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Time has come to revive a sound and safe securitization market in Europe

Jacques de Larosière - President of Eurofi, the European Think Tank dedicated to financial services

Financial regulations have made European banks more resilient. Indeed, banks have considerably strengthened their capital positions which have doubled on average, and have increased their levels of liquid assets, while reducing their risky assets, notably by scaling back market activities, an area in which they had been too frequently involved beforehand.

A deleveraging trend, with a reduction in banks' balance sheets, is normal after a debt crisis.

However, the European banks' reduced levels of profitability are making it difficult for them to find fresh capital to fulfill tightened capital requirements.

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Financing the recovery: issues and policies

George Provopoulos - Governor, **Bank of Greece**

Despite recent signs of a rebound in economic activity in the euro area, growth remains weak as banks continue to deleverage and bank credit is either flat or declining. Creditless recoveries like the current one are not rare animals. They tend to follow recessions coinciding with banking crises. Banking crises usually follow periods of credit booms, during which households and companies accumulate debt. Part of this debt becomes bad during the downturn and banks end up with a high burden of NPLs. As a result, bank credit is constrained by both demand and supply factors.

Given the weakness of banks to provide credit to the economy, the crucial question is whether firms can substitute bank credit with alternative sources of financing, in particular market based financing. The extent of this substitution, however, is constrained by financial structure and firm size. Financial structure determines the importance of bank relative to market-based intermediation. It is largely related to the legal framework and the degree of investor protection. Euro area countries, with legal systems in the tradition of civil law tend to have more bank-based financial systems. Anglo-Saxon countries, in contrast, with legal systems based on common law, tend to have more developed financial markets.

Firm size is also significant. Small firms are typically more dependent on bank credit. This is a constraint to financial market development in the euro area, where SMEs account for a substantial share of employment. The problem is more acute in peripheral euro area countries, because credit conditions there

have deteriorated more than in core countries and SMEs are even more prominent.

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Reviving the economy: funding and liquidity on solid financial ground

Yannis Stournaras - Finance Minister of the Hellenic Republic & President of the **Economic and Financial Affairs Council (ECOFIN)**

Europe is still in the process of fiscal consolidation and the first signs of recovery are already visible. Given the positive economic outlook, after a long-lasting contraction in economic activity, we need to return to sustainable public finances and at the same time we must put in place the appropriate policy responses that will afford sustainable growth momentum.

This could be achieved by stronger policy frameworks, including sound macroeconomic policies, structural reforms and strong prudential oversight that will ensure the necessary cohesion among national economic policies.

At the same time, in several European countries, the level of private debt remains high. Consequently, de-leveraging the private sector is equally essential. Given the heterogeneity of the debt structure across countries, a balance between public and private indebtedness should be guaranteed and actions be taken accordingly.

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Promoting growth-orientated financial reforms: a universal bank perspective

Jean-Paul Chifflet - Chief Executive Officer, **Crédit Agricole S.A.**

Five years after the outbreak of the global financial crisis, efforts towards the strengthening of the banking and financial system have been significant. Banks have largely anticipated the new Basel 3 rules and other ambitious G20 market reforms.

Since 2008, they have substantially increased their level of core capital whilst at the same time boosting their liquidity reserves and reviewing their liquidity management policy. In addition, they have set up more robust risk management processes and decreased their overall exposure to risky activities. They have achieved this through an in-depth reorganization of their business portfolio which has put customer focused market activities back at the very center of their business strategy.

This in turn has contributed to healthy deleveraging efforts which are still underway today.

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Europe's next challenge: financing growth

Michel Barnier - Member of the European Commission responsible for Internal Market and Services

Since the crisis onset, the EU banking sector is in a process of deleveraging and balance sheet downsizing. From a prudential perspective, this is clearly necessary to enhance the resilience and stability of the banking sector. Deleveraging, may also induce banks to tighten credit conditions and reduce lending.

On the one hand, there is no one-to-one relationship between changes in the balance sheet size of banks and the provision of loans to the real economy, i.e. balance sheet reductions and deleveraging can be achieved without hampering lending – e.g. through reductions in intra-financial system exposures and by cutting lengthy intermediation chains. On the other, it would be unrealistic to say that the crisis did not put a break on aggregate credit flows, which in part reflects corrections of pre-crisis excesses.

The EU financial regulation agenda has been mindful of the risk of disorderly deleveraging: transitional arrangements have been provided for in the legislation in order to allow deleveraging and the strengthening of bank balance sheets to be a smooth process that minimises the harm to economic recovery. This process is subject to ongoing monitoring by the EBA.

The EU is currently witnessing the first signs of an incipient recovery: according to the winter 2014 economic forecast, a moderate 1.5% economic growth is foreseen for 2014 in the EU, reaching 2% in 2015. With signs that financial stability has also been achieved, it being a precondition for growth, the efforts now need to focus on removing financial market fragmentation and its translation into uneven and asymmetric funding conditions, and on fostering alternative sources of finance, since difficult access to finance is one of the major factors delaying recovery.

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Systemic regulation of insurance: the challenges ahead

Christian Thimann - Member of the Executive Committee, **AXA Group**


Credit photo : Patrick Messina

As the Financial Stability Board (FSB) begins to explore rules for the insurance companies that it has designated systemically important, this is a significant year for the industry. Regulators are aiming to devise a common "basic capital requirement" for the five insurers from Europe, three from the US and one from China that together constitute the systemic group. They subsequently plan to identify activities particularly prone to systemic risk and consider applying higher capital charges to those.

One major challenge is that local regulatory and accounting standards will remain binding for the systemically important firms, but those standards are literally continents apart: whereas Europe is about to complete the world's most advanced, ambitious and complex regulatory standard with mark-to-market accounting, the US insurance sector is still regulated at the sub-national level and its accounting rules are not based on market values. Should Europe move backwards or will the US move forwards? And what about China's regulatory framework?

Finding a "middle point" in this triangle is a formidable task. There is a significant probability of creating double standards within and across the constituencies at any given point in time, with the risk of confusing policy-holders and financial markets, or somehow affecting the global level playing field. Moreover, differently constructed capital requirements will move in different directions over time, which would make internal management decisions exceptionally complex.

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New finance for growth in Europe

Ignazio Visco - Governor, **Banca d'Italia**

A pick-up in investment and domestic demand is needed to strengthen the still feeble economic recovery in Europe, and more favourable financing conditions for all firms are essential in this respect. We are not there yet: in December 2013 bank loans to non-financial corporations in the euro area decreased at an annual rate of 2%.

Given the ongoing adjustments of banks' balance sheets and the persistent fragmentation of funding markets, the role of capital markets is bound to become more central. Indeed, large companies are now widely tapping international capital markets. Yet, small and medium-sized enterprises (SMEs), key players in European economies, are still struggling, owing to their persistent difficulty in raising funds on capital markets and their heavier reliance on banks. Here is where action is required the most. Potential market interest for financing such companies exists, but appropriate financial instruments need to be developed further.

Securitization might be part of the solution to this challenge. It allows the screening and origination of loans by the banks to be separated from their financing, which is ultimately provided by markets.

Properly conceived securitization, which avoids the problems that plagued the technique before the crisis, could help relax SMEs' funding constraints without posing too heavy a burden on banks in terms of capital. In reviewing the prudential treatment of asset-backed securities, a balance should be struck between controlling the risk profile of the instruments and stimulating the market. Products should be standardized and transparent, while providing for a reasonable level of risk retention by the originator.

Several other initiatives, including those launched by the European Commission and the EIB to support the creation of joint risk-sharing instruments, have also been conceived to leverage capital market investments in SMEs, thus creating a bridge between banks and markets.

It is, however, crucial that firms directly address the imbalances in their financial structures. SMEs' access to bond markets may be progressively improved by removing the specific difficulties these firms encounter in terms of the cost, transparency and liquidity of their issuances.

An equally important goal is the gradual strengthening of their equity base. Economic recovery will contribute by raising profits, but tax incentives and initiatives aimed at reducing listing costs should provide a further stimulus in this direction. ■

The conditions to revive a safe and efficient securitization market in Europe

Christian Noyer - Governor, **Banque de France**

Bank intermediation remains the dominant way to finance the economy in Europe. However market based financing mechanisms can significantly complement this funding source. Both funding sources are complementary: securitisation feeds on existing bank loans and alleviates banks' balance sheets to allow for the provision of new credits.

Still, securitization has yet to recover to pre-crisis levels in the euro area, contrary to the US where the problems initiated and resulted in much higher default rates. In addition, the rebound in securitised issuances is primarily driven by the desire to create securities that are eligible as collateral for the Eurosystem (retained securitisation).

Simple and transparent securitization schemes should therefore be encouraged, as they would bring clear benefits to the economy and help to restore investors' confidence. During the crisis, the dramatic slowdown in securitization was due to a sudden loss of trust in ABS in the wake of the unraveling of too opaque and complex structures. The current development of market standards to increase the transparency, harmonization and safety of these products are therefore key factors to revive securitization.

Public authorities have already played a significant role. They contributed to reduce risks associated with these products for investors through increased standardization and improved transparency on underlying assets as already done with the ABS loan-by-loan initiative that is actively supported by the Eurosystem.

They tightened the regulation of credit rating agencies and increased the transparency of their methodologies. They promoted the use of simple and transparent securitization schemes, such as the initiative of several international banks active in France. Banque de France fully supports this initiative which will facilitate the securitization of private credit claims that are individually eligible as collateral for the Eurosystem. The scheme reduces the reliance of markets participants and central banks on credit rating agencies through the use of alternative analyses of risk.

