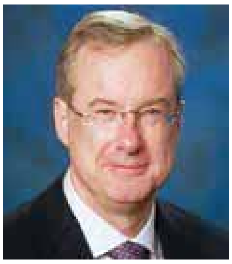
How resilient can we say our financial system is 6 years after the financial crisis?

Terry P. Laughlin - President of Strategic Initiatives, **Bank of America**



When talking about the resilience of the financial system now as opposed to 2008, we should not underestimate the immense amount of work and progress that has been made. These measures include intensive and effective supervision, recovery and resolution frameworks, a reduction of interconnectedness in the financial system particularly in the OTC derivative market and increased macro prudential supervision. Large banks have re-evaluated their own business strategies and operating models and introduced higher capital requirements and liquidity levels.

After the financial crisis, the issue of firms seen to be too big, complex or interconnected to fail was right at the top of regulators' reform agendas on both sides of the Atlantic.

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Financing growth: a priority for European policymaking

Vittorio Grilli - Chairman, Corporate and Investment Bank EMEA, **J.P. Morgan**

The next European Commission and newly elected European Parliament have an opportunity to pursue policies aimed at seizing the full potential of markets-based financing as an engine of growth. Over past years, banks' ability to extend credit to companies has been significantly reduced. The consequences of this are felt particularly by small and medium enterprises (SMEs), which form the backbone of the European economy. Policymaking can spur the creation of a new model for growth and reduce reliance on bank funding by improving the capacity of financial markets to fund the real economy. Capital markets have undergone significant reform and are safer and more transparent than ever before: policymakers can now explore new policies aimed at putting these markets to work for citizens of Europe.

The funding potential of financial markets can be increased by prioritizing certain existing legislative

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The capital framework should remain risk-sensitive

Jean-Laurent Bonnafé - Chief Executive Officer, **BNP Paribas**

Banks have made in recent years huge efforts to comply in a short period of time with the new regulatory framework, raising capital and deleveraging their balance sheets. According to ECB figures, the EU banking sector decreased in size by about 30 % of EU GDP since 2008. Banks are safer now, but at the same time their capacity to finance the economy has shrunk. The impact of all these regulations is much higher in Europe (where banks provide more than 70 % of the financing of the economy) than in the US where it represents an inverse proportion.

The right balance has to be found between financial stability and economic growth. It is now time – as stated by the Italian Presidency of Europe – to take measures to foster growth. It is also time to stabilize the regulatory environment. No economic actor can perform correctly its role if its legal environment changes every year.

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Weak investment and laggard growth in the EU despite the very low current interest rates

Ignazio Visco - Governor, **Bank of Italy**

The European Central Bank's comprehensive response to counter the euro area sovereign debt crisis since its intensification in the summer of 2011 has laid the groundwork for the marked improvements of financial market conditions over the last two years. The measures adopted on June 5th by the ECB Governing Council have already provided additional monetary accommodation; they will help consolidate the favorable financing environment and support investment.

Economic growth remains nevertheless moderate and uneven and inflation is still well below the ECB's definition of price stability. The Governing Council stands ready to act against risks of too prolonged a period of low inflation, also using unconventional instruments within its mandate, with a view to safeguarding the firm anchoring of inflation expectations.

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More monetary easing in itself is not a solution

Ilmārs Rimšēvičs - Governor, **Bank of Latvia**

With bank lending in Europe remaining weak, there are considerable concerns about the consequences of the prolonged lending weakness on the overall investment and growth in many EU countries. There are a number of reasons for the current weak credit growth. Limited number of potential borrowers, low savings, insufficient own funds and continuous repair of balance sheets are just a few examples.

To address the challenge posed by weak lending in the euro area, ECB's TLTROs are designed to boost lending to the real economy and stimulate an upturn in investments and growth. The TLTROs will supply long-term funding to banks thereby easing their financing costs and allowing to improve credit conditions to customers. At the same time, lending development is also closely related to several indirect factors, such as overall economic sentiment, investment environment, numerous structural fundamentals and health of the financial sector. Thereby, more monetary easing in itself would not solve the euro area's growth problem. While the ECB's recent policy actions is a remarkable step to support lending, it is beyond the remit of monetary policy to address impairments that are due to structural shortcomings. More active structural reform agenda is the true remedy in this case.

Effective monetary policy transmission is impossible without a healthy banking sector. Major steps have been taken in the euro area. The creation of SSM, SRM and the ongoing comprehensive assessment will support banking sector's ability to lend. While the current uncertainty about AQR results is negatively impacting lending in the short-term, AQR is designed to boost transparency, repair balance sheets and restore confidence in the market thereby creating the foundation for subsequent credit expansion.

It is broadly recognised that the development of non-bank financing is important to diversify the funding sources. Yet we also have to remain vigilant not to shift some risks to the less regulated shadow banking sector.

Three particular areas of possible measures to strengthen the recovery of the EU economy are: improving the resilience of the banking sector and making the banking union fully operational; diversifying funding for enterprises and fostering more effective credit allocation; promoting structural reforms aimed at enhancing productivity. ■

Long-term financing of the European economy

Marco Buti - Director General for Economic and Financial Affairs, **European Commission**

The financial crisis has forced banks to deleverage, repair balance sheets and to prepare for tighter regulatory requirements. It also had a negative impact on the risk appetite of banks, borrowers and institutional investors, resulting in less willingness to finance long term investments and SMEs.

The European Union has acted with determination to address these issues with the consolidation of public finances and the set-up of improved procedures for the coordination of Member States' budgetary and economic policies. The establishment of the Banking Union and the role played by the ECB have been instrumental in restoring confidence in the euro area.

EU capital markets should be further developed and integrated to accomplish a full Capital Markets Union, in which access to finance will be easier and costs lower, reliance on bank lending reduced and the shock absorbing capacity of the markets enhanced. This will boost the attractiveness of Europe as a place to invest. Improvement in market infrastructures is part of this process and, in this field, major progress has already been booked (e.g. EMIR, MiFID II and CSDR).

As announced by the President-elect, Jean-Claude Juncker, a first priority for the new Commission is to present an ambitious Jobs, Growth and Investment Package, to mobilise up to EUR 300 billion in additional investment in the real economy over the next three years. This requires the right regulatory environment and a climate conducive to growth and job creation.

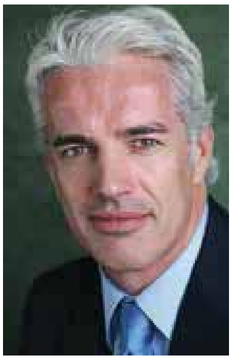
Long-term investment is a critical source of such growth. The Commission Communication on long-term financing sets out a concrete Action Plan to help support long-term investment and to leverage public funding.

We are taking measures to encourage capital market financing, facilitate insurers' involvement in long-term finance (e.g. Solvency II Delegated Act) and to support the financing of economically viable infrastructure projects.

For SMEs, the Commission is examining ways to reduce information asymmetries. Promoting high quality securitisation is one of the ways to increase fresh lending to the economy. There is broad G20 support on this. Much needs to be done to support long-term finance in Europe. We are confident that the Action Plan will allow Europe to stay focused on that target. ■

Rates, regulation and demographics resulting in a new normal for banks and markets

Garrett Curran - Chief Executive Officer, **Credit Suisse,** UK & Ireland



Creating a stable environment for economic growth, whilst implementing austerity, structural reform and the deleveraging of the banking system is clearly a challenge for Euro Area officials. Success is path dependent, and sequencing is key, but very difficult to control. With demographic forces unsupportive, productivity focused investment is critical. The economic impact of bank deleveraging is amplified in Europe where bank credit plays a more substantial role in business and household financing than in the US. EU financial wealth, not only outside of the banking system, but also outside of the more highly regulated trinity of banking, insurance and pensions is minuscule vs US levels. Therefore deleveraging will require the participation of non-Euro Area investors, particularly in the lower tranches of the capital structure.

Low rates, demography induced changes in the liability structure of the financial eco-system, financial regulation, and bank deleveraging have altered market characteristics and the nature of the growth challenge. These forces and trends, and their interactions, do not appear to be well understood yet. Bank balance sheets are smaller and less pliant as new prudential regulation reduces appetite and capacity to warehouse risk. The collective impact of regulation and market developments across banks, insurance and pensions has been to align their asset base more tightly to their increasingly fixed income-like liability streams, reducing risk appetite and trading incentive. The resulting illiquidity and lower base-level volatility also imply greater market disruption from episodic spikes.

Our goal must be to prevent deleveraging from deteriorating growth and inflation to such a point that they become immune to policy stimulus, as happened in Japan in the early 2000s. Whilst there is much to be positive about (recognition of the need for a securitisation revival, stronger & more credible banks post the AQR/Stress Test, EC focus on market-based and longer-term finance), more needs to be done, particularly in respect of macro-economic policy stimulus. We should proceed cautiously with regulation that hampers market liquidity or promotes excessive or unbalanced bank deleveraging at this fragile juncture: notably NSFR – funding costs for equity and FI market making, MiFID 2 transparency rule calibration, Bank Structural Reform, FTT and frontstop leverage ratios. ■

Interest rates will remain low, even if policy makers embrace the 'smart way'

Eric Chaney - Chief economist, **AXA Group**

The unthinkable -10Y Bund yields falling below 1%- happened on August 15th, 16 years after Japanese government bond yields crossed the same line. Bad surprises on GDP growth and rising geopolitical risks were contingent triggers. They should not hide the structural forces bringing down yields. As populations grow older, savings are shifting toward fixed income assets. The triple deleveraging of banks, consumers and governments has been and is still choking growth and inflation. Stricter regulatory capital rules for banks have made sovereign bonds more likable and lending to companies –a risky business by definition- less so. Last but not least, the European Central Bank is missing its inflation target and, worse, has been unable to anchor inflation expectations which, on a rolling five year time span, have steadily fallen from 2% in 2012 to 1% in the latest readings.

A kind of japanisation of the euro area has indeed started. The good news is, policy makers know it; the bad news, their hands are tied up by the institutional and political setup of the euro area. Large scale asset purchases by the ECB, including foreign assets, would meet strong political opposition, and the leeway for fiscal expansion is limited by the fiscal compact. In his Jackson Hole speech, President Mario Draghi has shown the 'smart way' out. Smart quantitative easing, i.e. helping banks to clean their loan books and lend more to SMEs, is possible. Fiscal coordination and expansion too, under the smart condition that supply side reforms make convincing progress in France and Italy. Investment in local or cross border projects conducive to stronger long term growth (infrastructures, education, R&D) could be smartly boosted by leveraging the joint lending capacity and expertise of the EIB and national investment funds (KfW in Germany, CDP in Italy, CdC in France).

Being smart in financial regulation is not forbidden either: reviving the much needed ABS market would be facilitated by further adjustments on the capital insurers are required to freeze in order to buy these assets. Similarly, the collateral universe of euro area central banks could be extended to high quality trade credit (B2B).

But even if policy makers embrace the 'smart way', the political and regulatory clocks are slow to move. In the meantime, nominal interest rates will remain low. ■

Securing the euro area recovery

Poul Thomsen - Acting Director, European Department, **International Monetary Fund (IMF)**

After a number of strong policy actions, the euro area is recovering. But the recovery is uneven and wobbly. Even though financial markets have improved, output and investment remain well below pre-crisis levels. High unemployment, large debt burdens, weak banks, and contracting credit are weighing down domestic demand. This leaves the region too dependent on foreign demand and exposed to external risks, like geopolitical shocks or slow growth in trading partners.

Low inflation is pervasive, making real interest rates too high, stifling demand, and slowing the pace of debt reduction. The more persistent low inflation is, the more the current monetary policy stance is questioned. On the supply-side, rigidities in capital, labor, and product markets are holding back productivity and job creation. At the same time, there is a danger that reform fatigue becomes entrenched, jeopardizing further progress.

To counter these risks, concerted policy efforts are needed to support demand, repair balance sheets, and address supply-side constraints.

Policy needs to prop up domestic demand until lowflation recedes and banks start lending. The ECB's recent actions aim at just that. But if inflation stays stubbornly low, the ECB may need to start quantitative easing, signaling that it will use every available tool to achieve its price stability mandate. The overall neutral fiscal policy stance appropriately walks the fine line between debt sustainability and demand support. However, large negative growth surprises should not trigger further tightening.

Further balance sheet repair should be encouraged. The euro area has made very good progress on banking union, with the SSM and SRM adopted and the ECB's Comprehensive Assessment's motivating bank balance sheet repair. But a common fiscal backstop is still essential to break the link between bank and sovereign risks.

Additional structural reforms should be pursued to raise Europe's growth potential. It will be tough to make growth robust without further reforms. Above all, these include product and labor market reforms to raise competitiveness, lower hiring costs, and reduce youth unemployment, and changes in capital market to enhance risk-sharing and SMEs' access to finance.

The complicated fiscal framework could be simplified and enforcement improved. The ability of the center to fund public investments in the euro area interest, like roads and energy networks, should be enhanced.

Taken together, these actions would help to solidify and strengthen the recovery in Europe. ■

A sound banking system is a prerequisite for growth

Claudio Borio - Head of the Monetary and Economic Department, **Bank for International Settlements (BIS)**

Some seven years on, the global economy has not yet stepped out of the shadow of the Great Financial Crisis. Despite a pickup in growth, it has not shaken off its dependence on extraordinary monetary stimulus. Despite the euphoria in financial markets, investment remains weak. And despite lacklustre long-term growth prospects, debt continues to rise.

The crisis was no bolt from the blue: like many before, it reflected a prolonged and outsize financial boom that ushered in a financial bust and a balance sheet recession. The joint behaviour of credit and property prices plays a key role in such financial cycles. Unlike normal recessions, balance sheet recessions are not only deeper and longer but also much less responsive to aggregate demand policies: undercapitalised financial institutions restrict and, above all, misallocate credit; over indebted borrowers pay back debt; and the major misallocations of capital and labour hidden by the boom emerge with a vengeance.

Different illness, different remedy. Addressing balance sheet recessions puts a premium on balance sheet repair, in both financial and non-financial sectors, and on structural policies. This is the way to establish the basis of a self-sustained and speedy recovery. The issue is not so much boosting short-term growth at all costs but removing the obstacles that hold it back.

What about the European Union specifically? To be sure, not all countries in the EU had a full-fledged balance sheet recession, linked to a domestic financial boom and bust. Countries that did, just like the United States, include the United Kingdom, Spain, Ireland and others in central, eastern and southern Europe as well as in the Baltic region. In others, notably Germany and France, banks suffered losses mainly on foreign exposures. In others still, such as Sweden, the crisis was largely imported through exports, even as domestic credit and property booms continued. And in the euro area, owing to institutional specificities, a doom loop between banks and their sovereign soon threatened. But, everywhere, the scars are all too visible.

Seen from this perspective, fixing the banking system is a critical step. The long-awaited asset quality review and stress tests under way are essential to unblock the system. Together with the completion of the post-crisis financial regulatory reforms, not least Basel III, they would ensure that the financial sector can again support lasting growth. And together with the necessary structural reforms and steps to secure fiscal sustainability, they would at last relieve pressure on monetary policy, which has been overburdened for far too long. As argued in the latest BIS Annual Report, the current policy mix, unless corrected, raises material risks in the years ahead. The sooner we recognise it, the better. ■

A stable and resilient financial sector as a key ingredient for future growth

Roberto Gualtieri - MEP, President of Committee on Economic and Monetary Affairs, **European Parliament**

Excessive risk taking and leveraging has been one of the main causes of the financial crisis. However, on-going deleveraging and diminishing credit supply is one major challenge for future growth in the euro area and the EU.[1] Therefore, various policy initiatives are on the policy agenda to counterbalance these negative effects.

Financial services reform is a major building block. A sound, stable and resilient financial sector capable of providing funding to the real economy is of major importance for growth in the medium and long term. Both the financial reform agenda (internationally coordinated by G20) and the unique project of creating a Banking Union with Single Supervisory and Resolution Mechanisms (SSM, SRM) and a single rulebook (CRD IV and CRR) will change the set-up of financial markets. These reforms will strengthen the resilience of the banking sector by contributing to the necessary balance sheet repair and will have an impact on the credit provision by banks.

The implementation of the financial sector reforms will also necessitate a vast amount of secondary legislation (implementing/delegated acts) that may have a sizeable impact on the funding of the real economy. The overall impact on growth of these reforms is not yet fully understood. One clarification was provided by the Commission Communication A *reformed financial sector for Europe* in May 2014.[2] Ensuring that reforms will contribute to growth will be one of the priorities of the ECON Committee.

The majority of real economy funding in the EU is provided by the banking sector.[3] Small and medium sized enterprises (SMEs) are a main contributor to employment and growth in the EU. However, they have few possibilities to directly access the capital market and are especially dependent on a functioning banking sector. Ensuring cost efficient access for SMEs to finance is therefore of crucial importance. Notably the ECB (e.g. via its collateral framework, non-standard monetary policy measures and reviving securitisation markets) and the EIB Group are contributing to the mitigation of financing difficulties but new bolder steps are required. The ECON Committee shall contribute to the design and the implementation of the "capital markets union" whose creation has been indicated by Jean-Claude Juncker as one of the goals of the new Commission.

In any case, all initiatives aimed to restore the efficient functioning of the banking and the financial sector will not be sufficient to boost economic growth and employment if they are not accompanied by appropriate initiatives to support domestic demand. ■

1. To be noted that deleveraging and balance sheet repair is not only a phenomenon seen in the banking sector. The public sector, corporate sector and private household are equally affected. See IMF Country Report No. 14/198, EURO AREA POLICIES: 2014 ARTICLE IV CONSULTATION–STAFF REPORT; https://www.imf.org/external/pubs/ft/scr/2014/cr14198.pdf.
2. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A reformed financial sector for Europe, COM(2014) 279 final; the Communication and supporting documents can be accessed via the following webpage: http://ec.europa.eu/internal_market/finances/policy/index_en.htm#True.
3. See Finance in an environment of downsizing banks, Speech of Yves Mersch, member of the Executive Board of the ECB, at Shanghai Forum 2014 'Asia Transforms: Identifying New Dynamics'; http://www.ecb.europa.eu/press/key/date/2014/html/sp140524.en.html.

Do well, then expand

Andris Vilks - Minister of Finance, **Latvia**

Banking union is an important step towards more integrated financial markets in the EU, however, we are at the very beginning of long way towards homogenous or harmonized pan-European banking system. First and foremost, the fundamental dichotomy exists between euro and non-euro zone countries, were banking regulation significantly differs. However, even if banking regulation has direct effect on real economy, and in this respect the banking union has a potential to have stabilizing effect on Eurozone economies at macroeconomic level, cost of borrowing, collateral and other requirement are deeply rooted in risk assessment and thus - economic development perspectives of each particular country in every given moment. In this respect, existing fragmentation of the EU financial markets reflects existing fragmentation of real economy in the EU.

Speaking of financing the real economy, unlike United States, where close to 80% of external financing of enterprises comes from equity and debt securities, in Europe bank loans are still the main source of external financing. Sure, most of European countries have system of development banks, partly taking care of development needs of enterprises, especially SMEs and micro-businesses, which often are government and EU financed or partly financed ventures, delivering subsidized development loans. This means that at least part of lending goes through national business support policies, which are far from being harmonized and which might, on one hand, witness the market failure, and on the other hand mean, that fragmentation of financial market will last for some time.

At this point we think that one should work on strengthening the progress reached so far and transform banking union regulations into functioning and effective banking mechanism. "Do well, then expand", this basic management principle should apply to the European banking union, in parallel looking for new ways how financial markets can support business via innovative financing mechanisms like securitization or other new financial instruments. ■

Investment and bank lending to enterprises

Peter Praet - Member of the Executive Board, **European Central Bank (ECB)**

Despite historically low interest rates and a gradual recovery in economic activity in the euro area, corporate investment has remained lacklustre, also compared with previous recessions. A number of factors have contributed to this weakness, including depressed demand and heightened uncertainty. But to what extent is bank lending playing a role?

Certainly, weak investment has been accompanied by a prolonged period of contracting bank credit to firms. Correlation does not however imply causation. While the decline in bank lending is in part related to supply factors, it is also linked factors on the demand side.

Weak demand for credit is partly related to the necessary deleveraging of the private sector. It also reflects the slow pace of recovery, which had led firm to accumulate higher cash buffers given the discouraging investment environment. At the same time, companies that do need external financing are being discouraged by the still high cost of loans and therefore, if possible, substituting bank loans with alternative sources of funding.

Supply factors are nonetheless still playing a role in the context of still elevated, though receding, financial fragmentation. Perceptions of balance sheet constraints are also curbing credit provision, especially in stressed countries. Although banks' funding conditions have improved significantly and cross-country differences narrowed notably, bank lending rates have remained elevated. Macroeconomic risks can only explain part of this phenomenon. The conclusion to draw from this, therefore, is that fixing the bank lending channel – which is essential for monetary policy transmission – involves action on both the supply and demand sides.

In line with its price stability mandate, the ECB has adopted monetary policy measures aimed at boosting credit supply. The TLTROs, introduced as part of a policy package in June, provide stable term funding at attractive rates conditional – and this is essential – on banks expanding their lending beyond a given benchmark. Moreover, the ECB's comprehensive assessment can be expected to eventually have a positive impact on credit supply.

Credit demand, however, can only be durably improved by policies that boost the outlook for potential growth and hence raise investment demand. This implies an essential role for national structural policies that raise labour participation and labour productivity. ■

Financing growth: a priority for European policymaking

Vittorio Grilli - Chairman, Corporate and Investment Bank EMEA, **J.P. Morgan**

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proposals and by launching a number of new initiatives. Firstly, it is important to revive the securitisation market. Securitisation, when appropriately regulated and well supervised, is a channel by which banks and non-bank lenders can fund their own lending. It frees up room on balance sheets and enables capital to be lent again as well as allows for increased portfolio diversification and better risk management opportunities.

Policymakers should consider promoting policies that will revitalize the European securitization markets, particularly for SME loans.

Secondly, policymakers should promote long term investment. Regulatory fragmentation among Member States has held back large scale and long-term capital commitments required for operating efficient investment pools for long-term assets. The proposed Regulation on EU long term investment funds (ELTIFs) can lead to the creation of an attractive alternative vehicle for investing in long-term investment assets. Europe should prioritize completion of an agreement on the proposal between the European institutions, although remaining questions around product suitability (for retail) and early redemption will need to be resolved for ELTIFs to meet the regulatory objective.

Thirdly, development banks can play a growing role for SME financing. New mechanisms can help promote the role development banks play in SME financing, and policymakers should consider whether current public sector support may be inhibited by fragmentation and under-funding relative to the size of the European economy.

Finally, the development of a private placement market in Europe will create opportunities for mid-size companies to borrow from the market at lower costs. As disclosure and reporting requirements for bond issues have increased, the cost of access to capital markets has dramatically risen. The creation of a formal "private placement" market would allow companies to tap sophisticated investors at lower costs.

After five years of legislative changes, Europe's financial markets are looking increasingly strong, safe and transparent. Time has come for Europe to put the markets to work to help spur economic growth. ■

A single market in capital for Europe

Benoît Coeuré - Member of the Executive Board, **European Central Bank (ECB)**
& Chairman, **Committee on Payments and Market Infrastructures**

A key policy objective in recent years has been the reintegration of financial markets in the euro area – but what does this really mean?

It cannot mean simply that prices on euro-denominated financial assets converge. We saw substantial price convergence in the euro area in its first decade, only to be faced with a sudden fragmentation of financial markets when the crisis hit. Convergence can be a welcome process if risks are being more accurately priced; but it does not in itself guarantee deep and resilient financial integration.

True financial integration is therefore something more – it involves constructing a genuine single market in capital, which has two components. The first is efficient allocation: credit is allocated without reference to location. The second is effective diversification: financial markets help firms and households cushion local shocks, which is especially important in a monetary union. On both accounts, however, there is still much to do.

Credit allocation in the euro area remains very much influenced by the location of borrowers, rather than their creditworthiness per se, in particular for SMEs. This reflects relatively low cross-border retail banking integration. Diversification is constrained by home bias in the holding of equity and limited mechanisms for private risk-sharing.

Banking Union can in principle help on both fronts, by creating the conditions for a more integrated retail bank market and better risk-sharing for banks in resolution.

A greater role for capital markets will however also be key to a more efficient and diversified financing mix, by increasing market contestability between banks and non-banks and by supporting access to finance for SMEs.

Bank deleveraging in the euro area is already boosting capital market financing. The key challenges now are, first, to even out access to capital markets across jurisdictions, which requires a harmonised framework for cross-border securities trading in the EU – a "capital markets union".

And second, to foster securitisation, which would provide smaller firms, for whom relationship lending will continue to be important, with a way to diversify their funding sources. ■

Can structural reforms relaunch economic growth in the EU?

Pier Carlo Padoan - Minister of Economy and Finance, Italy

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level and is simultaneously undertaken across countries. Benefits from reforms in terms of growth and jobs, however, take time to materialize, especially in absence of a supportive macroeconomic environment. This is why at a time of crisis, when negative short term considerations dominate private sector expectations, a coordinated reform effort is needed to restore confidence.

Structural reforms must be embraced also as a valuable tool to address persisting macroeconomic imbalances.

The asymmetric EU current account rebalancing - with debtor countries moving out of deficits without creditor countries reducing their surpluses – signals an excess of saving over investment. In fact, investment levels remain below their already modest pre-crisis figures across the whole Euro area. Country specific structural measures may help narrow the current EU saving-investment gap in a number of ways, including – on the investment side - by removing obstacles to productivity increases and cost of capital reductions.

Financial market integration complements structural reforms. Even if investments are reinvigorated by country specific structural reforms, their funding rests on a truly European financial market where credit and capital can freely flow across national borders and where banks are complemented by markets in the provision of credit to the private sector.

Moreover, countries' driven structural reforms cannot happen in a vacuum. Investments in infrastructures that, like transports, energy and the digital agenda, span the entire continent require, by the subsidiarity principle, EU interventions. The new EU Commission President, has recently indicated in euro 300bn the size of the infrastructures investment gap that must be filled in the next three years. We share his sense of urgency. The time for action on structural reforms and investments is now! ■

Spain: Deleveraging or Rebalancing?

José Abad - Chief Economist and Head of Research and International Relations,
Instituto de Crédito Oficial (ICO), Madrid

The ***stock* of domestic loans** to Spanish firms has fallen by 40% from the all-time peak reached in 2009. And while slowing down, the pace of contraction is still taking place at 2-digit rates. However, as terrible as these statistics may sound, they also paint a distorted picture of financing conditions in Spain.

If we also take into consideration securitized loans, loans transferred to the SAREB, loans by foreign banks, securities other than shares and loan loss provisions, the ***stock* of total corporate financing** would have cumulatively contracted by "just" 15% since 2009 and would be currently falling at a much lower speed (less than 5% y-o-y).

Furthermore, looking across sectors, while the stock of financing to firms in the real estate and construction sectors would be down by 1/3, financing to firms outside these two sectors would account today for 70% of GDP, slightly higher than in 2009 and well above pre-crisis levels!

Also, the recent pick-up in the *flow* of credit (new SME loans are up by 5% YTD), in combination with firms increasingly putting their cash surplus (+4% of GDP currently vs -11% of GDP in 2007-08) to work, is being translated into a **strong rebound in business investment** (+11% y-o-y in Q1).

Overall, what we observe in Spain is not a deleveraging process per se but a demand-driven **rebalancing process** in the composition of activity at the macro level which is having its reflection on credit dynamics. Not least, while residential investment accounts for just 4% of GDP (down from 12% in 2007), total exports account for 34% of GDP (up from less than 27% in 2007).

As Spain's national promotional bank (NPB), the objective of ICO is that of making such a rebalancing process as smooth as possible by improving funding conditions for SMEs, particularly when exporting or investing abroad, while promoting the development of alternative funding sources, such as venture capital.

At the international level, **increasing cooperation among NPBs, and well as between NPBs and the EIB Group**, is badly needed. By increasing their cross-border operations, NPBs could play a key role in reducing financial fragmentation, particularly for SMEs, across the Eurozone. ■

The nutcracker: Targeted quantitative easing

Rumi Masih - Managing Director and Senior Investment Strategist, Investment Strategy and Solutions Group (ISSG), **BNY Mellon**

Since the financial crisis, monetary policy has tended to favour the bulk purchasing of mainstream financial assets. However, if the goal is to restore economic health, this is the equivalent of cracking a nutshell with a sledgehammer. Monetary easing, if co-ordinated with regulatory and structural changes, need not involve the use of such blunt and unwieldy tools.

More accurate quantitative easing (QE) can have two benefits. Firstly, borrowing conditions may be improved amongst the sectors of the economy that are more likely to borrow and then make real investments. Currently, we see a situation in which those sectors that can borrow are often the ones who don't want to. Secondly, well-executed QE not only buys financial assets, but also encourages others to buy those assets; particularly if aligned with regulatory changes that make the asset class more desirable.

For the first of these outcomes, increased granularity can occur in both the financial asset type bought, and the area of the private sector that is the ultimate investee. By controlling monetary easing along these lines, corporate lending can be directed to the parts of the private sector most likely to increase demand.

For our second outcome, a mixture of monetary policy with structural and regulatory measures can act as a remedial cocktail of drugs. Asset purchases can boost liquidity and price discovery, and so help to bring more obscure markets into the mainstream. It is not only real economy actors who would benefit from this; investors would be able to better diversify and have a clearer understanding of what they own, reducing systemic financial risk.

An ideal target for this medicine (already acknowledged by policy-makers) is the securitized asset market, where asset purchases would have traction to the real economy. These purchases could be coordinated with structural measures to increase confidence and reduce information asymmetry, such as joint ECB/BoE proposals to create 'qualifying securitizations', ESMA-promoted improvements in documentation and disclosure, or Europe-wide harmonization of securities issuance rules and accounting standards.

This is not to say that 'conventional' QE is ineffective: by our estimates, just the possibility of the ECB buying bonds has driven European sovereign yields lower by thirty basis points this year. Sledgehammers will certainly crack nuts. But bringing asset-backed securities in from the cold would be welcomed by investors, as well as giving central banks a greater bang for each buck of balance sheet they choose to use. ■

Weak investment and laggard growth in the EU despite the very low current interest rates

Ignazio Visco - Governor, **Bank of Italy**

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Between 2007 and 2013 both public and private investment declined by 20 percent in real terms in the euro area as a whole; the fall was even larger in stressed countries: in Italy, for example, the figures are 31 and 26 percent respectively. Weak growth is partly due to a slower recovery of private investment than in most financial crises of the past. Moreover, despite the broad agreement that productive investment is a necessary complement for fiscal consolidation to be growth-friendly, actual fiscal consolidation has often implied massive cuts in public investment, which may cast a shadow on future potential output.

Reviving investment - public and private, national and European - is critical at this juncture in order to strengthen the recovery. Investment is the linkage between supply and demand. Accommodative monetary policy has been supporting capital expenditure by maintaining favorable financing conditions. But other causes have played a relevant role in holding back investment, offsetting the stimulus expected from the very low interest rates: unsatisfactory output dynamics; widespread uncertainty about prospective demand growth; deleveraging by over-indebted firms. Difficult access to credit, because of balance sheet repair in the banking sector, and higher cost of capital in stressed countries, owing to financial fragmentation, also bear major responsibilities for postponements and cutbacks in investment by firms.

Monetary policy must be complemented by other measures at both a national and European level to create a business environment that is more conducive to a stronger and sustained resumption of investment. Along with country-specific structural reforms on the supply side, broader economic policy action is required to accelerate the building up of infrastructure, both tangible and intangible, indispensable to the formation of a true Single Market. ■

Restoring competitiveness, job creation and growth in Europe

Pierre Gramegna - Minister of Finance, Luxembourg

At this important juncture of the business cycle, Europe needs a meaningful approach to re-launching and consolidating growth. Much of our time in recent years has been devoted to correcting the failures of the past, mostly out of urgent necessity. Unsustainable public finances and inadequate financial regulation have been important factors contributing to the outbreak of the economic and financial crisis and addressing these shortcomings were of an utmost priority.

Today, with uncertain growth perspectives looming at the horizon, unemployment in Europe remains too high and lending to firms in Europe too constrained. Dedicated structural reforms are necessary and this calls for decisive action by all stakeholders.

The upcoming launch of the SSM, preceded by the rigorous health check of the banking system, can help regain the necessary confidence in our banks and thus alleviate concerns on scarce financing to firms across Europe. Alternative means of financing should also be gradually developing to further ease the pressure, but further policy action is needed to support such developments.

These are all necessary, but not sufficient conditions to restoring growth. Both private and public investments are important elements supporting our economies. European institutions such as the EIB or the Commission can and should play a key role here, with the necessary support of the governments. Restoring the competitiveness of our economies will also be key to tackling these important challenges. It will require ample creativity, bold decision-making and steadfast implementation in Europe in order to spur growth and job creation.

European policy-makers therefore face an enormous challenge today. We are increasingly paying attention to all these issues in the relevant fora – as a matter of priority – and will continue to do so with the incoming Commission. Despite the difficult tasks that lie ahead I am confident that the EU will be able to devise a decisive strategy and implement much-needed policies to restore our competitiveness, job creation and growth. ■

The capital framework should remain risk-sensitive

Jean-Laurent Bonnafé - Chief Executive Officer, **BNP Paribas**

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Stability and confidence are essential to allow economic actors to invest and to encourage individuals to work, consume and invest.

The RWA framework for example is regularly questioned; some advocate it should be replaced by a leverage ratio and stress tests. While a leverage ratio as a backstop makes sense, it would be a huge mistake to make it the main capital driver. Banks do take risks; it is their very nature and purpose. Risk management should therefore be at the heart of the steering of a bank, and the minimum capital requirements should be adjusted to each bank's risk profile, reflected by its internal model, back-tested and checked by the competent supervision. As such for supervisors this approach is not more complicated than performing stress tests in a relevant and consistent way. If the leverage ratio becomes the primary trigger, this would incentivize banks to change their risk profile to a much more risky one to increase their profitability for the same balance sheet size. The current RWA framework represents 30 years of experience and progress which should not be thrown away. It can certainly be improved further as is the case in Europe for example, where major initiatives have been taken to make RWA more robust and comparable. A Single Rulebook has been established by the EBA for the 28 EU countries, a Single Supervisory Mechanism has been set up by the 18 Eurozone countries which will decide on internal models as from 4 November and which will conduct a transversal audit of internal models in 2015. Significant divergences between RWAs will and should remain as they reflect the various risk profiles and business models chosen by the banks. Europe is showing the way, evidencing that harmonization of practices and rules is possible and that supervision and regulation can be strengthened. ■

How resilient can we say our financial system is 6 years after the financial crisis?