Nevertheless, more can be done or is underway and deserves further attention. It concerns in particular the harmonization of prudential treatment across jurisdictions and sectors, to avoid misperception of risks by investors and the increase in investors protection and prevention of systemic risks through a more stringent regulation of asset management activities. ■

Revitalising the market for loan-backed ABS

Peter Praet - Member of the Executive Board, **European Central Bank (ECB)**

Several indicators are pointing to a moderate recovery of the euro area economy, but bank credit growth remains weak. This partly reflects a typical pattern: loans to firms lag the business cycle by roughly one year. But today, while the economy is recovering from a prolonged and exceptionally severe recession, firms' demand for bank credit may take longer to revive, as companies engage in a deep overhaul of their business plans and adjust their financing sources.

European financial intermediation – traditionally bank-centred – may change as a consequence. Early signs are already visible, e.g. in the euro area corporate debt market. Corporate debt issuance has partly compensated the fall in bank credit in 2013: firms' direct net issuance of debt securities was €84 bn compared to net redemptions of €129 bn in bank loans. Large corporations are increasingly able to replace bank with market finance.

Small firms remain at the margin of this process, though, and have to look elsewhere. A healthy market for loan-based asset backed securities (ABS) could be an efficient substitute for direct access to debt funding for firms lacking the minimum size and standing required for issuing their own securities.

Here the ECB bank lending survey signals mild optimism. Banks report on balance an improving access to the securitisation market, which is critical as a long-term funding source and an instrument to expand credit and contain capital charges. However, the revitalisation of this market faces several obstacles.

Initially, a key hurdle was a lack of confidence in the quality of underlying assets. Here, the ECB loan level data initiative with requirements for transparency and standardisation as well as private-sector labelling initiatives have helped reduce investors' information costs.

Other hurdles remain, though. On the regulatory side, calibration of risk parameters does not totally suitably account for the solid track record of European ABS. Thus, the capital charge for sound ABS is much higher than that for other assets of similar risk. This bias for high-quality ABS might need to be reassessed.

A rejuvenating market for simple loan-backed ABS could help support the origination of new loans to the real economy. Transparency and unbiased regulation are key factors in this process. ■

Time has come to revive a sound and safe securitization market in Europe

Jacques de Larosière - President, **Eurofi**

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The more this profitability is limited, the less it is possible for them to build up reserves and the more difficult it is to raise capital. This problem is being compounded by the increase in capital constraints. The banking sector's profitability for investors has become far lower than that of industrial companies. In this situation, compliance with the liquidity and capital adequacy ratios can only be fully achieved through a reduction in assets, including loans. In comparison, the impacts of these prudential requirements on the profitability of American banks are lower as far as they off-load a major part of their mortgage loans to entities like Fannie Mae and Freddy Mac.

Yet, resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. Besides the low margins and the high levels of indebtedness of enterprises in many EU countries, several factors are hindering credit provision. Non-performing loans in periphery countries are high, which deters banks from lending. Furthermore, the failure of several banks has either left SMEs with no bank or finding difficulty switching to another bank. In addition, the poor sovereign ratings of these countries lead to high credit rates which strongly impact the profitability of enterprises and their capacity to borrow.

Another issue which first emerged in periphery countries but is now touching other EU states, is the increasing credit rationing of SMEs. In France and Italy for example the proportion of bank loans facing obstacles (rejections, partial coverage or high price) has been increasing over the last months to reach 29% in France and 48% in Italy at the end of 2013. This situation can be explained by a combination of demand and supply factors. However many observers believe that this could be the prelude to a further decrease of credit supply in these countries caused notably by rising prudential constraints being progressively imposed on banks.

To sum up, it would be too easy to say that the classical deleveraging that always follows a banking crisis is the sole factor behind the present slowdown of credit to the private sector: the situation has to be observed in a more granular way. Figures show that a significant number of SMEs in good standing in periphery countries have great difficulty in accessing credit.

Given the difficulty of developing market-based direct financing mechanisms for smaller companies based on bond or equity vehicles, the time needed to improve significantly the profitability of EU banks and the potential credit crunch and recession in some EU countries, revitalising SME loan securitisation is key to the solution. The ECB notably has called for the development of high quality plain vanilla products capable of being rated and priced in a simple way.

The fact of the matter is that securitization is lethargic in Europe. We should therefore take simple and rapid actions to revitalise it. I believe that three conditions are to be met in order to achieve this.

A first condition is rebuilding investors' confidence which means that the quality of underlying bank loans must be unquestionable. Using the criteria already defined by central banks for accepting SME loans as eligible collateral and the capabilities of some central banks in assessing the risks of such products would de facto contribute to the defining of high quality standards for the securitisation market. On this basis, the Eurosystem could foster the emergence in each country of the Eurozone of securitisation conduits which would purchase SME loans complying with these criteria and would therefore issue "prime" securities.

A second condition would be the provision of guarantees by European and national development banks for the securities issued by these conduits. Provided that the high quality of such securities is demonstrated and that public guarantees can be provided, numerous investors should be interested in investing as they seek investments correlated with the real economy. This should counterbalance a relative lack

of return of bank loans compared with usual financial assets.

Thirdly, the ECB in conjunction with National Central Banks should be ready to purchase temporarily if needed such ABS to help the launching of this securitization market. This should be possible given the high quality of the underlying credits concerned by this proposal. ■

Deleveraging together

Andris Vilks - Minister of Finance, **Latvia**

Recent financial, economic and banking crisis had rather diversified impact in different parts of the world, but unlike many other countries, Latvia is in rather good situation regarding it's debt burden of public authorities, enterprises and households. Traditionally Latvia had low central government debt level that jumped up to around 40% of GDP during the crisis, which is still very decent figure even compared to some of its European pairs. Less than 30% of Latvian households have credits and number of NPLs has reached single digit territory in last quarters of 2013; we are quite conservative as far as municipal debt is concerned as well; by Latvian legislation municipal debt should not be higher than 20% of the yearly budget of any given municipality.

Looking at figures, deleveraging is taking place in Latvia, however it is also partly due to the fact that banks are reluctant to lend pretexting it by lack of good projects and poor financial health of enterprises; crediting businesses and households shrunk by 4% last year.

As for enterprises one of major problems for Latvia, but also for Europe is financing mainly through debt finance; depreciation of collateral has put considerable pressure on the banks during the crisis, but strong requirements for collateral to potential borrowers is major factor that prevents businesses from borrowing from the banks, especially SMEs in the after-crisis period; at the same time capital markets, particularly in Eastern Europe are small and weak and could not be really considered as source of financing.

However, speaking of deleveraging in general, I believe that to be effective and successful there are several pre-conditions: clear exit strategy should be in place, deleveraging of households should be accompanied by very precisely targeted measures aiming the social dimension (e.g. first domicile program, re-training or life learning opportunities etc.), good communication program on the Government side needs to be in place to reach out to the target groups.

Structural reforms need to be put in place or pursued for those countries that started them in earlier years; education and life- long learning programs are particularly important to foster the FDI; insolvency legislation and effectiveness of the court system needs to be improved, especially as concerns the exit from business by companies and personal bankruptcy procedures by physical persons.

Taken from another perspective, deleveraged society could be considered as common public good, and from this standpoint I can tell that yes – Europe has to do more in helping deleveraging process in its member states by offering SMEs even more development loan programs aiming to increase their competitiveness; to activate the capital markets one of the first steps could be the gradual introduction of State Owned Enterprises (SOEs) on the local stock markets.

Finally, we should not forget that the latest Global Financial crisis was also known for large bail-outs of the commercial banks, often involving public funds, so there is moral dimension to that as well, namely, bail outs were performed using also tax payers' money, in Latvia Parex case with 1.4 bn Euro, equivalent to around 6.1% of GDP, bail-out is a good example of such an operation; so, to be fair,

now, when the tide has turned, wouldn't it be just fair that banks are getting more involved in deleveraging the economies? ■

Deleveraging – a way for sustainable growth

Rimantas Šadžius - Minister of Finance, **Republic of Lithuania**

The legacy of the crisis, financing needs in the public and private sectors, fragmentation of financial systems and credit markets, sectoral restructuring and high levels of unemployment continue to weigh on the growth. Beyond the banking sector, households and companies in many Member States remain over-indebted and still need to complete their financial deleveraging.

At macroeconomic level, deleveraging of the economy is often being linked with the fiscal tightening and austerity measures. On the other hand, there is no contradiction between fiscal discipline and growth stimulation. However, everything depends on where, when and how these two policies are combined.

"Creditless" recoveries are rather common after credit booms (as this was the case in the Baltic countries) and banking crises. The deleveraging at the recovery stage should be assessed with caution and reasons behind the lack of credit demand or supply need to be evaluated in detail. In most cases, a process of deleveraging is necessary to repair companies' and banks' balance sheets. The Commission stressed the need for new forms of financing to be promoted as alternatives to bank financing, such as options for venture capital, development of SME bonds and alternative stock markets in its Green Paper on the long-term financing of the European economy. Some recent changes in the EU regulation, such as revisions of the Public Procurement Directive, allowing more flexibility to use financial engineering instruments, also contribute to developing the alternative sources of financing.

In Lithuania, the credit flow analysis reveals that banks' loan portfolio is showing steady signs of recovery with interest rates remaining at historic lows. According to the bank lending survey and the survey of non-financial enterprises on business financing, in the last quarters credit standards eased slightly. However, risk aversion is still elevated and banks remain careful in making lending decisions. On the other hand, surveys reveal that the demand for credit remains weak as companies plan to finance only 13 per cent of their business development with borrowed funds, hence mostly relying on internal financial resources.

The non-financial corporations have changed their saving behaviour, as they were net borrowers before the crisis and became net lenders after 2009. Cautious investment decisions and conservative credit supply nexus is the main reason for tepid credit recovery despite robust economic growth. A change in national legislation, in accordance with Directive 2011/7/EU on combating late payment in commercial transactions, was also a trigger preventing the risk of late payments that create a great danger for the activity and competitiveness, especially for SMEs.

In addition, a number of available information suggests that external financing is one of the least important problems for the corporate sector (lack of demand, qualified work force, etc. are usually on the top of the list). Recently, the positive trend of increasing the share of new loans with the State support (especially for SMEs') and more favourable business environment (Lithuania was ranked the 17th in the World Banks' "Doing Business 2014 Report") has been noticeable.

As regards the leverage of the public sector, the general government debt was 39.5% of GDP in 2013 (one of the lowest in the EU), and it is projected to decline in the medium-term (while the planned budget deficit being further reduced due to ongoing fiscal consolidation). Pursuing such a policy mix, which supports the near-term growth anchored by the medium-term public debt sustainability, should pave the way towards the full EMU membership as of 2015 and underpin credible obligations in the future.

Macroprudential policy could also play an important role in reviving credit growth in the future. Assessment of the optimal credit level could be a valuable asset as a lack of financing for productive investments is unwelcome for any economy, and over indebtedness (notably for some of the euro area countries) is not acceptable either. The most important is to ease access to financing for SMEs, using also alternative sources to close the funding gap, which is vital for creating and developing new enterprises, maintaining the sustainable economic growth and enhancing competitiveness. ■

What are the necessary actions required to create a large and deep EU securitization market?

Michel Barnier- Member of the European Commission responsible for Internal Market and Services

In the current context of funding constraints in Europe, securitisation constitutes an important instrument bridging banks and capital markets. Stakeholders and public authorities have actively supported the need to foster the recovery of safe and sustainable securitisation markets in Europe. The Commission is following this development with interest, as indicated in its Green Paper on long-term financing, published in March 2013.

Some securitisation models were inadequately regulated in the past. The weaknesses of these models have been identified early on and addressed in the subsequent EU financial reform. For instance risk retention requirements ("skin-in-the-game") have been in place in the EU banking sector since 2011 and have been widened to all financial sectors.

Many concrete actions are being taken by the authorities to make securitisation transactions more standardised and transparent, thereby enhancing investors' confidence. In addition initiatives led by industry such as the implementation of labelling contribute also to these objectives. Despite these measures, no substantial recovery of this market has been observed so far.

Many stakeholders have called for a differentiation of securitisation products for prudential purposes in order to foster the development of sustainable securitisation markets. In response to a request from the Commission, an approach identifying "high quality" securitisations has been advocated in the insurance sector

by EIOPA in December 2013. A detailed list of criteria has been proposed related to i) structural features, ii) underlying assets and related collateral characteristics, iii) listing and transparency features and iv) underwriting processes.

This approach appears promising and the Commission will explore the possibility of incorporating such an approach in the calculation of insurers' capital requirements. The Commission will also reflect on whether a similar approach could be adopted for other financial sectors to ensure a consistent approach for securitisation products taking into account the specificities of each sector. ■

Reviving the economy: funding and liquidity on solid financial ground

Yannis Stournaras - Finance Minister of the Hellenic Republic & President of the **Economic and Financial Affairs Council (ECOFIN)**

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In recent years, the lack of liquidity –and the associated contraction of investment - has been instrumental for the unfolding of the crisis, an element that has been underestimated so far, especially in the distressed economies of the European periphery.

Yet, investments are fundamental for the return to growth. Therefore, we need to create a stable and investor-friendly environment and explore all possible ways to increase funding for the real economy.

Essential to the safeguarding of financial stability as well as the restoration of trust in the European economy is the implementation of the EU roadmap for financial sectors reform, primarily the completion of the Banking Union.

Furthermore, Member States individually should work on the improvement of their regulatory and institutional framework, in order to promote transparency and accountability, to ensure assets quality and stronger buffers in the banking system, and to guarantee a coherent framework of corporate governance and enhanced supervisory duties that meet the needs and challenges of the financial system.

Given the process of deleveraging that is currently taking place in the banking sector in several countries, it is vital to promote discussions on the financing of investment, particularly of the SMEs. This is comprised of long-term alternative sources of funding, as well as the design of new financing tools.

The Greek Presidency underlines the importance of the enhanced implementation of the Compact for Growth

and Jobs, as well as improved SME's access to finance and the recommendations of the High Level Expert Group for the financing of investment in infrastructure and SMEs.

At a national level, public authorities could take initiatives to facilitate financing for enterprises, should the latter face difficulties in raising the necessary capital, or they could collaborate with the private sector (public-private partnerships), especially in projects of a larger magnitude.

Finally we should not underestimate the importance of macroeconomic adjustment modalities: member-states with chronic current account deficits and those with chronic current account surpluses have both responsibility for securing a well-functioning financial system. ■

Expected evolution of the EU financial system following on-going reforms

Only a sound financial system can support growth

Andrea Enria - Chairperson, **European Banking Authority (EBA)**

It is often suggested that regulatory reforms are having an adverse impact on growth: banks are forced to scale down lending, the argument goes, while market based financing will take time to develop, thus leaving a gaping hole in the financing of the economy. I would like to challenge this argument.

The excessive increase in bank balance sheets in the run up to the crisis was not driven by an increase in traditional intermediation. The Liikanen report provided conclusive evidence that retail deposits and loans to corporates and households grew roughly in line with European GDP, while it was wholesale financing and trading assets (and in some countries commercial real estate lending) that led to bloated bank balance sheets. As it should now be clear, a good part of these activities were not supporting sustainable growth. Hence, a deleveraging process mainly focused on capital market activities and inflated real estate assets should not be seen as hampering growth, but as an opportunity to restore confidence. The EBA's work on recapitalization and transparency suggests this is the path being taken. Regulatory reforms are just driving a much needed rebalancing of banking intermediation.

The direction of travel has been right, but the speed too slow. It is the slow progress in repairing banks' balance sheets that may have impaired banks' ability to lend. The empirical evidence is clear: the banks that cleaned their balance sheets and achieved a stronger capital position also show a stronger lending growth. The adjustment has accelerated significantly in recent months, with banks overcoming their reluctance to recognize losses and raise fresh capital, in preparation for the asset quality review and stress test. This is a welcome development, which should restore banks' lending capacity.

The rather sluggish adjustment process in the banking sector has been accompanied by a new interest from institutional investors, especially asset managers, for bank assets and the provision of bank-like services. This is a positive development, as corporates and households could rely on alternative sources of finance in case of further shocks to banks' lending capacity. At the same time, we should be watchful of potential new sources of systemic risk outside the regulated banking sector. ■

Corporate credit: disintermediation has its limits

Alastair Wilson - European Chief Credit Officer, **Moody's Investors Service Limited**

Promoting the flow of credit to corporates is a key objective of EU policymakers. Bank assets have fallen by over 10% from their 2012 peak and will decline further as new regulations bite. Debt finance has taken up some of the slack, and some see developing US-style corporate debt and securitisation markets as a means of promoting long-run growth.

First, a few realities. European corporates are, and are likely to remain, predominantly bank-financed. While corporate debt issuance near-doubled in parts of the EU after 2007, it did so from a low base and even now represents only 4% of corporate liabilities in the eurozone vs 20% in the US. This is no 'periphery vs core' divide: increased issuance in France and Finland has been comparable to that in Spain and Italy, and the leading issuers of corporate debt are in France, Finland and Portugal; German companies remain nearly as heavily bank financed as pre-crisis. Important parts of the corporate sector missed out on the debt boom – the micro- and SME sectors for which today's debt markets are ill-suited.

US and UK experience suggests that, having seen a spike in corporate debt issuance, we will now see a gradual decline as banks reassert themselves. Even if pre-crisis years saw a secular rise in corporate debt issuance, it seems likely that the recent jump represents a transitory rebalancing of risk appetite between banks and 'real money' investors rather than a structural shift towards debt finance.

Does that matter? Access to diverse funding sources makes for nimble, resilient corporate sectors. There is evidence that debt finance costs are lower (though more volatile) than loan costs. Debt markets are less likely to sustain 'zombie' companies. But the long term health of the corporate sector will rest on bank lending. Banks provide more funding to corporates than bond markets, have longer time horizons which can promote shock absorption, and are better able to assess the risks of lending to small companies with limited track records.

So it is understandable that policy has two prongs. Measures to promote infrastructure finance and SME debt financing, and

to develop domestic securitisation markets into pan-EU markets, aim to enhance growth and resilience. But the key focus will remain on developing a banking sector which is not just resilient but dynamic. Those objectives are not always consistent and regulators walk a fine line between constraining banks in the interest of financial stability tomorrow, and freeing them to promote growth today. ■

Will the regulatory reform agenda build the financial system Europe needs?

Charles Haswell - Global Head, Financial Sector Policy, **HSBC Holdings plc**

How will the Post Monetary Era financial system be shaped? The European pre-crisis landscape included: a belief that inflation targeting as the benchmark for setting the risk-free price of money would deliver financial stability as well as price stability; an assumption that the risk-free rate was the most important component of the cost of borrowing; a trust that markets were rational and needed minimal policy intervention.

There were also significant shortcomings in capital and liquidity standards, in risk management, and in the behaviour of individuals. The crisis instigated reform on an unprecedented scale, in particular addressing the role of banks within the financial system. New capital and liquidity standards have made banks safer.

But as we shift from an era when Monetary Policy dominated, to an era when Financial Policy – the determinant of credit volumes – becomes equally important, to what extent have the shortcomings of the policy framework been addressed? Are central banks and macroprudential authorities ready for this new world?