Terry P. Laughlin - President of Strategic Initiatives, **Bank of America**

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A significant number of UK and US policymakers believe the too-big-to-fail problem is now a thing of the past. But with key details on how resolution mechanisms will work still unclear, some believe that optimism may be misplaced. Even if a global standard is eventually agreed, there are doubts it will prevent individual regulators from making their own rules or push them to get rid of existing ones, such as the Fed's capital requirement for foreign banks.

The EU could be classed as still being in the recovery stage following the crisis and the European Commission's proposals on separating trading and deposit taking activities, which go even further than national initiatives in France and Germany, could potentially hamper the speed of that recovery. It is crucial that the universal banking system remains intact to avoid any potentially negative consequences as far as the financing of the real economy is concerned.

The FSB proposal on Gone Concern Loss Absorbing Capacity (GLAC) also needs to be mentioned as this is a key tool for regulators tasked with increasing resilience of the financial sector. The use of GLAC is to provide sufficient resources for a firm to be resolved, maintaining critical functions without taxpayer support or causing severe systemic disruption.

GLAC should allow a firm to absorb losses and replenish its required equity capital if it reaches the point of non-viability to a level that would be credible as a standalone institution, and enable the recapitalized firm to regain market access. It has been suggested that GLAC (which includes regulatory capital) should double the minimum required Basel 3 equity of 7%, plus any applicable buffer requirement (so 7% above regulatory requirements).

The industry has expressed concerns that GLAC may be applied by national supervisors ahead of the actual parameters being agreed. Regulators want additional loss absorbing capacities to be introduced ahead of agreement on the actual levels required. Concern also exists around the positioning of external GLAC within cross-border groups, which could trap capital in subsidiaries and lead to an inefficient use thereof. However, the concerns of host regulators with regards ensuring an ability to re-capitalise local entities is also recognised and a balance between the two needs to be achieved.

Banks around the world already have to hold far more capital from 2016 as a result of new rules to strengthen them post the financial crisis and we want there to be sufficient capital available to recapitalize the banks that are carrying out critical economic functions to a level where they can regain and maintain market access. ■

Regulators at a crossroads

Henri de Castries - Chairman & Chief Executive Officer, **AXA Group**

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Policymakers have reached a crossroads. It has been reported that the capital standards for some insurance firms could be higher than Solvency II's advanced risk-based requirements, as in banking. Yet even further tightening of the most modern and ambitious standard for insurance looks more arbitrary than economically justified, particularly as the business model of insurance is fundamentally different from that of banks. Rather than fostering a global level playing field, it might hurt the European insurance industry without justification, and especially the five European firms that have been designated 'systemic'.

Regulators should closely examine the business model of insurance and assess how best to tailor regulation to the role of insurance firms in the economy. That role is evolving rapidly, for example, as insurers have to master big data to design protection against new threats, such as climate risks or cyber risks. At the same time, they have to provide innovative solutions that fit the needs of societies in both ageing advanced economies and emerging market economies. And they are being asked to strengthen their support for growth and jobs by supplying the long-term credit from which banks are retreating.

To meet these challenges, insurance firms must be able to count on a coherent regulatory framework that matches their business model rather than being derived from banking rules. This need not mean less regulation but it does demand a framework based on an in-depth understanding of the economic role of insurance in modern societies.

Insurance firms play an essential role in managing risks and protecting firms and people – and they have a clear long-term orientation that is focused on sustainability. Regulation should support that role. ■

Solving financial fragmentation within the EU

Slavka Eley - Head of Home Host Coordination Unit,
European Banking Authority (EBA)

Prior to the financial crisis banks took advantage of the single EU banking licence to extend their business across borders, putting capital to work with allocative and operational efficiencies. Mergers and acquisitions saw the creation of several large truly European banking groups and, over the course of a decade, state dominated banking systems in Central and Eastern Europe were transformed into market functioning banking systems.

The financial crisis has impacted cross border banking in sometimes unexpected ways. The greatest ex-ante concern was that "foreign" banks would simply "cut and run" during difficult economic times. Possibly thanks to initiatives such as Vienna 2, this risk appears limited within the EU. Instead, the imposition of national ring fencing, at times uncoordinated and occasionally unwarranted, has been a focus of concern. Whilst robust supervisory actions to strengthen a banking group are needed, ring fencing raises concerns including:

1) uncoordinated supervisory measures which may impact other markets without proper mitigation actions being put in place, hence risking a "tit for tat" regime of ever increasing national measures;
2) unilateral action by one national supervisor, especially if not related to the risks posed by that group, which can impact the allocative efficiency of capital and liquidity resources within a banking group with unintended consequences.

The EBA has sought to raise, and mitigate, these concerns using all tools at its disposal, for example:

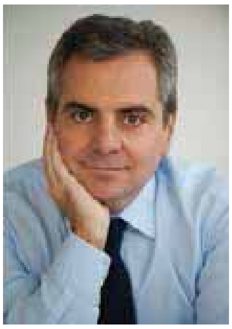
- promoting effective ex ante coordination and discussion of specific national measures to ensure proper planning and understanding amongst home and host supervisors;
- putting colleges to the fore of discussions about measures banks should take to strengthen their capital positions following the EBA's 20111 capital recommendation ensuring that those measures were agreed by all relevant supervisors;
- actively mediating where disagreements exist in the supervisory treatment of cross border banking groups;
- developing the Single Rulebook and a common approach to supervisory risk assessments to promote informed supervisory discussion on how to address possible banking risks.

The EBA will continue its efforts to promote a Single Rulebook and common supervisory culture, for example rolling out the common SREP Guidelines in 2015 and working with both supervisory and resolution authorities in colleges of cross border banking groups to ensure full and effective discussion and joint decision making. While welcoming the establishment of the Single Supervisory Mechanism (SSM), the EBA remains mindful that it will need to play an even greater role on supervisory convergence and cooperation across the EU.

Most cross-border banking groups will in fact continue to have operations both within and outside the Eurozone and as such will continue to make joint supervisory decisions in EU colleges. Hence, the role of the EBA will be fundamental to reduce the risk of further financial fragmentation in the EU single market. ■

Revitalising the market for securitised loans in the EU

Dario Scannapieco - Vice President, **European Investment Bank (EIB)**



SME securitisation is still suffering from the economic and financial crisis. The near-collapse of the European structured-finance market during the crisis has profoundly affected SME securitisation in Europe.

Since the end of 2011, the outstanding volumes have decreased by around one third and reached a level of EUR 174bn at the end of 2013. Compared to the US where securitisation has reached a market volume of EUR 2.2 trillion last year, the European market is comparably small and characterised by a high degree of uncertainty.

What can be done to revitalise the securitisation market? A first important step towards restoring investors' confidence in European ABS is to remove misalignments of interests and information asymmetries between issuers and investors, including greater transparency to ensure the accurate pricing of credit risks. Several financial regulations as well as a number of public sector initiatives in the EU have been implemented recently to address this concern.

However, there are a number of remaining structural roadblocks that should be addressed. In this context, it is crucial that public development banks, the European Commission and European agencies engage in a close dialogue with regulators, both in response to public consultations as well as on a bilateral basis to ensure that the capital requirements framework is consistent with the quality of the assets it applies to.

A particular focus should be put on the promotion of simple structures and well identified, transparent underlying asset pools with predictable performance ("high-quality securitisation") in order to revitalise the securitisation market.

One initiative which the EIB Group has launched recently to contribute to the revitalisation of the securitisation market is the EIB Group Risk Enhancement Mandate (EREM) which aims to further enhance access to finance for SMEs and small midcaps by providing a range of targeted capital market instruments, including ABS credit enhancement. Under the umbrella of this initiative, the EIB Group provides credit enhancement for senior and mezzanine tranches of securitisation backed by SME loans, including guarantees. ■

What is needed to launch a large and deep EU securitization market especially for SME loans?

Jonathan Faull - Director General, DG Internal Market and Services, **European Commission**

In the current context of funding constraints in Europe securitisation is an important instrument bridging banks and capital markets.

As indicated in its Communication on long-term financing, published in March 2014, the European Commission actively supports the recovery of safe and sustainable securitisation markets in Europe, including SME asset backed securities (ABS).

EU authorities and the private sector have already taken many concrete actions to enhance investors' confidence. Despite these actions, there is no substantial recovery of this market so far. Further efforts should therefore be made.

In Europe there is now a broad consensus to develop a prudentially sound and operational distinction between the different types of securitisation instruments. Not all these instruments are the same. For that purpose, a number of initiatives have been launched at EU level.

The primary objective of these initiatives is to identify high quality securitisation instruments. A detailed list of potential identification criteria is under discussion, notably in the insurance sector. These criteria mainly concern i) the structural features, ii) underlying assets and related collateral characteristics, iii) listing and transparency features and iv) the underwriting processes of these instruments. This approach appears promising and the Commission is exploring the possibility of incorporating such criteria in EU legislation.

In addition, securitisation may help in alleviating the financing situation of SMEs as it may allow banks to refinance their exposures to SMEs, freeing additional funding capacities to generate new loans. Our initiatives will contribute to the development of securitisation instruments backed by SME loans/assets in the EU. However, developing this market segment still requires addressing specific technical issues.

One of main hurdles is the absence of standardised and continuous credit quality information on SMEs as there is a lack of third-party assessment for these entities. There is also a significant degree of heterogeneity among underlying assets of SMEs which may generate a bias in investors' perception. Indeed SMEs loans may be seen as riskier than other asset classes. In this context, all initiatives from the private sector – such as discussion at EUROFI level - may help to overcome these difficulties and to develop EU-wide SME ABS markets. ■

Beyond the regulatory aspects of securitization

Delphine d'Amarzit - Assistant Secretary, Financial Sector Department, Directorate-General of the Treasury, **Ministry of Economy and Finance, France**

Much has been said about regulatory changes needed to develop a European securitization market. In this respect, the recent regulatory initiatives, including the latest drafts of the Solvency 2 and LCR regulation circulated by the Commission, constitute a very interesting first step by stating several principles to define a "high quality securitization". While defining and establishing high quality standards with appropriate regulatory treatment is essential to allow the development of a sound, safe and transparent securitization market, these changes might not be enough on their own to get the market off the ground.

Beyond the regulatory aspects, operational aspects also have to be considered. In particular, securitization requires specific IT infrastructures that some banks may still be lacking.

The development of information disclosure requirements, imperative to foster a transparent market in which investors conduct their own due diligence, can compound this issue. Since such IT investments take time, these operational features may in practice constitute a real bottleneck in reviving the securitization market. Such issues should be addressed by banks as early as possible in order to avoid "show-stoppers" and unnecessary limitations of market potential. Clear communication and predictable processes will be key in this regard, so that banks see for themselves the benefits of investing in their IT systems.

Moreover, the economic equation for securitization is not always clear-cut. Due to inherent internal and external costs, securitization may be relatively expensive compared to other funding options. More fundamentally, the economics of securitization requires that the underlying assets cover these costs and a fair remuneration of the risks taken by the investors, whose baseline funding cost and benefits associated with the loans are different from those of a bank.

Regulatory aspects matter, and we fully support the current international and European initiatives. But other operational aspects also deserve our attention, if we do not want them to become the next roadblock. ■

Securitisations, part II: The devil is in the detail

Carlos Montalvo Rebuelta - Executive Director, **European Insurance and Occupational Pensions Authority (EIOPA)**

European securitisations keep suffering from the bad reputation they acquired during the financial crisis 2007-2009. At the same time, the real economy in a number of European countries is faced with a difficult funding situation. In view of these two factors, a number of initiatives have been started to facilitate investments in securitisations. One of them is the idea to create a specific category of securitisations by formulating a number of criteria on structural features, underlying assets, transparency etc. and to introduce a regulatory treatment that reflects such features (e.g. via lower capital requirements).

Given the large differences that could be observed in the risk profile of securitisations, a more granular approach is clearly justified, and EIOPA fully supports the taken initiatives. But to ensure a successful outcome a number of prerequisites have to be met:

First, the capital requirements have to be commensurate with the associated risk. Neutrality with regards to all assets in terms of risk/capital charge ratio is a precondition for sound regulation.

Second, given the potential utility of securitisations there might be the temptation to expand the scope of qualifying securitisations by relaxing criteria. It is important to ensure that the risk profile of qualifying securitisations is really lower. After investors "burned fingers" during the financial crisis, it will be difficult to raise again renewed interest in this asset class. Policymakers as well as market participants, both from the supply and demand sides, have to get it right this time; otherwise we all together might be contributing to another disappointment, which we cannot afford. If we fail, we will not get a third chance.

Third, the introduction of a category with the better risk profile and the very strong political support for the asset class should not result in complacency by investors. There is still the need for due diligence. Blind trust in a category is as undesirable as blind trust in external ratings. Didn't we see enough of it in 2005-2007?

Fourth, a balance has to be found between the risk sensitivity of an approach and the costs of its implementation. Higher granularity may result in a better reflection of risk, but it will also increase complexity. In a similar vein, more principle based criteria promise a more nuanced assessment but introduce ambiguity.

It takes these four steps to succeed, but the reward of doing so is certainly worth it. What is stopping us to do it, and most important, to do it right? ■

Creating a well-functioning securitisation market in the EU

Lars Overby - Head of Credit Market and Operational Risk Policy Unit, **European Banking Authority (EBA)**

A well-functioning and prudentially sound securitisation market in the EU would strengthen the resilience of the financial system by providing an alternative funding channel. Furthermore, it would provide a useful tool to effectively transfer credit risk and accomplish risk-sharing in the financial system. Both aspects would enable banks to better perform their crucial role of supplying credit to the economy.

Capital requirements on securitisation structures should be calibrated in such way that they cover the risks and potential losses stemming from such instruments. It is important to keep in mind that the securitisation process itself generates additional risks, most notably model and agency risk. Hence complete neutrality between the capital charges for underlying assets and those for the corresponding securitisation exposures - i.e. same assets in a securitised format - is neither prudent nor desirable.

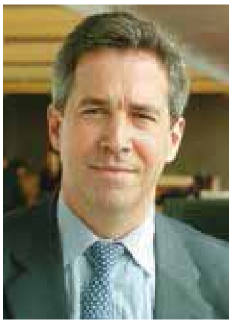
The risk introduced in the securitisation process may also differ depending on the transactions. For instance, simple, standard and transparent securitisation transactions with certain desired risk characteristics on the underlying assets could reduce the modelling risk and the asymmetry of information between originators and investors. Identifying these characteristics would at least provide more investor confidence in securitisation products.

The EBA is currently undertaking a review of the EU securitisation framework, the results of which will be submitted for public consultation later this year. This work will provide relevant input to whether and how to grant regulatory recognition to simple, standard and transparent securitisations. So far, the prudential framework has followed a one-size fits all approach, with no differentiation across segments of the market.

While this might have adversely affected the development of safer and sounder forms of securitisations, it should also be noted that any differentiation in the prudential treatment has the potential to trigger regulatory arbitrage. This risk may not be particularly pronounced at the moment, but as history tells us, such regulatory arbitrages are likely to occur in periods of risk complacency. ■

A consistent policy framework can help to boost Europe's securitisation market

Spencer Lake - Group General Manager and Global Head of Capital Financing, **HSBC Bank plc**



Europe needs a well-functioning, liquid ABS market to address a funding gap resulting from reduced banking sector capacity following post-crisis reforms and to allow risk transfer from banks to the institutional investor market.

A robust framework for high quality or 'qualifying' securitisations should focus on aligning incentives between originator and investor, notably risk retention requirements; on originators providing transparent, comprehensive, consistent and regular information so investors can analyse and monitor the risks; and removing disincentives to buy-side participation in the market that may result in asset allocation distortion, increasing asset-liability mismatches.

Risk retention and data disclosure are already addressed in existing rules. More alignment is needed between prudential rules and initiatives aimed at reviving investor demand for ABS.

Changes proposed to the composition of the LCR buffer to include certain ABS would bolster demand and promote secondary market liquidity. More important is increasing buy-side participation in 'qualifying' securitisations. In 2013, insurers and pension funds accounted for only 10% of investors, indicating a major source of untapped capital – a result of punitive requirements under Solvency II. Even with recently proposed improvements, capital charges for ABS would remain high, linked to an overstatement of the risk associated with the long-term liability structure. Tax incentives should also be considered to broaden the institutional investor base.

Bank capital requirements also need recalibrating. Despite proposed changes, these remain punitive, particularly when considered against the strong historical performance and low default rates of the European ABS market.

Another challenge is to wean banks off central bank funding, which does not address fundamental impediments to SME lending – a key policy objective – and redirect them towards capital markets. SME loans present challenges due to lack of standardisation, lower credit profile and lack of historical default data – hence the involvement of the EIB and EIF in supporting SME securitisations. Development and promotion of a functioning securitisation market, alongside creation of an EU credit registry, could be significantly more effective in stimulating SME lending. ■

How to revive the market for securitised loans in the EU

Philippe Bordenave - Chief Operating Officer, **BNP Paribas**

More than 70% of the European economy is financed by banks. Even more so in the SME sector where banks are and will remain essential. After several years of forced deleveraging due to new regulations, it is fundamental, to enable an adequate financing of the economy, that prudential rules impacting bank loans are stabilised. Complementarily, it is also important to favour the development of securitisation. To achieve this purpose there are four key conditions.

At first, regulation should not introduce penalties against securitisation. For capital requirements, issuers should be encouraged to use quality pools and investor-banks to invest in high quality securitisations (HQS). At the moment, Basel proposals imply a capital multiple for holding all tranches of securitized loans compared to the underlying pool, thus deterring issuers, and the floor is too high, thus deterring investor-banks. For liquidity requirements, banks should be able to include HQS as "High Quality Liquid Assets" in their liquidity coverage ratio. Insurance companies should be incentivised to invest in senior tranches; instead, Solvency 2 pushes them to invest directly in the underlying pool, a riskier proposition.

Second, an appropriate skin in the game with a sufficient retention rate should be foreseen to avoid repeating past errors of the subprime activity where originators had no incentive to originate good credit. For the same reason, HQS label and benefits should be reserved for originators that are regulated and follow responsible lending practices.
Third, reliance on rating agencies should be diminished. The crisis showed the inefficiencies of external ratings, especially in Europe (sovereign ceiling issues) and for the SME sector (methodological issues). In the US, the Dodd Franck Act removed external ratings in a regulatory context, whereas European regulations are reinforcing the role of ratings, contrary to the wishes of the G20. An alternative to external ratings developed by the banking industry with inputs from BNP Paribas exists: the Conservative Monotone Approach (CMA).

Last but not least, to reduce further and sufficiently the balance sheet of European banks, securitisations of residential mortgages and consumer credits should be encouraged. To do so, a form of government sponsored guarantee should be provided. In the US, guarantees from GSEs enable large scale securitisations; a similar guarantee mechanism from a European institution would lower the cost of financing and bring confidence to investors. ■

Asset managers ready for secure securitizations

Yves Perrier - Chief Executive Officer, **Amundi** & Member of the Executive Committee, **Crédit Agricole S.A.**

Securitization is one of those words that people try not to use any longer. It refers too much to excessively complex structures that enjoyed top class ratings and failed. Financial crisis and securitization have been assimilated, on the dark side of the shadow banking.

This perception must change. First, the experience of securitization in Europe is not as bad as on the other side of the Atlantic Ocean, probably more because the market was less mature than because European actors had higher ethical standards. Second, there is a need to develop off bank's balance sheets financing and, third, institutional investors are looking for a good risk /return profile and asset managers want to supply them with new secured investment solutions. Securitization can help to achieve these goals.

In order to attract investors, securitizations must at least offer three characteristics:

- The structure must be safe and understandable: on one side it implies that legal and financial teams are not too innovative and do not go too far in the "optimization" process; on the other side the link to the real economy has to be evident so that the investor can understand the purpose of the financing and the economic reasoning behind the structure;
- The credit risk can be easily assessed : the investor must be in a position to gain a clear view of the risk stemming from the underlying loan portfolio; for that purpose our analysts require a large access to information, more and more at the level of individual loans; it is particularly so for SMEs loan portfolios where statistical approach of diversification has to be accompanied by an analysis of individual situations;
- The price has to include a premium for lack of liquidity: securitization is largely a buy and hold market; price must show a premium that will benefit to investors that are ready to take a longer term view.

Eventually, securitization is a good tool to finance SMEs or more globally the economy and should expand, provided that investors are not prevented by excessive regulations from taking some risk. Amundi has developped an expertise in this specific asset class. ■

Revitalising the EU securitisation market: turning wishful thinking into reality

Deborah Shire - Head of Structured Finance, **AXA Investment Managers**

As key long-term investors holding €8.6tn of assets under management in 2013, EU insurers welcome the increase in momentum on long-term financing and most particularly the ECB's appeal for a better functioning securitisation market. Given that their long-term liabilities enable them to hold long-term assets that support the real economy, insurers are indeed ideally placed to invest in high-quality securities, the most promising instrument to provide new funding sources for businesses in the Single Market.

Regulatory obstacles are important. High Solvency II capital charges for securitisations act as a barrier to a well-functioning securitisation market in the EU. Recent developments point in the right direction as the approach of separately identifying "good quality" (i.e. "qualifying") securitisations is needed and welcome, but the definition of the high quality "Type A" is restrictive and the calibrations proposed are too high.

Regulators should rather adopt a principle-based approach around three pillars: (i) the underlying pools of assets should be homogenous, granular and have measurable risk profiles; (ii) securitisation structures must be simplified and standardised; (iii) transparency obligations should complete the framework. Compliance with such principles for "qualifying securitisations" should be checked and assessed by an independent, private or public body and could be rewarded by the granting of a label, which could become compulsory and delivered before any new issuance.

Such harmonized standards and improved data availability would ultimately make the asset class more attractive for investors. A qualitative approach also carries the benefit of not discriminating against non-senior tranches of high-quality securitisations, in accordance with the ECB view that a quality designation should apply to all tranches.

Other important steps could be taken to revive securitisation. A more liquid secondary market would for example limit cases of balance sheet volatility and thus increase the attractiveness of securitisations. Price volatility could also be reduced via the implementation of an effective market making and of specific liquidity crisis solutions, or even via a "last recourse buyer" with specific programs (such as the asset purchase program in the US or the program on European Covered Bond).

Market participants agree with public authorities that a well-functioning securitisation market would be a fundamental asset to strengthen long-term financing and growth in the EU. It is now high time we convert this unanimity into concrete actions. ■

Finetuning regulation could harness securitization for Europe's economy

Neeraj Sahai - President, **Standard & Poor's Ratings Services**

A well-functioning, transparent securitization market could help boost funding to the European economy. S&P's recent research on global banks shows lending capacity is more constrained in the Eurozone than almost any other part of the world.

However, European banks have made very limited use of securitization in recent years to transfer economic risk and free up capital for more lending to SMEs and other businesses.

For securitization to serve as a viable, large scale mechanism for funding the real economy, regulation will likely have to evolve. A number of proposed changes to banks' and insurers' capital and liquidity requirements treat securitizations unduly conservatively, we believe, relative to their historic credit performance and compared to other asset classes such as covered bonds and whole loan portfolios.

For example, in proposed revisions to the Basel securitization framework, the risk weight for a typical AAA-rated tranche is up to eight times higher than under current regulations. And in the latest draft calibration of Solvency 2, insurers investing in a AAA-rated securitization would incur capital charges that are more than 17 times higher than those for a similarly-rated covered bond.

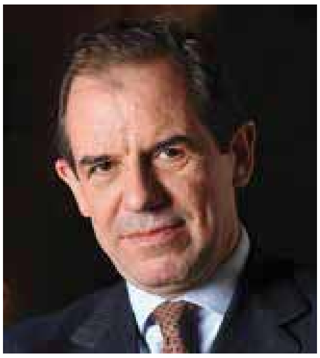
Counter-intuitively, an insurer holding a AAA-rated commercial mortgage-backed security could require more than four times as much capital as another insurer holding the same portfolio of mortgage loans backing that security but without any credit enhancement.

Risk retention rules may also be hindering certain segments of the securitization market. They are a particular burden, for instance, for collateral managers in leveraged loan CLOs, as few have the balance sheet capacity to retain significant portions of the CLOs that they oversee.

Hopefully, the ECB and Bank of England's focus on defining "qualifying securitizations" could be a step towards levelling the regulatory playing field for simple, transparent securitisations and reviving market demand for them. ■

Revamping the SME ABS market in the EU: time is crucial

Giovanni Gorno Tempini - Chief Executive Officer, **Cassa Depositi e Prestiti Group (CDP)**



After two years of talks, the SME ABS securitization market in the EU may finally take off. The ECB in June gave a clear message that it is time to move. To be successful, however, each of the main actors (regulators, policy makers and the market) need do their part, possibly fast.

Two general conditions seem to be crucial. First, the model originate-to-distribute, which had characterized the pre-crisis securitization, need to be simplified and better regulated.

The practice of excessive slicing and repackaging of loans into ABS, with too complex and opaque structures, was one of the main reason for the global financial crisis. So the ECB calls for the promotion of simple schemes and well identified and transparent underlying asset. At the same time, the FSB has adopted new strategies to ensure a more transparent and resilient shadow banking system, of which securitization markets are a key building block.

Second, from the point of view of capital charges, regulators should create so called "condition of neutrality", which means that capital charges for holding on the book a loan have to be at least equivalent to the ones required for holding a tranche of junior notes – skin in the game.

Capital treatment for AAA ABS was risk weighted 5% after the crisis (and this was one of the reason for the subprime bubble). It was proposed to be increased to 20%, which contributed to drain the securitization market after 2008. In December 2013 it was suggested to be brought down to 15%. Still too high. A similar problem – as EIOPA keeps stressing – strongly limits the insurance companies as major ABS investors.

According to recent estimates by Bruegel Institute (2014) the potential EU market for ABS is worth roughly €3 trillion, of which €1,6 of RMBS (Real Estate Mortgage Back Securitizations), €1.1 of large NFC (Non-Financial Corporations), and 325 bn of SME ABS. They are, indeed, very large volumes. However, if the process ought to be successful – both for the unlocking the Eurozone credit markets and for enhancing the ECB monetary policy stance - time is crucial. Regulators, policy makers and the market, should make an extra effort to set the right conditions now. ■

Building securitisation markets to last – The way forward

Greg Medcraft - Chairman, **Australian Securities and Investments Commission** and Chairman, **International Organization of Securities Commissions (IOSCO)**

Securitisation markets globally have contracted significantly since the Crisis of 2007-2008.

Recovery has been slow with revival limited to some geographic and product markets. Revival is now evident in US markets, in parts of Europe and in the Asia-Pacific – but not to pre-Crisis levels. Cross border activity has also fallen away.

Activity has been largely in structurally simple, easy to understand homogeneous asset classes.

A recent survey undertaken by an IOSCO-BCBS Task Force on Securitisation Markets (TFSM) (led jointly by David Rule from the Bank of England and me) sheds light on why investors and issuers have been slow to re-engage in these markets.

Put simply, investors lack confidence in securitisation as an investment class.

The Crisis-generated negative perception of securitisation as an asset class has lingered. Concerns about the impact of regulatory reform, uncertainty about when reforms will be implemented and what they will involve, and the absence of a level regulatory playing field with similar asset classes, have together also played a role. Investors – and particularly non-bank investors – have found the risk return profile they are looking for in other, better priced asset classes.

What steps can we take to help revive securitisation markets which last?

An active and urgent response to this question is critical. Industry, and particularly the SME sector, are increasingly turning to the capital markets as an alternative to funding from the banking sector. I passionately believe securitisation is a technology which can deliver financing solutions. It has done so very effectively in the past. It can – and will – do so again.

The key to revival is about restoring – and maintaining – investor trust and confidence in securitisation as an investment class.

As investors – and non-bank investors in particular – told us in the recent TFSM survey – this trust and confidence is more likely to come with a reduction in product complexity, with improved disclosure and standardization. These features will help investors to better understand and assess with confidence and ease the risks (be they asset, structural, fiduciary or liquidity risks) and returns of the products they are offered.

The Official Sector has a role to play by working with investors and issuers to define the features or criteria of those securitisations which will lay a foundation for restoring trust and confidence. We in the TFSM are working to develop these criteria around what we are describing as simple, transparent and consistent securitisations.

Consultation on our work later this year will be an opportunity for industry to provide input on these ideas. I encourage industry to support this work by participating in this consultation. ■

Time has come to revive a sound and safe securitisation market in Europe

Jacques de Larosière - President, **EUROFI**

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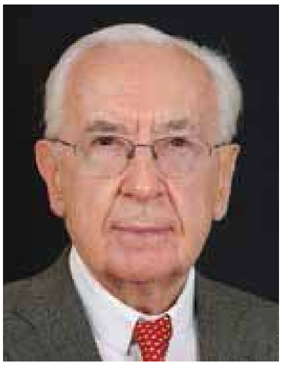


Relaunching the securitisation market nevertheless requires strong actions in order to restore sufficient confidence among investors and policy makers. This requires offering investments that are not only transparent and predictable, but also positioned on assets with a low exposure to asset bubbles, or to economic contingencies.

Consequently we are suggesting creating a new category of securitisation – a prime high-quality securitisation (PHQS) – based on loans to very high-quality SMEs and subject to requirements both in terms of securitisation process and of choice of underlying assets.

For this, we propose to renouncing the dangerous practices that developed before the financial crisis by creating products that are structured with a simple, transparent and demanding approach making it possible to eliminate potential legal risks, align the interests of the originating banks with those of investors, and also eliminate the risks associated with the modelling approaches implemented for structuring these products.

We propose to restrict securitised assets part of this new category, to loans to high-quality SMEs, conforming with a criterion (companies with a three-year default rate of less than 0.4%) stricter than the one set by the European central banks for accepting them as security for refinancing operations. We indeed assume that it is essential that the quality of the underlying bank loans be unquestionable.

Checking the quality of the businesses benefiting from the bank loans is a key point within this approach. It requires a common methodology under the control of the central banks, to be defined. Some central banks of the Eurosystem have already the capacity to rate SMEs. Those that do not can rely on different instruments (banks' internal models, external agencies..) to achieve the same results.

In addition, the potential investors for this type of product - insurers, pension funds, funds, banks - must be able to participate in such a market. For this, as stressed by the EIOPA, their regulations must be calibrated based on the specific risks associated with these very high-quality assets, which have nothing in common with the financial products that were behind the financial crisis.

Consequently the current proposal for delegated acts under Solvency II, which would otherwise compromise their economic viability, should take into account the risks relating to PHQS-type securitisations. Provided that very strict requirements are set we believe that PHQS should be required a regulatory capital charge similar to the level that would be applied for the underlying assets they hold.

Similarly, Europeans must take into consideration the quality of these PHQS in the new regulatory approaches defining the capital charges required for banks investing in these securitised SME assets, being calibrated by the Basel Committee - BCBS – that currently would be around 7.5 times higher than the levels applied for unsecuritised assets of the same quality.

Given the dire situation of their economy, Europe's legislators and regulators need to implement the measures enabling the PHQS offer to develop, now. ■

EU corporate bond and equity markets

Maximising the potential of European SME Growth Markets to deliver growth and jobs

Luca Peyrano - Head of Continental Europe – Primary Markets, **London Stock Exchange Group**

A platform to help SMEs to prepare and structure for external investment coupled with a more diverse range of funding sources is needed to support the growth of Europe's 22 million SMEs. On the one hand, SMEs often lack enough aspiration, confidence or understanding about growth financing strategies and need help to make themselves attractive to investors; on the other hand, debt and equity finance work together but debt on its own is often not suitable for SMEs as they may not be able to meet interest payments, require significant capital prior to revenue generation or lack credit-worthiness.

Therefore, two policy priorities are key parts of the solution:

1. Support for SMEs to transition up the funding escalator

The Commission has identified growth coaching programmes, such as Borsa Italiana's ELITE, as a model which can be tailored to individual member states and to help SMEs to transition up the funding ladder.[1] ELITE is neutral with respect to financing outcomes and measures its success through business growth not the number of IPOs. The Commission has committed to producing an assessment of best practices on helping SMEs access capital markets and their work deserves to be acted upon by policymakers alongside the Commission-backed European IPO Task Force, reporting later in 2014.

At the same time, action is needed to re-catalyse SME advisory ecosystems of issuers, investors, advisors, entrepreneurs, academics and innovation centres. As they grow, SMEs use a mix of bank finance, seed capital, business angels, venture capital and public markets. Each type of funding depends on each other, as they must be confident that they can exit their investment to reinvest in the next generation of entrepreneurs. Helping such ecosystem understanding the "equity chain" is crucial to secure a more efficient mechanism of capital allocation.

2. A tailored regulatory and fiscal regime for SME Growth Markets

The new SME Growth Markets under MiFID II should be supported in the 2015 Prospectus Directive review, to make it easier for SMEs to access a wider investor base at lower cost. There are at least 15 equity markets across Europe tailored for SMEs, home to 1700 companies valued at €180bn. Producing a prospectus imposes high costs, so this requirement should be abolished for certain classes of SME issues (e.g. secondary issues).

Moreover, boosting the post IPO profile and liquidity of SMES is key to reducing the cost of capital. Incentives are needed for brokers and others to produce research and the ability to disseminate it, especially to retail investors – who should not be dissuaded from backing growth companies by regulatory or conduct of business barriers.

Finally, the Commission should assess the impact on the cost of capital of the tax bias against equity. Tax has a critical impact on investment (equity is taxed four times, debt is tax deductible) so a Commission assessment would inform national fiscal decision making. ■

1. European Commission Communication on Long Term Financing of the European Economy, March 2014, section 5 page 11

Deepening EU regulation to promote capital market corporate financing

Gérard Rameix - Chairman, **Autorité des Marchés Financiers (AMF)**

Capital market financing is growing and currently accounts for circa 30% of corporate funding in Europe. This trend is expected to continue due to prudential constraints, deleveraging and reshaping of the banking model. After the post-crisis regulatory agenda focused on transparency, robustness and resilience, there is a clear trend towards initiatives dedicated to consistency of sectoral rules, growth and sound long-term financing.

In the field of equity, while some true improvements (visibility, passport) might ensue from recent initiatives such as ELTIF or EVCF and SME Growth Market labels, the European legal framework should go one step further in setting proportionate requirements for SMEs, especially with regards to prospectuses and financial information. Corporates might benefit from a better integration of marketplaces in Europe; however such evolution remains contingent upon competitors' initiatives. We also have to carefully assess the impact of the new inducements' regime to avoid the emergence of a two-tier financial analysis, which would have a direct impact on the issuers' ecosystem. Furthermore, any desirable reform of the existing tax bias in favour of bonds would require unanimity of Member States.