For economies to expand, money must expand, and traditionally this has been the contribution of deposit takers, who in addition to mediating savings can lend money to fund specific economic activity, whether consumption or production, against a contract to repay. Unrestrained credit expansion lies at the heart of financial crises.

But are we creating constraints on credit expansion which will require the once-vilified "shadow" sector to become the principal source of finance to the real economy? What are the implications of this more US model of financing? Is China already grappling with the implications of this shift? The major corporates can tap the markets directly, but can we ensure access to finance for the SMEs, and for households at reasonable cost? And can we develop a new spectrum of finance, from patient capital for new businesses up to long term finance for infrastructure and low carbon technologies? ■

Both bank lending and market finance are needed to boost economic growth

Mark Garvin - Vice Chairman, Corporate & Investment Bank, **J.P. Morgan**

We are moving from economic crisis toward deeper recovery and stability in Europe. Financial markets have evolved markedly over the period since the crisis and will continue to do so over the coming years.

Through new rules and regulations, banks have become less risky and more resilient. But as banks deleverage and seek to hold more capital, lending will be constrained – which can create a funding shortfall in light of 80% of corporate funding coming from banks in Europe, compared to 20% in the US. EU policymakers recognize the need for well-functioning capital markets and the European Commission is working on initiatives to help long term growth, which we support.

A diverse financial system is a healthy and liquid financial system. We should therefore encourage market-based forms of intermediation, including better corporate bond, equity and securitization markets. We also need to support the asset management community and avoid applying disproportionate regulation to the buy-side.

Banks will still play a vital role in the post crisis world. Europe needs both bank lending and more developed capital markets to generate economic activity. We need regulation that does not unduly increase the cost of participating in capital markets, constraining clients' access to such financing.

European policymakers have agreed important bank capital rules, rules for trade execution and transparency and bank recovery and resolution rules which tackle the crucial issue of cross-border resolvability for banks and – according to Paul Tucker – 'break the back of the too-big-to-fail problem'.

As we move toward implementation of detailed rules, these should be fleshed out and applied in a consistent way globally. Duplicative, extraterritorial rules across the Atlantic have created a great deal of distrust and uncertainty over the past years – leaving room for improvement in cross-border negotiations. The Transatlantic Trade and Investment Partnership (TTIP) can help us here. Inclusion of financial services in the TTIP would enhance the way in which policy-makers and regulators ensure we have properly regulated markets that support the transatlantic economy.

We have come a long way since 2008. While we work toward a Europe that is less reliant on its banks, we cannot ignore the important role that banks play in facilitating market finance. Regulation needs to be consistent globally to allow banks and markets to work together toward a strong and stable economy. With projected growth figures where they are, we cannot afford not to do so. ■

Mixed versus bank-based financial systems

Mark Carey - Associate Director, Division of International Finance, **Federal Reserve Board**

European and United States financial systems are different. Both are served by bond markets, equity markets, and large and small banks, but important parts of credit in the United States are provided by so-called shadow banks. Some are banks by another name- credit unions and industrial loan companies are examples.

But some organize intermediation differently than banks, for example providing only credit (General Electric Capital Corporation), only liquidity services (money market mutual funds), or only doing a piece of a job. A large fraction of residential mortgages, for example, are still ultimately financed by securitizations with credit guarantees by Fannie Mae or Freddie Mac, even though the majority are originated by banks.

The variety of players makes interconnections more complex, so the system is more difficult to understand, but in many situations it also makes the system more resilient....if one part has trouble, other parts are available to do the work that is needed. However, if both parts of the system are in trouble, crisis management is more difficult.

A mixed financial system is more difficult to regulate, but an advantage is less governmental ability to control credit and liquidity services and less incentive to favor national-champion banks because they are less crucial to the system. Though some people might prefer more control, economic efficiency and growth might be better served in the long run. It is also more politically difficult to rescue banks because the nonbanks are rarely rescued, which in turn provides impetus toward strong solvency regulation.

We are stuck with our financial systems. It would be naïve to think that covered bond markets can be eliminated, for example, just as shadow banks cannot be eliminated. Thus, as we talk about international regulatory coordination, we should recognize that some differences in regulation are sensible, since regulation must fit the system. ■

Risks associated with banking over-regulation for the European economy

Philippe Bordenave - Chief Operating Officer, **BNP Paribas**

Basel 3 rules have doubled banks' capital ratios and increased liquidity reserves fivefold. These adjustments have been achieved both through capital increases and deleveraging. The latter has been increasingly weighing on loans outstanding since 2013. Economic theory on money (or bank lending) multiplier demonstrates that the full LCR enforcement will further decrease lending for a given level of central bank money. In the euro area, weak credit demand tends to mask the effect of regulation on lending supply but the latter will slow the recovery down. Regulators and legislators should be aware of this risk since new draft regulations are also threatening financing of GDP growth (revised NSFR definition, initial margins on OTC derivatives, further capital requirements for the banking book).

The EC proposal for regulating structural measures for EU credit institutions seems to endorse the principle according to which market activities should be separated from other activities. But euro area universal banks make extensive use of their market activities to grant loans to the economy, as reflected by their 118% average Loan-To-Deposit ratio.

Once separated from market activities, "pure" commercial banks, if obliged to lend only up to the tune of their deposits, would have to cut lending by 18%. By increasing the cost of market resources for "pure" investment banks on the other side, this reform could paradoxically result in simultaneous declines in bank lending and market financing.

After two recessions, in 2009 and 2012/2013, the euro area's immediate priority is to fuel recovery, including through reasonable private credit expansion.

This implies a pause, in the short term, in the regulatory piling up. Beyond that, the building of structural European securitization markets is necessary in order to partially replace the banks' now constrained activities. ■

Returning to growth, what role for financial markets in the EU and the US economy

Jennifer M. Taylor - Chief Operating Officer EMEA, **Bank of America Merrill Lynch**

As we commence 2014, year 6 post the financial crisis, we can observe a more and more divergent economic development in the European Union and the United States. Whereas the US seems to have returned on the growth path, the EU still seems to be struggling. As a major capital markets participant, we find that the US capital markets have played a strong role in the US economic recovery and the re-launch and growth in credit lending, without which any economic recovery would be tepid at best. Its much deeper capital markets populated by a wide range of players with different investment strategies and risk preferences are certainly underpinning the return of credit creation and related economic recovery.

As banks on both sides of the Atlantic are coping with the implementation of banking regulations such as Basel 3 and, in the case of Europe, are also still in the process of deleveraging, banks capabilities of lending to the wider economy has been reduced and is currently significantly curtailed. Hence, the role of capital markets in financing the economy has become even more important in this economic cycle than ever before.

Historically, the US economy has been much more reliant on capital market financing whereas in the EU banks were and continue to be the key players in financing the economy. This has eased the economic recovery in the US and is challenging the recovery in Europe. Additionally, the effects of the different national (regional) approaches to regulating and overseeing the functioning of the capital markets on both sides of the Atlantic should not be underestimated.

Among the aspects which define the US capital markets as more developed than those in Europe lie the high share of securitisation in funding real economy assets and the availability of a large number of investors with different and complementary investment risk appetite.

It is indisputable that the weight of capital markets will have to increase in the EU in order to provide the much needed financing to companies to create growth and jobs, and securitisation has a fair role to play in that process, if and when it is allowed to.

The matter at hand is how capital markets in Europe through securitisation can become more efficient and take a more active role in financing the overall economy. Several key steps have already been taken such as the adoption of MiFID/R and CRR with its retention rules.

That said the devil will be in the details as we move into the implementation phase, and open dialogue between the European Regulators and Industry will be key. We believe that any requirements of securitisation regulation should be based on a clear cost benefit analysis - the cost and administrative burden of this and other regulations should not stifle securitisation market recovery, especially when such requirements are not placed on other funding techniques, essentially similar to securitisation.

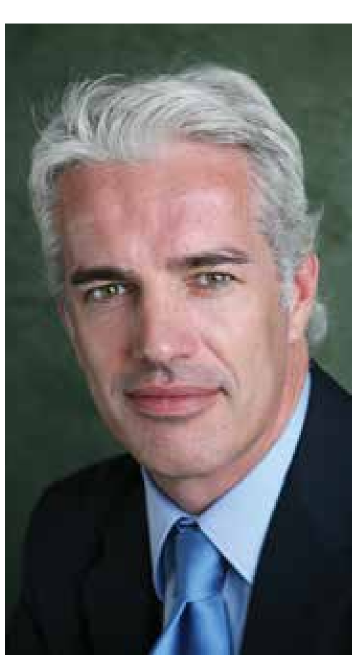
We believe that an objective and comprehensive assessment of the effects of financial services regulation on the wider industry would be useful to highlight any inconsistencies between different types of financial services regulation and jurisdictions. Any unintended consequences could be properly assessed and quickly addressed.

We understand that this might prove to be a very challenging undertaking, but we are convinced that such an assessment would permit policy makers to evaluate the current state of play of financial services regulation and allow them to take the necessary steps to ensure regulatory consistence across all products, sectors and jurisdictions. In doing so, regulatory arbitrage could be addressed and reduced, and a real level playing field could get closer within reach.

The above is as true for securitisation as for any other aspect of financial regulation. ■

European and US financial ecosystems – financial stability requires a more holistic approach

Garrett Curran - Chief Executive Officer for the UK & Ireland, **Credit Suisse Securities Limited**



Much time and effort has been invested in financial services reform. We have not spent sufficient time debating the design of the Financial Ecosystem as a whole, and how that system interacts with the economy it serves. A Financial Ecosystem is the structure via which savings are transported across an economy to fund the activity of households, corporates and the public sector. Financial Ecosystems, like the environment, require holistic solutions. We observe that some proposed solutions to environmental degradation may involve zero-sum exchanges, and can sometimes run the risk of negative sum outcomes. Throughout history, cultural, biological and societal evolution towards long-term wellbeing derived from positive sum solutions requiring cooperation and collaboration on a vast scale, as Robert Wright set out in his book "Nonzero". Financial stability is similarly dependent on joined-up thinking and cooperation on the design and regulation of our Financial Ecosystem(s) to ensure they interact with the real economy in a way that sustains growth and defends stability.

The Financial Ecosystems of Europe and the United States reflect the history of their respective economic, political and currency union development. Research affirms the conventional wisdom about the roughly 80-20 inverse relationship between bank lending vs capital markets intermediation in Europe vs the US. However, when we break down the actual flows for the Eurozone, the UK and the US, we see some interesting points. Financial wealth per capita is lower in Europe than in the US. This reflects three factors: lower levels of aggregated funded wealth per capita, a higher percentage of off balance sheet entitlements (pensions) not measured, and a higher percentage of household assets channelled offshore or outside the financial ecosystem. The composition and distribution of these financial assets is widely divergent. Eurozone savers channel a far higher percentage of their assets via banks, whose gross balance sheets are more than 3x GDP vs the 1x multiple we see in the US, and US pension funds materially higher at 1.2x GDP vs 0.2x in the Eurozone. A more stable Eurozone might not only involve smaller banks, but also include a more balanced funded vs unfunded pension model.

It is in the long-term interests of all that we broaden the debate to encompass the entirety of the system and search for positive sum outcomes, which depend upon increased levels of multidisciplinary collaboration and trust. This can only be achieved through holistic thinking and cooperation on a new scale. ■

The way out of the European corporate financing dilemma

Fabrizio Campelli - Head of Group Strategy (AfK), **Deutsche Bank**

EU economies are heavily reliant on bank balance sheets for financing: bank loans make up ~70% of corporate credit in the Eurozone vs. ~15% in the US. The key driver behind this structural difference is the abundance of SME in EU economies: they employ close to 90 million people vs. just above 30 million in the US.

Consequently, EU capital markets are less developed compared to the US: capital market depth in the Eurozone – defined as stock market capitalization and debt securities over GDP – of ~225% is almost 30% lower than in the US.

The ability and willingness of many EU banks to provide balance sheet capacity, however, is constrained by tougher regulatory requirements, need for deleveraging and concerns about macroeconomic developments. While the final element will hopefully be a transitory phenomenon, we are not expecting the uncontrolled levels of pre-crisis EU bank balance sheets growth to occur.

Therefore, EU leaders and policymakers should focus on building deeper, stronger capital markets and on identifying alternatives capable of supporting the funding needs of SMEs across the continent.

More than EUR 400 billion of net corporate bond issuances by Eurozone companies since the beginning of 2009 is a positive sign, but activity was primarily limited to large caps. Avenues to provide better access for SMEs could include standardized bond structures or sound pooling of loans / securitization solutions.

More generally, there is potential for developing a stronger commercial paper market for EU companies, or even for innovative solutions, such as crowd funding and peer-to-peer lending. Investor appetite for these ideas – in the search for yield in the low interest rate environment – could be strong.

One thing is for sure: ongoing financial reforms are making bank financing less available and more expensive. The EU will have to act in order not to lose its long-term competitiveness vis-a-vis the US and key Asian markets. ■

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Calibration of banking prudential requirements and expected impacts on lending

GR 2014 eu
Hellenic Presidency of the Council of the European Union

Challenges posed by the calibration of liquidity and leverage ratios

Nicolas Duhamel - Head of Public Affairs, **Groupe BPCE**

Beyond doubts, Basel III will heavily impact banks lending capacities and balance-sheets. CRD4-CRR increases by more than fourfold the level of minimum Common Equity Tier 1 capital requirements to be held by European banks by 2019, this without taking into account the systemic surcharge to be applied to SIFIs. Given market pressure, major banks already meet these capital requirements. Major banks will also be forced to anticipate and fully respect the application of liquidity and leverage ratios as early as 2015.

All of these new constraints directly impact European banks lending capacities. Outstanding loans to SMEs in Europe declined by 3% during 2013. Banks lending capacities must not be abruptly cut off. SMEs and micro enterprises are the most likely to be hurt during the coming months by any attempt to further restrict banking liquidity. It is therefore crucial to ensure that prudential ratios end up being pragmatically calibrated. We would therefore contend that:

- With respect to the Liquidity Coverage Ratio (LCR), it is paramount that the liquidity buffer accounts for Committed Liquidity Facilities contracted with Central Banks. It must be priced at the current Central Bank liquidity facility price level. This would facilitate the substitution of the ECB VLTRO with CLFs, effectively replacing cash contributions with a simple commitment. It would also lead to a possible monetisation of corporate credits by Central Banks. It would not seem unreasonable to expect Central Banks to grant collateralised liquidity commitments, in compliance with their role as lenders of last resort, the LCR itself representing a permanent severe liquidity stress.
- On the leverage ratio, netting of repos and of credit derivatives should be authorised in the calculation as it is currently the case under the CRR, including for cash and securities. A gross approach for repos would disproportionately increase the capital requirements for this activity. This would dislocate interbank funding markets and dramatically reduce the liquidity of bond markets and more specifically sovereigns. This would be in total paradox with the recognized necessity for financial markets to substitute banks in their corporate credit role. It would also hinder efficient diffusion of the monetary policy deployed by the ECB.
- On the Net Stable Funding Ratio, still in its inception, an early calibration in December 2009 would have required European banks to call on financial markets for around €1,300bn of additional resources with a maturity period over one year. The new calibration proposed by the Basel Committee in January 2014 has only but insufficiently softened this requirement. If the current proposal was to be maintained, it would imply additional financing requirements with maturities beyond one year, which the markets will simply not be able to absorb.

Alternative modes of finance will develop progressively. Let us not however loose sight that the European economy is currently ¾ financed through bank intermediation. Bank loans must be allowed to remain a key factor in financing the economy, where it comes to SMEs. ■

Two sides of the coin: internal models and leverage

José Manuel González Páramo - Member of the Board of Directors, Chief Officer, **Banco Bilbao Vizcaya Argentaria (BBVA)**

The leitmotiv of the financial regulation reform has been how to strengthen the financial sector resilience. Basel III is the guide to deal with the measurement of banks' capital requirements. Both internal models and the leverage ratio must play a significant role in defining capital requirements, and none of them can be used in isolation. We need to preserve the risk-sensitivity of capital while at the same time correcting unwarranted differences in risk weights with a well-designed and well-calibrated leverage ratio.

Internal models are the best suited instruments to value as precisely as possible the risk of each asset. The validation of the model by the competent authority should ensure that it is accurate. However, higher scrutiny of banks' balance sheets after the crisis has unveiled notable discrepancies in RWA density between jurisdictions and banks. To address those concerns, harmonization of supervisory practices has to be enhanced rather than imposing mandatory floors as internal models are very valuable management tools for global banks. Authorities are already rightly working on that issue. The ECB, as the single supervisor in the banking union, would prove instrumental in achieving the needed supervisory convergence.

The leverage ratio, which basically compares the high quality capital with the value of total assets, is the right complement. The leverage ratio lacks risk sensitivity but defines the total deterioration of assets that could be absorbed through capital. One of the lessons of this crisis is that this ratio cannot be forgotten. Bank's leverage sharply increased in the years previous to the crisis but, since little risk was perceived, RWA did not increase consequently and, therefore, little additional capital was required to match the increase in assets.

In sum, we need to ensure that financial entities hold enough capital, both in relation to the risk profile of its assets but also in absolute terms. ■

Global liquidity standards – the way ahead

Mario Nava - Director Financial institutions, DG Internal Market and Services, **European Commission**

Basel III introduces for the first time internationally harmonised global liquidity standards:

- Liquidity Coverage Ratio (LCR), to improve short-term resilience of the liquidity profile of financial institutions and
- Net Stable Funding Requirement (NSFR), to ensure that a bank has significant levels of funding to support its activities over the medium term. NSFR should help limit over-reliance on short-term wholesale funding associated with upswings in private liquidity, thus dampening liquidity cycles.

Because of concerns that too rapid implementation of the LCR would have had detrimental impact on the real economy, the Basel III text proposed an observation period and phasing-in of the LCR over maximum 5 years, rising progressively to reach 100% in 2019. The EU legislators considered it appropriate to have a faster implementation schedule than Basel. The CRDIV/CRR package, which transposes Basel III, therefore adopted progressive phasing in until 2018, i.e. one year earlier than Basel. An observation period is also applied before adoption of the NFSR into EU law. However, as the NSFR standard is due only in 2018 there is still a very considerable amount of development work to be carried out by the Basel Committee.

An impact assessment of European Banking Authority for liquidity coverage requirements showed that a specification of the general liquidity requirement is not likely to have generally a material detrimental impact on the economy and the stability of bank lending. The Commission is required by 30 June 2014 to adopt a delegated act specifying the general liquid coverage requirements. This will include the legal definition of liquid assets. When adopting that delegated act, the Commission shall take into account the reports submitted by EBA in December 2013, the Basel III rules as well as EU specificities. The Commission will carefully take these reports into account. Besides, since some issues are highly sensitive for most of the stakeholders, the Commission has engaged itself in a series of meetings with the Member States and the European Parliament but also with all stakeholders, bilaterally and during a public hearing, in order to understand deeply the concerns expressed widely. ■

Basel III's leverage ratio

William Coen - Deputy Secretary General, **Basel Committee on Banking Supervision (BCBS)**

Leverage is an inherent and essential part of modern banking systems. But there comes a point beyond which leverage becomes dangerous – something that was painfully obvious during the financial crisis. For this reason, sound prudential controls are needed to ensure that private incentives do not result in excessive leverage.