Corporate debt markets have been expanding for the past few years but did not really act as a catalyst for issuance and trading practices. In the primary markets, a higher degree of standardisation of issuance contractual terms for bonds and private placements could be an interesting path to explore. The high yield segment is dynamic in a low interest-rate environment and does not really need specific incentives. In the secondary markets, there is still room for improving banks' involvement so that transactions take place on transparent venues ensuring a more reliable price formation mechanism.

On the governance side, it is also necessary to enhance regulatory convergence in the interpretation and enforcement of rules as well as in regulators' operational practices. In that respect, ESMA's standing committees play a crucial role in building this common culture and policy. ■

Nordics market dialogue serves SMEs well

Magnus Billing - President, **NASDAQ OMX Nordic**

In 2013 NASDAQ OMX Stockholm launched an IPO Task Force, after a year-long dialogue with market participants about what could be done to ameliorate the listings climate in Sweden.

The work came to focus on SMEs, which the group identified as the main providers of potential growth and job creation going forward.

All of the measures recommended by the Swedish IPO Task Force within the control of the exchange have been implemented, with encouraging results. A number of identified actions to improve conditions for SMEs' possibilities to raise capital on public markets still remain to be effectuated. One example is putting in place meaningful incentives for investors to take risk in SMEs in the long term. Simultaneously, the macro climate has improved in parts of the Nordic region. These factors combined contribute to the fact that NASDAQ OMX as per the end of Q2 enjoys the second place in numbers of listed companies in Europe.

The IPO Task Force initiative rapidly grew to encompass other Nordic markets. Interestingly, but perhaps not surprisingly, SMEs remained in focus.

The Danish and Finnish IPO Task Forces also identified multiple initiatives, including a set of new best practices for the listing process, tailor made prospectus for smaller companies and an optimized approval process at the FSA. There has also been a focus on incentivising investor attention on SMEs, increased analyst coverage and a push to improve liquidity in SMEs.

I am currently discussing our findings also at European level, in particular as a member of the European IPO Task Force, recently set up by FESE, European Issuers and EVCA. Possibly, some of the findings may serve as inspiration beyond the Nordics. One example is incentivising analyst coverage of SMEs. Such measures are important and could potentially have great effects on the visibility of and investors' attention on SMEs.

NASDAQ OMX will continue its broad dialogue with market participants, enlarging the scope of questions raised in order to improve and develop SME equity markets. ■

Stimulating corporate bond and equity markets: the Italian experience

Giuseppe Vegas - Chairman, **Commissione Nazionale per le Società e la Borsa (CONSOB)**

Since 2000, as a reaction to corporate scandals and financial crises, legislators all around the world have given in to the temptation to over-regulate. A single-rule book, consolidating the European directives and regulations on securities markets in a plain language, along with a deeper coordination in supervisory practices over member countries, are now needed. Coordination in supervision would rule out arbitrage over national oversight approaches. The most effective way to do this is to centralize supervisory responsibilities at the European level, creating a financial union, similar to the Banking union.

In order to further develop EU corporate bond markets in Italy "Mini-bonds" were introduced to allow issuance of short/medium term ordinary and convertible bonds by unlisted SMEs. Also in Europe they could be a viable alternative to banking financing for SMEs and a new investment opportunity for investors.

New bank loans to SMEs could be made available by revitalizing the European securitization markets, severely hampered by the financial crisis. Investors' confidence may be rebuilt by enhancing transparency, encouraging the issuance of "plain" ABS, and strengthening the rules on risk-retention by the originators (in line with the initiative of the ECB and BoE).

Moreover, the support of growth in Europe needs a further development of the credit funds sector. Other innovative forms of non-banking intermediation are developing, such as the collection of venture capital on online portals (crowdfunding).

The Italian legislator has been the first to regulate equity crowdfunding and Consob has recently issued the secondary regulation, in this way creating a reliable environment for investors, not too onerous for webmasters and accessible to companies using portals.

To help the development of EU corporate bond and equity markets it is fundamental to fully harmonise the legislation concerning the taxation of financial transactions.

For this reason it is important to speed up the process of enhanced cooperation in this field among eleven European countries in order to achieve the implementation of a common system of financial transaction tax as soon as possible. ■

Towards more market-based financing for the European economy

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

The financial crisis has impeded the ability of the European banking sector to provide the capital that the real economy needs to finance its recovery. We therefore need the capital markets, in particular the equity and bond markets, to step in and bridge a possible funding gap. This has partially been addressed through MIFID II which enhances the transparency of equity and bond markets and introduces the new SME growth markets, which are designed to minimise the administrative burden for issuers in this sector.

However, as the Commission Communication on Long term financing of 27th of March 2014 sets out, further action is required. The Commission will therefore undertake a study to determine whether additional measures are required to enhance the trading of corporate bonds in the EU and facilitate the creation of a transparent and liquid secondary market. By the end of 2015, the Commission will also assess the implications and effects of the Prospectus Directive rules, in particular the disclosure regime for SME issuers and companies with low market capitalisation. And the Commission will explore whether the eligibility criteria for UCITS could be extended to securities listed on SME growth markets. Whether European Long-Term Investment Funds (ELTIF) should be permitted to invest in listed SME's is an area that is being debated in the negotiations on the Commission's ELTIF proposal.

The Commission has therefore set out a range of measures, ranging from concrete legislation to plans to explore new ideas, to enhance the European bond and equity markets. These aim to diversify the way in which investment is financed in Europe and make the capital markets a more effective and resilient conduit for channelling funds to the real economy. ■

Retail investor confidence is the key to European financial markets development

Jean Berthon - President, **Better Finance for all**

According to a study conducted at the request of the European Commission and the FSUG in 2012 by OEE and IODS, the relative weight of foreign investors (including European) in European listed companies almost quadrupled, from 10% in 1975 to 44% in 2012. In the meantime, the weight of households was divided by almost three, from 28% to 11%. But, considering European investors rather than only national ones as domestic, the picture is quite different: at the end of 2011, non-European investors accounted only for 22% of market capitalisation holdings and the share of intra- EU cross-border investments in overall cross-border investments decreased from 48% in 2001 to 43% at the end of 2011, after a peak at 50% in 2004 and 2006.

Some lessons to be drawn from these figures: first, the increase of the weight of foreign (including European) investors since 2001 is only the fact of non-European investors which perhaps demonstrates the failure of the single market.

Worse, the share of direct investment by households collapsed, despite the privatization campaigns, due probably to strategies of key market players which prefer to channel savings towards investment funds or structured products much more remunerative to them but far less attractive to individuals.

Another cause of these problems, are the barriers to shareholder engagement that were reported in the study published by EuroFinuse in 2012.

So if we consider that more integrated European financial markets and more cross borders detention by European should be favoured, because of the increasing role of financial markets in the financing of our economies, it is necessary to develop the single market approach by harmonizing rules and taxes, to restore individual investors confidence by facilitating the access to capital markets for retail investors, suppressing the financial transaction tax, limiting or banning HFT and removing the barriers to shareholder engagement. ■

A TLTRO especially dedicated to infrastructure: A proposal

Franco Bassanini - President, **Cassa Depositi e Prestiti Group (CDP)**

The ECB has recently launched the TLTRO as a new line of liquidity earmarked for medium-term bank financing to the real economy. The liquidity injected in the economy is expected to be great and the effect on the economy is supposed to be positive. The risk of a "improper" use of the facility by banks, i.e. "carry trade", is probably not high thank to the strict "by laws" set by the ECB.

According to the guidelines published by the ECB, the infrastructure sector is eligible for bank loans financed through the TLTROs liquidity. This is very important, since infrastructure have great potential to foster the process of structural adjustment and growth in the Eurozone.

An "Infrastructure-Targeted Longer-Term Refinancing Operations" (ITLTRO) could then be also introduced. It would be characterized by longer maturity (more in line with the horizon of infrastructure projects and therefore able to reduce the refinancing risk and the uncertainty about the pool of financing institutions), specific mechanisms to reduce capital absorption (i.e. guarantee schemes), and reduced haircut on collateral (so as to unfreeze more liquidity).

Long-term Investors (LTIs) – like the Promotional Banks (PBs) of the Eurozone – would be the ideal candidates to be admitted to the measure, due to the nature of their business model, featuring a typical attitude for infrastructure financing.

PBs can ensure the effectiveness of the measure (liquidity will be totally transferred to the firms) and its enforcement, due to their monitoring activity based on bank-firm contracts. If PBs would be admitted to the facility, ECB would be exposed with counterparts (PBs) with creditworthiness higher, on average, than commercial banks. Commercial banks should be also admitted to avoid market distortions. The measure could be established as a direct lending facility and not as a second floor (i.e. intermediated) tool. The BCE may also introduce a special "track" for collateralized TEN-T, TEN-E and CEF initiatives and/or for those co-financed with EIB loans or Euro Project Bonds. ■

European priorities for long-term investments

Alessia Mosca - MEP, **European Parliament**

Long-term investments are central to economic growth and to the creation of jobs, and they are essential for the start and successful implementation of major projects in key sectors for our development, such as infrastructure and research.

Unfortunately at the moment the system of long-term financing is totally lacking, for several reasons: firstly, because of the global financial crisis and the sovereign debt crisis in the European Union, the European financial sector has been unable to converge savings towards the needs of long-term investments. Limited public finances, then, have prevented the member States to invest in infrastructure. In addition, both private investors and institutional ones still suffer a significant lack of confidence and high-risk aversion. Finally, the heavy dependence on commercial banks for the financing of long-term investments excludes many SMEs, the true backbone of the European economy, from accessing to credit.

The actions to be implemented in this new legislature to reverse this trend and facilitate long-term investments are various: first of all, on the regulatory side, you need to solve the current fragmentation of the bankruptcy codes in force in the Union, which often discourages cross-border investments and limits investors' capability to recover their money in case of failure of a project. So: certainty of the law. In this sense, it will be a great help when the Banking Union will be completed.

We need, then, to find new sources of funding to supplement those provided by commercial banks and fill the funding gap for SMEs. One possibility is the expansion of national and regional development banks, which may, among other things, be a valuable stimulus to private investment.

Finally, in this list of proposals with no claim to completeness, I should mention the TTIP: I believe in fact that this agreement, as well as other trade treaties that EU is signing with major economies in the world, will bring significant investments that will give oxygen to our economy. ■

Solvency II calibration for infrastructure will not allow significant involvement by insurance companies

Xavier Larnaudie-Eiffel - Deputy Chief Executive Officer, **CNP Assurances**

Infrastructure provides services that are essential to a well-functioning economy. Insurance and pension funds have a role to play in long term investment and growth and should so be participating in financing infrastructure. So it is a key issue that Solvency II regulation helps to facilitate insurance companies to invest in long term assets. However the current proposal for calibrating the capital charge for infrastructure is not favorable to ensure that insurance could be sufficiently involved.

In December 2013 EIOPA released a technical report indicating that calibration for infrastructure is adequate, considering the lack of solid data in the area (historical yields…).Initiated at the request of the European Commission, this document aimed to evaluate the need to revise the standard formula used to calculate solvency capital ratios.

According to the proposed calibration in Solvency II, there is today no specific capital charge for infrastructure (neither for equity or debt): what is asked to Insurance is to implement the capital charge of a similar investment (duration, rating), that does not take at all into account any specificity of infrastructure.

Nevertheless, it is clear that infrastructure investment reduces interest risks for insurers that have long term liabilities linked to retirement products. They also provide higher yields than sovereign debt.

Furthermore capital charge, based on credit risk, essentially linked to rating and duration of the investment, is not appropriate for infrastructure:

- the rating of an issuer essentially reflects its probability of default and does not usually take into account any level of loss in case of default,
- However, if infrastructure loans could face risks that lead to restructuration or losses, they usually show far better recovery rates than corporate issuers of the same ratings.

These key points are not taken into account in today's Solvency II calibration and if this calibration is not reviewed, financing infrastructure by all insurers would be dramatically penalized in the future. ■

Involvement of re/insurers in the financing of infrastructures and implications of Solvency 2

Philippe B. Brahin - Head Group Qualitative Risk Management, Managing Director, Group Risk Management, **Swiss Reinsurance Company Ltd**

The importance of infrastructure investing for economic growth is well recognised. Policy actions are required to accelerate the development of infrastructure as an asset class for re/insurers in Europe. By increasing the pool of investable longer-term assets, the large asset base of long-term investors can be activated. Furthermore, leveraging the expertise and credibility of international financial institutions will help to promote standardization.

With regard to Solvency II, further progress is required in addressing regulatory impediments to long-term investing. The capital rules, notably under the standard formula, have to be more supportive for long-term investing and infrastructure in particular.

The EU Commission is currently finalizing the Solvency II draft Delegated Acts (DAs). An adoption of the DAs by the Commission will be followed by a three months period for objection by Parliament and Council. The DAs are expected to include a clause requiring a review of the calibration of the standard formula within 3 years after its launch.

The review is expected to include a new calibration for the use of long-term infrastructure, taking into account the experience of the insurance industry. EIOPA expressed clear interest to follow up on infrastructure calibration and the industry is keen to work with regulators and policymakers to ensure appropriate treatment of infrastructure investments.

Swiss Re is engaged in many industry initiatives to make infrastructure more accessible to institutional investors: infrastructure investments needs to become an asset class. Key objectives are to increase transparency and harmonization of project pipelines, structures, financing and performance. Further availability of best practices, benchmarking, as well as performance data, are also needed to increase the supply of projects and improve public and private investor confidence in the sector. ■

Helping ELTIFs successfully channel long-term investment in Europe

Massimo Greco - Head of European Funds Business, **J.P. Morgan**

We support the European Commission's long-term growth agenda and see ELTIFs as a tangible and credible step in achieving this policy goal. We believe that institutional and retail investors may find this an attractive alternative vehicle for infrastructure investments.

Infrastructure covers an exceedingly wide span in the risk-return spectrum. On one hand, core infrastructure, i.e. mature assets with established operations and demand patterns, enjoy quite predicatble and stable cash flow streams. Greenfield and development projects, on the other hand, can be volatile as infrastructure projects tend to be large scale, involve complicated engineering works and are unique in the sense that demand forecasting is challenging. Infrastructure assets mature very slowly; it may take a decade or more for a development project to complete its demand ramp-up period and become a core asset. It is also important to highlight that not all development projects produce core assets in the end.

For ELTIFs to successfully meet the financing needs of infrastructure projects as well as investor expectations, it is vital to avoid the impression of liquidity and stability where it does not exist in the development stages of infrastructure projects. Investors need to be aware that they are investing in illiquid assets under development. This also brings into question the suitability of ELTIFs for retail investors and raises important elements of investor protection which are currently subject to debate by European institutions.

Longer duration assets, such as infrastructure equity assets, offer an alternative source of financing. That being said, professional investors would need a more flexible regulatory framework adapted to their particular needs in order to invest in those types of long-term projects. Diversification across either geographies or infrastructure sectors (or preferably both) is one characteristic that mitigates some of the risks of developing projects for the investors. Maturity should also allow for flexibility to avoid forced selling in potentially difficult markets or for the fund to go into "run-off" for a long period before maturity. Ultimately, investors need and seek a stable and predictable regulatory environment – this becomes even more important in the case of illiquid investments, in which the link to a particular jurisdiction is of longer duration.

We understand that the Italian Presidency of the EU Council has made ELTIF a policy priority during its mandate. We look forward to policymakers starting negotiations and continuing to make efforts to find sound and innovative ways to channel long-term investment in Europe. ■

Funding infrastructure for growth – what to do?

John Moran - Board Member, **European Investment Bank (EIB)**
& Former Secretary General, **Irish Department of Finance**

Is the Eurozone heading into stagnation while borrowing costs are at all-time historic lows? Is Europe losing ground on other economies? The OECD forecasts productivity growth in the Eurozone of 1.5% will lag that of the United States at 1.9% over the period of 2014-2020.

Highly indebted governments running primary deficits have limited room to invest despite historically low rates. Current yields suggest rates may already be running ahead of the adjustment process so government priorities must remain structural and fiscal reform. A way of catalysing private sector investment into Europe is therefore be required. Worryingly, recent numbers show a recent retreat of some US investors.

Can anything be done?

With Alberto Giovannini, I had the honour of co-chairing such an analysis for the European Union. The full list of recommendations are set out in our report "Finance for Growth".

Member States and the new Commission and Parliament must now act on these recommendations. Regulatory rules must also be designed not to work against this imperative.

Firstly, capital requires top-class business environments so structural reforms to ensure best practices are adopted by all member states are a key priority. Fewer national differences means less costly local due diligence and thus easier and cheaper capital from outside the EU. An annual due diligence review might even be offered by the EC.

Better funding, also requires better available information – historical information on projects consistently across all member states, a data warehouse tracking covenant performance, a real-time database of infrastructure in planning and procurement phases.

Within Europe, moves can be taken to facilitate the development of new cross border investment funding by creating new pan-European vehicles and also removing national barriers such as taxation or bank lending preferential treatment.

Public procurement practices can also be streamlined and made more non-bank funder friendly.

But finally, let's not waste the finance. No more "motorways to nowhere". The EC, EIB and national governments should work together to establish and communicate national investment plans over a three year horizon with each national plan developed not as a silo but holistically across the EU so that the collective impact of the plans is an even greater improvement in European productivity. The availability of EIB financing and their key role in catalysing capital markets funding could be predicated on convergence with these plans and on progress by national governments in business environment structural reform. ■

Creating the right conditions for attracting long-term investment in Europe

Barbara Novick - Vice Chairman, **BlackRock**

For Europe to unlock the economic potential of long-term financing, we need the right products and regulatory framework to attract private capital.

An important starting point is to recognise the critical role played by asset owners in allocating capital and to develop an understanding of their specific investment needs. Although some believe asset managers have discretion to allocate assets, in fact, the primary control over asset allocation decisions rests with the asset owners – such as pension funds, family offices, charities, endowments, and individual savers and investors – and each of these asset owners have different investment objectives and operate with different regulatory and accounting concerns.

Ideally, regulatory, accounting and tax rules would be aligned to encourage capital to be allocated to long-term asset classes like infrastructure and SME loans. Accounting treatment for pension plans, regulatory capital for insurance companies, and passports for offering funds across borders are just a few of the areas worth reviewing. It is important that asset owners are encouraged to make these allocations through appropriate prudential treatment for long-term assets (for insurers, banks and pension funds), and the right incentives (e.g. investment eligibility and appropriate tax treatment) to invest in vehicles like the ELTIF or the ability to offer non-bank loans to unlisted companies.

Creating new investment vehicles, such as the current initiative on ELTIF, could help channel funding that has already been allocated to long-term asset classes if they are constructed in a way that appeals to asset owners. Additional efficient and specific fund structures that give greater ease of access into specific types of long-term investments – for example, securitisation, infrastructure and non-bank direct lending – should also be encouraged.

Perhaps even more fundamentally, we need to ensure that Europe is generating more attractive investment opportunities by creating contractual certainty and a coherent regulatory framework for the projects themselves to avoid excessively high risk premia, and creating accurate and standardised data to allow asset managers to perform effective due diligence and risk monitoring.

The greater the policy focus on creating a comprehensive framework, the greater investors' ability will be to invest in long-term assets. ■

Diversifying the financing of small and medium infrastructure projects

Odile Renaud-Basso - Deputy Chief Executive Officer, **Caisse des Dépôts**

In the recent years, the long-term funding of big infrastructure projects has been regarded as the main issue, due to their political visibility. However, small and medium infrastructures represent more than 2/3 of the total infrastructure investment and have up to now a limited access to market-based financing. In order to address this gap and diversify the funding sources, a wide array of financial tools has to be investigated, drawing experience on recent infrastructure deals in France.

A straightforward approach would be to provide financing through direct loans, in addition to public subsidies. EIB and CDC have implemented such a scheme for a very high speed broadband network project in Haute-Savoie: the two public institutions loaned each 36 M€, alongside with public grants amounting to 63 M€.

However, such a scheme relies heavily on public funding, and arrangements allowing for higher leverage of public spending have to be sought. The EIB project bonds meet this additionality objective and have recently proved their ability to finance medium size projects: the Axione deal will allow to raise 190 M€ on the capital market, with a credit enhancement provided by the EIB. This is the third project bonds deal in Europe and the first involving digital infrastructure.

Another interesting scheme, involving banking and insurance financing, has been applied to the Cité Musicale project. At the completion of the project, the refinancing of the commercial banks construction loans will be subscribed for by insurance company (Allianz).

In order to finance smaller projects, the creation of securitization vehicles should also be looked into. Sponsored by public banks, they would issue investment grade bonds, backed by a portfolio of

selected infrastructure projects. In order to attract long term investors, these debt funds would also provide a credit enhancement, through bonds subscribed by their public sponsors.

These various financing techniques should ease the access of infrastructure projects to capital markets. ■

Long Term Funds ("ELTIFs") for individual investors?

Guillaume Prache - Managing Director, **Better Finance for all**

We are definitely living in strange – *"unconventional"* the ECB would say – financial times!

After all, ELTIFs are mainly meant as packaged portfolios of loans (to infrastructure/housing projects and to SMEs) and of real assets.

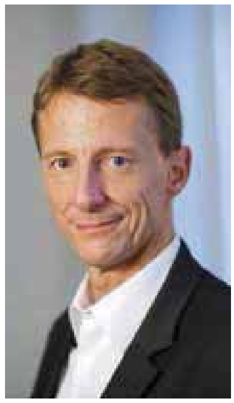
With this initiative, the EU seems to accept as fait accompli that banks are no longer - and will not be – delivering adequately one of their core services, i.e. long term lending to the real economy, in particular unsecuritized lending to infrastructure projects and to SMEs.

Assuming that professional asset managers have the competence and experience to step into commercial banks' shoes and originate and manage portfolios of such loans may be a bit of a stretch. But deciding to sell these packaged long term / SME loans & real assets to individual investors is yet another and bigger challenge.

Besides, we do not believe the solution to an identified financial need is to add yet another specific legal category of product. The European retail investment landscape is already planted with too many and often too complex products. Even the CEO of Goldman Sachs advocated in 2009 for less complex financial products (although he and many others obviously forgot about it since then). There is indeed already a plethora of retail "AIFs[1]" including AIFs already specifically dedicated to long term investments[2]. How adding yet another legal category will make a real difference?

We believe there are more effective initiatives to be taken to develop long term retail investment in Europe (revive the retail equity markets - mid/small caps in particular, and increase pension funds' and life insurance asset duration to name a few), but if the EU regulators still decide to have ELTIFs sold to retail investors then we would recommend to :

- sell the same ELTIFs to all investors – retail or not, and ban funds of funds;
- grant ELTIFs most favored long term retail investment product tax regime in every EU Member State;
- apply the product disclosure rules of UCITS funds;
- make listed small cap equity an eligible asset class.



- The last word to a quite successful individual investor named Warren Buffet: *"Never invest in a business you can't understand."* This is why we fully support a high threshold for minimum investments in ELTIFs: those should be "advised" only to qualified and very financially literate investors. Besides, what applies to investors applies also to retail distributors. I doubt a lot of them have the competence to adequately sell packaged Infrastructure/SME loans & real assets. ■

1. AIF: "Alternative Investment Fund". ELTIFs will be part of AIFs.
2. For example, there are already no less than 10 different long term retail AIF legal categories in France alone, funding anything from property, to innovation, to company stock, to local unlisted SMEs or to forests.

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J.P.Morgan

Without a true capital market union the European single market for financial services will not be complete

Wolf Klinz - Founding Partner, **3C Consulting and Capital Co.Ltd.**

Years after the G20 agreed to regulate every financial product and every market participant in every jurisdiction the same way, it is obvious that this ambitious objective has not been met. There are still differences betwenn the USA and Europe. The EU has even seen trends towards renationalisation in the financial services sector after the crisis. Can the obstacles holding back further integration of the European financial system be overcome and will the Banking Union help to achieve this?

1. Obstacles to further integration: Whenever member states of the EU implement European legislation, they try to account for national specificities (not the least because they consider themselves sovereign). Since company and civil laws differ in most MS, differences in regulation cannot be avoided completely. Hence regulatory arbitrage persists.

The protection of the (particularly retail) investor is a goal shared by all EU MS. However, not all MS wait until the EU has agreed on a common approach, but rather move ahead with national regulatory legislation. Hence we see some MS ban short sales, HFT or certain bank structures, while others hold back – another source of fragmentation.

MS refuse categorically to seek agreement on a harmonised corporate tax base, let alone tax structure and rates. Financial market related taxes continue to differ between MS and allow tax arbitrage. The € facilitates offering financial services across political borders in the Eurozone, but risks to provoke a rift between the Eurozone and the rest of the EU. Historically most of the EU MS have been bankcentric: 70% of the financing of industry, commerce and infrastructure is bank based as opposed to 30% in the US. This bank focus is primarily national or even regional and does not support the European integration of the financial sector.

2. The Banking Union is the right way forward. The Banking Union is a crucial step towards creating a true European financial services market. In fact, the Banking Union is so important, that it should have been decided right after the crisis and not only years later. The implementation of the Banking Union has to deliver in practice what the rationale of the project promises in theory. The Banking Supervision seems to be up for a good start in November this year. The Single Resolution Mechanism, however, is still very much MS based. Hopefully its implementation will not be slowed down by national political interference. The mutualisation of the depository guarantee schemes is not in sight.

The Banking Union will not be sufficient to complete the integration of the European financial system. A true capital market union has to be established. That will enable the EU to reduce the toxic links between banks and governments and generate the funds needed to finance growth, infrastructure and the creation of jobs. ■

Enablers and obstacles to further integration of the European financial system

Alex Wilmot-Sitwell - President Europe, the Middle East and Africa, **Bank of America Merrill Lynch**

The effects of the financial crisis on the European Union's (EU) financial integration have been undeniable. The level of cross-border debt securities held by Euro area banks has decreased by more than 20% in the past 5 years while cross-border interbank lending positions within the Euro area have halved since 2008.

When put forward in 2012, one of the goals of the EU's Banking Union (BU) effort was to reverse this trend and promote financial integration in Europe. Legislation such as the CRR/CRD4 Package, the Recovery and Resolution Directive, the Single Supervisory/Resolution Mechanism (SSM/SRM) is meant to ensure high standards of prudential supervision, enable a better identification of emerging risks, help counter financial imbalances and allow for orderly resolution. All these are essential for well-functioning, integrated financial markets.

Although the benefits of the BU could be far-reaching, a flag needs to be raised in terms of implementation. The EU needs to make sure rules are implemented consistently and do not harm those countries outside the BU. Regulatory uncertainty and a lack of proper implementation could have a disruptive effect within the Eurozone and the EU more widely.

Global financial services are regulated through an international framework of regulatory standards, which the BU follows to a certain extent, as agreed by organizations such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). We need to be mindful however that deviating too far from the original standards could lead to further fragmentation of financial systems across the world, and place the EU at a potential competitive disadvantage relative to third country jurisdictions.

Other examples of obstacles to financial integration in Europe are the Financial Transaction Tax (FTT) and proposed reforms relating to derivatives activity and banking structure. Our concerns on the FTT relate to proportionality and extra-territoriality. Evidence collected demonstrates that the tax would adversely affect countries outside of the enhanced cooperation procedure as well as countries outside the EU as a whole. Regarding derivatives reform, consistent clearing obligations and rules for the treatment of third country Central Counterparty Clearing Houses (CCPs) need to be enforced across jurisdictions and practical implementation needs to be seamless with mutual recognition and substituted compliance seen as key. Last but not least, while the CRR/CRD4 and BRRD have been broadly welcomed as necessary steps for dealing with "Too Big to Fail" (TBTF), the current proposals on bank structure have been widely challenged. At the moment they raise more questions than answers on a TBTF solution and the promotion of greater financial integration.

Before looking to further financial integration it is worth taking a step back to focus on the consistency of rules and how they form a cohesive network tasked with mitigating risks in the sector. This way unintended consequences can be quickly addressed and financial institutions are more able to pursue their activities in a safe, predictable and competitive environment. ■

Banking Union will reduce financial fragmentation, but divergences in funding costs will remain

Michel Madelain - President and Chief Operating Officer, **Moody's Investors Service**

During the crisis, euro area financial conditions significantly diverged between member states, developments referred to as 'financial fragmentation'. Since 2012, fragmentation has declined, largely because of the ECB's commitment to preserve the monetary union and its associated actions to help harmonise banks' funding costs.

Fragmentation can impair the cross-border functioning of the financial system and the transmission of monetary policy. Unchecked fragmentation could even, in extreme circumstances, break the monetary union.

Banking Union addresses some causes of fragmentation by providing a level regulatory playing field, enhancing transparency about banks' financial health, loosening the bank-government nexus and providing a resolution mechanism to reduce contagion.

However, financing conditions are unlikely to converge fully in the near future, and differences in lenders' and borrowers' creditworthiness will justify differentiated cross-country spreads. Moody's baseline credit assessments, which measure standalone creditworthiness of banks, are currently 2 notches lower on average for banks in peripheral countries than in core countries, reflecting weaker operating environments and fragile funding and liquidity markets. Moreover, during the last six years, corporate bond default rates in peripheral countries have been seven times higher than in core countries. Non-performing loan rates also remain significantly higher in peripheral countries than in core countries, illustrating differences in credit risk within the euro area. While we expect faster growth in some peripheral countries than in parts of the core, differences in the assessment and pricing of risk are likely to remain within the Eurozone.

Differences in financing conditions further reflect structural issues in the euro area. Without full fiscal union and mutualisation of potential costs associated with economic shocks, different market yields will reflect different risk profiles. A return to the financial convergence of the pre-crisis years is not warranted. In fact, we may not be far from the 'new normal'. ■

Supervising diversity

Jesper Berg - Managing Director, **Nykredit Bank**

From afar, everything looks the same. It is only close up that the differences show. One of the major challenges in any union is to combine equal treatment with respect for differences. This will also be a challenge in the banking union.
If you are part of an economic institution, you are tempted to base your work on numbers. Numbers have the added advantage that they appear objective. Thus, for the Single Supervisory Mechanism as well as the rule setters at the European Banking Authority, there is a strong temptation to base both their supervision as well as rule setting on metrics and "one size fits all" definitions.

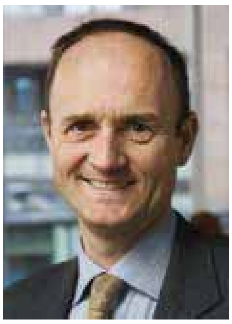
The problem is that one size does not fit all. The European universe of credit institutions is very diverse. It is much more diverse than the universal bank paradigm according to which the Basel framework is modelled. We have public-sector banks with very high capital ratios but very low leverage ratios. We have cooperative banks that by nature have no access to equity markets. We have standalone mortgage banks that have a deposit deficit relative to their lending of 100 pct, as they do not take deposits and where all assets are encumbered as they serve as collateral for covered bonds. We have many national specificities that reflect differences in tax laws, bankruptcy legislation and social safety nets.

The diversity of institutions has served Europe well. Public-sector banks ensure financing of public-sector projects, when public finances are strained, cooperative banks are the true relationship banks in Europe who serve even the most rural areas in Europe in good times as well as bad times, stand-alone mortgage banks have proven a pillar of stability, where properly structured.

The single market, the rule setting and the supervision need to respect these differences. If not, they will, in their quest for harmonisation, face the wrath of the general public that depends on the differences. ■

The banking union should trigger more regulatory convergence

Roar Hoff - Executive Vice President, Group Risk Management, **DNB**



The finalisation of the CRR / CRD IV opened up for significant national discretion regarding capital requirements through the macro-prudential toolbox (systemic risk buffer, O-SII buffer, countercyclical buffer). The scope of Pillar 2 has also been widened. This could potentially undermine the single market through the introduction of national capital requirements that do not reflect actual differences in risk, but rather some regulators' ambition to introduce strict capital requirements. This development should be avoided.

National authorities will often claim that they know best what is needed to maintain financial stability in their countries. In many ways this is indisputable, however, national authorities are not necessarily the best to assess the relative risk that faces its own banking system compared with the situation in other countries.

International bodies like the ESRB and the EBA should play an active role in harmonising the use of macro-prudential measures and Pillar 2 requirements. The current EBA draft guidelines relating to SREP are a step in the right direction. Guidelines for assessing or quantifying systemic risk should also be prepared. The Basel Committee has developed a guide for setting countercyclical buffer rates. Similar tools should be considered for setting the systemic risk buffer and the O-SII buffer.

Under the banking union the ECB will have supervisory responsibility for the largest banks in the euro area, making it the most important bank regulator in Europe.

The ECB practices will most likely be used as benchmarks for local regulators with respect to small banks as well as for regulators outside the euro area. The ECB should therefore be transparent and open about its role as a regulator, which would be of great help to us all. ■

Banking Union: benefits from cross-border banking integration and risk-sharing

Peter Praet - Member of the Executive Board, **European Central Bank (ECB)**

How will Banking Union be welfare-improving? An enhanced supervisory framework and a unified resolution framework should improve financial stability. Not less important will be the impact of Banking Union on cross-border banking integration and private risk-sharing as it aims at eliminating the link between banks and their national sovereigns.

The first decade of the euro area saw European banks beginning to develop cross-border business strategies. In principle this should have deepened credit market integration and improved the smoothing of income shocks across countries through diversification. But the way banks integrated, which was short-term and debt-based, in fact produced little genuine risk-sharing. In the event of a shock, some jurisdictions faced a "sudden stop". And even those banks that had integrated through acquisitions, and so should in principle have been insulated from a fragmenting financial system along national borders, sometimes found their internal funding markets disrupted by supervisory ring-fencing. The cost of backstopping banks fell largely on national fiscal authorities, contributing to the infamous bank-sovereign nexus.

Banking Union can improve risk-sharing by dispersing the costs of bank failure in a crisis event and enforcing a level-playing field in bank creditor protection.

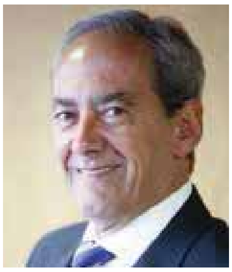
In a crisis event, the new resolution framework shifts the costs away from sovereigns and onto the private sector. And through the resolution fund, it spreads those costs more evenly across the euro area banking sector. Insofar as this weakens the bank-sovereign nexus, it should help reduce financial fragmentation and in turn support the deeper integration of the banking sector.

In general, risk-sharing will be improved through a more robust integration of credit markets. Banks will be able to develop genuine EU-wide balance sheet strategies, thereby exploiting cross-border economies of scale. A single supervisor will create a set of homogenous standards, reducing the compliance costs of operating across borders. And because the single supervisor will take a European view, the fungibility of liquidity within banking groups should increase.