Basel III aims to ensure that the high leverage inherent in bank business models is carefully and prudently managed. It is at the core of the regulatory framework for internationally active banks and a minimum leverage ratio – that is, an absolute cap on bank leverage – is a key component of the Basel III package. Basel III's leverage ratio is a complement to – not a substitute for – the risk-based capital adequacy regime.

The leverage ratio should be a meaningful backstop: it will only influence bank behaviour if it will conceivably become binding in some circumstances. While the risk-based regime should ideally be the binding constraint on most banks most of the time, that means the leverage ratio will be binding on at least some banks some of the time, and maybe even some banks most of the time. A requirement that does not constrain anyone at any time is meaningless.

It is often asserted that the leverage ratio is inconsistent with the other components of Basel III. For example, whereas the Liquidity Coverage Ratio (LCR) encourages banks to hold a portfolio of highly liquid, lower-risk assets, a non-risk-based leverage ratio provides incentives to switch from lower-risk to higher-risk assets. This is said to be an example of regulatory inconsistency, but this view misses the point.

First, regulators are well aware of the adverse incentives that a leverage ratio – if used in isolation – can create. But that is why we do not use the leverage ratio in isolation. Basel III must be looked at as a package of constraints that mutually reinforce prudent behaviour. A leverage ratio provides an absolute cap on leverage but, by itself, may also create an incentive to take on high-risk assets. The LCR compensates for this by preventing banks from imprudently running down their liquidity. And, of course, the risk-based framework would quickly constrain any bank that materially increased its risk profile without additional capital to support it.

The leverage ratio, by placing an absolute cap on borrowings relative to a bank's capital, is an important component of the Basel III framework, and complements the risk-based capital adequacy regime. Neither of these parts of the framework stands alone and, together, they reinforce prudent behaviour. Even though the leverage ratio has been designed as a backstop, it must be a meaningful backstop if it is to serve its intended purpose. A careful review of the leverage ratio's calibration is next on the Basel Committee's agenda and getting this right is a critical part of the Committee's remaining work on the post-crisis reforms. ■

The first step is to realize where our strength comes from

Sylvie Goulard - MEP, Committee on Economic and Monetary Affairs, **European Parliament**

The biggest challenge for the EU is to act in accordance with its global position. To do so the EU needs to realize that its weight (and therefore strength) comes from the fact that it is a common area. The EU needs to speak with a single voice in the global regulatory fora. A scattered, rather than consistent and focused, approach is a waste of time, money and influence.

If a clear and single message is delivered then the chances that specificities relating to the needs to the EU are reflected appropriately are greatly increased. An EU which performs well and efficiently – which requires appropriate rules – is in the global interest. A weak EU does not serve the interest of any part of the world. Competition is of course welcome but competition does not mean erasing all competitors. Compatibility of the different sets of rules across the globe is key. To achieve it a clear, singular message from EU is a prerequisite. A single message – which allows certain national specificities to be taken into account when legitimate – is best achieved through a single representation.

Alas, this has not yet been achieved, because for some inside the EU they consider that keeping their own few (remaining) powers matters more important than increasing joint powers. When looking at it from a cross-sectorial perspective, the creation of truly Europeans actors (ESMA, EBA, EIOPA) or actors specific to the euro area (SSM, potentially SRM) is a step in the right direction, but the legislative process or their daily functioning show that there are still some reluctances to recognise that this is the best option for the EU as a whole. National competent authorities do still need to play a role, given their knowledge of the national markets, but they should be able to delegate the representation of the European interest completely to the appropriate level, in order to better influence the discussions in those global fora. One must not forget that the systems put in place do not replace national systems but build on their expertise to increase tenfold at the EU level and recognise that the relevant level for decision making in this sphere is the EU level. ■

Leverage ratio requirements should be differentiated

Bjorn Eric Naess - Group Executive Vice President and Chief Financial Officer, **DNB**

The Basel Committee has recently defined the denominator in the leverage ratio, and the numerator seems to be a question of choice between CET1 and T1 capital. The banks will start to report leverage ratios from 2015, and by 2018 the intention is that the leverage ratio will be a minimum requirement in line with capital adequacy rules. The committee has not yet decided on the calibration of the requirement, although the starting point is the current proposal of 3 per cent T1 capital.

The leverage ratio should be a backstop for leverage and a supplement to the risk-based capital adequacy regulations. Even though risk weighting is based on good judgment and long experience it might in some cases underestimate risk, hence the need for a safety net. To be meaningful the leverage ratio should be a binding constraint in some cases, but normally not. However, what is a prudent leverage will depend on the business model. The argument that our understanding of risk might be flawed should not be given too much weight, as this could result in too little importance being attached to the risk profiles of the institutions. Although the granular risk-weighting might be questioned, we do know that some businesses are more risky than others.

A mortgage company that has to comply with strict qualitative standards for its assets and is funded by covered bonds, should be allowed to have a higher leverage than an investment bank. The universal commercial bank might be placed between the two other business models. A "one size fits all" concept for the leverage ratio will mean that the leverage ratio will be a potential constraint for low-risk business and lending while the more risky business lines will be more or less unaffected by this measure.

A differentiated requirement by business model will allow us to establish, to the best of our knowledge, the same safety margin for all business lines. That should be a reasonable target to strive for. Otherwise, low-risk lending might end up outside the regulated banking systems. It is difficult to assess the long-term effect of this on the stability of the banking system and the overall financial system. ■

Post-crisis bank regulations, pro-cyclical and dangerous

Prof. Dr. Steve H. Hanke - Professor of Applied Economics, **The Johns Hopkins University**

The post-Northern Rock/Lehman crisis that we are still suffering from has drug on and been more menacing than it should have been – particularly in Europe and the U.S.. Global bank regulations, as well as local ones, have contributed massively to our economic problems. These regulations have been ill-conceived, procyclical, and fraught with danger. In consequence, bank regulations have pushed us down, not pulled us up. And they have made us less, not more, safe.

To understand this, we must revert back to John Maynard Keynes at his best. Specifically, we must look at his two-volume 1930 work, A Treatise on Money – a work that no less than Milton Friedman wrote about approvingly in 1997.

In particular, Keynes separates money into two classes: state money and bank money. State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in the Treatise dealing with bank money. This isn't surprising because, as Keynes makes clear, bank money was much larger than state money in 1930. Well, not much has changed since then. Today, bank money accounts for 91% of the total Eurozone money supply, measured by M3. In the U.S., bank money dominates, too, accounting for 80% of total M4.

So, bank money is the elephant in the room. Anything that affects bank money dominates the production of money, broadly measured. And changes in money and credit set the course for economic activity.

We have prepared the stage – now for the play. On August 9, 2007, the European money markets froze up after BNP Paribas announced that it was suspending withdrawals on two of its funds that were heavily invested in the U.S. subprime credit market. Northern Rock, a profitable and solvent bank, turned out to be the victim of a botched Bank of England lender of last resort operation.

Looking to save face in the aftermath of what turned out to be the Northern Rock scandal, Prime Minister Gordon Brown – along with fellow members of the political chattering classes in the U.K. – turned their crosshairs on banks, touting "recapitalization" as the only way to make banks "safer" and prevent future bailouts.

In the prologue to Brown's book, Beyond the Crash, he glorifies the moment when he underlined twice "Recapitalize NOW." Indeed, Mr. Brown writes, "I wrote it on a piece of paper, in the thick black felt-tip pens I've used since a childhood sporting accident affected my eyesight. I underlined it twice."

For politicians, as well as central bankers, the name of the game is to blame someone else for the world's economic and financial troubles. Their accusatory fingers have been pointed at bankers. The establishment asserts that banks are too risky and dangerous because they are "undercapitalized" and "underregulated". It is, therefore, not surprising that the Bank for International Settlements has issued new Basel III capital rules that will bump up banks' capital requirements. The BIS has also proposed higher leverage-based capital ratios and higher liquidity ratios for banks. And if that isn't bad enough, many new local regulations have been embraced, too. This has resulted in a damaging pro-cyclical policy stance in the middle of a slump – just what we don't need. Indeed, all this regulatory zeal has created a credit crunch.

The E.U. and U.S. monetary stances are not only wrongheaded but schizophrenic. When it comes to the big elephant in the room – bank money – they are very tight. But, when it comes to state money, they are loose. The end result in Europe has been expansionary state money, growing 35% since the crisis, and lackluster bank money growth of 3% since the crisis. In the U.S., state money has exploded by 299% since the crisis, while bank money has actually contracted by 14%. Since September 2008, total money supply has grown by only 5% in Europe (as measured by M3). In the same time span, total money supply has grown by a pitiful 3% in the U.S. (as measured by M4). ■

Differences of risk weighting among banks of the Eurozone

Danièle Nouy - Chair of the Supervisory Board, **European Central Bank (ECB)**

In describing the SSM approach to dealing with risk weighting one must differentiate between the periods before and after the operational start of the SSM in November 2014.

During the period until November 2014, the ECB together with the National Competent Authorities of the SSM Member States is carrying out a comprehensive assessment of credit institutions, comprising an asset quality review (AQR), and a stress test. Given the already enormous scope and tight time frame of this exercise it is not feasible to conduct a full assessment of internal models as part of the comprehensive assessment. However, specific findings of the exercise can lead to a bank being required to adjust its risk-weighted assets (RWAs). For instance, regulatory exposure classifications as provided in the CRR will be reviewed as part of the credit file review, which forms one component of the AQR. Should this reveal significant misclassification for a bank, then the latter will have to correct those, which may lead to a change in RWAs.

The SSM is keenly aware of the challenges which potential heterogeneities in banks' calculations of risk weights imply for banking regulation and supervision. Consequently, tackling those with a view to improving supervision and enhancing the level playing field across banks constitutes a priority among the SSM activities to be developed after November 2014. The Directorate General Micro Prudential Supervision IV, in charge of horizontal functions, will contain a dedicated unit specifically tasked to ensure consistency of supervisory approaches and uniform interpretation with regard to the internal models used by banks for the calculation of minimum capital requirements. This unit will also participate in further developing supervisory methodologies and standards regarding internal models. The SSM efforts in this context will build on the important work which has already been carried out by the Basel Committee on Banking Supervision within the framework of its Regulatory Consistency Assessment Programme. ■

Risk weighted assets: measuring loss potential

Ralf Leiber - Managing Director, Group Finance, Head of Group Capital Management, **Deutsche Bank AG**

The financial crisis has triggered a wide debate about risk weighted assets (RWA) and their use in bank capital ratios. In this discussion it is important to remember the primary purpose of RWA, namely to measure a bank's loss potential. Like a Yen and a Pound Sterling loan must be converted at different rates to make them comparable to a Euro loan, making the loss potential (risk) of a high yield and an investment grade loan comparable requires conversion at different rates, i.e. risk weights. Such risk weights are – unavoidably – derived from models and to support the primary purpose of RWA those must be risk sensitive and accurately differentiate between different risk profiles, across banks and over time. Here, the BCBS (like others) has identified weaknesses in the current internal model based approaches and it is for the industry and regulators to address them.

As a key step, unnecessary modelling choices provided by regulation (e.g. length and weighting of historical market data for VaR and conversion of 1-day to 10-day VaR) should be eliminated. Also, where the use of internal model parameters does not provide demonstrable benefits in risk measurement over global parameters (e.g. sovereign LGDs) the introduction of standard parameters may be justified. However, simplifications (e.g. a move towards standardized approach parameters and measures) should only be made where the reliability of the risk measure is not compromised.

In this context the BCBS should consider conducting a study of standardized approach RWA and how these might lead to "same risk – different RWA" and "different risk – same RWA" outcomes so that the alternative to internal models is fully understood. RWA are a key constraint for bank activity and hence their measurement drives relative benefits of conducting one business vs. another. Predominance of a non-risk based measure or an overly simplified risk measure would risk misallocations – this must be avoided. ■

Shadow banking unlikely to fill the credit gap in the near term

Craig Parmelee - Managing Director, EMEA Financial Services Ratings, **Standard & Poor's**

Banks play a pivotal role in financial intermediation across Europe. Their constrained lending capacity and ability to finance the real economy is one reason for the relatively slow economic recovery in the region. Although Western European banks have made substantial progress in deleveraging their balance sheets in the past few years, they still have some way to go to comply with regulatory and investor demands.

In the Eurozone, the cumulative shrinkage in bank balance sheets between the peak and October 2013 stands at €3.5 trillion, or 10% of the aggregated balance sheet of eurozone banks. In the U.K., the adjustment has been sharper: the decrease has reached nearly 20% or €2.1 trillion.

Against this backdrop, alternative financing, also known as shadow banking, continues to grow. In addition, high-yield issuance by European nonfinancial corporates has increased steadily since the financial crisis, although access to capital market debt funding has so far largely been limited to larger nonfinancial corporates. While we believe that shadow banking will continue to grow as a financing source in Western Europe, there are a number of factors that are likely to constrain its growth. These include sluggish demand for credit and evolving regulation.

The good news is that not all of the lost lending capacity will need to be replaced straight away as businesses and households continue to repair their finances. Central bank surveys appear to confirm this view.

From a regulatory perspective, there are many initiatives targeting systemic risk and threats to financial stability from the loose amalgamation of activities in the shadow banking space. We recognize the rationale and the need for better regulation of the shadow banking sector. However, in our view, the significant role of shadow banking in financing the real economy, especially in the context of continued banking sector deleveraging, must not be overlooked. Otherwise there is a risk that evolving regulation could hamper the sector's future growth. ■

Implementing the Banking Union, the SRM and the BRRD

Bank resolution: nearer to fruition

Alain Laurin - Associate Managing Director, **Moody's Investors Service Limited**

While governments have extended financial support to many distressed banks during the crisis, not all banks' creditors have been protected. Junior creditors have often incurred losses and voices in the official sector increasingly assert that senior creditors should no longer be immune. This step has not yet been taken in the absence of enabling legislation in many countries and for fear of financial contagion. But new rules on bank resolution are close to completion, which aim to address the limitations in legal frameworks exposed by the crisis and limit the risk of contagion.

The Bank Recovery & Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) are at the heart of a resolution framework which is intended to (i) provide uniform legislation to support orderly resolution and bail in, (ii) limit the use of public funds for support, and (iii) minimise contagion by conditioning investor expectations. Centralisation of decisions to be taken by an EU Resolution Board will also be an important determinant of the credibility of bail-in. The more centralised, the less national discretion, the likelier bail-in becomes.

The outcome is intended to be negative for senior creditors. It will only be possible for governments to bail out banks where truly exceptional circumstances justify public support, and even then there are intended to be strict limitations.

That matters for Moody's unsecured and deposit ratings. The presumption of systemic support translates into rating uplift for standalone assessments. For example, the largest banks in EU core countries and other banks in periphery countries may currently receive three notches of uplift to reflect the likelihood of support: they represent 20% of Moody's rated banks, but over 50% of assets.

We have not yet taken rating actions to reflect the new Directive. We need to see both it and the Single Resolution Mechanism in something close to their final forms. We need to see how much comfort policy-makers take that they have achieved their core aim of managing contagion and are willing to tie their own (future) hands in the process. But as their plans come to fruition and intentions translate into concrete action, risks to senior bank creditors will increase and the pressure on ratings will be downwards. ■

How to address the capital shortfalls in the asset quality review and in the stress tests?

Danièle Nouy - Chair of the Supervisory Board, **European Central Bank (ECB)**

The ECB will deliver the final result including banks failing the AQR and those failing the stress test in October 2014. In the event that a severe weakness arises before October 2014, then corrective measures will need to be imposed by the national supervisors, liaising with the ECB, as they are still the competent authority during this period.

Concerning the tools to face up potential needs for capital arising from the asset quality review or the stress tests, the first and best way for a bank to fulfil its recapitalisation needs is a private recapitalisation. Banks that cannot satisfy their capital needs because they do not have a viable business model should exit the market, via an orderly resolution procedure.

However, there may be cases of viable banks which nevertheless cannot attract sufficient private capital, for example due to some 'crowding out' in the wake of the system-wide balance sheet assessment. For those banks, in these special circumstances, we need credible public backstops.

Concerning public backstops, on 15 November 2013, the ECOFIN Council confirmed the commitment by the June 2013 European Council that "all Member States participating in the SSM implement appropriate arrangements, including the establishment of national backstops ahead of the completion of this exercise".

Moreover, the ECOFIN Council statement of 15 November 2013 provides that if national backstops are not sufficient, instruments at the euro area/EU level will be available as appropriate.

First, the ESM can provide through its normal procedures financial assistance for the recapitalisation of financial institutions in the form of a loan to a Member State, after appropriate bail-in, in full respect of EU State Aid rules.

Second, the direct recapitalisation instrument with its €60 billion ESM exposure limit could also be used when adopted according to euro area and national procedures, in line with the June 2013 Eurogroup agreement, following the establishment of the SSM. ■

Financial integration and the Banking Union

Roberto Nicastro - General Manager, **UniCredit**

A key objective of the European Council's decision of last summer to press towards a Banking Union was to break the link between the sovereign and the banks. However such a link is not yet fully broken. The ECB liquidity provision increasingly directed towards banks located in crisis countries, could not stop rates from diverging; sovereign bond yields have come down, but that is due to the existence of the Outright Monetary Transactions program of sovereign bond purchases rather than to the banking union progress.

Overall, the fragmentation of lending conditions is a significant disadvantage for companies (especially small ones) in a few countries, affects the level playing field and is ultimately not sustainable in a common market.

It is a key priority to complete all the remaining pillars of the banking union, and solve the outstanding open issues for the establishment of the SRM especially by setting a fiscal backstop at the EU level. Without such a fiscal backstop banks would, in the event that bail-in and the resolution fund are insufficient, continue to depend on the strength of their respective sovereign. In order for such a backstop to be credible, decisions about its use should be taken by at the European level, the conditions for its use should not be too restrictive and it should be available as early as the SRM becomes operational. Furthermore, financial assistance should be recouped from the financial sector in an adequately long time horizon in order to avoid procyclical effects.

As for the bail-in, it is still unclear if and to what extent the market has already priced it; an earlier entry into force instead of providing for more legal certainty in fact could lead to the opposite; as bail in would apply also to outstanding unsecured debt, its disruptive effect would especially be felt by retail bond holders while a later adoption would have allowed banks to substitute bonds with other non bailinable financial products. In this respect, we are confident

the Board of the to be established SRM will make the right decision by evaluating whether bailing in retail bonds will in fact have disruptive effects on the financial system. ■

The price of bail-in

Jordi Gual - Chief Economist, **Group "la Caixa"**

Bail-in rules essentially state that, before any public capital is injected in a troubled bank, shareholders and debtholders must contribute to the absorption of losses. In particular, full contribution will be required for the most junior instruments up to an equivalent of 8% of assets. Governments may then inject the equivalent of 5% of assets before proceeding with the write-off of other unsecured claims. This represents a commitment not to bail-out banks and, to the extent that this is perceived as credible, the elimination of implicit guarantees for bank debt. Bail-in rules will most likely raise the average cost of funding, although the extent of the increase will depend on the specificities of each institution and on improvements in supervision.