In short, if all goes to plan, Banking Union promises a more stable and prosperous euro area. ■

Banking union: from 1.0 to 2.0

José M. González-Páramo - Global Economics, Regulation & Public Affairs, Executive Member of the Board, **Banco Bilbao Vizcaya Argentaria (BBVA)**



The trend towards fragmentation in EU financial markets from 2010 to 2012 was incompatible with the euro. The European authorities successfully counteracted this trend through monetary policy measures and declarations – in particular Mario Draghi's famous "whatever it takes" - as well as with the banking union project. As is well known, some of these elements, like the Single Supervision Mechanism, have an immediate application, whereas others, like the Single Resolution Fund, will require a gradual process. But some of the beneficial effects are already perceptible and market player's expectations of a breakout of the euro have been almost totally dispelled.

The ultimate objective of banking union is, however, more profound than simply overcoming fragmentation: a true single market for financial services in which not only wholesale markets are integrated (like they were to a significant extent in the mid-2000's, before the crisis) but also the retail segment. In the endpoint, financial consumers should be able to operate freely with any financial institution of the Eurozone and benefit from the ensuing competition and efficiency gains. This would require moving at a certain stage from banking union 1.0 to the 2.0 version, one in which all Eurozone banks will *inter alia* share a common Deposit Guarantee Scheme. This step will require a degree of fiscal union beyond what is possible with the present Treaty.

Progress in the European construction has always been the result of an ambitious vision of long term objectives accompanied by a politically realistic roadmap and a policy of gradual steps. The progress made towards banking union over the last two years is impressive, but we should keep in mind the vision of the endpoint: a market in which consumers and corporates operate with Eurozone banks without regard of where their headquarters are located, in the same way as US households and companies operate with US banks today. ■

We are making history

Juan R. Inciarte - Executive Board Member, **Banco Santander**

These are historical times for Europe. Despite the difficulties and some initial skepticism, the institutional architecture of the euro is today close to completion. We are only two months away from the effective start of the Single Supervisory Mechanism (SSM): the main pillar of the European Banking Union.

The outcomes of the comprehensive assessment will be key to restore the confidence in the banking system and to solve the 'legacy assets' issue before the SSM starts operating.

Significant progress has been made in the implementation of the Single Resolution Mechanism (SRM), to be operative by January 2015.

Banking Union is key to break the vicious circle between sovereign and banking debt. It is a catalyst to foster a more integrated European financial sector. Europe needs a strong financial sector that generates confidence in investors and customers alike.

A European banking sector that is efficient and profitable, customer-orientated, innovative and cross-border. This is the best way to support economic internationalization and competitiveness and the integration of Europe's economies and markets.

Achieving a common supervisory culture will be a transformational change not only for banks but for Europe as a whole. It will contribute to a level playing field among European banks and foster competition, which in turn will result into a better allocation of financial resources within the region.

A healthy, solvent and well-integrated financial sector is essential to provide European businesses with all the support they need to grow and occupy positions of leadership. In this way European citizens and companies will all benefit from better and cheaper banking services. ■

Regulatory priority is ... a regulatory truce

Giovanni Sabatini - General Manager, **Italian Banking Association (ABI)**

For the European commercial banks, as for other EU industries, the real top priority is the return to growth of the European economy. As to the regulatory side, we noted that from January 2009 to the end of July 2014, 252 documents concerning regulatory matters in the banking sector were issued: 118 in our national jurisdiction, and 134 in the EU frame.

Almost all of them were followed by a legislative, regulatory or administrative act that banks had (or still have) to implement in their internal rules. Some were adjustments to existing rules, others true revolutions, like the realization of a Banking Union, whose complexity can be measured in hundreds of pages.

A substantive part of the new rules was necessary but the continuous flow of new measures has raised the regulatory uncertainty up to a point which is detrimental for the efficient functioning of the banking sector and the role it plays in the European economy.

Now, with the adoption of so many rules and near accomplishment of the Banking Union, a 'comprehensive assessment' of the new regulatory body and its effects on the real economy is needed.

Regulators provide us with deep analysis of the impacts that any new rule will have on the economy. Often these impacts are underestimated due to not taking into account interactions occurring among the different rules.

In the meantime, we have been experiencing a sharp decrease in banks' profitability. The average ROE of the EU banking sector has drifted from 10% in 2007 to -1.55% in 2012. Preliminary estimates for 2013 show that the data has not improved that much.

That indicates the real priority for the banking sector: dedicate more resources to restoring profitability by increasing incomes and reducing costs, pursuing the completion of the process for the adoption of measures concerning the Banking Union, but refraining from launching new regulatory initiatives on an industry whose reduced lending capacity ends up hitting other sectors' enterprises.

Only by recovering a good profitability, can banks continue to serve their customers as they have been doing till now. New regulations make sense only if imposed on banks which are healthy: let's complete the reforms undertaken, let's implement them in the banks' DNA, not modify them for some years, let's evaluate the global effects of these measures. Only then, if needed, will we proceed to adopt new regulations.

Finally, as rules per se are not sufficient to ensure financial stability but need to be complemented by an effective and efficient enforcement, before adding new layers of regulations, let us see the SSM at work. ■

European supervision for a European banking system

Luigi Federico Signorini - Deputy Governor and Member of the Governing Board, **Banca d'Italia**

While banking regulation in Europe became more and more harmonised with each new version of the CRD/CRR, supervision was until recently basically national. National supervisors operate in a national legal framework, have their own supervisory culture, answer to a national public opinion, and have legitimate national priorities. This makes the single market less than perfectly integrated at the best of times; when times get tough, it will seriously endanger it. The crisis brought this point dramatically to the fore. Cross-border interbank lending dried up; big banks went under; while cooperation between authorities did not stop, indeed increased, during the crisis, national reactions led to a retrenchment within borders. The efficiency and stability benefits of the single market were largely forgone.

With the creation of the SSM and the SRM, the institutional response to the fragmentation of markets during the crisis has been impressive. While still largely reliant on national authorities' activity, European supervision and resolution will function as one system, and bring down many barriers to intra-European cross-border banking. Thus it will create the conditions for a more efficient allocation of capital, better liquidity management and better risk diversification within and among banking groups. Cross-border M&A activity will also be eased, which means that the market structure may change–though it is too early to say how rapidly and to what extent.

The work is not all done. The ECB has built its supervisory structure *ex nihilo* with remarkable speed and is working with national authorities to start the SSM in a few weeks; the resolution authority must follow suit. The framework is complex, with many authorities and potentially overlapping or conflicting responsibilities; it must be made to work effectively. It is also incomplete: a single deposit insurance scheme should eventually be created; further harmonisation of civil and bankruptcy law will help the SSM work best. EBA must ensure that the single market does not stop at the euro area's border. Some obvious lessons of the past have been learnt, but the future still has many non-trivial challenges in store. ■

Banking Union – A force for change in EU banking

John Berrigan - Director for Financial Stability and Monetary Affairs, DG Economic and Financial Affairs, **European Commission**

The creation of the Banking Union is a seminal event for the EU banking system. The longer-term (or steady-state) impact of the Banking Union is difficult to predict with certainty, as this will depend on a range of factors, which will emerge only of time, e.g. the number of participating Member States, the relative proportions of the banking system subject to direct and indirect supervision within the Single Supervisory Mechanism (SSM), the effectiveness of the new resolution framework etc. However, it is easier to assess the likely shorter-term effects of Banking Union as we await the imminent results of the ECB's comprehensive assessment and look forward to the early phases of an operational SSM and SRM.

The fundamental rationale for creating the Banking Union is to revamp the cross-border banking model within the EU single market. So, we can expect that a successful start to the Banking Union will begin to reverse the process of financial fragmentation that has characterized the period since the financial crisis in 2008/9. Improved quality and uniformity in banking supervision provided by the SSM across all participating Member States should encourage banks to resume their cross-border activities, while the existence the of SRM – operating on the basis of a new EU resolution framework which adequately protects taxpayers from bank failures - should provide national authorities with the confidence to accommodate such cross-border activities. On this basis, Banking Union should stimulate more cross-border banking.

A key condition for Banking Union to revamp the cross-border banking model will be the restoration of investor confidence in the quality of participating banks' balance sheets. To this end, the ECB's Comprehensive Assessment will be crucial and may also bring more immediate change in the EU banking system. The Comprehensive Assessment, which will include a rigorous asset quality review and stress test, is now well-advanced and has already triggered a wave of bank recapitalization. While the results of the Assessment will not be known for some weeks, the possibility that some banks will require capital reinforcement clearly exists. Such banks will have sufficient time to seek private sector solutions, with any subsequent public intervention being subject to EU state-aid rules and commensurate restructuring. Alternatively, some of these banks may opt to reinforce their capital position via consolidation with other banks, although the implications for competition and resolvability would need to be carefully assessed. ■

Key steps towards a fiscal union in Europe

Marco Buti - Director General for Economic and Financial Affairs, **European Commission**

Over the past years, European policy-makers have taken strides to fight the crisis and build stepping stones for a more resilient EMU architecture. Yet, further EMU deepening towards fiscal union is warranted over time, and steps towards it can be envisaged in the shorter-term.

The institutional shortcomings of our current set-up stem from the persistent challenge of implementing sound and consistent policies across countries, as well as from the still under-developed channels of adjustment to heterogeneous developments. Important progress is being made with the enhanced economic and fiscal governance, the emergence of safety nets to preserve financial stability and the gradual build-up of banking union. But this remains an incomplete construction as it runs against the limitations of a setting of common monetary policy with still largely decentralised fiscal and economic policies.

The Commission Blueprint of November 2012 laid out a clear sense of direction towards full fiscal, financial and economic union. It made the case for even stronger governance combined with deep common tools for risk-sharing and deeper pooling for sovereignty. For the final stage, the vision of the Blueprint requires a change in EU Treaties and can be pursued only in the long run.

In the near term, we can try to take steps in that direction within the present institutional and legal framework. These can include: sound and smart implementation of the revised governance framework; the implementation of a fully-fledged banking union; the exploration of avenues for better sharing risks; reflecting about the role of market discipline without reigniting existential fears about the integrity of the euro area; a better interplay between budgetary requirements and structural reforms; and possible evolutions of our governance system in order to streamline it and increase its effectiveness.

We can also give thought to the necessary institutional and Treaty changes in the medium to long-run in order to put the political contract in par with the needs and realities of deeper integration. ■

Now is the time for greater euro area fiscal integration

Sylvie Goulard - MEP, Coordinator of the ALDE group,
Economic and Monetary Affairs Committee, **European Parliament**

Greater fiscal integration is definitely one of the tools which may boost EU economic growth. Yet while it is in the interest of the whole EU it can only be achieved, both for economic and mainly political reasons, from the euro area as the core. Several options exist and have been suggested by groups such the Glienicker Gruppe or the Eiffel Group. The idea of a specific euro area budget is on the table. Many hurdles remain before this option could become a reality, but it would address issues that are specifically linked to the existence and functioning of the euro (absorption of asymmetric shocks) and would enable resources to be raised in order to improve training, increase worker mobility, create a euro area unemployment benefit, investment in infrastructure.

Partial common issuance of debt is another option which triggers lots of legitimate political, democratic, legal and economic questions. Given the recent debates, it would appear more productive to look at the option of issuing common bonds that would be used to finance long-term projects rather than the option of the pooling of existing national debts.

However, although greater fiscal integration is a necessary step, alone it is insufficient. In order to have growth you need to build a resilient system. For that you also need the confidence of the citizens, implying that democratic accountability must also be strengthened.

This should be achieved on two levels: firstly make some international technical fora (FSB, Basel Committee etc.) more transparent and accountable. A unified external representation of the Euro zone, as proposed by JC Juncker, on the basis of article 138 of the Treaty, could help. Secondly, a clearer role is needed for the European Parliament and/or a Euro zone Parliament, to control the decisions taken by the Eurogroup.

Yes there is work ahead but there might also currently be sufficient momentum to advance progress: the installation of the new European Parliament - which is faced with an ever greater imperative of delivering to citizens - and the new European Commission may, and should, be a time for taking and implementing the right choices. ■

Towards a fiscal union for the Euro area

Rolf Strauch - Member of the Management Board, Economics and Policy Strategy,
European Stability Mechanism (ESM)

The euro area has taken a number of steps during the crisis to create a more integrated economic and fiscal union. Its institutional setup was overhauled. Arrangements have been made to strengthen fiscal policy coordination in order to bolster crisis prevention capacity. The economic governance framework was substantially revamped to put national budgetary policies on a sound footing. In addition, Member States pooled resources to establish a permanent fiscal backstop through the European Stability Mechanism. Finally, Member States created the banking union, including a common supervisory structure, resolution authority and resolution fund.

Next steps

The current debate on fiscal union is based on the report titled "Towards a Genuine Economic and Monetary Union" by the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup issued in 2012. This report has also been included in the programme of the designated Commission President Jean-Claude Juncker. While a number of measures have already been completed since the report was launched, further steps are envisaged to achieve fiscal union. These steps would give more fiscal capacity to the euro area level.

A first step is an incentive-based arrangement allowing Member States to engage in contracts with the Commission. Member States that implement reforms contributing to the functioning of the EMU, or addressing labour and product markets weaknesses would in return receive a financial 'carrot' instead of a 'stick'. This should result in more vigorous structural reforms enhancing the growth potential of the Eurozone.

A further step in the medium term along the roadmap will have to focus on risk sharing between Member States, in line with the subsidiarity principle. This requires some clearly rules-based mechanisms and observing the principle of subsidiarity to help countries address economic fluctuations.

A third step for more fiscal union was assessed by the Tumpel-Gugerell expert group, which analysed various options for joint-debt issuance - especially through eurobills - and a potential debt redemption fund that could assist distressed countries. Their analysis outlines economic benefits of more integration and underscores that such initiatives require very strict controls to cover an inherent moral hazard risk. The benefits of these proposals will be more apparent again when the current buoyant liquidity and eased market financing dissipates.

A Long-term perspective

In the very long-run, when confidence in national and local government fiscal responsibility becomes fully anchored, solutions that would lead to an even larger degree of fiscal centralisation – based on a European or euro area budget - may gain some traction. This central budget could be limited and complement national budgets in areas with strong cross-border effects (such as network infrastructure or defence). Further measures towards the fiscal union require policy-makers to strengthen, under all circumstances, the democratic procedures legitimising such a setup. The implementation of any measure of that sort would require a deeper revision of the EU Treaties and profound legal and institutional reforms. ■

Monetary union dangerously incomplete without some fiscal union: "Delors 2" needed

Paul Tucker - Senior Fellow, Mossavar-Rahmani Center for Business and Government, **Harvard Kennedy School and Harvard Business School**

The crisis revealed the Monetary Union to be dangerously incomplete, jeopardizing global economic stability. As Jean-Claude Trichet has said, EMU always needed the E as well as the M. That wasn't so surprising given research on previous currency unions, but that earlier literature and the pre-EMU debates did not focus on the vital importance of banking union. While much has been done to unify supervision and resolution, a vital lacuna of strategic significance remains. The monetary union employs two kinds of money: central bank money and private-bank money, ie deposits. Both need to be homogenous. The former is: by definition, the ECB issues the euro area's central bank money. But the private deposit money, comprising most of the money used in the euro area, is not homogenous. That is because the deposit-insurance regime in one member country is not the same as in another, so that a retail deposit in one country is not the same as in another. This is fundamentally inadequate for a sustainable monetary (and banking) union. Without a collective deposit-insurance scheme, the monetary union will remain fragile: an incipient fracture in the credit system will persist, even when the current crisis has finally passed. As the Bank for International Settlements 2012 annual report suggested, banks domiciled in euro area countries need to be euro-area banks. A euro area deposit-insurance scheme should be funded by the banks themselves, in order to ensure that defaulters contribute something. A funded scheme can also shield the taxpayer somewhat, but I recognize that this would be a step towards some kind of a fiscal union.

That is why this apparently technical issue is truly strategic, substantively and in what it signals.

In the US, the deposit-insurance regime is part and parcel of the fiscal union. The euro area needs to debate what kind of fiscal union it should have, and through what staged-process it could move there. The issues are profound, requiring thorough technical and public exploration before political decisions could be taken. A decent first step would be an expert commission, completing the work of the 1980s'Delors group on EMU.

Fiscal unions come in lots of varieties. On possible route would be a union of rules, where control over fiscal policy in a euro-area member country was transferred to 'the centre' if certain debt or deficit thresholds were breached. That seems to me likely to create political resentment at tension in the event of a country suffering a crisis that's not of its own making.

Another possible route would involve some kind of collective insurance against the costs of cyclical unemployment. This has the key feature of the people of the euro area helping each other out, but with discipline on member-country governments. That discipline comes in two forms. First, there would be no subsidy for structural unemployment, underlining the incentive for necessary supply-side reforms.

Second, there would be no bailout for insolvent states. The US established in the mid-19th century that the people of America would not bail out bankrupt State governments; the Federal government would not stand behind the government of, say, California. The euro area needs to establish the same. But a 'no bail-out' rule means nothing unless it is clear how a member state government could go bankrupt in a reasonably orderly way. As with bank resolution, that too needs some technical ground clearing. It was absurd that government insolvency threatened euro area membership, threatening EU membership.

I offer these thoughts as a citizen outside the euro area. But the whole of the EU, indeed the whole of the world economy, badly needs the euro area to have firm foundations. ■

Why is consistent global regulation and supervision so important but also challenging to achieve?

Steven Maijoor - Chair, **European Securities and Markets Authority (ESMA)**

Regulators, when regulating financial markets, not only need to regulate local market players and local transactions, but also foreign market players active in their local market and transactions with a foreign component. In today's interconnected global financial markets, these international elements are very important in all the world's main financial centres.

Not regulating these foreign market players and transactions would result in a failure to meet regulatory objectives such as investor protection, stability and avoiding regulatory arbitrage. However, they are typically already subject to the regulation of one or even more other jurisdictions. As a result, market players and transactions may become subject to multiple regulatory regimes, which can be overlapping, inconsistent and conflicting.

While the community of regulators around the world is striving to achieve consistent international regulation and supervision, one of the most prominent issues is the fact that legislation is established by independent sovereign states or, in the case of the EU, by co-legislators representing citizens and the 28 heads of governments. Political processes take local characteristics of financial markets into account, and it is not a secret that legislation sometimes reflects local private interests. Hence, local exemptions for certain market participants create consistency problems at global level.

How can we address these challenges? The first step is for regulators to be more proactive in identifying broad risk areas, which potentially require future regulatory action. Then to develop at international level, in a timely way, sufficiently granular standards. Having granular standards available on time, will help reduce the development of differences when an activity becomes subject to regulation across the globe. An example where this has worked fairly well is the area of credit rating agencies and I am optimistic that it will also achieve good outcomes in the area of margin requirements for bi-lateral clearing.

This will not make regulations identical but it should facilitate the second step which is the reliance on foreign equivalent regulatory systems when they achieve the same regulatory outcomes. This mechanism is the standard European Union approach to international coordination issues in many pieces of financial regulation, which avoids fragmentation and supports the global nature of financial markets. ■

Towards a more integrated EU insurance supervision

Gabriel Bernardino - Chairman,
European Insurance and Occupational Pensions Authority (EIOPA)

The creation of the SSM is certainly a historical step for banking supervision in the European Union. As for the way forward for the insurance sector, I see an evolutionary rather than a revolutionary development. We need to build on the important EIOPA achievements and, step-by-step, reinforce its mandate and powers in order to improve the quality, consistency and convergence of EU insurance supervision. In this sense, the implementation of Solvency II is a great opportunity.

The EU legislators should consider extending the current power of EIOPA to conduct an inquiry into a particular type of financial institution, type of product, or type of conduct, in order to support the independent assessment of supervisory practices. EIOPA's power to ban or restrict financial activities is due to be brought to life under the PRIIPs Regulation. We need to build on that. It would also be of added value to grant EIOPA a centralised oversight role in the field of internal models. In the medium term, as part of a step-by-step approach, consideration should be made to assign EIOPA an enhanced supervisory role for the largest important cross-border insurance groups.

In order to be beneficial for all European citizens, insurance supervision should become more consistent and coordinated. This will help to avoid regulatory arbitrage, will ensure a level-playing field and enhance the long-term potential of the insurance market in the EU. ■

The ESRB, the ECB and the SSM: synergies or conflicts of interest?

Prof. Rainer Masera - Dean of the School of Business, **Università degli Studi Guglielmo Marconi**

The ESRB (2010) was created following the indications of the de Larosière Report (2009) and tasked with the macro-prudential oversight of the financial system in Europe: its primary goal was to maintain financial stability and contribute to the identification, prevention and mitigation of systemic risk. This required monitoring macroeconomic developments which could endanger the sustainable contribution of the financial sector to economic growth.

The ESRB started its activities shortly before the Euroarea entered into a systemic crisis arising from the intertwining of bank and sovereign risks in many countries, but failed to recognise the vicious loop between banking crises and public finances. It was left to the ECB to identify the immediate threat to financial stability and act accordingly. The crucial distinction between idiosyncratic vs. endogenous/systemic risk and the problems posed by fallacies of composition were also encountered with the transposition process of Basel III in the EU. The dangers to economic recovery of "bad" de-leveraging and of the drying up of credit flows, notably to SMEs, were not adequately signalled by the Board.

These two instances show that the ESRB should develop a comprehensive flow-of-funds approach to detect and monitor financial imbalances leading to systemic risk. Admittedly, its complex organisational structure (the decision-making General Board comprises no less than 65 members) makes it very difficult to reach timely decisions on risk assessment, warnings and recommendations.

Under these circumstances, the creation of the Banking Union and the SSM may well increase difficulties for an effective role of the Board. The AQR and the stress testing of Eurozone banks, as well as attendant macro-prudential responsibilities, belong primarily to the ECB. It is also not clear how the Board will interact with the Resolution Mechanisms.

All in all, a necessary condition for the Board to play a significant role is the streamlining of its decision-making process and the redefinition of its powers as a result of BU, hopefully focusing on an effective interplay with the EFC and the ESM. ■

Towards a Fiscal Union?

Jean-Marie Andrès, Didier Cahen, Marc Truchet – Eurofi

Remarkable efforts have been undertaken in the EU to prevent future crises and improve fiscal discipline but there are doubts as to the sustainability of budgetary discipline

The review of the main areas of financial regulation following notably the G20 commitments and the gradual implementation of a true banking union within the Eurozone should reduce the risk that a financial crisis of the magnitude that we have just experienced will materialise again.

In parallel significant improvements to the rules-based framework for fiscal policies have been achieved in the past few years. The six-pack, the two-pack and the Fiscal Compact represent an important step towards providing the EU with tools to manage public finances in a sound and consistent way.

Moreover, with the European Stability Mechanism (2012) and the two-pack, both a permanent funding instrument and a governance framework, the euro area is endowed with instruments to respond to possible future crises.

These are key steps to reinforcing the European Economic and Monetary union. Indeed a monetary union is not workable without fiscal discipline. Sound fiscal policies are essential for growing out of the present level of public debt which is penalizing EU economies. The economic problems of individual Member States that share the same currency impact the whole union because this undermines the cohesion of the Union and the solidity of the currency. This has been shown by the recent examples of Ireland and Spain that have been affected by very strong asymmetric shocks which they were unable to handle on their own and which impacted the whole of the Eurozone.

However despite these improvements, economic and fiscal policies remain a national responsibility which does not guarantee a permanent stability of the Eurozone. In addition although budgetary positions in structural terms are close to balancing in many Eurozone countries this is not the case in the whole zone and several Member States do not comply with the requirements of the Maastricht treaty at present despite the implementation of the recent economic governance package. Moreover the euro area's debts remain at high levels. It is also uncertain whether these governance mechanisms will be strong enough to convince Member States to bring their fiscal policies in line with the Stability and Growth Pact and the Fiscal Compact in a lasting way.

The potential benefits and feasibility of a fiscal union are debated in this context.

The President of the Deutsche Bundesbank recently stated that "the euro area has reached a kind of cross roads: either we proceed towards a fiscal union in the sense of establishing joint liability with centralised rights to intervene in fiscal matters at the European level, or we turn back to the original framework as specified in the Maastricht Treaty and reinforce the principle of individual national responsibility (which would require in particular to end the preferential treatment afforded to sovereign debt)".

Progressing towards a fiscal union would reduce the incidence and severity of any future crisis by providing an ex ante framework for enforced fiscal discipline and temporary transfers.

The Four Presidents Report "A genuine and comprehensive Economic and Monetary Union" (2012) outlines the economic rationale for such a fiscal capacity. "In a common currency area, the burden of adjusting to country – specific economic shocks falls on labour and capital mobility, price and cost flexibility and fiscal policy. In order to protect against negative fiscal externalities, it is important that fiscal risks are shared where economic adjustment mechanisms to country-specific shocks are less than perfect. This is clearly the case in the euro area where labour mobility is comparatively low, capital flows are susceptible to sudden swings that can undermine financial stability, and structural rigidities can delay or impede price adjustments and the reallocation of resources… In this context, setting up risk-sharing tools, such as a common but limited shock absorption function, can contribute to cushioning the impact of country specific shocks and help prevent contagion across the euro area and beyond."

Deeper fiscal integration would also boost economic growth in Europe since it would reflect a dynamic community approach that would be able to restore confidence in the benefits of European integration, while reviving entrepreneurial development and investment in Europe.

This would however mean yielding a great deal of national sovereignty in fiscal policy matters since a significantly stronger element of centralised intervention regarding the definition of national budgets would be required. It can be considered that if the "new budgets" are admitted by a central authority as adequate, the new debt would be the object of a mutualised treatment (leaving aside the legacy debt). This raises difficult political issues. The confidence of the citizens is therefore needed, implying that democratic accountability must also be strengthened.

The various ways of progressing towards a fiscal union and the possible ways forward

The convergence process should imply the transfer of certain budgetary responsibilities to the European level with a view to strengthening risk-sharing within the currency union. But this can only occur once trust has been restored across countries and within countries. Mutualising legacy public debt created in the past is not possible at this stage. However once Member State governments have demonstrated for a certain number of years that their budgets are in accordance with requirements defined and monitored centrally at the Eurozone level, one may consider mutualising the new debt issued.

The economic convergence process within the Euro area could be complemented by joint European investments in public goods such as network industries and R&D, as a way to bolster Europe's growth potential and to even out drops in public investment in economies hit by shocks. Yet, this should be achieved by prioritizing spending and should not undermine efforts that remain necessary to bring down debt levels. This action would be consistent with proposals by the upcoming President of the European Commission who has proposed a €300 billion public-private investment programme to help incentivize private investment in the EU economy.

There are however several different options for achieving deeper fiscal integration. Four main options for achieving deeper fiscal integration in the Eurozone have been proposed: a common budget, an insurance mechanism against strong cyclical fluctuations, a common unemployment insurance scheme, and an equalisation of interest burden via a European debt agency.

Deciding on the appropriate course of action requires thorough technical and public exploration before political decisions can be taken. A decent first step could be, as proposed by Paul Tucker in the Eurofi newsletter, to set up an expert commission to conduct such assessments, completing the work of the 1980s'Delors group on EMU.

Transitioning to sustained growth

Jaime Caruana - General Manager, **Bank for International Settlement (BIS)**

Weak growth is the key challenge to the EU economy. Returning to a sustained growth track requires policies that facilitate two important transitions: a transition to growth that is less dependent on debt, and a transition to a more reliable and resilient financial sector.

Overcoming the financial crisis will require addressing real sector rigidities. The EU economy must find a new balance: productive resources must shift from sectors that over-expanded, fuelled by abundant credit during the boom, to more productive sectors that will drive future growth. This means more flexibility: workers who change jobs and new firms that replace failed ones. The key that will unlock this dynamism is policies focused on structural reforms in labour and product markets. Finance plays a supporting role in this transition. Financial flexibility means a balance between the role of markets, which have integrated more rapidly in the European Union, and banks, which remain the bedrock of the European financial system. Development of market-based instruments and closer integration of banking, a process that suffered a setback in the crisis, will improve flexibility.

Financial sector flexibility is founded on reliability and resilience. Wobbly banks do not lend, so the priority is to ensure that banks are robust, are seen as robust, and remain robust. The challenges of this transition are clear for European banks and supervisors: dissipate market uncertainty by addressing decisively balance sheet weaknesses and building ample buffers, build an effective prudential framework covering both micro and macro risks, and complete the banking union project with resolution and deposit insurance frameworks that deal transparently with troubled institutions. Accomplishing this in the presence of several sovereign fiscal authorities requires compromises and careful design. Progress is being made. By avoiding past shortcomings, the AQR promises to restore confidence in banks. An effective Single Supervisory Mechanism will place European banks on a firmer footing and will contribute to integration. The first elements of a resolution framework are emerging.

The benefits to the European economy from completing the job are clear. ■

Economic growth required!

Dr. Andreas Dombret - Member of the Executive Board, **Deutsche Bundesbank**

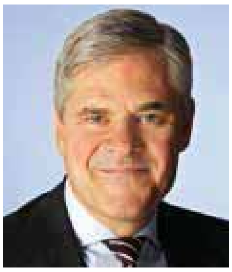
Particularly in Europe, banks are still in the process of addressing the weaknesses that were uncovered during the crisis: asset quality was lower and more volatile than expected, while liquidity risks were higher.

At the beginning of the crisis, US banks suffered even more than those in the EU. However, with regard to profitability they have now outpaced their EU peers. To a large extent this is the result of the positive macroeconomic environment in the US, which offers banks sufficient earnings potential.

In order to respond to new regulatory requirements, banks need the support of investors and clients, particularly when it comes to increasing the amount and quality of capital or improving liquidity profiles. As an investor's incentive is to seek out attractive yields, banks' profitability is key to success in this regard.

Figures show that banks are well on track to fulfil these regulatory requirements. However, several banks still face challenges: poor asset quality, low interest rates and weak growth. Combined, these challenges act as a drag on profits. In addition, major structural changes have appeared on the horizon: demography, new technical opportunities and gateways to and for customers, and new players in the market such as PayPal and Google. To respond to these challenges, European banks and supervisors alike have to act – for instance, by redesigning their business models or by adapting the supervisory architecture respectively. In this context, European banking supervision and the preceding comprehensive assessment of the largest banks will also provide an impetus for necessary adjustments.

However, the leadership of US banks in terms of profitability



underlines the importance of macroeconomic growth for bank profitability. In order to return to sustainable profitability and fulfil regulatory requirements, banks therefore need balanced economic growth right across Europe. This sets the objective for EU policy makers: to prepare the ground for economic recovery by fostering the necessary reforms in, for example, the labour markets or the public sector. ■

Change was necessary, careful implementation and assessment even more so

Sylvie Goulard - MEP, Coordinator of the ALDE group,
Committee on Economic and Monetary Affairs, **European Parliament**

The crisis has hit the economy and citizens, particularly the weakest ones, hard. Change was necessary both as a political sign to citizens and to improve the resilience of the EU economy. Therefore, the EU acted: the creation of the European Supervisory Authorities and the ESRB, Short Selling, MiFiD, CRD 4, Market Abuse, BRRD, Banking Union….

The wave of level 2 measures is now hitting the shores. The individual aim of each piece of legislation was targeted and legitimate and still is. However the cumulative impact of all of them, as well as their interactions, may have been underestimated. Both because the legislative process and the fear of facing a new crisis have added complexities. Having to deal with so many issues in a limited timeframe makes the challenge even tougher. Now the time has come to implement the thousands of pages of legislation and to particularly focus on the implementation with level 2 measures. Where necessary the undesired effects, be it the excessive burden for industry or the shortage of funds to finance the real economy, need to be corrected. Responses lie in those implementing measures, in the reviews to come, in the on-going legislation, such as Money Market Funds, Benchmarks or European Long Term Investment Funds but also in complementary legislation.

Securitisation (to fund SMEs) is certainly one issue to look at, as are ways to improve the perception of the specificities of the euro in international fora, to stop the fragmentation of the internal market, and to better explain the EU to foreign investors. The latter implies that the EU banks which are ill or weak should be cured in order to restore confidence in the EU banking sector as a whole. In this regard, the first steps of the Banking Union will be key and thus we all know the importance of the Assets Quality Review. The legislative process undertaken at EU-level in the next years will be closely watched. It has to be efficient and balanced in terms of achieving a resilient, inclusive and performing economy. The proposal on "structural measures improving the resilience of EU credit institutions" (follow-up of the Liikanen report) is likely to be a crucial test. ■

Non-risk based measures - the new guiding star in banking regulation?

Sabine Lautenschläger - Member of the Executive Board
& Vice-Chair of the Supervisory Board of the SSM, **European Central Bank (ECB)**

Many market observers and regulators see non-risk based measures as state-of-the-art, transparent and simple backstops to existing prudential requirements. And quite a few consider the leverage ratio to be superior to risk-based capital ratios, taking the view that the latter are more likely to understate the risks stemming from a build-up of excessive leverage.

While I am convinced that the leverage ratio has its merits as an additional tool for supervisors assessing banks' capital adequacy, I also believe that some of the current enthusiasm is not entirely justified. Firstly, the leverage ratio is by no means a new concept. In some ways it goes back to the roots of Basel I, which was dismissed by the Basel Committee on Banking Supervision for creating incentives for risky banking activities.

The same is true for the leverage ratio: when applied rigorously as a binding constraint for business, it favours the substitution of low-risk assets with high-risk ones. Judging from the Basel Committee's intense discussions, and keeping in mind the different accounting standards used, one can hardly argue that the leverage ratio is an easy-to-calculate panacea that renders the complexity of assessing a bank balance sheet a thing of the past.

When incorporating the leverage ratio into our supervisory toolkit, we should not turn a blind eye to risk-based approaches, but ensure that their central role in prudential regulation remains reliable and credible. The Basel Committee's work on balancing risk sensitivity, simplicity and comparability, such as the reviews of the standardised approach to credit risk and the trading book, help greatly here. At the European Banking Authority level, benchmarking exercises have also supported the drafting of harmonised standards for model validation methods and have helped identify areas for improvement vis-à-vis the risk weights resulting from the application of the internal ratings-based approach by banks.

To stay on target in an inevitably complex world of financial risks, banking supervisors are well advised to regularly recalibrate their sophisticated navigation instruments and, of course, to check their compass once in a while. ■

Removing regulatory uncertainty: a key policy priority

Jordi Gual - Chief Economist and Chief Strategy Officer, **Group "la Caixa"**

EU institutions start a new political cycle as the European economy appears to be on the mend. However, the recovery is tentative and patchy. In the wake of the ECB's review of European banks, weak credit growth is perceived as a drag for the economy. It is, therefore, critical to avoid policy mistakes and lingering regulatory uncertainty.
The contraction of bank lending within the Eurozone is both a supply and a demand-side phenomenon. As economic growth returns, nurturing loan demand and better credit quality, it is fundamental to ensure that supply-side constraints do no restrict bank lending. Over the last years, the accelerated implementation of the Basel III agreements has hindered loan supply, an effect that had been underestimated by the official quantitative assessment models. Those models were based upon simplifying assumptions which have not been borne in practice. In particular, they assumed no credit rationing and full access to capital markets, and both assumptions have proved untenable. The ex-ante assessments also considered a gradual introduction of the new requirements, but some Member States have introduced them much faster than planned. In a context of regulatory uncertainty, financial markets have also demanded accelerated compliance.

Policy makers should be extremely cautious with regards to the ongoing regulatory program. The priority must be to complete the calibration and the introduction of the already approved regulations and to assess their impact over the coming years.

The regulation of the banking industry has already been significantly strengthened, with a non-negligible procyclical impact on

economic activity. Removing regulatory uncertainty should now be the priority. The introduction of a regulatory moratorium would foster the recovery of bank lending. Anticipating no further regulatory requirements, banks would be willing to take on more credit risk and the financial markets would be willing to accept it. ■

Time to pause in the regulatory reform agenda

Etienne Boris - Senior Partner, **PwC**

Regulatory reform was a legitimate and necessary response to the shortcomings of the banking system revealed by the financial crisis.

The magnitude of the changes is such that it is having pervasive impact on all aspects of the business. New regulations are imbedded in policies and procedures at a very operational level. Individual behaviors change. To illustrate, the leverage, liquidity and capital ratios are managed as "scarce" resources not only at a global level but down to the deal level; the Basel committee proposal to move the Interest Rate risk in the Banking Book from pillar 2 to a standard pillar 1 capital requirement will impact lending decisions.

The complexity and quantity of regulatory change put employees under undue and endless stress adding human risk to risks resulting from the very complexity of regulations and to non-compliance risk. Fear of sanctions adds to employee potential excessive risk aversion.

The change underway is profound and far reaching with risk of unintended consequences.

Widespread concern over the unintended effect of regulation is increasing. Uncertainties are numerous; there are complex interactions between the different pieces of the new regulations and across jurisdictions, important banking activities are moving to the non-banking sectors. The banking system does not have the capacity to operate efficiently with so many moving parts. The growing prescriptive nature of regulation is a key factor influencing the markets, paving the way for potential distortions, herd behaviors, wrong incentive and potential threat to financial stability. New business models that are being driven by regulation create new risks such as asset bubbles. Regulation should fully recognize the critical importance of governance, culture and behaviors. According to the 2014 Banking Banana Skins the excessive weight of new regulation could damage banks and hold up the economic recovery. The cost of more regulation may well exceed the benefits.

Regulatory action was necessary. It is now time to pause. ■

Setting new priorities for EU financial sector legislation: target growth!

Jean-Paul Chifflet - Chief Executive Officer, **Crédit Agricole S.A.**

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In this context, what should be the key priorities of the new European Commission in the field of financial services? In our view, the new Commission should focus on four key areas:

Firstly, it should move away from purely *"constraints-based"* financial reforms towards more *"growth-orientated"* measures. To achieve this, the Commission should refrain from adding new layers of regulatory constraints on financial institutions and final users (e.g. financial transaction tax) and rather focus on the implementation of the recently adopted G20 reforms. The objective should be to help financial institutions comply with the new rules, whilst at the same time allowing them to fulfill their role in terms of financing the economy and supporting growth. In this context, it is important that the so-called "level 2" rules, or "technical standards", remain fully in line with the *"spirit"* of the level 1 framework legislation. Over-prescriptive regulation is never good: it typically adds cost and complexity to businesses and their final customers without necessarily improving the quality – nor the safety - of financial products or services.

Secondly, together with the European Central Bank and the European Supervisory Authorities, the Commission should pursue its work towards the finalization of *the Banking Union*, including the *"single rule book"*. What we need here, is a *"smart"* single rule book, one that can enhance the harmonization process of banking and financial rules across the EU, whilst at the same time respecting those national specificities which have been designed in the best interest of clients and which have demonstrated a prudent conduct of business.

Thirdly, the Commission should pursue its efforts to preserve the diversity of the European financial landscape whilst defending – at the global level- the importance of the European bank-led financing model and the key role of universal and cooperative banks in this process.

Finally, policy makers should aim to strike a better balance between, on the one hand, the need to secure a safer financial system, and on the other hand, the need to promote sustainable economic growth. European financial firms need to remain competitive and innovative within a framework of long-term and stable growth. Crédit Agricole fully supports the recent initiatives put forward by the Commission to promote long-term investment and infrastructure financing. We also strongly support regulators' efforts aimed at re-launching healthy securitization markets. These constitute, indeed, vital channels to re-boost the financing and growth of the European economy. ■

Next steps in improving regulation

Koos Timmermans - Vice-Chairman, **ING Bank**

As a result of the implementation of Basel III, individual banks and the banking sector as a whole have become more resilient. Capital and liquidity buffers have been strengthened significantly and with the BRRD a solid framework will be in place to deal with bank recovery and resolution. Also, bank's internal processes have been strengthened and capital and liquidity have become an integrated part of bank's strategic planning processes.

Despite the good progress that has been made, the different rules together result in a number of unintended consequences. Firstly, there is still a misalignment between the interests of local regulators and the European economy as a whole.

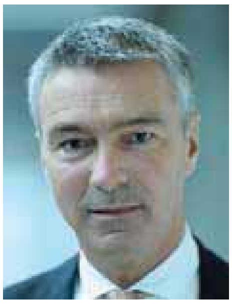
Local regulators limit the transferability of capital and liquidity between banks of the same group in different countries, in order to optimise the solvency and liquidity of the local unit. As a result of this a subsidiary in a liquidity-rich country would ultimately put its excess liquidity at the ECB, while the subsidiary in a liquidity-poor country would have to fund itself in the professional market. This makes bank lending in the liquidity-poor countries unnecessarily expensive and interest rates in the liquidity-rich countries unnecessarily low. Although this current approach is understandable from the national point of view, it is clearly sub-optimal for the European financial sector and the European economy as a whole.

Secondly, there is the impact of the revaluation reserve on bank solvency. Through the direct impact of the revaluation reserve on a bank's solvency ratio, bank solvency has become very sensitive to changes in interest rates; especially in the current low interest rate environment. In combination with the LCR, where banks are required to hold a liquid asset buffer to cover for potential outflows, this can have a significant negative impact on banks' lending capacity.

Based on EBA data, we can roughly calculate the impact on lending capacity of a 100bp upward shift in interest rates. Per Q4-2012 a group of 357 European banks held EUR 3.739 bio of liquid assets on a balance sheet total of EUR 33.000 bio. The average composition of the liquid asset buffers is such, that roughly 60% (EUR 2.200 bio) of the liquid asset buffer consists of interest rate risk sensitive securities (government bonds, corporate bonds, etc).

The market value of this part of the liquid asset buffer will be impacted by changes in the level of interest rates and the total change in market value will be reflected in a bank's solvency ratios. Assuming an interest rate sensitivity of -/- 1% for a 100bp upward movement in the interest rates, implies that in such scenario the solvency of this group of banks will drop with EUR 22 bio. Assuming an average leverage ratio of 4% for this peer group, this means that the lending capacity of this group of banks declines by EUR 550 bio in case of a 100bp upward movement of interest rates.

It is clear that in a scenario of economic growth, which is normally accompanied by an increase in interest rates and an increased demand for lending, banks could face great difficulty facilitating economic growth by providing credit to the economy. This is a clear example where new regulation, i.e.



LCR, on a standalone basis makes much sense, but has severe negative consequences when looking at entire capital- and liquidity framework.

One of the most important priorities while making the banking sector more resilient, is to minimise the impact on the real economy. Corporates – especially SME – and households are still very dependent on banks as source of their lending.

Full transferability of capital and liquidity would be a logical next step in the integration of the financial sector in Europe, one that would have a positive impact on the cost of bank lending in liquidity-poor countries. Also, addressing the negative impact of increasing interest rates on bank's lending capacity is important to ensure that banks can continue to lend in a scenario of economic growth.

It is important to address these issues, in order to ensure that the banking sector can continue to be an enabler of economic growth rather than to becoming a decelerator of economic growth. ■

Managing the leverage of the financial system for growth and stability

Douglas Flint - Group Chairman, **HSBC Holdings plc**

Some commentators argue that increasing the ratio of capital to bank assets carries little or no additional funding cost. They argue raising bank capital reduces the risk that the bank will fail so equity investors will settle for lower returns and the effect on the economy and bank will be neutral.

This might work if these were the only factors to consider. But the world is not that simple: we have introduced distortions to the price of funding such as tax incentives and deposit insurance. Our investment pools are separate by geography, industry and asset class so the supply of equity finance for banks is not infinite. And we cannot escape the underlying mathematics of tail risks – the benefits from each new tranche of equity are not the same, as the reductions in risk of failure become progressively smaller. Ultimately, there will be an inflection point beyond which investors will deploy their capital elsewhere in the economy.

This would have little impact if banks simply acted as intermediaries for depositors and investors' money. But banks create new money through lending (see Bank of England, *Money creation in the modern economy*) and the volume of credit in the economy can have a major impact on both financial stability and economic growth. The crisis was the result of unrestrained credit expansion during a prolonged period of stable interest rates. Conversely, as we saw in the second phase of the financial crisis, less lending was a constraint on economic activity. The volume of credit needs to be managed and, like an inflation target, any goal should be both symmetrical and subject to democratic oversight.

How is this achieved? It is clear from the crisis that credit volumes cannot be managed simply through monetary policy and a single interest rate target. Credit volumes need to be managed using macroprudential tools, targeted where there is asset price distortion – both bubbles and dips. We need a framework to determine when these tools should be used – based on leverage, measured not just in banks as they are not the only source of equity and risk, but across the system as a whole including households and corporates. This approach would also apply for asset classes where discrete risks arise. And unlike the bank leverage ratio, this may actually recognise asset classes where the risks are genuinely low because it counts the 'skin in the game' from the owners of those assets. ■

Banking regulatory requirements and the flow of finance to the EU economy

Mario Nava - Director Financial institutions,
DG Internal Market and Services, **European Commission**

The financial crisis and the costs it imposed on the EU economy showed that a fundamental reform of the banking sector and the wider financial system was absolutely necessary. Our reforms have been guided by the clear objective of building a financial system that better serves the real economy and facilitates sound growth in Europe.

At the same time considerable efforts have also been made to strike the proper balance between ensuring financial stability and facilitating an adequate and sustainable flow of finance to the real economy. Recent Commission analysis shows that many impediments to the flow of finance in Europe have in fact little to do with regulation, and that higher capital and liquidity requirements for banks are unlikely to have a significant impact on bank lending to the economy.

The most recent results from ECB lending survey are promising. For the first time since 2007[1] banks are easing their lending standards in Q2 2014. These results support our view that the reform process has also been mindful of the potential costs of regulation. Rules have been made subject to observation periods or phased-in and, where required, appropriately adjusted.

But these remain preliminary findings. The Commission will conduct an in-depth review of the impact of the Capital Requirements Regulation (CRR) on long-term financing. In fact the CRR foresees two reports for submission to the European Parliament and the Council by end 2015. In the meantime, full implementation of the CRD IV package is continuing and some major challenges still lie ahead. For instance, the new liquidity standards in our prudential regulations will have to balance the need for banks to withstand liquidity shocks while allowing them at the same time to engage in maturity transformation by lending to finance needed long-term investments. While the role of banks remains fundamental, there is a need to further develop EU capital markets. We need to promote the development of alternative funding sources, as identified in the Commission's March 2014 Communication on long-term financing[2]. ■

1. The Euro Area Bank Lending Survey. 2nd quarter 2014; July 2014; ECB; https://www.ecb.europa.eu/stats/pdf/blssurvey_201407.pdf?da48b686a17b77a3521c30083610656f
2. Communication of 27 March 2014 (COM (2014) 168) from the Commission to the European Parliament and the Council on Long-Term Financing of the European Economy; http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0168&rid=1

Regulators need to assure the right balance between the strengthening of banks' resilience and their ability to lend to the real economy

Dr. Karl-Peter Schackmann-Fallis - Executive Member of the Board,
Deutscher Sparkassen- und Giroverband (DSGV)

One of the major challenges in the context of the calibration of the upcoming regulatory requirements will be to assure the right balance between the regulatory aim to strengthen the resilience of the European banking sector and the ability of the financial system to channel funds to the real economy, in particular to SMEs. SMEs do not only need long-term bank lending, but also an expansion of bank lending to pave the way for a strong economic recovery.

The new liquidity management requirements for banks will, the way they are designed now, potentially discourage long-term financing. It is therefore paramount to adapt the calibration of international standards to the specificities of the European context:

- *LCR:* The definition of liquid assets should be broadened and the instruments to be included into the buffer of liquid assets enhanced in order to diversify the HQLA buffer. Therefore, instruments such as covered bonds, credit claims and asset-backed securities of good quality should be included or given better treatment in the buffer.
- *NSFR:* The observation period should be fully used to review unintended consequences on corporate financing. In the current set-up, this ratio would strongly reduce the maturity transformation capacities of banks and limit their credit intermediation role.
- *Leverage Ratio:* As currently designed by the Basel Committee, it would eventually have an undesirable side effect on the market making of government and corporate bonds which runs contrary to the Commission's objective to develop capital markets in Europe.

Currently the Basel Committee is also working on a fundamental review of the Standardised Approach (SA) for credit risk with the aim to reduce the use of external ratings and simultaneously raise risk sensitivity. We are worried that the new SA will entail new administrative burdens, especially for small- and medium-sized banks, which are generally strongly involved in SME lending. Negative impacts on the lending capacity of these banks may be the result. ■

Innovation and competition: main drivers of the new legislation on payments

Emerico A. Zautzik - Director General for Markets and Payment Systems, **Banca d'Italia**

In the financial sector, as in other sectors, the validity of a regulatory framework can be measured by its resilience with respect to changes in the external environment. In the world of payments, the most relevant changes are now linked to the spread of services on the Internet and via mobile, to the establishment of new business models on the web, to new user habits.

The security of payment transactions is a vital requirement to support the confidence of the consumers in the most advanced services. A further requirement refers to speed and simplicity, in particular for transactions of small amount.

PSD2 will need to confront all these aspects. In order to manage, in a dynamic and harmonized way, the innovations proposed by market agents it is crucial to ensure technological neutrality of the legal solutions and to define stringent and reasonable rules for security issues. The development of payment solutions tailored to the needs of the user can be promoted by a proportionate approach to risk.

Competition is another key issue. The goal of PSD1 in this regard has not been fully attained yet: fair competition has been hindered by regulatory uncertainties that may have encouraged regulatory arbitrage. European legislators must remove these limitations with PSD2. The strengthening of competences of the host country supervisory authorities, the review of the exemptions applicable to telecom and web operators, the new discipline of the services offered by *third party providers* are all moving in this direction.

In the field of payment cards, the regulation on interchange fees is an opportunity to foster competition among all operators and to improve the conditions applied to customers. This opportunity must not be missed.

Taken together, the proposed legal acts should form a more stable and modern framework of rules, able to attract the most innovative operators in the payment market, in full compliance with the rules of an open competition.

The Italian Presidency will seek full convergence of Member States on the legislative package, with the awareness of the importance of the reform to achieve the objectives of growth and integration of the European single market. ■

Card fraud: high interchange is not better security

Mario Nava - Director Financial institutions DG Internal Market and Services, **European Commission**

The value of fraudulent card transactions within SEPA amounted to 1.3 billion EUR in 2012. Looking into the details, 60% of the value of fraud (and growing strongly year-to-year) resulted from card-not-present (CNP) payments, mainly internet payments. If we take into account that 3.5% of the EU retail trade is currently transacted online, part of it by means of cards, this is a high figure. As card fraud at the POS and ATMs in the EU has been mitigated thanks to introduction of EMV ("chip and PIN"), fraudsters shifted to other countries with lower security standards. Furthermore, much of the fraud happens outside SEPA: 2% of SEPA card transactions are done outside the area, but they account for 25% of all card fraud.

These figures lead to several observations. First, is a card payment a good choice for an internet transaction? There are safer, often less costly and more convenient solutions to do online payments than cards. Yet, in a market of unregulated, high interchange fees, providing high and easy income, there is little incentive to offer compelling alternatives to card payments. Second, as fraud goes where the security is weaker, be it to CNP payments or card payments outside the EU, our answer should be to step up the overall security of internet transactions and this is what we propose in PSD2. On the other side, as payments are increasingly global, we need to encourage others to follow the same route.

Attempts to link the card fraud discussion to the matter of interchange fees levels are not convincing in theory and not supported by facts. Interchange fees are not the tool to address the issue of fraud and cannot be justified by the need to compensate banks or their clients for incurred losses. Otherwise, there would be no incentive for the card systems and banks to fight fraud, plain and simple. As an example, one may observe that in those markets, where high interchange fees are explained as necessary to tackle fraud on signature cards, investments in the security of card transactions, e.g. in EMV implementation, are actually blocked for years. ■

Emerging security threats increasingly require a coordinated European response

Denis Beau - Director General Operations, **Banque de France**

The European landscape of electronic payments has changed considerably with the entry of new actors and an influx of innovative payment solutions. Although necessary in order to answer evolving users' needs in the wake of the rise of e-commerce, these changes have introduced new vulnerabilities and security weaknesses in the processing chain of electronic payments. As the European retail payments market becomes ever more integrated, it is of the upmost importance that these emerging security threats be addressed in a coordinated manner at the European level.

Much attention has been focused in recent years on the security of payments made over the internet which is more exposed to risks of fraud than proximity payments. The need for a coordinated European response to those risks was the driving force behind the creation in 2011 of the European forum on the security of retail payments (SecuRe Pay), which brings together national central banks and supervision authorities.

Building upon the groundwork of national authorities or committees involving the major stakeholders, such as France's Observatory for payment card security (OSCP), this forum published a set of harmonized recommendations for the security of internet payments in 2013 with the goal of having them enforced by February 1st, 2015.

Noting that the high fraud rates of internet payments is mainly due to the use of static data easily reusable by fraudsters, the forum notably called for the wide scale adoption of strong payer authentication, a measure promoted by the OSCP since 2008. It is therefore quite welcomed that strong authentication measures are foreseen to become a legal requirement in the reviewed Payment Services Directive currently under consideration by European authorities.

It is important that the same cooperative approach be taken when addressing the security risks linked to innovative solutions, such as the involvement of third party payment service providers (TPP) in the payment chain. On this particular topic, and although discussions are still ongoing, a European consensus is

emerging on the fact that TPPs should be subject to licensing, which is a step in the right direction. A similar approach could be taken for actors providing conversion services for virtual currencies. ■

Reform Policy: A positive push in payments

Gottfried Leibbrandt - Chief Executive Officer, **SWIFT**

The policy intent behind the current slew of payment market reforms is rightly centred on ensuring safety, transparency, innovation and competition.

Meeting the resulting challenge isn't to be underestimated; it will require agility, innovation and creativity. As a provider of vital services to the payments industry, SWIFT is working to that very end; we are innovating and adapting our services and solutions to enable our community to adapt to these regulatory changes.

In the area of safety, for instance, we see initiatives such as the CPSS-IOSCO principles, focused on ensuring that payment market infrastructures are resilient and quickly able to recover essential services. SWIFT not only believes it meets the new requirements that the CPSS has set for Critical Service Providers to market infrastructures, but we also recently developed a service designed to offer market infrastructures additional operational resilience.

The Market Infrastructure Resiliency Service (MIRS) is a generic payment settlement service which is hosted and operated by SWIFT and designed to keep key functions of Real Time Gross Settlement (RTGS) systems operating in the event of a major outage.

Transparency is meanwhile manifested in the AML Directive, which will implement the latest FATF requirements. Here, SWIFT has already implemented the related data requirements in our message standards, and we are also enabling our community to manage the financial crime challenge with a range of new services including: sanctions testing, sanctions screening and a KYC registry.

And in innovation and competition, there is PSD II, which seeks to open up access, widen consumer choice and encourage new market entrants. The same policy push is also ensuring that real-time low-value payments systems are now gaining momentum; this move is not without challenges, not least on the technology front, but here too SWIFT is actively pursuing new solutions.

With messaging services, standards, technologies and ancillary services supporting both domestic and international payments, SWIFT not only welcomes the policy goals, but is proud to be working to help the industry meet them. ■

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Remittance payments and their contribution to the EU economy

John Dye - Executive Vice President, General Counsel and Secretary, **Western Union**

Money transfer operators provide consumers with a fast, secure and convenient way to transfer funds. At Western Union we offer services to more than 200 countries and territories. The size of the global remittance market will reach $600 billion by the end of 2014 and is expected to grow by 7-8% in the coming two years.

Remittance services are used by individuals to support relatives. They are also used by NGOs to support projects all over the world. What might be less known is that a significant part of the business caters for SMEs engaged in international trade.

Remittance transactions are often one-off transactions involving small sums of money but they play a crucial role in fostering financial inclusion by ensuring that underserved consumers have access to formal financial services. The EU regulatory framework needs to stay proportionate in order not to overburden such remittance transactions, thereby fuelling an already sizeable informal remittance sector.

An important element of the remittance business model are 'agents': partners across the globe where consumers can make or receive payments. At Western Union, two thirds of the agent network consists of financial institutions, with the remaining part being non-financial companies, such as local convenience stores.

As the EU develops its regulatory framework for payment services the rules for these agents need to be proportionate to the type of service they are providing.

This aspect should be addressed with reference to the current revisions of the Payment Services Directive (PSD) and the 4th Anti-Money Laundering Directive (AMLD):

- We believe that there is no need for separate PSD fit and proper requirements where a regulated EU financial institution acts as agent.
- The EU should introduce an effective home/host cooperation framework for the supervision of agents, without adding new local reporting requirements.
- A properly authorized and supervised payment institution should be able to open and maintain bank accounts.
- The concept of a Central Point of Contact in the AMLD should be applied flexibly and in a proportionate manner.
- The ESAs should take into account the specificities of the remittance sector when drafting future guidelines under the AMLD or revised PSD. ■

Payment card system: the dangers of too low interchange fees

Rémy Weber - Chief Executive Officer, **La Banque Postale**

Multilateral interchanges fees (MIF) are necessary to enable issuing banks to maintain affordable card prices for consumers. If consumers had to bear their real share of the cost of the payment card system (substantial and continuous investments for innovation and safety), they would prefer using other (and facially free) payment instruments, like cash. But cash is less efficient than cards for all economic players. Reducing the cost of cards for consumers is therefore essential to ensure broad card issuing and wide use. Yet, low prices can be guaranteed by issuing banks only if they receive contributions from the merchant banks: it is the very purpose of MIF.

Excessive MIF discourage merchants from accepting cards. It is true. But drastic reduction of MIF will have damaging effects on consumers. And the problem is that the European Commission is currently working on a MIF cap too low to ensure the system balance. If such caps are indeed applied, consumers will necessarily support increased bank costs. And debit cards users (among them are the most vulnerable people) will especially suffer this, if the cap for debit card (0.2%) is lower than the cap for credit card (0.3%).

Moreover, there is no analysis demonstrating that merchants would pass on the cost savings from lower MIF to consumers by reducing their prices. Consumers would therefore be losing out on both sides.

One of the draft regulation objectives is the development of payment cards in the European Union. I agree with this target. But it will not be reached if the MIF caps are too low, as consumers will not buy cards.

So what is the right level for card MIF? It probably differs from one country to another, as domestic payment markets are very different in Europe: number of cards issued, percentage of merchants accepting cards, presence of domestic payment systems, universality of the card, consumers habits on cash usage, transfers or checks...

So a 0.5% cap for debit and credit cards can both prevent merchants from too high costs and consumers from damaging consequences, thus giving Member states sufficient flexibility to determine their optimal MIF levels according to the specificities of the country. ■

Challenges to adopt PSD 2 and concerns for banks

Jean Naslin - Head of European and International Public affairs, **Groupe BPCE**

There is unfinished work to be done with important questions left open requiring further debates.

Much has already been done in order to better protect the account holding consumer and begin to balance the liability issues raised by the intervention of third party payment providers in the value chain in particular where it comes to the provision of clear, transparent and comprehensive information and their duties and obligations.

There are still some very critical issues left open concerning the selection of third party payment services providers to effect a payment transaction and how Payment initiation and use of Payment Account information will be treated as well as unintended consequences in case of fraud with a single key stroke or in the event of a loss as a consequence of any given failed transaction. Banks should not be expected to bear the cost of the payer's choice.

For the sake of fostering competition and develop e commerce the Commission proposal was prepared to allow free use of account holders[1] credentials to access their payment accounts, gather and re-use account history, and initiate payments. The Parliament has rightfully limited the type of information and data to be collected (only one-time credentials may be shared by the account holder and the third party) although still underestimating implications of developing technologies such as search engines.

What is at stake is consumer protection and the trust that consumers place in the security of e-payment transactions allowing for a competitive market place conducive to innovation.

Banks play a central role in clearing payment transactions and should continue to do so, acknowledging that payers should be allowed to engage with merchants and related service providers as they deem suitable provided they are appropriately informed and indeed protected against any unintended consequences. ■

A unique opportunity to expand financial offer to consumers beyond traditional limits

Fernando de la Rica - Head of Loans and Payment Systems Director, **Banco Bilbao Vizcaya Argentaria (BBVA)**, Spain

New digital technologies and Internet expansion have created an environment in which companies of all sizes have access to the international market, enabling them to grow faster, improving their economic efficiency and profitability. Consumers have easy access to new digital services that are offered from all across the world. E-Commerce is just one example where convenience and competitive prices are the reasons behind fast growing figures.

We have witnessed a broad range of industries transformed by new technologies, and financial services is one of the next to go through a deep transformation process which has already started including new non-bank competitors that have gained relevant position in every part of the banking value chain. Niche players like Paypal or even "Internet giants" like Google, Facebook or Amazon, are entering financial services in one way or another offering easy, user-friendly ways to offer payments process at competitive costs. Virtual currencies and alternative online-payment networks as Dwolla or Ripple are also starting to thrive, while traditional networks still deal with off-line clearing and settlement process. All these new players have a growing customer base and in many cases, they operate globally from geographies where regulation is laxer or even non-existent involving manifold risks.

Yet the potential of e-commerce and digital economy and the opportunity it provides for economic growth cannot be fully exploited unless a trustworthy environment is defined for the different stakeholders, companies, consumers. Thus, regulators should tackle the big challenge to ensure security, privacy, consumer protection and systemic stability in a digital world and, at the same time, leave space for fair competition and innovation, promoting transparency and benefit customers. Regulation in this area must be international in scope, as e-commerce is truly global and inconsistencies in national regulations may hinder its development.

For banks shifting from "place" to "space," from the physical to the digital world is a matter of survival and at the same time a unique window to expand banking beyond its traditional limits. BBVA´s digital banking strategy includes, nevertheless, the development of new channels and distribution models, offering new digital products, adapting internal processes, human talent, organizational structures and corporate culture, all of them geared toward excelling on the customer experience front with an innovative, convenient and secure experience. ■

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Europe moves forward: SEPA this year, T2S next year

Jean-Michel Godeffroy - Chairman of the T2S Board & Co-Chairman of the PSSC, **European Central Bank (ECB)**

Cross-border infrastructures and harmonised processes are preconditions for the achievement of effective financial market integration, an important target on the European agenda. Though they rarely make headlines, these preconditions are essential for our currency to work smoothly. I am happy to be witnessing very good progress in this field.

The first step was the establishment of TARGET, the large-value payment system launched in 1999 to support the creation of a money market for the euro and the implementation of the single monetary policy in the euro area. Its successor, TARGET2, opened in 2007.

Big changes are now taking place on two fronts: retail payments and securities settlement. Since 1st August, all credit transfers and all direct debits in the euro area have followed a single set of SEPA standards. Next year will see the launch of T2S, the new platform for securities settlement in central bank money. Today, money can be transferred with equal efficiency from Lisbon to Helsinki, from Aachen to Arlon or from Paris to Marseille. Tomorrow, with T2S, the same result will be achieved for securities.

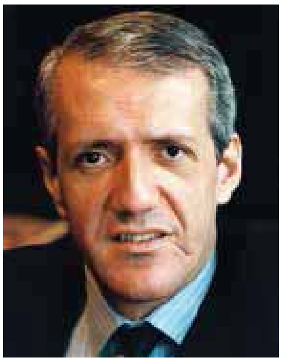
In both cases, the euro and the Eurosystem have been the catalysts for market integration. However, SEPA and T2S are also available to European countries that have not adopted the euro, if they so wish.

Rome wasn't built in a day – and neither will Europe be! In order for both SEPA and

T2S to fully deliver their benefits, continued efforts are needed on the part of both the authorities and the industry. On the SEPA front, much remains to be done, for card payments and also for new payment procedures such as electronic invoicing or mobile payments. A fully efficient T2S requires harmonised standards and practices for securities processing. To allow market participants to contribute, the Eurosystem has set up dedicated Europe-wide governance arrangements with stakeholders from the payments and securities sectors: the European Retail Payments Board and the T2S Advisory Group. European market integration will continue to be a success if public authorities and market participants continue to work hand in hand. ■

The European financial system: an unfinished project

Alberto Giovannini - Chairman, **MTS**



In Europe the drive to make the financial system more efficient dates back many years. The original approach was that of the single market. Controls on capital movements among member states were disbanded. Later, the Financial Services Action Plan aimed at achieving what the simple liberalization of investment flows could not, by delving into the details of individual regulations (the equivalent of tackling non-tariff barriers in international goods trade). Along the same logic, the initiatives in the clearing and settlement area were also inspired by the observations that a number of different barriers provided a hindrance potentially preventing securities trading across EU member states. The recent financial crisis has exposed many failures of associated with a fragmented supervisory regime and, in the case of the Euro-Area, of a potentially incomplete union, limited to the currency. This prompted a new wave of regulatory initiatives.

Some of the recent reforms have tremendous transformational potential. Among them, the Target 2 Securities project, providing a single settlement engine in Europe is certainly one of them. The Single Supervisory Mechanism which creates a regulatory level playing-field for the European banking system will also change in a fundamental way the structure and functioning of the financial system. But these have not stopped the initiatives of national and European authorities: the current project being talked about is the Capital Markets Union (a concept parallel to that of the Banking Union).

The project of the Capital Markets Union responds to the desire to improve the financial system and make it a strong pillar supporting a vibrant, innovative economy, and to facilitate access to financial resources by all actors in the economy, including small enterprises, complementing the functions of the banking system. Ideally, it should create a framework of rules covering securities law, bankruptcy rules, capital markets regulations, secondary markets designed to allow the development of a uniform securities market, which means a market that can issue and trade large sizes, therefore supporting liquidity.

What are the challenges? The main one is that individual member countries have very different financial systems, different practices and different degrees of efficiency. Hence, they do not all have the same incentives to embark in wide ranging reforms.

Another significant challenge is that the governance of financial markets by public authorities needs to account for the fact that private actors normally operate globally, therefore requiring strict and solid cooperation among national authorities, including exchange of information. My perception is that there is still a lot to be accomplished on this front. ■

Financial Market Infrastructure - The way forward

James Cunningham - Managing Director and Senior Advisor, Office of Public Policy and Regulatory Affairs, **BNY Mellon**

Financial market infrastructure is undergoing major change. The list of new legislation is intimidating: MiFID2/MiFIR, EMIR and CSDR, amongst others; and we should not forget other initiatives such as TARGET2-Securities.

The size and impact of these measures explain why many observers are calling for a halt to new initiatives.

But as regulators and market participants work their way through these measures, they will see gaps and shortcomings, and will identify areas for further work.

This further work falls into three categories.

The first is the category of competition. More work is needed to open up markets, and to lower barriers to entry. The new legislation has positive effects, in particular by increasing access rights. But the approach of creating separate regulatory categories for market infrastructures, of mandating the use of market infrastructures, and – very justifiably – of imposing high prudential and conduct of business requirements, has the effect of raising barriers to entry, and of privileging incumbents.

A second category covers topics that have been largely untouched by the new legislation. One such topic is securities law. The liability regime set out in AIFMD and UCITS V may, or may not, be an appropriate measure to tackle legal risk in non-EU countries; but as a measure to deal with legal risk in EU countries, it is absurd; we do need to ensure that the legal regimes in all EU countries fully recognize the role of intermediaries in custody holding chains, and safeguard the rights of end investors.

Another such topic is tax procedures. Despite excellent preparatory work by the European Commission and by the OECD, we have seen little progress in this area. This is doubly disappointing. Idiosyncratic national tax procedures place heavy burdens on end investors, on intermediaries and on market infrastructures; they inevitably have the effect of discriminating against individuals, and other small investors. They should be part of an agenda to achieve fairness in taxation.

A third category covers the technical implementation of the new legislation. Three topics that need particular attention are the topics of pre- and post-trade transparency, of settlement discipline, and of mandatory segregation of securities positions. In these last two cases, we see a tool that is effective in achieving specific objectives being used to try and achieve broader objectives, with – unsurprisingly – suboptimal effects. ■

Delivering on the objectives of MiFID II

Edwin Schooling Latter - Head of Market Infrastructure & Policy, **Financial Conduct Authority**, UK

The objectives behind MiFID II were clear: to make markets more efficient, resilient and transparent, and to strengthen the protection of investors. The framework legislation agreed earlier this year represents a significant step towards achieving those objectives.

Resilience will be advanced by new requirements for circuit breakers and on firms using algorithmic trading strategies. There is to be a comprehensive regime of pre and post-trade transparency for the trading of all financial instruments. This will be backed by enhanced proposals to ensure that market data is made available on a reasonable commercial basis. Improvements to transparency and data access also support an efficient price-formation process.

On investor protection there are important enhancements to existing MiFID provisions on inducements and best execution. There are also explicit new provisions on the control of the design and distribution of financial instruments, and the remuneration of sales forces.

MiFID II will be implemented on 3 January 2017. Getting from here to there will be testing. Firstly, there is still a very significant amount of complex policy work that has to be done to complete the implementing measures and provide interpretative guidance. Secondly, the breadth and depth of the practical changes required of both firms and regulators is such that it will require considerable planning.

To meet its objectives the changes required by the legislation have to be deliverable, and delivered, on the ground. In some areas, such as aggregated disclosure of costs and charges, transaction reporting, position reporting and transparency obligations, there will be significant systems implications.

To make sure they can implement on time firms need to begin the initial phases of their implementation planning now. A strategy of "do nothing" until all the technical standards are completed will put firms at significant risk of being unable to comply in time. Regulators will need to support firms in their planning through education about the new obligations and an open dialogue to identify issues and seek practical solutions. ■

Application of clearing to diverse asset classes

Paul Swann - President and Managing Director, **ICE Clear Europe**

Centralised clearing has been applied to a range of different types of products during its long history, including exchange traded derivatives, more recently securities, and most recently OTC derivatives. Each of these product types has different characteristics, clearing properties and competition considerations.

For securities, which are homogenised products, and have a considerably shorter settlement cycle than many derivatives, regulators have approached competition between CCPs through interoperability.

This policy decision does not read across to exchange traded derivatives (ETDs) for two structural reasons. First, ETDs are individually designed by trading venues; and second contracts require life cycle event management throughout their tenor which may be measured in years. Competition in exchange traded derivatives comes about as a consequence of different trading venues creating competing products.

OTC derivatives have different considerations. First, OTC contracts are typically traded under standard ISDA terms; second, regulatory reform is forcing market participants that trade in OTC markets to clear. As a consequence, regulators have realised that this creates a significant dependency, particularly where certain OTC contracts may be reliant on a single CCP to underpin them. If the CCP fails, aside from the financial consequences for the participants, the market may become illiquid and systemic risks similar to those which emerged in 2007/8 may reoccur.

The policy solution to this should be encouragement for more than one CCP to service each OTC derivative class; and also to ensure CCPs have robust and viable resolution and recovery plans. This policy objective will need to be weighed against the inherent advantage of centralisation of risk which benefits both direct and indirect users by optimising margin correlation benefits. The author believes that the

market will find the best solution to this problem, subject to close monitoring by relevant authorities. ■

What are the main challenges ESMA is facing in defining MIFID and MIFIR's level II standards? what are the main next steps?

Verena Ross - Executive Director, **European Securities and Markets Authority (ESMA)**

ESMA's MiFID II/MiFIR consultation process is an important step in the biggest overhaul of financial markets regulation in the EU for a decade. The reform of MiFID is an integral part of the EU's strategy to address the effects of the financial crisis and aims to bring greater transparency to markets and to strengthen investor protection. These changes are key to restoring trust in our financial markets.

MiFID II/MiFIR introduces changes that will have a large impact on the EU's financial markets, these include transparency requirements for a broader range of asset classes; the obligation to trade derivatives on-exchange; requirements on algorithmic and high-frequency-trading and new supervisory tools for commodity derivatives. It will also strengthen protection for retail investors through limits on the use of commissions; conditions for the provision of independent investment advice; stricter organisational requirements for product design and distribution; product intervention powers; and the disclosure of costs and charges.

ESMA must now translate the Level 1 of MiFID II/MiFIR requirements into practically applicable rules and regulations to address the effects of the financial crisis and to improve the financial market transparency and strengthen investor protection. It will do this based on as much analysis of concrete data as possible and by holding extensive consultations with all stakeholders.

ESMA considers that many of the changes introduced by MiFID II/MiFIR are designed to enhance transparency, create sounder financial markets and stimulate firms to place consumers at the centre of their business models and product designs. ESMA's challenge is to ensure that a robust supervisory model is built around these objectives and that the relevant Level 1 provisions are adequately implemented while at the same time ensuring the feasibility and cost benefit balance of any proposals.

ESMA is now in the process of reviewing over 400 responses to its Consultation Paper and over 300 to the Discussion Paper. Following this review, ESMA will deliver its final technical advice to the Commission and hold another consultation round for the technical standards by the end of the year. ■

Priorities of EU Commission in the securities and derivatives trading and post-trading areas

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

MIFID II represents a key step to creating a safer, more open and responsible financial system. Having agreed this legislation, our first priority is to ensure that it is implemented on time and as intended. The timetable is challenging but achievable. ESMA has already completed the initial consultation for the level 2 implementation rules, which we aim to have in place at least 6 months before the legislation comes into application. This should allow sufficient time for market participants to adapt.

However the implementation of MIFID II cannot be considered in isolation; securities and derivatives markets are both global and interrelated. G20 commitments, in particular in relation to derivatives, are implemented in Europe through MIFID II but it is inevitable that other jurisdictions will move at different speeds. To avoid dual regulation, the St Petersburg G20 communiqué agreed that regulators should defer to each other when justified by the quality of their respective regimes. However the challenge is not just to realize this once all the final legislation is in place, but also to ensure a smooth transition in the intervening period. As the 'Path Forward' agreement sets out, the European and US authorities are working to ensure a transition to a safer financial system without fracturing international capital markets.

In relation to CSDR, the first challenge is that CSDR will come into force close to the launch of T2S. The contemporaneous implementation of two major harmonisation initiatives may be a challenge for CSDs, their participants and markets. Secondly, CSDR introduces a new, more European supervisory framework for CSDs which will change the way in which supervisors work, such as by requiring cooperation arrangements and the involvement of ESMA. These challenges are however an inevitable consequence of regulatory change. The changes to CSDR and T2S have long been foreshadowed and the benefits of more efficient and safer settlement in the EU will outweigh the current implementation challenges. ■

Will MiFID II / MiIFR help capital markets to better serve the EU economy?

Dominique Cerutti - Chief Executive Officer and Chairman of the Managing Board, **Euronext**

Well-regulated infrastructures which are orderly and transparent should be the aims of any legislative proposal. It is absolutely right for policy makers to require minimum standards of safety and prudence in the way in which business is conducted. It is also legitimate for them to prohibit and take actions against abuse which can result in loss and damage to market confidence. One size fits all solutions would stifle innovation and choice.

Most of the financial reforms currently being pursued in the EU meet the test of addressing demonstrable market failures but they don't necessarily help directly the best financing of the economy. With MiFID II/R, policy makers have identified clear market failures and have determined a policy response based on the costs and benefits of different policy options.

In contrast, some other items have made their way onto the regulatory agenda without having passed the test of addressing a demonstrable market failure. These items pose considerable dangers for the system as a whole because they run the risk of imposing damaging without addressing any manifest weaknesses in the operation of the market.

For example, while requiring mandating open access between EU trading venues and CCPs within MIFIR might seem superficially attractive, it has the capacity to undermine the continued ability of proven market infrastructures to both manage financial risk at the clearing level and maximise liquidity at the trading level. Another example relates to market data relies on the undocumented assertion that market data costs in Europe are too high. Consequently, the proposed approach fails to take account of the characteristics of the market and would not, if imposed, deliver any of the supposed benefits. Finally, there is also great doubt that the SME Growth Market would not fragment the scarce liquidity available for this type of firms.

Overall, the proposed framework introduced by MiFID II is likely to improve the current situation but its objectives of fostering more safety, resilience, and efficiency in EU capital markets should remain paramount to the level 2 process. Thus regulators and legislators must ensure these objectives, central to strengthening the capital markets' financing of the real economy, are met. At the same time, I urge regulators to also ensure that proven infrastructures are not be undermined by proposed reforms which, whilst well-intentioned, may produce some unintended consequences and thus undermine the benefits of MiFID II. ■

Challenges remain in the implementation of post-trade regulation

Marc Antoine Autheman - Chairman, Euroclear

Much welcome progress has been made with the recent finalisation of the CSD Regulation (CSDR), although the current post-trade regulatory agenda is not yet quite complete. We still await the precise technical standards that will underpin the CSDR, as well as further details of how Recovery and Resolution mechanisms will be applied to Financial Market Infrastructures.

The most uncertain element of the CSDR remains the design and implementation of a European settlement discipline and buy-in regime covering a wide range of asset classes, many of which have never before been subject to such a regime. This is a topic that affects all users of securities markets. Settlement rates in the EU are already in excess of 98% by value, so any regime must be proportionate. And the consequences of new fines on asset classes such as funds, or on financing transactions such as repos, must be fully understood before the rules are applied. The industry is already working together with ESMA and other authorities to ensure that the most efficient model is applied.

There is also a very real capacity challenge for the post-trade industry. Over the next three years, 24 CSDs and their clients will migrate to Target2-Securities (T2S), the largest IT project ever attempted in the post-trade world. It would not be prudent to expect the industry to implement a complex new settlement discipline regime at the same time as migration to T2S; especially when Europe will also have only recently moved to a T+2 settlement period. A phased approach to these initiatives is essential to preserve market integrity and reduce systemic risk.

We strongly support the introduction of a consistent settlement discipline regime across the EU, but its consequences – both desired and unintended – must be carefully considered. We must all ensure that the final regime improves market efficiency, and does not impose unnecessary burdens on clients or create wider inefficiencies. ■

About EUROFI

The European Think Tank dedicated to Financial Services

- **A not-for-profit organization created in 2000 chaired by Jacques de Larosière**
- **A platform for exchanges between the financial services industry and the public authorities addressing issues related to the evolution of financial regulation and supervision**

MAIN ACTIVITIES

The main objectives of Eurofi are to help industry and public decision-makers reach a common understanding of possible evolutions required in the regulation and supervision of financial services and to open the way to legislative or industry-driven solutions that may enhance the safety and effectiveness of the EU financial sector.

Eurofi acts in a general interest perspective, facilitating exchanges of views between diverse financial industry players and the public authorities. These exchanges are prepared by objective fact finding and issue analyses.

Eurofi has two main types of activities conducted by **Didier Cahen**, Secretary General of Eurofi, **Jean-Marie Andrès** and **Marc Truchet**, Senior Fellows:

Events and meetings:

- **Eurofi organizes annually two major international events (the High Level Seminar in March / April and the Financial Forum in September)** gathering together industry leaders and EU and non-EU public decision makers for discussions on the major on-going regulatory projects in the financial area, as well as informal networking.
- These events have been organised in recent years in association with the EU or G20 Presidencies in parallel with informal ECOFIN councils or G20 Finance Ministers meetings. They are organised with the support of **Christian Hawkins** and his team.
- **Additional workshops** involving the members of Eurofi are set up to exchange views on regulatory issues. Bilateral meetings are also regularly organised with representatives of the public authorities and other stakeholders (e.g. end-users, experts) to fine-tune assessments and proposals.

Research and documentation:

- Assessments and proposals taking into account economic, risk and end-user impacts are prepared with the support of cross-sectoral working groups comprising members of Eurofi.
- Topics addressed include prospective and on-going regulatory proposals at the EU and global levels, as well as industry trends.

Central Counterparties and other financial market infrastructures – finding an answer to the financial crisis

Elke König - President, **Federal Financial Supervisory Authority (BaFin),** Germany

In reaction to the global financial crisis the European Union introduced the European Market Infrastructure Regulation (EMIR) to make it compulsory for standardised OTC derivatives to be cleared through Central Counterparties (CCPs). It was clear from the very beginning that it would at some stage also have to finish the job and create a cross-border resolution regime for these CCPs. CCPs require authorisation, are subject to regulatory requirements and, in particular, they make the financial market more transparent and reduce the number of bilateral business relationships. They therefore offer more security – on the one hand. On the other hand, care must be taken to ensure that new systemic risks do not build up there and that we – as was the case with the banks – do not get sucked into a too-big-to-fail and moral hazard maelstrom.

The EU is now finishing the job. The Commission is working on a draft Directive for the resolution of CCPs and other financial market infrastructures (FMIs). The Financial Stability Board (FSB) also has this item high on its agenda, which is a good thing and makes sense for, as we all know, the world does not end at the borders of the EU.

This is not a simple regulatory exercise when one considers how important FMIs are; many of their functions are of such great importance that the financial market would no longer function if a FMI were to fail. These functions – so vital for the market – must be maintained without using taxpayers' money and even if all recovery attempts have failed.

There are still many questions that remain unanswered, such as: When has a recovery failed? When does resolution begin? What are the triggers? How can we remove the obstacles to effective resolution such as complexity of firm structures? What resolution instruments do we need? What about recovery and resolution planning? Colleges can provide good services in this field. But are they as well designed for issuing extremely urgent resolution orders? Or do we need more efficient structures? Should there be separate resolution authorities? Or should the supervisory authorities themselves carry out the resolution – possibly through a special resolution unit? How should we deal with a cross-border failure? Do we need a European resolution authority? What do we have to keep in mind while creating a global resolution regime for FMIs? There are still a lot of questions to be addressed and it will take time to come to satisfactory answers – as we all know from banking regulation. But this has to be a key priority. ■

What is the resolution plan for CCPs?

Emily Portney - Global Head of Agency Clearing, Collateral Management and Execution, Corporate and Investment Bank, **J.P. Morgan**

The dramatic increase in the number of transactions channeled into central counterparties, combined with the fact that their use is no longer optional, means that many CCPs could represent a single point of failure for the entire system. As with any Systemically Important Financial Institution, this makes the issue of resolution crucial.

Current industry solutions favor tear up and/or liquidation in the event of a CCP failure. Although these options would provide some immediate crystallization of losses, they could create risk asymmetry across market participants, a sudden price collapse for various forms of collateral, and the inability to replace closed-out trades where only one CCP clears a particular product.

We believe that maintaining the critical operations of a CCP, rather than liquidation and/or allocation of losses, should be the driving principle in default. As such, regulators should require CCPs to have a resolution plan and recapitalization resources on hand in the event of a failure. Without a credible recapitalization strategy, policymakers confronting a failed CCP will be presented with the same Hobson's choice faced for other SIFIs in 2008—and would likely have to bail out a failing CCP with taxpayer funds rather than liquidate it.

A comprehensive resolution framework, including the following principles, would be additive to the discussion on recovery tools already underway:

- A standard disclosed stress test framework mandated by regulators to size total loss absorbing resources—creating more resilient and transparent CCPs and fostering market confidence.
- Fully pre-funded total loss absorbing resources—removing uncertainty and reliance on unfunded commitments or assessments.
- Defined, pre-agreed resolution framework— limiting market contagion or destabilization.
- Recapitalization Resources—allowing the CCP to open on the business day following failure with a fully funded Guarantee Fund.
- Parity between CCP and member contributions to the Guarantee Fund and Recapitalization Resources—giving all parties 'skin in the game' and aligning incentives between CCPs and members.

We believe substantive changes are needed to ensure CCPs can serve as the market stabilizing forces envisaged by regulators, and look forward to assisting policymakers as they design a resolution framework in the coming months. ■

Learn more: What is the Resolution Plan for CCPs? (J.P. Morgan September 2014)

RRPs for Financial Market Infrastructures: users need strong visibility and predictability

Laurence Caron-Habib - Head of Public Affairs, Strategy and Corporate Development, **BNP Paribas Securities Services**

The recent regulatory developments have pushed Financial Market Infrastructures (FMIs) into a very prominent role for ensuring the stability of the financial markets. It is therefore of upmost importance that FMIs are robust and operationally sound, and have appropriate tools in place to deal with default management. Recovery and Resolution Plans are the ultimate means to ensure that financial market stability is preserved despite and beyond any FMI's potential or actual demise.

The future framework for FMI Recovery and Resolution should include minimum pre-requisites. Firstly, it should ensure that the non-defaulting users are not dragged into the default management process by pure contagion. Moral hazard among users must be appropriately disincentivised.

Secondly, it should guarantee a high level of ex ante transparency, so that the users are fully aware of the risks they may have to support in the case of recovery or resolution. Notably they must know precisely the trigger for the initiation and for each subsequent step of the default management process, as well as which tools would be used in each phase and how exactly the losses would be allocated. Transparency on the delineation between recovery and resolution is particularly crucial for the users' exposure risk assessment: the location of this breaking point in the waterfall process will determine the scope of members' potential liability. In any case non-defaulting users must not be ascertained not being submitted to unlimited liability.

Thirdly, users should be involved in the process of defining and implementing the recovery and resolution measures, and have their say on the identification of the critical functions.

The proposal expected from the European Commission at the end of this year will focus on CCPs only. However, the basic principles listed above should apply to CCPs and to (I)CSDs likewise. As (I)CSDs have been authorized to perform some banking services according to the new CSD Regulation, it is also required that comprehensive plans are in place to manage times of market stress resulting from difficulties they may face. ■

Recovery and Resolution of CCPs – EU legislation won't come soon enough!

Dr Kay Swinburne - MEP, ECR Coordinator, Committee on Economic and Monetary Affairs, **European Parliament**

Legislation on the recovery and resolution of CCPs will take at least 2 years after initial publication by the Commission to get through the political processes and technical stages before implementation. Yet, arguably to reduce systemic and investor risk, it should already be in place before the vast majority of derivative contracts in the EU are mandatorily cleared through CCPs.

EMIR has put in place measures, which seek to ensure CCPs operating in the EU are sound, and encourages positive incentive structures as well as good risk management practices. However CCPs must be able to withstand not just the last crisis but future crises as well.

The immediate goals of a CCPs' management in times of distress may be different to that of its clearing members and different again to the clearing members' clients. Therefore the recovery tools utilised at any time should be dependent on the cause of the current crisis, possibly differentiating between those originating due to a CCP mispricing an asset class or other mismanagement and those caused by a general market failure beyond their control.

Additionally, while the dispersion of losses over the widest number of market participants in order to limit the possibility of taxpayers having to step in can, and arguably should be a line of defence for a Resolution Authority, this should not be an option for a CCP as a recovery tool.

Whereas resolution measures involving end-customer assets being handled by public authorities will require in some cases new legislative measures, the same is not true of recovery plans and various recovery tools. In order to ensure a stable clearing operation in advance of EU wide legislation, a CCPs' management, the clearing members and their clients should already be discussing market solutions that work for market participants in the many different scenarios that could cause difficulties for a CCP.

In any event, if a CCP were to reach the end of the default waterfall, the clearing members and their clients should know exactly what measures will be taken by the CCP and what financial burden will fall where. Clear rules should have been agreed following extensive scenario planning and in consultation with all three parties involved. Importantly, these need to be communicated in advance to all involved so market panic can be reduced.

Legislators will have to listen to competing interests from across the spectrum as the debate becomes more heated in advance of the Commission's first draft that is due early next year. However, EU Capital Markets as a whole will benefit from having participants agree to mutually beneficial principles that are in-line with emerging global guidelines that stand up to scrutiny. Adopting sensible principles for recovery across the critical market infrastructures in advance of final EU legislation means the whole market will benefit from safer, more resilient CCPs in the long run. ■

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Establishing a framework for CCP resolution

Andrew Gracie - Executive Director, Resolution, **Bank of England**

FMI resolution, including of CCPs, must be about ensuring continuity of their critical services. Whilst one might want to achieve this by moving assets and positions from the failing CCP to another – in effect extending the concept of porting from clients to clearing members – this option does not credibly exist today. Even if two CCPs have enough overlap in contracts and membership, they may well be suffering from the same market shock; the concentration of positions in the surviving CCP could be significant; and there will doubtless be other barriers to a transfer over a resolution weekend. A transfer would take weeks and months, not hours and days. And for many CCPs, there may simply not be a ready substitute at the point of resolution.

So to ensure continuity of service, a failing CCP must first be stabilised. The focus of the debate has largely been about loss allocation in resolution. This is of course necessary, and should respect the distribution of claims in insolvency.

But to have continuity the CCP must also be recapitalised, without recourse to public funds. And to aid market functioning and stability, we should aim to find a way of avoiding, where possible, imposing large liquidity calls on clearing members in already distressed markets, or writing down operating liabilities.

There is no European legislative proposal yet on FMI recovery and resolution. But when it does come, it must be consistent with the FSB's Key Attributes. And it must recognise that the largest CCPs are global in reach and so the resolution co-ordination framework must reflect this.

The issues of global reach and limited substitutability of CCPs point to a much deeper debate about the market structure, especially where there is mandatory clearing. An important debate, but one that could take time to play out. For now, we must face up to the reality of CCPs as they are, as well as what we might want them to be, in designing a resolution framework that delivers continuity and stability. ■

Transparency, continuity of service key to R&R planning

Larry Thompson - General Counsel, **The Depository Trust & Clearing Corporation (DTCC)**

The post-crisis landscape has put the risk management practices of central counterparties (CCPs) under the microscope...and with good reason. They are a crucial component of the financial system because of their role in reducing counterparty risk and limiting contagion across global financial markets. But with the percentage of financial transactions cleared through CCPs expected to increase dramatically in the coming years due to new regulatory mandates for OTC derivatives, their ability to manage additional risk is critical to the safety of the system.

A number of regulatory initiatives are being implemented to buttress these infrastructures against risk concentration, including the development of recovery and resolution plans for a failing CCP. This is critical because we have witnessed the devastating effects of a CCP failure without such safeguards. When the Hong Kong Futures Exchange's clearinghouse collapsed during the 1987 market crash, the impact was catastrophic but largely restricted to the HK capital markets. However, in today's world of more global and interconnected markets, the impact of a major CCP failing has the potential to bring down the financial system as a whole.

Given the systemically important role played by clearinghouses, it is prudent to take appropriate steps to ensure continuity of service by focusing on the recovery of a CCP on the brink of failure.

How this is accomplished will differ according to the entity, as each CCP is unique in its governance, in the pre-existing risk management tools and loss-allocation processes that they employ and the nature of the losses themselves. Furthermore, the diversity of financial markets and products that infrastructures serve adds additional complexity to the issue. As such, it is the primary responsibility of the CCP to take the lead in designing and implementing an appropriate recovery plan in coordination with its stakeholders.

Recovery planning is not one-size-fits all, yet regardless of the mechanisms employed by a recovering CCP, it is vital that the recovery tools are agreed by all stakeholders beforehand so the process is transparent and clearing members have a clear understanding of their financial obligations. ■

Recovery and resolution plans for CCPs ensure prudently organized and operated financial markets

Thomas Book - Chief Executive Officer, **Eurex Clearing AG**

Across the main jurisdictions, policy makers and regulatory authorities have made great strides towards ensuring that financial market participants' potential defaults will no longer lead to the choice of either a public bail-out or a disorderly failure and its accompanying negative externalities. These go hand in hand with the new regulatory regime for safer financial markets, which includes the upcoming clearing obligation start. As part of this drive, FMIs, and CCPs in particular, have had consideration applied to how recovery and resolution frameworks apply to them.

As CCPs are not the same type of entity as, say, banks, and it is important that their recovery and resolution plans reflect their role as a risk manager across their participants' positions. Furthermore, the recovery and resolution plans must be flexible, as they would only be used in circumstances of the most dramatic market stress given the scenarios CCPs already incorporate in their usual course of business.

During the course of the coming year, the industry expects to see global standards and hopefully jurisdictional rule-making in this domain. Such rules are widely expected to address how losses arising from risks other than member defaults (such as fraud, or operational risk) are covered, who the resolution authorities of the CCPs are, and which tools are included amongst the recovery and/or resolution package.

Once completed, the recovery and resolution planning for CCPs will strengthen important features of the clearing landscape and promote systemic stability. In particular, they should ensure that the competitive CCP landscape is not distorted by perceived public support, strengthen and clarify the recovery options, and ensure that resolution is enacted only by choice in a controlled manner.

These plans will complement the standards for micro-prudential CCP risk management, rounding out the regulation and enhancing the macro-prudential aspects of the CCP market structure. As such, at least for the centrally cleared portion of the markets, a holistic and actionable mechanism exists to tackle and future crises; even if in the most extreme of cases they overwhelm a CCP's risk mitigants' calibration levels. For such scenarios, the ability of a CCP and its resolution authority to decisively act from a central point, based on accurate information, cannot be underestimated as a beneficial tool for equitable and orderly crisis management. ■

Defining an appropriate CCP recovery and resolution framework

Jean-Marie Andrès, Didier Cahen, Marc Truchet – Eurofi

Defining an appropriate recovery and resolution (R&R) framework is the main forthcoming legislative challenge for Financial Market Infrastructures (FMIs) in the EU after the adoption of EMIR and the CSDR. Following a consultation paper published in 2012 by the EU Commission on the R&R of non-banks and proposals made at the global level in 2013 by CPSS-IOSCO regarding FMI recovery and by the FSB regarding FMI resolution, the Commission is expected to publish a proposal for the R&R of CCPs in the coming months. The EU Parliament adopted a self-initiative report covering the R&R of non-banks at the end of 2013. Measures have also been proposed in the UK.

The proportion of centrally cleared OTC derivative transactions is expected to strongly increase in the coming years with the implementation of EMIR. This will provide many benefits for the market in terms of risk management and netting, but it will also increase risk concentration within CCPs. Interdependencies will also expand in the financial system between CCPs and their members and among interoperating CCPs. The failure of a CCP is a very low probability risk but it is not to be fully excluded and would have extremely severe consequences for the market.

EMIR already requires the implementation of risk management policies, capital requirements, disaster recovery arrangements and the establishment of a default waterfall including pre-funded loss-absorbing mechanisms. Most EU CCPs have additional rules in place such as "rights of assessment" which are an unfunded obligation to replenish the default fund similar to a bail-in tool. But since ordinary bankruptcy rules, which focus on creditors, are not adapted for such entities that provide critical services for the market, these EMIR measures are due to be completed by a specific recovery and resolution (R&R) framework providing additional crisis prevention and management tools in case the resources mandated in EMIR are not sufficient. Several key questions remain to be solved in this perspective.

Distinction between ordinary risk management procedures, the recovery and the resolution phases

A first question is clarifying the measures that should be part of the recovery phase of a specific R&R framework, in addition to the ordinary risk management actions already mandated in EMIR. Suggestions have been made that the recovery phase should be triggered when the collateral posted by the defaulting member is insufficient to recover losses and when the viability of the CCP is threatened.

A second issue is how far recovery should be pursued once the ex ante agreed loss-absorbency measures are exhausted before triggering resolution. Many stakeholders believe that ensuring the continuity of the critical services provided by the CCP should be the main objective of an R&R process. This means first attempting to recover a CCP in financial distress (unless it is clear from the outset that this is impossible) and if this is not successful, transferring positions to another entity. When the market considers that losses are too high and that there is no point in continuing certain business segments then this is a resolution situation. Defining clearly when this move should happen is a key challenge.

Other participants, mainly from the buy-side believe that once the ex ante agreed loss-absorbency measures are exhausted the best course of action is to resolve the CCP, with a fast liquidation of positions, in order to return remaining margins to non-defaulting members and avoid penalizing them or their customers, rather than using additional resources (e.g. customer margins) to support a failing CCP. Two factors are put forward by these participants: (i) first the loss of confidence there is generally in a failing CCP, making its recovery unlikely beyond a certain stage as participants may leave the CCP in such a case, (ii) secondly the difficulty of transferring positions to another CCP or bridge entity in a short period of time. Augmenting pre-funded and pre-agreed loss-absorbency tools in order to strengthen the defences of CCPs has been proposed as an alternative to recovery instruments, although the effectiveness of such approaches is questionable in the view of some participants.

Finally, some participants think that a distinction should be made between the different types of products cleared by the CCP i.e. tools may vary depending on underlying cleared products and it should be possible to isolate products from each other in case of recovery as it could facilitate the effective implementation of the recovery itself.

Loss allocation tools in the recovery phase and the extent of the commitment of participants

Another issue is defining the tools that may be used for allocating losses and possibly continuing the core activity in a recovery context and the extent of the commitments of different participants. Recovery plans should provide the right incentives in order to increase the likelihood of recovery and be sufficiently predictable and transparent. Haircuts on variation margins (VM) in order to distribute losses to a large participant base and buy time for an orderly reorganization of the CCP are favoured by many stakeholders as they can be implemented fast. The procyclical effects of VM haircutting are however stressed as well as the fact that the possibility of such haircutting might deter clearing members from increasing their exposure to CCPs. Some have also suggested using additional cash calls and partial tear-ups but such tools may be more appropriate in a resolution phase as they are not so predictable. Haircutting the initial margin of non-defaulting members has been rejected in the consultations recently conducted and drawing additional funds on shareholders seems unlikely at such a stage.

Moreover stakeholders generally suggest that recovery regimes should not give rise to open-ended liabilities that would potentially create incentives for participants to leave the CCP, which means defining precise triggers for activating the resolution process. The degree of flexibility that might be left to CCPs in the design and implementation of recovery plans in order to potentially adjust tools to specific circumstances also needs to be defined.

Resolution tools and authority

Two main options are envisaged for resolving a CCP: transferring the positions to another CCP or bridge entity or liquidating the positions. Many observers argue that transferring positions is difficult to achieve in a short timeframe particularly in a cross-border setting unless it is prepared in advance. Suggestions have been made that a CCP resolution could contain a recapitalization plan to potentially re-start the operations of the CCP on new grounds once positions have been liquidated.

Another issue is the nature and the role of the resolution authorities of cross-border CCPs given the speed of reaction that is needed when executing a resolution process and the possible fiscal implications. The way to handle the R&R of a cross-border CCP operating in countries with different rules also needs defining.

Whether central banks should play a role in the recovery or resolution of CCPs, either as a liquidity provider or as a backstop, is another issue that needs to be decided, taking into account the possible moral hazard this may generate and whether this may create obligations in terms of the supervision or location of the CCP.

A further issue is the coherence that is needed between the R&R frameworks of CCPs and of their clearing members - many of which are likely to be G-SIFIs.

Which issues remain to be addressed in the asset management and shadow banking areas in the EU?

Verena Ross - Executive Director, **European Securities and Markets Authority (ESMA)**

The EU investment fund sector is subject to an extensive regulatory framework. Via the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD), all investment funds (or their managers) are now subject to oversight at EU level.

The approach taken in the EU is based on a distinction between relatively strict safeguards and prescription for funds that can be marketed to retail investors (i.e. UCITS) and greater flexibility, at least with respect to such elements as eligible assets and leverage, that is appropriate for the funds sold to professions (i.e. AIFs).

Notwithstanding this comprehensive coverage of the EU fund sphere, there is a need to introduce specific rules in relation to certain entities and activities. In particular, the issues around money market funds (MMFs). On 13 September 2013, the European Commission adopted its proposal for a Regulation on MMFs. This proposal is subject to extensive debates with the co-legislators.

Another set of activities that has been under close scrutiny by regulatory bodies are securities financing transactions (SFTs). The Commission's proposal on SFTs aims at mitigating the risks arising from SFTs and improving the transparency of these activities. To some extent, the UCITS legal framework (as supplemented by ESMA's guidelines on ETFs and other UCITS issues) is already broadly in line with the proposal on SFTs. In addition, the AIFMD foresees disclosure of similar information by AIFMs both at the pre-investment stage and in the context of regular reporting.

Finally, earlier this year the FSB and IOSCO issued a consultative document with a view to establishing assessment methodologies for identifying non-bank non-insurer (NBNI) global systemically important financial institutions. The objective of this methodology is to identify NBNI financial entities, including potentially some global asset managers, whose distress or disorderly failure, because of their size, complexity and interconnectedness would cause significant disruption to the global financial system and economic activity across jurisdictions. ESMA is following the global discussions, as it will need to be considered how to implement the final methodology in the EU. ■

Financial regulation reform: looking forward

Barbara Novick - Vice Chaiman, **BlackRock**

The 2008 financial crisis gave regulators and market participants ample reason to step back and evaluate many aspects of the financial market ecosystem. This review has resulted in myriad new regulations covering bank balance sheets, cash products, market structure, alternative funds and more. Looking forward, we need to step back again. This time we must assess how new rules are working and the cumulative impact on end investors (e.g. pension plans, insurers and individual savers) to ascertain if any changes are needed and what gaps remain to be addressed.

We believe the best approach to regulating risks in asset management requires industry-wide changes. For example, the solution to OTC derivatives exposure did not involve regulating a handful of the largest swap dealers, since the business would simply have moved to different market participants. Likewise, if reforms to money market funds (MMFs) were applied to only the largest ones, clients would move their assets to other non-affected MMFs. Not surprisingly, US and EU regulators comprehensively changed the ecosystem for swap markets by instituting reporting, clearing and mandatory trading on regulated platforms; and changes to MMFs are expected to apply to all MMFs, not just the largest ones or those sponsored by large asset managers. This horizontal approach is needed to avoid creating gaps that would inevitably lead to regulatory arbitrage and it will improve the financial ecosystem for all market participants.

BlackRock considers markets and products from the perspective of an asset manager acting on behalf of our clients. As such, and recognising that many changes are already underway, we have identified areas that warrant deeper analysis and potentially changes in regulation:

- Address reduced liquidity in corporate bond secondary markets
- Ensure CCPs are not too big to fail
- Review fund product structures with the intention of adopting best practices across a number of features
- Extend analysis of levered products to include ETFs, CLOs, REITS etc.
- Address perceived data gaps (e.g. separate accounts)
- Harmonise SFT, alternative fund, derivatives and threshold reporting
- Mitigate the impact of prudential regulation on securitisation and long-term investing
- Consider market plumbing incl. pricing services, custodians, transfer agents, benchmark providers, and technology. ■

Key-objectives of EU Commission in asset management and shadow banking

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

The Commission's general objective is to set up a stable, transparent and resilient framework for the development of market-based financing channels. The benefits achieved by strengthening the resilience of banks should not be diminished by systemic risks moving to less regulated sectors. Many EU legislative initiatives have already addressed some of the most relevant risks. However, the shadow banking system is constantly changing and adapting to the regulatory context. There will therefore be a need to actively monitor shadow banking activities to ensure that they serve the economy without undermining its stability.

With respect more specifically to asset management, the main objective in the next few months is to conclude negotiations on the Money Market Fund (MMF) proposal, adopted in September 2013. The Italian presidency has started discussions and Parliament will soon appoint a new rapporteur. The aim behind the proposal is to increase the stability and liquidity of MMFs so that these funds can continue to play their crucial role for the financing of the economy. In terms of liquidity, the proposal stresses daily and weekly maturing assets as well as rules on issuer diversification. In terms of stability, the proposal focuses on how MMFs have to value their assets and whether additional measures are needed. The recently adopted SEC rules on MMF should provide further impetus for this work.

Given the size of the investment funds market in general, it is essential that potential systemic risks are identified and addressed. The debate on the liquidity and stability of MMF could inform a wider debate on how to limit systemic risk and prevent investor runs across the fund management industry. Consideration could in particular be given to issues like redemptions in stressed markets and the potential for events at large asset managers to influence asset prices across large sectors of the European economy. ■

Asset protection and collateral management – what needs to be done?

Nadine Chakar - Executive Vice President, Global Collateral Services, **BNY Mellon**

The European legislator is faced with an apparent contradiction.

It wants to increase asset protection and ensure that the assets of end investors are protected. It also wants to minimize risk in the financial system, choosing the provision of collateral as an important tool to achieve this.

This contradiction is in fact a twin challenge. There is the challenge of ensuring a sufficient supply of collateral. Add to this, the challenge of ensuring that both the collateral-giver and the collateral-taker are protected.

These challenges require sound operational and legal environments for the provision of collateral.

Without such, the overall supply of collateral will diminish as end investors will choose, or be forced by regulation, not to provide collateral, and collateral as a tool to mitigate risk will be ineffective.

The Proposal from the European Commission for a Regulation on Securities Financing Transactions (SFTR) is welcome.

It takes the right approach, which is to improve legal certainty and transparency in securities holding and in securities collateral chains, thereby making progress towards the twin objectives of asset protection and increased usage of collateral. As an aside, we think the technical criteria within SFTR with respect to reporting obligations could use further refinement.

SFTR is doubly-welcome as we have seen other regulatory initiatives that, often without deliberate intent, place unnecessary obstacles on the provision of collateral. Recent examples include AIFMD and UCITS V.

Understanding how securities account segregation works is essential. As a tool to increase asset protection in securities holding chains, securities account segregation works at the level of the last intermediary in a chain, and it works at each level of the chain when it differentiates client assets from proprietary assets.

Beyond this level of segregation, any additional requirements for segregation have perverse effects. They increase complexity and risk in custody holding chains without – in countries with sound legal regimes – enhancing legal protections.

In the case of tri-party collateral management providers, any requirements for additional securities account segregation are particularly cruel, as they are a major barrier to the use of tri-party services, while the purpose of a tri-party provider is precisely to offer an optimal operational and legal environment for the provision and receipt of collateral. ■

The SIFI debate for asset managers and mutual funds: To designate or not to designate?

Ken Volpert - Head of Investments, **Vanguard,** Europe

In the wake of the global financial crisis, regulatory entities around the world, including the FSB and IOSCO, seek ways to heighten oversight in hopes of preventing a future crisis. The discussion centers on identifying and designating non-bank, non-insurers as systemically important financial institutions (SIFIs). However, there remains a lack of clarity around the SIFI designation as it relates to asset managers.

As a leading global investment manager, Vanguard strongly believes that asset managers and mutual funds are properly and effectively regulated, size is not an appropriate indicator of systemic risk, and investors will ultimately bear the costs and consequences of a SIFI designation.

Foremost, Vanguard, along with other asset managers, operates under a highly effective regulatory structure, with key investor protections established under the Investment Company Act of 1940 and in the EU, under the UCITs Directive. Fund investors are afforded significant protections including transparency of holdings; robust disclosure; limits on leverage and derivatives; and limits on illiquid security holdings.

Secondly, size is a poor indicator of systemic risk. For an asset manager or mutual fund to pose systemic risk, it would have to be significantly interconnected to other institutions through leverage or possess a mismatch between assets and liabilities—neither of these conditions is met by asset managers or mutual funds.

Lastly is the effect a SIFI designation could have on investors. A designation of an asset manager or a mutual fund will not mitigate systemic risk, but instead increase the cost of investing for all investors. By putting designated firms at a competitive disadvantage relative to non-SIFI firms, investor choice and preferences would be negatively impacted.

Vanguard supports appropriate regulation to ensure the resiliency and efficacy of the global financial system. Nevertheless, we strongly believe that existing regulation mitigates risk of investment funds, and to the extent additional requirements are needed, investors and the financial markets would be best served by an activities-based regulatory approach. ■

Structural banking reforms: beware of the consequences on financing mechanisms

Christian Noyer - Governor, **Banque de France**

Several countries, including France and Germany, have already adopted structural banking reforms to limit excessive risk-taking by banks, improve the resilience of credit institutions and enhance financial stability. The project of the European Commission (EC) published on 29 January 2014, which still has to be discussed by the European Parliament, shares similar objectives but proposes a different approach, which raises some issues of concern.

The reform proposed by the EC would impose not only the prohibition of proprietary trading, like the Volcker rule in the United States, but also the potential ring-fencing of other trading activities including market making. This combination of measures might have serious negative consequences on the financing of the economy and on the competitiveness of European banks, to be compared with unproven effects on resolvability and potentially adverse effects on the resilience of the banking sector.

By contrast, the French law passed in July 2013 distinguishes between speculative activities and other trading activities, such as market making, which are useful for the financing of the economy and market liquidity. It aims at preserving the benefits of the European universal banking model, which proved resilient during the financial crisis, and its capacity to lend to the economy. Thus, the French law does not a priori ring-fence market making activities. Moreover, it does not prohibit proprietary trading, but, if a certain threshold is exceeded, requires that such activities be ring-fenced into entities that are legally, economically and organizationally separate. The following threshold shall be applied: a value of financial assets above 7.5% of the total balance sheet. In addition, regardless of this threshold, I want to stress the importance of the supervisory discretion given to the competent authority, which can request the separation of market making activities if they might threaten the solvency of the deposit-taking credit institution or that of its group.

In short, any proposal for further structural banking reforms should be carefully assessed against its negative impact on the financing of the economy, which might outweigh the potential benefits with respect to financial stability. ■

Structural reform of the EU banking sector

Olivier Guersent - Deputy Director General, Financial Services, DG Internal Market and Services, **European Commission**

In the last five years the EU has undertaken a large number of reforms to establish a safer, sounder, more transparent and responsible financial system serving the economy and society as a whole. However, the size and complexity of a small number of very large banks remain an issue of concern. The balance sheet of some of these banks is larger than the GDP of their home countries. The shift towards a transaction-oriented banking model and the corresponding increase in trading has been one of the major reasons of the growing size of bank balance sheets in the years leading up to the financial crisis. Much of the growth was driven by intra-financial-sector borrowing and lending, rather than real economy lending.

While prudential requirements and preventive/resolution powers are essential and necessary instruments to reduce the probability and impact of bank failure, they may in practice not be sufficient to fully address the risks that these banks pose to the financial stability. In particular, the challenge of implementing an orderly resolution of the largest and most complex banks should not underestimated.

Structural bank reforms complement the reforms related to capital requirements by adding another disincentive towards banks excessively expanding their risky trading activities, thus putting a break on the main source of unsustainable bank growth in recent years. This would correct distorted incentives and contribute to a better deployment and allocation of resources towards the real economy. Structural reforms could considerably facilitate the orderly resolution of the above mentioned TBTF banks, thus making the newly granted powers in BRRD more effective.

Universal banks providing a broad range of commercial and investment banking activities are an important feature of the European banking landscape and will continue to serve clients with a broad set of services and financial products, even if the separation of trading activities is imposed by the competent authority. Furthermore, the Commission is also mindful of the important diversity of the EU banking landscape which is not called into question in any way by this proposal.

The Commission's proposal aims to ensure that universal banks do not grow beyond a size and risk profile that threatens financial stability. It provides a framework ensuring a uniform set of structural measures at EU level. ■

Structural banking reforms – finding the right balance

Axel A. Weber - Chairman of the Board of Directors, **UBS AG**

In recent years, many jurisdictions have come up with new requirements regarding how banks should organize their legal structures and have tightened restrictions on business activities and services that can be provided from a particular entity. The underlying rationale is to isolate some critical banking services (in particular deposit-taking) from supposedly more risky activities. Whether structural separation increases financial stability is debatable, since no particular business model fared particularly well or poorly in the financial crisis. The following should also be considered:

- Structural measures which break up universal banks with diversified portfolios and income streams ultimately result in a less diversified financial services sector, with potentially negative consequences for its resilience against potential shocks.
- Proposals which result in the withdrawal of some firms from certain capital market activities could lead to a situation where such activities are pushed into less regulated areas.
- Client relationships may be disrupted, reducing the range of offerings and the capacity to manage clients' risks. The resulting increase in costs may not be visible for some time, given that reforms are still underway and interest rates are exceptionally low.
- This effect would be amplified by a likely banking sector consolidation. Structural requirements, which work with thresholds, contribute to this effect. For banks that slightly exceed the thresholds, the requirements pose a heavy burden and could impact profitability. Thus, banks will either remain well below the thresholds or try to exceed them substantially, leading to further concentration.
- Finally, a particular concern is the increasing push for self-sufficiency linked to structural requirements, which limits the ability of banks to allocate capital and liquidity in the most efficient way.

Potential unintended consequences are constraints in lending capacity.

Thus significant caution is warranted in the design of new requirements to avoid adverse effects. Marginal benefits of reforms may not justify their likely sizeable negative impact on the economy. ■

We need to give banks room to drive Europe's real economy

Federico Ghizzoni - Chief Executive Officer, **UniCredit**

Universal banks are vital to Europe's real economy. Their role extends well beyond what is typical in the United Kingdom or United States, where banks provide 50 percent or less of corporate financing. In Europe, more than 80 percent of the market is supplied by banks. Enterprises and consumers on the continent will continue to rely heavily on banks for funding of all kinds.

Today, European banks are among the most stable and resilient in the world, having overcome crisis and successfully increased their collective capitalization by €700 billion since 2011. They have met the rigorous Basel III requirements ahead of schedule.

And they are particularly well equipped to serve changing needs in corporate finance. As banking regulation becomes more stringent, Europe's universal banks are already transforming some part of credit exposure into capital market financing. European corporations are increasingly turning to the capital markets for financing, and universal banks are in the best position to match borrowers with the funds they need in a timely manner. This shift will serve the needs of the largest corporate clients while freeing up conventional funding resources for smaller borrowers.

Moreover, the universal banking model is enabling greater business diversification, better capital allocation and improved cost synergies, all of which can lead to enhanced and more resilient profitability.

Yet the EU Commission's new proposal on structural reforms, which appears to be far stricter than the rules now in place in the United States, risks disadvantaging our banks worldwide. There are more effective measures that could be taken to ensure that banks support the real economy while preserving their stability, beginning with the harmonization and simplification of metrics and rules. These should be implemented in the context of a more clear-cut definition of the banking model that regulators ultimately aspire to implement.

Finally, whatever decisions are made, banks can only do well by doing good. We must remain committed to our core values and continue to support the real economy to the best of our abilities with the tools available to us. ■

Asset management and shadow banking regulation

Robust depositaries are key to a stable and safe asset management industry

Eric Derobert - Manager, Group Head of Communications and Public Affairs, **CACEIS**

The asset management industry is expected to fill most of the gap created by the diminishing supply of traditional sources of financing coupled with a growing demand from many sectors of the economy (especially SMEs) as well as demand for investment into infrastructure.

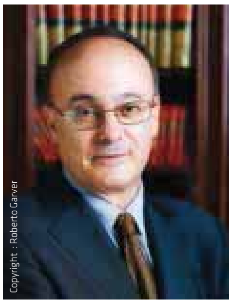
Efforts to maintain this positive trend should obviously not trigger excessive risks or leave aspects of major financial risk unmonitored.

More than 25 years ago, when creating the UCITS directive, and recently when addressing issues concerning the regulatory landscape for alternative funds and traditional funds in UCITS V, the European Union clearly established the duties of the fund depository. Subject to strict eligibility criteria and equipped with the necessary resources, the fund depository is a key player in Europe's heavily-regulated Asset Management industry, given the substantial fiduciary responsibilities attached to its functions. Independent by nature, and carrying out on-going oversight functions, the fund depositary - which should under no circumstances be viewed as a substitute for asset managers achieving full compliance with regulations - has proven itself to be a committed and reliable risk-mitigating player, and as such, has been a solid contributor to the success of the European fund industry.

At a time when so much is expected from the fund industry, close attention should be paid to ensuring the robust nature of the asset servicing sector, which is key to a stable asset management industry. In order for this to be achieved, there needs to be a balanced distribution of risks and rewards along the entire value chain, with the duties assigned to each player defined in a fair and transparent manner. Investor protection and financial stability are legitimate objectives pursued by the regulatory authorities, and fund depositaries are fully committed to playing their part in ensuring the European fund industry is both safe and stable. ■

Loss absorption and recapitalisation capacity for G-SIBs in resolution

Luis M. Linde - Governor, **Banco de España**



An orderly resolution of a G-SIB requires adequate capacity to absorb losses and to recapitalise the institution so it may maintain its critical business operations while minimising the risk of recourse to public funds. To this end, at the time of this article being drafted, the Minimum Requirement of Eligible Liabilities (MREL) concept in the EU Bank Recovery and Resolution Directive (BRRD) is well-defined and established, whereas the new Gone Concern Loss Absorbing Capacity (GLAC) concept is still being debated by the Financial Stability Board. In this latter forum, discussions have focussed on the advisability of Total Loss Absorbing Capacity (TLAC) compared to GLAC.

The GLAC concept envisages a recapitalisation capacity that is entirely separate from the capital levels a G-SIB holds. Owing to that separation, it does not contribute to a commonly shared objective of the supervisory community, namely the strengthening of the capital base of institutions. With regard to GLAC-eligible instruments, it is being disputed whether excess capital over minimum regulatory levels could be envisaged. Were that the case, then GLAC may be entangled with the capital framework and may require changes to the newly implemented Basel III regime, which might not be desirable from the standpoint of regulatory certainty for institutions. Also, the separation principle embedded in GLAC differentiates the supervisors' intervention framework from that of the resolution authorities, as the breaches in capital requirements and, ultimately, in the GLAC requirement would not coincide and would be sequential.

Under the TLAC concept, capital instruments and qualified financial instruments count towards the requirement. In that regard, an institution is allowed to accumulate capital instruments to cover the TLAC requirement. In this framework, when an institution begins to incur significant losses, these would impact both capital levels and TLAC levels. Supervision and resolution authorities could simultaneously activate their respective intervention measures in a coordinated manner to redress the situation; and this is expected to be more effective than a sequential intervention. However, the TLAC concept is also sensitive to the need for adequate recapitalisation capacity when capital is fully – or almost fully – depleted and resolution has to be triggered. To that end, the TLAC concept should include a certain percentage of the requirement that has to be met with qualified financial instruments that are not capital instruments. This portion of the TLAC requirement meets the objectives of a separate GLAC requirement without forgoing the aforementioned advantages and without the inconveniences of the GLAC concept.

In many senses, the TLAC concept is similar to that of MREL as it includes own funds and qualified eligible liabilities; and especially so if, in the BRRD context, authorities use the discretion available in Article 45.13&14 to require that a certain proportion of MREL be covered with qualified financial instruments, namely including a bail-in clause. ■

Global solutions for bank crisis management: Reconciling the GLAC with EU Rules

Jérôme Brunel - Head Group Public Affairs, **Credit Agricole S.A.**

The 2008 financial crisis has led regulators and policy-makers across the world to profoundly review the resolution regimes and bankruptcy laws applicable to the banking sector. The underlying philosophy of these new resolution rules is globally the same everywhere: no taxpayer should continue to bear the heavy cost of rescuing the banking sector and no financial institution should be considered too big to fail. In Europe, the banking resolution toolbox rests on two main pillars: the Banking Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM). The bail-in instrument constitutes a distinctive feature of this new resolution regime and it is complemented by an obligation for banks to hold a Minimum Requirement for Eligible Liabilities (MREL) for the purpose of bail-in. In addition, European policy-makers have signed-off the creation of a 55 bn EUR Single Resolution Fund - which will be entirely contributed by banks - to backstop the eurozone's banking sector in case of deep financial stress. Combined with the Basel3/CRD4 prudential framework and the Single Supervisory Mechanism (SSM), the new European bank resolution regime is expected to offer an unparalleled level of financial security to EU citizen and investors.

Notwithstanding these developments, international regulators are pursuing their work towards the development of global standards for crisis management. In particular, the FSB is reflecting on the introduction of a new prudential standard, namely the Gone-Concern Loss Absorbing Capacity (GLAC). Through this new rule, the FSB hopes to increase the "credibility" of the banking resolution regime by raising requirements for additional loss absorbing capacity beyond minimum regulatory capital requirements. At Crédit Agricole, we support the FSB's efforts aiming at developing global solutions for crisis resolution. However, it is critical in our view that the new GLAC standard does not end up unduly penalizing EU banks which are already subject to the stringent rules of the BRRD, including the MREL for bail-in purposes.

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MREL and GLAC, a milestone towards ending "Too Big To Fail"

Christian Noyer - Governor, **Banque de France**

At the end of 2013, the FSB identified adequate gone-concern loss absorbing capacity (GLAC) as one of the tools aiming at ending "Too Big to Fail" (TBTF). GLAC objectives are to avoid use of public funds for loss absorption and to allow resolution strategies to effectively be implemented while ensuring the continuity of the critical functions of the failings banks. For this purpose, authorities will need to ensure that G-SIBs hold sufficient resources at all times. In that sense, the European MREL (i.e. the Minimum Requirement and resolution for own funds and eligible liabilities which the EU's draft recovery and resolution Directive refers to) and the GLAC concepts are identical in their objectives.

Whereas discussions on GLAC are still ongoing, MREL has already been approved by all European Member States and is precisely defined in the BRRD as a « Pillar 2 without Pillar 1 » requirement not limited to G-SIBs. This capacity to customize the level of MREL following the purposes of the resolution authorities and the situation of each bank is one of the most positive features of the MREL concept. In addition, the broad range of eligible liabilities and the possibility to meet MREL requirements on a consolidated basis will limit the risk that institutions would face market capacity shortages or be obliged to further increase the size of their balance sheet to issue specific instruments. The latter would be contradictory with the aim of ending TBTF. Finally, MREL does not measure the full range of loss absorbing capacities of an institution, as some elements excluded from the ratio are indeed bail-in under BRRD (for example, some liabilities with a remaining maturity of less than 1 year).

MREL and GLAC – if not fully similar by the end of the international discussions – will in any case share one important characteristic: they are not sufficient to ensure an orderly resolution worldwide, due to the divergent crisis management frameworks. Beyond the intense cooperation required by crisis times, we need to develop ex-ante mechanisms for statutory mutual recognition of the resolution tools and powers. This demanding challenge should be high on the FSB agenda. We need in particular to avoid an excessive fragmentation of loss absorbing capacities, which may weaken the capacity of a group to overcome even medium-sized shocks. Moreover, it would make the resolution process more complex. ■

Gone-concern loss absorbing capacity of global systemically important banks

Neil Esho - Deputy Secretary General, **Basel Committee on Banking Supervision (BCBS)**

Basel III's main focus is on increasing the likelihood that banks can survive a period of stress and thereby remain a going-concern. It requires banks to increase their minimum levels of common equity tier 1 (CET1), which is the highest quality form of capital, and to improve their capital buffers, which can be drawn down during periods of stress. Basel III requirements are significant but not sufficient to address the negative externalities posed by Global Systemically Important Banks (GSIBs) or to protect the system from the wider spillover risks of GSIBs.

To address the cross-border negative externalities they create, GSIBs are also subject to additional loss absorbency requirements that will enhance their going-concern loss absorbency and reduce the probability of their failure.

In January 2011, the Basel Committee took further steps to ensure that all classes of capital instruments fully absorb losses at the point of non-viability (PON), before taxpayers are exposed to loss. In essence the PON requirements ensure that all non-CET1 capital and Tier 2 capital will be written-off or converted into common equity upon the occurrence of a trigger event (such as a decision to make a public sector injection of capital to rescue a failed bank).

Gone-concern loss absorbing capacity (GLAC) extends the PON concept (or bail-in) to other forms of bank funding, and seeks to address the problem that, when a bank fails, losses could exceed existing levels of regulatory capital. Work is ongoing to define this funding, what would constitute minimum requirements and how the location of the funding may depend on the resolution strategies of the banking groups. In developing these details there is consensus that GLAC must fit neatly with the existing Basel III framework.

The objectives of GLAC and the minimum requirements for eligible liabilities (MREL) established by the EU are broadly the same. Both seek to ensure that bank liability holders – not taxpayers – bear the cost of bank failures, and that critical financial services are

maintained while a GSIB is restructured or wound-down in resolution. While work is continuing on the GLAC details, it is too early to say how GLAC and MREL may differ. Nevertheless, a key feature of MREL is that it is tailored to each bank. GLAC, on the other hand is only applicable to GSIBs and may include, at least in part, a common minimum standard. ■

Setting the MREL within the new resolution regime

Andrea Enria - Chairperson, **European Banking Authority (EBA)**

During the crisis bank creditors have almost all escaped unscathed, protected by taxpayers. This is not only unjust and burdensome for public finances, but also inefficient: bank creditors must have incentives to monitor and discipline banks, to prevent short-termism and risk shifting by bank shareholders and managers. At the same time, some bank liabilities play a special role in facilitating economic transactions, which requires them to be "informationally insensitive". These liabilities are therefore accompanied by deposit insurance and preference, and safeguards for collateral in resolution regimes. To preserve market discipline, large banks cannot fund themselves entirely through the latter category of liabilities. This is the goal of the FSB's forthcoming gone concern loss absorbing capacity (GLAC) proposals, and the minimum requirement for own funds and eligible liabilities (MREL) set out in the Bank Recovery and Resolution Directive (BRRD).

How will MREL work? Resolution authorities will set it for each bank on a case-by-case basis, and shall use common criteria spelled out by the BRRD with the aim to ensure that similar banks have similar MREL, independently of their location within the Single Market. EBA technical standards (TS) will further flesh out these criteria, building a framework of "constrained discretion" which should ensure a level playing field and allow resolution colleges to discuss and agree joint decisions on the MREL for cross-border groups. Moreover, as the TS will define criteria for setting the MREL for banks with different business models, we expect them to be consistent with the FSB requirements for G-SIFIs.

What about the quality of MREL? The BRRD sets out some specific criteria: liabilities must have a residual maturity of more than one year, and both own funds and other liabilities will be included, so as not to disincentivise higher levels of equity. Senior unsecured liabilities may count, but the BRRD does not ignore the problems which may arise from bailing-in them; rather it allows flexibility on how to deal with them. Indeed, the MREL may include a requirement for subordinated, contractually bail-inable debt, and more generally the MREL should be set within the larger context of resolution planning. In this regard, the EBA's draft TS on resolvability assessment aim to build a framework of constrained discretion to get to joint decisions, by requiring home and host resolution authorities to identify whether there are obstacles to the feasibility of bail-ing-in certain liabilities - for example due to set-off rights, the valuation of derivatives, or the risk of treating creditors worse than in insolvency; or to the credibility of doing so, e.g. in light of the importance of corporate transaction deposits to the economy. ■

Cross-border resolution can be made to work! Banks will need restructuring

Paul Tucker - Senior Fellow, Mossavar-Rahmani Center for Business and Government, **Harvard Kennedy School and Harvard Business School**

Some people doubt whether home and host jurisdictions can credibly commit to co-operate in the resolution of a globally active bank or dealer without a binding international treaty. A treaty would be useful, but it is not going to happen in this cycle of international financial reform. So is that it, game over? No.

Most people are becoming familiar with resolution jargon: single point of entry (SPE) when a group is resolved top down, as one; multiple point of entry (MPE) when it is resolved in distinct pieces, each of which themselves may be subject to SPE resolution. An SPE resolution of a complex group/ subgroup has two stages. In the first stage, losses in a subsidiary exceeding equity would be transferred to its holding company (holdco) by way of writing down/converting into equity a super-subordinated debt instrument held by the holdco. The trigger would be something like: if the conditions for the host authorities to put the subsidiary into local liquidation or resolution were met, they could instead trigger the intra-group debt conversion/loss transfer. The second step is typically for holdco bondholders to be bailed in, thereby restoring the solvency of the group so that it restructured in an orderly way.

For this strategy to work, obviously the intra-group debt instrument needs to exist. And thus the holdco and the group's home authorities need overtly to have agreed in advance to its existing. The host authorities need to agree too. Even with the local subsidiary's financial problem having been transferred to the holdco, the host authorities remain exposed to disorder in their jurisdiction if the home authorities are not capable of conducting a SPE resolution of the holdco and yet their local subsidiary is not operationally viable without the rest of the group.

The effect is to force home and host authorities to hard wire up front how they will coordinate the resolution of a global group. That means that they find out ex ante whether or not they can co-operate on that hard-wiring, rather than, as in the recent crisis, finding out ex post whether they can cooperate in a more ad hoc resolution.

For example, if a group's home authorities will not make a holding company issue a minimum level of bailinable bonds or if they (or the group board) will not agree to a trigger, in the hands of host authorities, that allows excess losses to be transferred up to the group holdco, then host authorities know that the home is either unable or unwilling to effect a whole-group resolution. However awkward, that is much preferable to discovering ex post, as a crisis breaks, that they can't rely on each other. This can give a harder edge to discussions amongst home and host authorities in supervisory and crisis-management colleges, which otherwise are, I suspect, inclined to flabbiness

This model synthesizes the effects of a treaty. As will be clear, it needs to be accompanied by corporate restructuring. Banking groups (or, for MPE banks, subgroups) need to be headed by pure holding companies. The group's subsidiaries need to issue to that holdco deeply subordinated debt, with the requisite triggers under the control of the authorities. And the holdco needs to issue a minimum value of bonds to the market (so-called gone-concern loss-absorbing capacity), providing the means for recapitalizing a bankrupt holding company.

The EU has a good resolution law with a good set of powers. It is behind the US on getting its banks to restructure so that those powers can be used effectively. The EU needs to get on with it, starting with supporting a strong global 'GLAC' policy on bond issuance at the coming Brisbane summit and getting the obvious banks to restructure. Liikanen, Vickers and Volcker are sub-plots in comparison. ■

Making cross-border resolution work in practice

Flavio Valeri - Chief Country Officer Italy, **Deutsche Bank**

Debates on resolution often get lost in acronyms: G-SIFI, TBTF, BRRD, OLA, SRM. The latest we are getting to grips with is GLAC, or 'gone-concern loss-absorbing capacity'. Jargon which obscures a very simple aim - to make sure even the biggest global banks can fail.

Ending "too big to fail" requires authorities to have both the tools and confidence to shut down failing banks. There is now legislation in place in major jurisdictions - US, EU, Japan and Switzerland – which provides the tools. In particular, the EU power to "bail-in" private creditors will ensure costs of failure are not borne by taxpayers. However, authorities also need the confidence that there is enough bail-in available to absorb losses.

If there is doubt about this, then authorities are incentivised to ring-fence local operations, rather than co-operate, on cross-border banks. This is in nobody's interest, as trapped capital and liquidity raises customer costs and fragments the global system, making it less resilient in future crises.

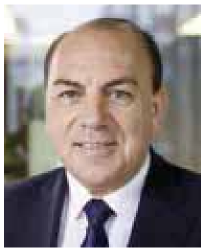
This is why global agreement on minimum GLAC is so important. It will give authorities confidence that resources will be available in resolution. However, to be effective, this needs to work across different resolution regimes and business models.

It is therefore important that GLAC is not limited to subordinated instruments – not only would this favour specific national banking structures, but it would be bad for financial stability. It would make the system more fragile by increasing reliance on wholesale funding and funding costs. In a crisis, it risks contagion as it concentrates losses and creates false expectations in senior bondholders they will not be bailed-in. EU banks would be particularly affected; given the competitive distortions a narrow GLAC requirement would create relative to the broad EU bail-in regime.

GLAC is necessary to end too big to fail and it is critical that we take the time to get it right. A comprehensive approach - as under the EU regime - will avoid disruptions to funding markets, business models and, ultimately, financial stability. ■

Making resolution possible – open issues and next steps

Axel A. Weber - Chairman of the Board of Directors, **UBS AG**



While I am encouraged by the progress made by both the industry and the official sector in responding to the "too big to fail" challenge, some issues still need to be addressed to make resolution possible, especially for large global financial institutions:

- Banks need their local authorities to commit to setting reasonable self-sufficiency requirements. I am concerned about the ambiguity created by calls for credible global resolution plans on the one hand and increasing self-sufficiency requirements in several jurisdictions on the other. The trend towards self-sufficiency challenges the merits of global resolution strategies, especially if leading financial centers begin to take a predominantly local perspective. It also leads to the creation of more subsidiaries within the global banking system and threatens the success of the "Single Point of Entry"-resolution strategy, which we see as the most efficient approach for global resolution.
- In light of the challenges authorities face in committing to binding international agreements for global resolution, the definition of global standards for "Gone Concern Loss Absorbing Capacity" (GLAC) is crucial, including amount, location and eligible instruments. The amount should be based on a percentage of risk-weighted assets and be sufficient to allow a bank, should it reach the point of non-viability, to replenish its required equity capital to a level considered credible by the market.
- Recovery and resolution planning and putting in place the necessary adjustments to banks' legal structures entail a significant commitment of resources and potentially irreversible adjustments of G-SIFIs. These plans are extensive and complex, and they need to address all of the resulting business implications and operational changes. That's why firms depend on clear and reliable guidance from the authorities.

On balance, while significant progress towards resolution has already been made, there is still a lot of work to do. The industry stands ready to work with the authorities to find solutions that further strengthen confidence in the financial system. ■

Bank loss absorbency rules need to reflect diversity in markets and business models

Douglas Flint - Group Chairman, **HSBC Holdings plc**

Since 2009, important steps have been to address Too Big Too Fail, notably through the Basel III reforms, implemented in Europe through CRD IV.

More recently, in May 2014, following a rigorous negotiation in the European Parliament and Council, the EU adopted the Bank Recovery and Resolution Directive (BRRD), which places an obligation on banks to hold a Minimum Requirement for Eligible Liabilities (MREL) for bail-in purposes. The Financial Stability Board will shortly establish rules on Gone-concern Loss Absorbing Capacity (GLAC) to facilitate cross border resolvability of Global Systemically Important Banks (G-SIBs) through private means.

As European policymakers have already accepted in the BRRD, banks should be able to meet their GLAC requirement through a range of credibly and safely bail-in-able instruments which are appropriate to their funding market, regulatory regime and business model. In my view, this should include capital instruments held in excess of regulatory requirements and, where the local authorities agree, the loss absorbing capacity of deposit insurance schemes.

Moreover, the assessment of any 'gone concern' scenario used to define and calibrate GLAC requirements must take into account a banking group's organisational structure and resolution strategy, as agreed with its Crisis Management Group. A single measure of GLAC may be appropriate for those G-SIBs that will be resolved cross border on a 'Single Point of Entry' basis, but banking groups that are 'Multiple Point of Entry' have limited cross border issues and resolution is locally driven. A toolbox of GLAC components, to be used by national authorities to resolve such groups and which can be calibrated according to the intensity of supervision and available level of central bank liquidity support, is likely to be more appropriate.

Finally, it is important to recognise that loss absorbing capacity is not free and the benefits to stability need to be balanced against the economic consequences of raising the cost of credit. Europe's economy relies on bank credit, which depends on efficient capital allocation. Trapped capital and liquidity, either at individual or consolidated level, cannot by definition support growth. ■

The road to Brisbane – what hope for GLAC?

Giles Williams - Partner, EMA Regulatory Centre of Excellence, **KPMG**

We now have a greater appreciation for the number of moving parts involved in solving the "too big to fail" issue. While progress continues to be made across a number of fronts, none has yet landed e.g. key attributes have still to be incorporated into statutory frameworks, resolution planning remains incomplete and the legal, financial and operating structures of global banks are not yet aligned to a preferred resolution strategy. Therefore, more work is needed for meaningful resolvability assessments and institution specific cooperation agreements to be on the table by the G20 summit in Brisbane.

However, one challenge that will be discussed in Brisbane is how to create sufficient gone concern loss absorbing capacity (GLAC) to enable a global bank to be restructured while keeping its critical economic activities going. The concept of bailing in certain classes of creditor has already gained traction, making it easier for the FSB to establish high-level policy priorities to drive the quantity, quality, location and ownership requirements for GLAC. However, big questions still need to be answered e.g. how can you set GLAC without a transparent resolution strategy and ex-post restructuring plan? Is it possible to raise eligible GLAC within certain jurisdictions? Is GLAC as currently articulated the optimal solution for state owned or retail funded banking groups?

A GLAC mechanism will also have to overcome the common challenges associated with operating across differing regional and local financial markets, national legal systems and divergent regulatory and crisis management frameworks. However, in the absence of an alternative solution that enables global banks in resolution to bear losses through a stabilisation and restructuring phase, there is an understandable momentum behind trying to make GLAC work. Let's hope the desire to find a solution quickly does not overlook the need to construct GLAC in a way that allows global investors to assess and price their risk at a level that works for the diverse bank business models across Europe, but more importantly allows them to support economic growth. ■

Laying the foundations for co-operation on cross-border bank resolution

Andrew Gracie - Executive Director, Resolution, **Bank of England**

One of the lessons from the global financial crisis was that banks which had been "international in life" were "national in death". It is perhaps unsurprising that, in recent years, authorities have taken steps towards strengthening local prudential requirements. National authorities are accountable to national publics and need confidence that financial stability and depositors in their jurisdictions would be protected should an international bank fail.

But excessive fragmentation of groups along national lines would be harmful to banks and their customers and could make the financial system more fragile and less resilient to shocks.

Instead we must make cross-border resolution work. Following FSB Key Attributes, resolution regimes need to be better aligned. This includes host countries having a statutory power to recognise resolution actions of home countries, as has been done in the EU BRRD.

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Beyond Solvency II: Challenges for insurance supervision

Edouard Fernandez-Bollo - Secretary General,
Autorité de Contrôle Prudentiel et de Résolution (ACPR)

While the implementation of Solvency II, a major work in progress, is definitely on the good track, insurance supervisors have to face simultaneously other important challenges.

We are creating common international prudential standards. The IAIS has decided to tackle the issue in two steps: first, in 2010, it initiated the design of a comprehensive framework for the supervision of Internationally Active Insurance Groups (IAIGs). Then in 2013, it started the development of a global insurance capital standard (ICS) that should be published in 2016. Regarding the systemic institutions, a first standardized capital requirement (Basic Capital Requirement) will be publicized by the end of 2014. It will be the basis for a Higher Loss Absobency Capacity to be applied starting in 2019.

These developments will be a landmark for insurance supervision enhancing convergence and setting a level playing field that we very much welcome. Of course, as a European supervisor, consistency with Solvency II principles is an issue of paramount relevance. Another extremely important issue raised by the FSB is to have a well-adapted framework for systemic risk that really captures the specificities of this industry. To that purpose, we think that the support of further research is useful and a careful analysis of the activities of each relevant group needed. ACPR is actively contributing to this analysis through its supervisory work on the main groups present in France. It has also launched a network of research on insurance supervision and systemic risk gathering supervisors, academics and representatives from the industry.

At the level of the European Union, we must reap the full benefits of the further integration of the EU market. The harmonization of the prudential regimes, the building of common approaches to detect risk and vulnerabilities should contribute to avoid any risk of fragmentation. We think furthermore that building up an efficient European-wide consumer protection, will also be an important contribution to the financial integration. ACPR, for which consumer protection is a key mission, will be actively involved in the elaboration of the different ongoing European legal drafts. Our aim is to ensure that a cross-sectorial approach is adopted to clarify the information disclosed to consumers and that it is adapted to the different financial industries and channels of distribution. ■

Solvency II delegated acts: More weight on parliament's scrutiny power

Burkhard Balz - MEP, Coordinator of the EPP group, Economic and Monetary Affairs Committee,
European Parliament

The preparation towards Solvency II is in full progress. It is understood that, for a successful preparation, the insurance undertakings and supervisory authorities need better clarity and predictability on the details of the rules. The delegated acts and implementing technical standards play a key role in this regard. Both, European Parliament and Council, have the right of objection to the draft delegated acts. With the tight timeline until 2016 in mind, the Commission shall proceed as quickly as possible with the consultation of the Parliament and the Member States in order to ensure a smooth finalization of the process. As Parliamentarians we count on the Commission that the guiding principles and basic parameters set out in the directive will be fully respected.

The Parliament continuously advocates the principle of proportionality that shall be binding for the Commission, the European and national competent authorities and the Member States. It is important that all the different layers of the new regulatory or supervisory framework allow for a size-proportionate and risk-proportionate implementation. Particular scrutiny is given to the delegated acts that specify the Long Term Guarantee Measures.

The technical calibrations have to be risk-appropriate and shall ensure the insurers' abilities to invest long-term and to provide sustainable long-term products. On the decisions on temporary equivalence for third countries the Parliament will be equally involved with objection rights. Granting equivalence or temporary equivalence is also an important tool with regard to the current international regulatory developments. It shall be our major interest to safeguard the global competitiveness of European insurance and reinsurance groups.

In recent financial services legislation the Parliament expressed its increasing reservations towards the delegation of power to the Commission. This general concern has to be addressed. I consider it necessary that an early exchange of views is established between the Parliament and the Commission, similar to the procedure that is foreseen for Member States by expert group meetings. A participation of the relevant EU supervisory authorities shall also be assessed. ■

How insurers differ from banks

Christian Thimann - Member of the Executive Committee, **AXA Group**

Four differences and two similarities can be identified between insurers and banks as regards their interaction with the financial system and hence as regards possible systemic risk.

The differences are the following: banks are institutionally connected with each other through the interbank market, whereas insurers are stand-alone operators; banks engage in maturity transformation, whereas insurers aim to match the duration of assets and liabilities; banks are inherently liquidity-short, whereas insurers are inherently liquidity-rich; and banks create money, credit and handle the payment system, which insurers do not.

The two similarities are that both insurers and banks are financial intermediaries, contributing to the intermediation between savings and investment; and both are large-scale investors in financial markets, with insurers being focused particularly on the long-term.

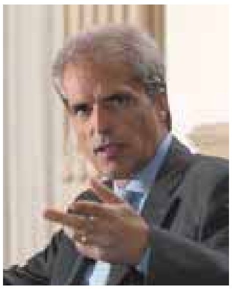
The differences underscore the fact that banks have a fundamentally different role within the financial system and with regard to systemic risk. Banks operate, and can only operate, within a banking system. Liquidity is allocated on a daily basis and shifted in substantial amounts between banks and the central banks; the system also serves as a protection against a possible liquidity risk that comes from handling money and holding short-term deposits. The banking system constitutes a kind of "inner core" of the financial system, where contagion and liquidity risks are prevalent.

Insurers operate only in an "outer circle" of the financial system, connected to other financial institutions essentially through their financial market investments. They act and react as other investors do, with the specific quality that leverage is quasi-absent in insurance and hence insurers do not act as other leveraged investors in financial cycles.

These fundamental differences need to be accounted for in systemic financial regulation so as to foster diversity in the system. Otherwise, if all financial institutions are broadly treated in the same fashion, they will all react in similar ways, which will augment procyclicality that is damaging the economy. The issue is not more regulation or less regulation. The issue is about regulation that is appropriate, coherent and takes societies' interests in long-term sustainability explicitly into account. ■

The latest insurance regulatory developments require deep analysis and a coordinated approach

Sergio Balbinot- Group Chief Insurance Officer, **Generali**



Preserving the fundamental role of insurers as long-term investors should be our common goal. And our priority is the need for balanced, clear and consistent regulation.

Overlaps and contradictions among regulatory requirements would lead to greater costs, higher administrative workload, legal uncertainty, compliance concerns and reputational issues.

The insurance sector is facing several challenging developments. Among others, the BCR, the new capital standard for the Global Systemically Important Insurers. The fundamental lesson we learnt from SII is that if we want capital standards to be not only "numbers" but actual, effective protection mechanisms, we need analysis, proposals and long discussions with the parties involved. And this means time, but time is precisely what is amazingly missing from the ambitious deadline set by the IAIS and the FSB. So the coming weeks and months are critical and there will be limited possibility for the industry to provide input and try to define a balanced, simple and comparable global capital standard.

I personally called on European policymakers to bring greater political accountability and transparency to the discussions at international level. We welcome steps taken by the Commission and I hope this constructive dialogue will continue and bring useful results, reminding us that the ultimate end–users of a sound regulatory regime are our customers.

It is equally important that the outcome of the work on international capital standards is compatible with Solvency II.

The Omnibus II agreement of November 2013 was a great achievement as it updated the Solvency II Directive in important ways.

If implemented correctly, the Omnibus II measures can reflect the way the insurance industry manages its long-term business avoiding unintended consequences. These measures can help to avoid overstating the risks to which our balance sheets are exposed and reduce the problems of exaggerating the real volatility identified in the quantitative impact studies and impact assessments.

One of the most important measures, in this sense, is the Volatility Adjustment. Anyway, the formulas and parameters adopted for the its calculation need transparency and clarity. Otherwise, the VA will not be replicable and predictable.

Despite the above challenges, I am sure that the insurance industry will maintain an open and constructive engagement with policymakers, legislators and supervisors and will contribute to global and European frameworks that allow our distinctive and innovative sector to grow, continuing to protect and serve the needs of its customers. ■

Appropriate use of internal models will be critical for the success of Solvency II

Alberto Corinti - Member of the Board of Directors, **Italian Insurance Supervisory Authority (IVASS)**

Authorising the use of internal models to determine the SCR is one of the first, main challenges for supervisors in Solvency II.

SCR measures the amount of capital that would be necessary to stand unexpected losses under a predetermined worst case scenario. It is clear that the best calibration of this amount can be achieved by modelling the actual risk profile of the specific company. In this sense, the use of the standard formula could be seen as a "simpler" way to determine a proxy of the economic capital, based on average market data and assumptions. Use of internal models is also intended to promote good risk management, as it is a tool to better understand the impact of risk factors' changes.

As experienced in other financial sectors, however, internal models could also be misleading and lead to serious undesired consequences if their results are poorly understood or mismanaged. They could also fail to quantify robust capital requirements, because of excessive uncertainty and subjective judgment in the calculation.

While insurance regimes around the globe are still seeking consensus on how to balance, on one side, risk sensitiveness and incentives and, on the other, prudence and objectiveness in determining capital requirements, many European insurance companies have already applied to get supervisory approval in time for Solvency II first application.

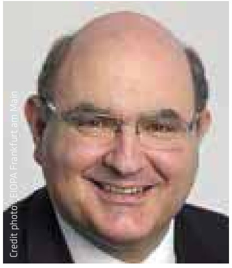
EU supervisors are now asked to strike that balance in practice, in the context of complex prudential valuation processes. It is crucial that the expected level of prudence is achieved and, at the same time, a level playing field at national and international level is ensured.

Besides appropriate level of resources within national Authorities and EIOPA, this requires diligence and commitment from companies, which should refrain from using internal models simply as a way to save capital. Sustaining quality in data gathering and in statistical methodology, ensuring actual and effective use of the models, setting the appropriate governance and reporting for their use are all key criteria to meet, if we want that internal models deliver the expected advantages and the new European regime succeed. ■

Global insurance regulation

The risk-based approach should become global

Gabriel Bernardino - Chairman,
European Insurance and Occupational Pensions Authority (EIOPA)



In the last 15 years, several countries across all continents have enacted risk-based regulation and supervision, with different nuances, but with lots of commonalities. In the EU, a major step towards risk-based supervision is represented by the development of Solvency II.

But the world keeps changing. Globalisation and increasing integration of financial markets have shown us the need to go further and to develop global regulation. This idea has been evolving from a fairy tale to reality.

We already have a methodology allowing us to assess and ultimately identify global systemically important insurers (G-SIIs). The next objective is to develop standards to be applied to G-SIIs and Internationally Active Insurance Groups (IAIGs).

With the Basic Capital Requirement (BCR), we aim to create a first level of comparability at global level. The Insurance Capital Standard (ICS) should be risk-based and contain fundamental principles such as a total balance sheet approach; clear and transparent target calibration criteria for capital requirements; explicit recognition of risk diversification; and consideration in capital requirements of all the material risks to which the IAIG is exposed. The details of these building blocks should be developed further until the end of 2016 and subsequently, a testing phase should drive us towards setting up a global capital regime.

Global capital standards should not replicate Solvency II; in fact, I do not think that they should be as granular as Solvency II. Going forward, European regulators should be open to make adjustments to our system if that is needed. Companies should be subject to only one capital regime. ■

Getting international insurance rules right

Susan Greenwell - Vice President, Head, International Government Relations, **MetLife**

An important consideration as we look at next steps in the regulation of the insurance sector in the context of global standard setting is the current G-20 focus on economic growth.

The insurance industry's contribution to economic growth is well documented. However, the future of the industry depends on regulation, and in particular capital requirements, that reflect the unique insurance risk profile and business model, and ensure a level playing field for all insurers. Additional considerations are difficulties arising from a lack of a common valuation and accounting standards.

While the current IAIS capital standard setting agenda appears to be moving in the right direction, and aims to develop a common balance sheet, key elements that would permit fair assessment of the structure and application of capital requirements are absent.

For this reason, there is continuing concern that capital charges may be inappropriately levied on a few companies with the resulting unintended consequences on competition, markets and policyholders.

There is no doubt that agreement on a common international capital standard would be highly desirable. I would like to highlight just some of the elements which are essential for making it a success:
- The relationship between the Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA) for so-called systemically important insurers and the International Capital Standard (ICS) for all globally active insurance groups needs to be clarified;
- The final calibration of the rules needs to be tested against economic data;
- Many fundamental specifications of the BCR have not yet been defined even though the IAIS is to reach agreement on this part of the capital framework before the end of this year;
- The timetables for developing the capital framework seem overly ambitious;
- The potential imposition of any new capital charges need to be proportionate to the specific risk profile of insurers. ■

A Global Capital Standard needs to be sufficiently credible, to overcome regulatory fragmentation and unlock its potential benefits

Stephan Unterberger - Head of Economic Capital Management, **Zurich Insurance Company**

Over the past few decades, insurance has undergone a fundamental transformation from a largely domestic business to a truly global industry. This process was mainly driven by changing customer needs: the increasing economic integration, the rising importance of multinational companies in production and trade, and the growing mobility of consumers in the globalized economy required insurers to expand their business models. At the same time, the risks themselves have become global. Yet, the regulatory and supervisory frameworks underpinning a safe and sustainable insurance industry have remained in large part domestically or regionally focused. This gap increasingly limits the ability of insurers to meet the needs of their global client base or respond to global risk challenges, while rendering the effective supervision of insurance groups a highly complex endeavor.

The transition towards a global insurance regulatory framework is not a smooth process, however. Indeed, Zurich observes a growing willingness of national supervisors and policymakers to focus on local regulatory frameworks and to embrace protective measures. Such measures are seen by many national supervisors and regulators as a way to keep capital close. However, the resulting regulatory fragmentation limits the ability of insurers to manage their capital effectively and realizing global diversification effects, which are ultimately at the heart of the business model of every insurance company and which are the main reason for the positive contributions insurers can make to societal and individual welfare. In addition, a well-designed and executed global standard can also contribute to the greater stability of the financial system through the benefits of a common methodology and Group supervision. Such a global standard needs to be sufficiently credible though in order to allow for convergence of the wide set of national and regional standards towards one common and comparable metric across the globe.

For any global standard to achieve these benefits, it must
- i) fully reflect the economics of the insurance business by applying an economic and market-consistent valuation framework
- ii) be risk-based, i.e. the level of capital that must be held depends on the risks that an insurance group assumes
- iii) consider diversification benefits, i.e. diversification benefits within an insurer's portfolio must be reflected in the determination of the capital to be held
- iv) apply on a consolidated basis to the total balance sheet of an insurance group to ensure all activities within the group are covered appropriately

Otherwise we risk that a global standard will exist in addition to the current set of national and regional requirements, clearly an un-desirable outcome for policyholders, policy makers and the insurance industry. ■

Considerations on HLA and systemic risk mitigation

Dr. Martina Baumgärtel - Head of Group Regulatory Affairs, **Allianz SE**

After completing the Basic Capital Requirement (BCR) later this year, the focus will shift to develop a Higher Loss Absorbency (HLA) capital add-on for GSIIs. Unfortunately, substantial uncertainty remains regarding key elements of the new requirements. As such, we are still waiting for the final calibration of the BCR as a basis for the HLA and relevant BCR details like the treatment of Margins Over Current Estimates. In addition, the definition of the scope of the HLA in terms of Non-Traditional Non-Insurance business is still under discussion. Notwithstanding this, a few key considerations are essential for the HLA development:

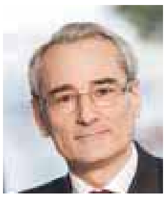
GSII focus for HLA is short-sighted - If systemically risky activities are only regulated for GSIIs, it can be expected that those activities will either move to non-GSIIs or are reinsured, which could even increase systemic risk as they would fall short of supervisors' focus.

HLA needs to be incentive-compatible - If supervisors want to restrain systemic risk effectively, the regulation needs to incentivize the reduction of activities triggering systemic risk and must therefore be applied to those activities only.

Systemic relevance versus riskiness - Activities with systemic relevance (spill-over effects from other market participants which affect the insurer) must - irrespective of the GSII status – be subject to normal prudential regulation and - if not already done - be tackled uniformly for all market players. In contrast, systemically risky activities, in which the insurer could through their own activities "infect" other institutions, might warrant additional regulation.

Finally, we wonder whether additional capital is the best answer to mitigate systemic risk. Looking at examples like the AIG failure, we believe that other measures like the establishment of effective Group supervision (no unregulated activity) and globally consistent capital standards and prudential rules for insurers would be more effective. As such, the new capital measures must not automatically lead to additional capital requirements but should depend on the risk profile and soundness of the existing capital regime of the insurer. ■

Bank crisis management at the global level



Global solutions for bank crisis management: Reconciling the GLAC with EU Rules

Jérôme Brunel - Head Group Public Affairs, **Credit Agricole S.A.**

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Whilst recognizing that the scope of application of MREL and GLAC might differ, we would urge the FSB to come forward with a proposal that is consistent with the BRRD approach on the MREL. In this context, it is key that the FSB takes a flexible approach towards the composition of GLAC liabilities so that banks can meet the GLAC requirement through a broad range of bailin-able instruments, as currently permitted under the BRRD. Such an approach would help banks to best accommodate the GLAC requirement to their specific business models, regulatory environments, organizational structures and, last but not least, their funding model. It would also help resolution authorities to spread losses over a broad investor base if necessary and limit the risk of moral hazard at the level of unsecured senior debt holders. Equally important, the location of the GLAC should be consistent with the group's organizational structure and its high-level resolution strategy (SPE or MPE) as agreed in its Crisis Management Group (CMG), as already foreseen by EU legislation.

Ultimately, any decision on new global resolution standards such as the GLAC (including calibration, timeframe, etc.), should be informed by a proper feasibility study and impact analysis, based on a structured dialogue with industry stakeholders. The duplication of tools and regulations across jurisdictions should be avoided at all costs. Instead the FSB should aim at promoting better coordination between supervisors at global level. ■

Laying the foundations for co-operation on cross-border bank resolution

Andrew Gracie - Executive Director, Resolution, **Bank of England**

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Authorities have been co-operating in "Crisis Management Groups" to develop group strategies for G-SIBs. This involves working towards cross-border co-operation agreements setting out how home and host authorities would coordinate actions in a resolution.

But for such arrangements to work at the point of crisis, they need concrete underpinning that barriers to coordination are addressed and firms are set-up safe to fail. One example is adequacy of loss-absorbing capacity (LAC) and how it is distributed within groups.

Groups need sufficient LAC, e.g. capital or unsecured long term debt, which could readily be written down or converted to equity in resolution. Prepositioning of LAC to relevant subsidiaries within a group would provide authorities, creditors and customers of the subsidiary with confidence that necessary resources would be available in resolution, avoiding the need to "ring-fence" nationally. And, even in a domestic context (or within Banking Union), and in particular if combined with requirements to disclose the creditor hierarchy on a legal entity basis, it would ensure enhanced clarity that losses would fall to shareholders and private creditors over taxpayers. ■

G20 Transparency: more work to do

Michael Bodson - President & Chief Executive Officer, **The Depository Trust & Clearing Corporation (DTCC)**

As we approach the fifth anniversary of the G20 Finance Ministers meeting in Pittsburg, the mandate requiring the reporting of all over-the-counter (OTC) derivatives transactions to trade repositories is among the most advanced in implementation. The measure, which is designed to improve the transparency of derivatives markets by providing a window into exposures across the global system, has been enacted in some form in 15 of the G20 jurisdictions, according to the Financial Stability Board's most recent progress report. However, the reality is that significant obstacles continue to deny regulators and the investing public the level of transparency envisioned in Pittsburg.

Despite near unanimous agreement among policymakers on the benefits of the trade reporting requirement, a regional approach to the rulemaking process has resulted in reporting mandates looking very different across major derivatives jurisdictions. The lack of harmonized rules and implementation timelines across markets have produced challenges for participants and infrastructures seeking to fulfill their global reporting obligations. Moreover, the absence of data-sharing agreements among jurisdictions and the ongoing divergence over protocols for supervising derivatives markets across borders continue to prevent regulators from having a single global view of activity to effectively monitor and mitigate risk.

This lack of harmonization is forcing market infrastructures to build regional solutions instead of global ones, which only serve to increase the cost of compliance and operational complexity, create legal uncertainty and negatively impact market efficiency. If trade reporting remains regionally fragmented, regulators will never achieve the level of transparency that is needed to protect the stability and integrity of the financial system. The result could be an increase in systemic risk.

As we look to the future, we urge policymakers to work collaboratively with one another and with the industry to build trust and to resolve differences in policy and approach. They must also look beyond national interests to establish globally-consistent policies. While a great deal of progress has been made over the past 5 years, there is still more work to do to deliver on the promises of the Pittsburg meeting. ■

Meeting the challenges of cross-border regulation

Greg Medcraft - Chairman, **Australian Securities and Investments Commission** and Chairman, **International Organization of Securities Commissions (IOSCO)**

The post-crisis decline in cross-border activity in the markets we regulate, and its impact on global economic growth, are well documented.

The jury is out on why this has been the case. Macroeconomic conditions and forces have no doubt played a role. Differences in the way in which key jurisdictions have implemented regulation in response to the Crisis and guidance developed by international standard setters may also have played a part.

Whatever the reasons, I believe we in the Official Sector must reflect on the actions we should take to address regulatory impediments to cross-border activity - be they duplicative or inconsistent national or regional regulation. Addressing these impediments will, I believe, support global economic growth.

We at IOSCO are taking action within a framework with 3 elements.

The first element of our approach is continuing to **design** global standards – or a global rule book – which sets out expectations about how activity in global markets should be regulated at the national and regional level. This rule book provides a foundation for consistent national and regional approaches to regulation.

IOSCO has a strong track record in this space, having developed guidance in relation to credit ratings agencies, financial benchmarks, financial markets infrastructure, commodity derivatives and OTC derivatives. Our challenge is to develop appropriately granular and timely standards which are amenable to being implemented in a consistent and co-ordinated way.

The **second** element of our approach is about encouraging consistent and harmonized implementation of these standards.

This area poses particular challenges. We recognize that the implementation of standards at national and regional level will always reflect domestic political, legal and regulatory philosophy considerations. Even though we may be on the same page about the outcomes we want to achieve, there will inevitably be differences of detail and different thinking about whether and how regulation might apply to foreign activities and firms.

The Task Force on Cross-Border regulation we established last year is progressing IOSCO's thinking in this area.

The Task Force will issue a Consultation Paper early in the final quarter of this year setting out a tool kit of measures which might be used by national and regional regulators to regulate foreign firms and their activities.

The tool kit will include measures (including substituted compliance, equivalence, mutual recognition and passporting) which are being used by national authorities as the basis for deciding whether to trust and defer to regulation in the home jurisdiction as the basis for allowing a foreign firm to engage in activities in the host jurisdiction. Our thinking is the tool kit will at the very least help develop a common language as a basis for common approaches to reducing unnecessary regulatory duplication and regulatory costs associated with cross-border activity.

We encourage industry to respond to the Consultation Paper.

The **third** element of our approach is our work on cross-border regulatory co-operation in supervision and enforcement.

Without co-operation, we cannot be confident the standards and regulation we implement at national and regional level are – in effect – operating in a consistent way. Effective co-operation will feed into national authorities' thinking about whether to trust and defer to the regulatory framework of other jurisdictions.

IOSCO has provided a successful framework for this in relation to cross-border **enforcement** activity through its *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (MMoU). Regulators from over 100 jurisdictions have signed up to what is now seen as the global benchmark for cross-border regulatory co-operation. Over 2,500 requests for co-operation under the MMoU were made last year.

IOSCO's next challenge will be to develop a similar MMoU covering co-operation in supervision of cross-border activity building on its work in 2010 in designing Principles of Supervisory Co-operation. ■

Consistent implementation of OTC derivatives rules

Steven Maijoor - Chair, **European Securities and Markets Authority (ESMA)**

The OTC derivatives reform is one of the few areas where we early on in the process agreed global reforms with detailed calendars. Unfortunately, when we transposed these high level commitments in our laws the inconsistencies started to raise and the timing slipped. So what was conceived as a global reform for a global market risks turning into market fragmentation and reduction of cross-border business, as recently reported by some market studies.

The regulatory community has a duty to respond to these detrimental market developments following the implementation of what was envisaged to be a globally coordinated market reform. Although there are a number of fora to develop international standards and global solutions, when it turns to local implementation the rules always differ slightly in view of local specificities. These differences now impede in too many cases the reliance on, or deference to, foreign regimes.

So far the regulators of the major OTC derivatives markets agreed one basic principle applicable to cross-border transactions, i.e. the strictest rule. This means that for pure cross-border transactions when for example one regime applies the clearing obligation to a particular product or a particular entity and another regime does not, the regime applying the clearing obligation should prevail. Unfortunately, this basic principle does not work in all cases. In particular, when the clearing obligation applies in both jurisdictions but the rules are incompatible, market participants will be unable to fulfil the two sets of rules simultaneously and will therefore be exposed to legal uncertainty, as none of the two is stricter. Similar cases apply to the treatment of branches and affiliates which are potentially exposed to multiple sets of rules.

To avoid the market fragmentation that we are already experiencing there is only one solution: reliance on equivalent regimes. We all agree that this is a solution; unfortunately not all the relevant regulators are ready to implement this principle widely.

With the forthcoming standards on bilateral margins we have the opportunity to implement them in our local rules in a globally compatible manner. We have developed detailed international standards and we are now moving to the transposition of these standards in our own regimes. ESMA together with EBA and EIOPA has already consulted on the proposed rules and is in constant dialogue with foreign regulators on their implementation. Given the granularity of the international standards, we should be able to achieve compatible and equivalent rules. This will allow to rely on each other and avoid the complex exercise of determining which set of rules is the strictest. ■

Challenges of implementing consistent cross-border market regulations

Ashley Alder - Chief Executive Officer, **Securities and Futures Commission (SFC),** Hong Kong

Six years after the onset of the financial crisis, the initial enthusiasm for a set of global, top-down regulations has dimmed. National regulators have been hard at work putting in place rules designed primarily to protect their own domestic interests, many of which fall short of the G20 ambition for more harmonized implementation of standards and synchronized global solutions.

Rather than exporting standards to other jurisdictions extraterritorially, agreeing upon on a set of common tools and processes for implementing rules that aims to achieve equivalent outcomes remains a worthy goal.

There is a growing realization, however, that the reality on the ground is far more complex. For one, harmonized financial regulation operating at an international level is only truly effective if grounded in legal treaties. Absent this, global agencies will find it difficult to implement consensus-driven solutions, based only on peer pressure and applying broad principles of soft law.

Moreover, if national regulators are to be given a clear remit to act collaboratively beyond borders, national legislation must be amended to reflect this. In both cases, governments are best placed to drive this process and enable this to happen.

That said, much has been done on the national level to increase the safety and soundness in the financial system, all based on enforceable national laws which are bound to differ as they are products of different political processes. Jurisdictions in Asia, for instance, have specific circumstances and needs, and have largely rejected a "one-size-fits-all" approach exported from other parts of the world. Where these laws collide, regulators are dealing on a practical level, using measures such as deferring to a foreign law or regulatory regime when it is judged to be sufficiently "equivalent", or to apply "substituted compliance" instead of exporting their own.

This is where the IOSCO Task Force on Cross Border Regulation comes in. Acknowledging the complex reality of cross-border securities regulations, the Task Force is developing a toolkit which describes issues and experiences with the use of different techniques to regulate cross-border activities. It will update the G20 at the Brisbane Summit in November, and aims to issue a consultation paper by the end of 2014. ■

Making it work - Global Market Regulation

Jennifer Taylor - Chief Operating Officer, EMEA, **Bank of America Merrill Lynch**

Global market regulation is certainly not a new concept. It has been on the agenda for years in the Americas, in Europe and in Asia. Everyone agrees that global rules are a precondition for well-functioning global financial markets and clear and consistent market regulation allows all market participants to function properly within a global framework and respond appropriately to customers' needs.

We need to acknowledge that much has been achieved in this regard already. The BCBS and IOSCO work on margin requirements for non-centrally cleared derivatives is a good example of a top down cross-border regulation approach. However, now we need to safeguard this work and not allow it to be undermined by localized initiatives leaving unworkable and inconsistent final rules in the different jurisdictions.

As a global market participant, we have witnessed the emergence of major inconsistencies between national jurisdictions, caused by the much discussed "bottom-up approach" towards regulation, one example being derivative clearing requirements. From an EU perspective, the process of non-EU Central Counterparty Clearing House (CCP) recognition under EMIR has taken longer than expected and communication with the market could be improved. On this we would urge the European Commission to consider that any form of mutual recognition needs to be practical and workable for both US and Asian market participants. Commissioner Barnier's announcement before the summer on the equivalence determinations for CCPs in Japan, Singapore, Australia, Hong Kong and India was a very welcome step in the right direction. We do, however, remain concerned about US-EU CCP mutual recognition. In the US, the CFTC Derivatives Clearing Organization (DCO) rules which require non-US CCPs that meet the CFTC'S DCO definition to register may be construed as a hindrance as it places the non-US CCP directly under CFTC supervision. Needless to say this would not be welcomed by the non US home regulators of the CCP in question.

These bottom up approaches see market participants, including financial institutions, investors and commercial end-users confronted with duplicative, inconsistent and conflicting requirements often aggravated further by divergent implementation timeframes. As a result, cross-border trading and investment is challenged and meeting client needs is impacted. At the same time, regulators are faced with increased supervisory and oversight burdens. All of which could be alleviated through enhanced international dialogue and collaboration between policy makers, regulators and international market participants. We welcome the work of the IOSCO Task Force on Cross-Border Regulation and have actively engaged via the Cross-Border Regulation Forum (CBRF) in the bid to make market regulation work for all participants. To this end, the development of cooperation and consultation mechanisms will be paramount to ensuring the early identification of potential conflicts and bringing together the relevant stakeholders. ■

Reconciling global financial markets with national regulatory systems

Michel Barnier - Vice-President of the European Commission, responsible for Internal Market and Services

We have come a long way in post-crisis financial reform since 2007/08. G20 and FSB co-ordination has ensured that rules for the financial sector have similar characteristics, regardless of where they apply. Globally agreed frameworks pursue similar aims, whilst still taking account national specificities. Yet, despite these shared objectives, we all know that financial markets differ between countries. So do legal and regulatory traditions. This means that some differences in the details of applicable rules and the way supervision functions on the ground are unavoidable.

The challenge we face is to reconcile the needs of global financial markets and cross-border businesses with the diverse legal, regulatory and supervisory reality in different countries. Requiring companies to comply with all the rules of all countries in which they do business cannot be the answer. This is costly, unnecessary and often impossible in practice since even rules pursuing similar outcomes can be contradictory. Global financial markets do not require one single set of rules. What they do need is internationally co-ordinated financial regulation and co-operation between supervisors, based on a system of reliance and deference. In EU financial regulation, this is referred to as the equivalence concept. Based on an assessment of the outcome achieved by a foreign regulatory and supervisory system, the European Commission may recognise that system as being equivalent to the EU standards. This approach allows foreign firms to operate in the EU subject to the rules and supervision of their home country and EU operators to treat foreign counterparties as if they were EU entities. The equivalence concept is not new to EU financial legislation but its importance has increased considerably in the wake of the crisis.

Where countries have committed to the G20 agreed reforms, as further developed through fora like the FSB, Basel, IOSCO or IAIS, their regulatory and supervisory systems should have sufficient similarity to justify a system of deference and recognition. I am not advocating that there should be a single system of recognition to be applied by all countries. Reliance should not be automatic or subject to a uniform process. However, given the common, global regulatory agenda, I do believe that many countries could have a favourable predisposition to recognition and deference to a foreign regulator. It would be helpful for global financial operators but would also improve the safety and resilience of the whole financial system enabling more effective global supervision. Our common efforts to this end must continue. ■

Financial Regulation - Global but also consistent?

Stefan M. Gavell - Executive Vice President, Global Head of Regulatory, Industry and Government Affairs, **State Street Corporation**

A key objective of the G20 regulatory reform agenda was to achieve global consistency and a harmonised approach in responding to the financial crisis. Half way through the agenda, it is a good moment to assess to what extent this objective has been achieved with derivatives regulation being a goodtest case.

Compared to the pre-crisis period, good progress has been made. The G20 agreements have resulted in common areas of objectives, regulations and coordination in implementation. At the same time, more can and must be done. Often, the devil is in the detail and national or regional implementation differs in small but very important areas. Relevant examples here are the definition of FX financial instruments and the extent to which they are in scope or the types of assets that will be eligible collateral. Things often become even more complex as implementation timetables vary significantly, e.g. for mandatory central clearing and trade execution venues.

These differences make outcome-based equivalence and substituted compliance assessments even more important to avoid the disruption of the functioning of global financial markets. Recent experience has shown, however, that these assessments need to be undertaken with increased speed and transparency to avoid creating uncertainty in the markets.

But there are also positive examples such as the requirements for uncleared derivatives where consistent implementation seems likely. This is due in part to the important work that IOSCO has done by drafting global principles. In general, IOSCO is playing an important role in promoting global consistency in cross-border market regulation, a role that should be further strengthened and supported by national regulators.

In light of further regulation in the area of financial markets and market structure, as well as newly emerging questions such as the suspension or early termination of derivative contracts in the context of a bank's recovery or resolution, international consistency and close cooperation among national regulators and facilitated by bodies such as IOSCO will be key. ■

The Pittsburgh G20 commitments: Avoidance of regulatory arbitrage

Paul Swann - President and Managing Director, **ICE Clear Europe**

In July 2013 the European Commission and the CFTC agreed to solve remaining differences in EU and US derivatives clearing rules. This has been achieved in regards to OTC derivatives or 'swaps', but not in Exchange Traded Derivatives (ETDs) where the reforms have created regulatory arbitrage in margin standards. Long established practices and procedures embedded in other jurisdictions' legislation and supervisory rules are now inconsistent with EU arrangements. At the time of writing the EU and US dialogue was ongoing with no resolution on the horizon.

This unfortunate experience provides important lessons for the creation of future legislation and supervisory rules. It is essential to co-ordinate at a global level while laws are at a formative stage avoiding the risk of marketplace fragmentation through regulatory arbitrage. Without global standards, markets will simply migrate to the least prescriptive jurisdiction and any benefit of higher standards may be lost or lead to global market dislocation. The development and implementation of EMIR has achieved significant progress in ensuring financial markets are safer and will serve the interests of society; this is to be applauded. However, fixing the remaining cross jurisdiction differences is essential.

At the end of June Vice President of the Commission M. Barnier updated the market on the international dialogue. His statement gave grounds for optimism in his determination to ensure alignment of "key aspects of margin requirements to avoid arbitrage opportunities".

These are positive signs, but the need to "fix" problems can be avoided through engaged international regulatory and industry agreement on the substance of detailed Laws and supervisory rules in the formative stages. The challenge is to avoid a repetition of the difficulties we have seen in

EMIR. The finalisation of MIFID II/MIFIR will prove whether lessons have been learned and whether the international financial market's regulatory leaders can develop harmonious reform. ■

International efforts to enhance cross-border regulation

Elke König - President, **Federal Financial Supervisory Authority (BaFin),** Germany

The interconnectedness of financial markets has made cross-border regulation a core focus of financial market policy. Which makes it all the more surprising that national lawmakers and international policy-makers do not always pay transnational aspects the attention they deserve. Trade reporting and the regulation of over-the-counter derivatives appear to be particular problem areas. It is in the nature of things that approaches to supervision will differ as long as conditions in individual countries differ, either for political and legal reasons or for structural reasons. Global regulatory harmonisation is therefore almost too much to expect and – as long as these differences exist – not desirable either.

But things that are the same should be regulated in the same fashion world-wide, which is clearly hard enough already.

The International Organization of Securities Commissions (IOSCO) has taken on this Herculean task. It has charged a Task Force on Cross-Border Regulation with putting together a "toolbox" that it aims to use to help it remove impediments to cross-border regulation. The Task Force has asked market participants for their experiences and invited IOSCO members from all parts of the world to explain their national regulatory provisions. This survey has shown that what (among other things) makes shaping cross-border regulation so difficult is – to put it blunt – to some extend a lack of trust. Most jurisdictions are reluctant to allow themselves to be represented in supervisory matters by foreign authorities and even claim extraterritorial powers – sometimes even when the substance of the legislation is identical. If it is not, many jurisdictions demand that the foreign regime is at least equivalent. The countries involved can only agree if they succeed in agreeing on a common regulatory objective. A lack of such common understanding may result in inconsistencies, an unnecessary regulatory burden for supervised entities and ultimately higher costs for the consumer. IOSCO´s initiative is intended to support jurisdictions by making it easier for national supervisory authorities to come to an understanding early on, to build confidence and to find practical solutions – not only, but also with the aid of the toolbox, which contains a number of tried and tested approaches. ■

SAVE THE DATES

Next Eurofi event organised in association with the forthcoming Latvian EU Presidency

The Eurofi High Level Seminar 2015

22, 23 & 24 April 2015

Riga, Latvia

- Seminar by invitation only on the eve of the informal Ecofin meeting
- Invitations will be extended to representatives of the public authorities and members and partners of Eurofi
- Main focus of the discussions: Measures required to foster an appropriate financing of the EU economy and priorities for the new EU Commission and Parliament in the different sectors of financial regulation

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Following Eurofi event

The Eurofi Financial Forum 2015

9, 10 & 11 September 2015

Luxembourg

Forum organised with the contribution of the Eurofi members

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