Consider the cost of debt. Insofar as the loss of the implicit guarantee effectively increases the probability of losses for debtholders, unsecured debt will become more expensive. Highly leveraged institutions will be particularly affected, since they will have to issue additional equity or hybrid debt. Conversely, the cost increase may not be material for banks whose own funds are above that threshold and are deemed sufficient to cover unexpected losses. In any case, the cost of debt will now include an implicit judgement about the capital adequacy of the institution and, in particular, about the ability of supervisors to counteract any possible incentive that managers may now have to increase "non verifiable" risk.

Indeed, the ultimate effects on the average cost of funding largely depend on the managers' response to bail-in rules. In this scenario, managers may have incentives to take on more "non verifiable" risk at least for two reasons. First, a cheap way to reach the 8% balance sheet threshold is through internal capital generation, exploiting any opportunity to invest in risky assets without raising RWAs. Second, managers may perceive that their performance is measured through the institutions' return on equity and feel pressured to boost it. If investors, aware of these incentives, believe that supervisors are ill-equipped to constrain managers' behaviour, they will certainly increase the risk premium demanded.

Since a higher cost of funding is likely to be passed through the price of credit, regulators and supervisors should make sure that the scope to take "non verifiable" risk is minimized. Better regulation and supervision can contribute to that goal but we should be aware that this sort of information asymmetries are hard to tackle. ■

Credibility and crisis stress testing

Ceyla Pazarbasioglu - Deputy Director, Monetary and Capital Markets Department, **International Monetary Fund (IMF)**

Stress tests have become the "new normal" in financial crisis management. A "crisis stress test" is essentially a supervisory exercise accompanied by detailed public disclosure to remove widespread uncertainty about banks' balance sheets and the authorities' plans for those banks. Thus, transparency, and hence the quality of disclosure, is critical (see "Credibility and Crisis Stress Testing" by Ong and Pazarbasioglu, 2013).

The first country to use this tool was the U.S. in early-2009, in the form of the Supervisory Capital Assessment Program (SCAP). The findings revealed that the capital needs of the largest U.S. banks at the time would be manageable. Investor sentiment rebounded and the assessed banks were able to add more than $200 billion in common equity in the following 12 months.

To be credible, crisis stress tests should be designed with the following features:

- The governance of the tests must be perceived to be independent, with the requisite technical expertise.
- The scope, coverage, scenario design and methodology need to be sufficiently comprehensive and robust to capture key risks to the institutions and system.
- The stress tests should be simultaneous, consistent and comparable cross-firm assessments to enable a broader analysis of risks and an evaluation of estimates for individual institutions.
- The stress tests should usefully inform markets about the risks associated with the banks, and the results must be sufficiently granular such that there is clear differentiation among institutions to guide subsequent actions.
- Most importantly, the manner in which the stress test results will be backstopped must be clarified early on to guide depositors and investors.

Crisis stress tests should be seen as one element of an overall strategy to rebuild public confidence in a banking system. Ideally, such a strategy should include (i) diagnostics (asset quality review, data integrity and verification, and stress test); (ii) recapitalization of viable but undercapitalized banks; and, (iii) restructuring or exit of nonviable banks. ■

ESM as a backstop to the ECB's balance sheet assessment

Rolf Strauch - Member of the Management Board, Director of Economics and Policy Strategy, **European Stability Mechanism (ESM)**

The ESM and its predecessor the EFSF were created as European crisis resolution mechanisms. Their creation filled a gap in the institutional architecture of the euro area. By providing financial assistance to euro area countries, they have materially helped to overcome the European financial and sovereign debt crisis and prevented a break-up of the euro area. The ESM has a series of instruments to create an efficient backstop for euro area countries in financial difficulties. This also applies to any financing needs that may emerge in the context of the balance sheet assessment (BSA) by the ECB.

The banking union project, launched by the European heads of state or government, has three major complementary components to overcome the remaining fragmentation of the banking sector: a single supervisory mechanism, a credible resolution regime, and direct bank recapitalisation via the ESM. All projects are very advanced and are either adopted, or, in the process of finalisation. Direct bank recapitalisation, when adopted, could therefore serve as a measure of "last resort" to cover capital needs when other means have been exhausted.

A thorough BSA is a cornerstone for the credibility of the ECB as the newly created single supervisory mechanism (SSM). Any capital shortfall identified by the supervisor would be covered by various sources: In the first place, financial institutions should aim to raise capital on the markets. National governments could step in if this were not possible. The ESM can support governments in need based on the existing instrument of indirect bank recapitalisation, already implemented for Spain. State support under the new state aid rule implies the bailing-in of equity and junior debt. After further bailing-in according to the Bank Recovery and Resolution Directive (BRRD) principles, the ESM direct bank recapitalisation instrument could eventually be applied, if this is indispensable to safeguard the financial stability of the euro area or the Member State concerned. The support is linked to policy conditionality for the requesting country as for all ESM instruments, which should allow the beneficiary to overcome structural weaknesses in the financial sector and support the success of the operation. ■

Access to central bank liquidity: rules for the SRF and bailed-in banks post resolution

Eleni Dendrinou-Louri - Deputy Governor, **Bank of Greece**

There may be situations where the Single Resolution Fund (SRF) established under the SRM regulation may need additional funds. The SRF cannot access central bank liquidity facilities due to the prohibition of monetary financing according to Article 123 of the Treaty on the Functioning of the EU. However, the regulation allows the SRF to borrow from financial institutions or other third parties. Furthermore, in their statement of 18.12.2013, both the Eurogroup and ECOFIN, recognizing the need for a backstop facility for the SRF especially in the initial period, provided that "In the transition period, bridge financing will be available to the SRF either from national sources, backed by bank levies, or from the ESM in line with agreed procedures."

According to the SRM regulation, the bail-in tool will be applied by the Single Resolution Board to the extent necessary to restore the financial soundness of the bank under resolution and ensure its long term viability. To this end, the failing bank, after the application of the bail-in tool, should be considered solvent. Ideally this bank could access liquidity from the private sector, but history has shown that in the early days after resolution it may face widespread mistrust. In this case, bailed-in, solvent banks would be eligible to access eurosystem refinancing operations and/or receive Emergency Liquidity Assistance from national central banks (subject to ECB approval). In both cases liquidity will be provided against adequate collateral under the same conditions that apply to all other solvent banks. Additionally, it should be noted that the SRM regulation provides for the ability of the SRF to make loans to a bank under resolution, thus allowing it to address an urgent liquidity problem without requesting access to central bank funding (e.g. when there is no eligible collateral). ■

SSM – Uncertainty all round

Giles Williams - Partner, Financial Services, KPMG's Regulatory Center of Excellence, EMA region, **KPMG**

Nearly seven years after the beginning of the financial crisis we continue to live in a world of great uncertainty. Banks are uncertain about the results of the Comprehensive Assessment, the transition to European Central Bank (ECB) supervision – since it would be reasonable to expect the ECB to adopt a generally tough and intensive supervisory approach – and the ECB's message that they should already be taking precautionary measures to boost their capital ratios ahead of the Comprehensive Assessment. Coming on top of adjustment to Basel 3 capital and liquidity requirements, and the weakness of the European economy, this has reinforced deleveraging by banks. Meanwhile, KPMG in the UK analysis has shown that 82 percent of Europe's largest 75 banks' return on equity was below their costs of equity in 2012. And of the €1 trillion drawn down under the ECB's long term refinancing operation approximately €600 billion has yet to be repaid. The impact on the rest of the economy is clear. Banks' customers face continuing pressures on the price and availability of products and services provided by their banks.

The ECB is uncertain about what the Comprehensive Assessment may uncover; how any severe shortfalls will be met; and whether and when the Single Resolution Mechanism will apply across the banking union. Despite progress on the Bank Recovery and Resolution Directive it remains unclear what powers and appetite there will be later this year to recapitalise banks through the bailing-in of creditors, while the appetite of private sector investors to pour fresh capital into banks is very limited. The revised state aid rules, with a clear message on replacing management in a refinancing will also drive risk aversion when banks should be funding growth. The prospect of further state support for banks therefore looms large, despite all the efforts to avoid this, and therefore a deepening of the "doom loop" between banks and sovereign states. ■

Getting capital raising right

Gert Jan Koopman - Deputy Director General for State Aids, Directorate General for Competition, **European Commission**

Dwight D. Eisenhower used to say that "in preparing for battles plans are worthless, but planning is everything". Planning is certainly necessary to address the follow up of the comprehensive assessment of 130 credit institutions due out in November. It is also needed to prepare for operating in a regulatory environment where conditions for public recapitalizations of banks are set both by State aid rules and the BRRD.

First, planning of tapping different sources when faced with a capital shortfall. Here, the sequencing is crucial. Capital raising measures typically include rights issues, sales of assets, deleveraging or liability management exercises. If still needed, public support will only be possible at the last stage, after a full burden-sharing of the junior creditors of the bank, as required by the State aid rules. If needed, such burden sharing has to take place through mandatory means.

Secondly, planning of the revisions of legislative frameworks is indispensable. Conversion or write-down of junior debt instruments must be 100% capital generating under State Aid rules. National legislation allowing for mandatory burden sharing of shareholders and junior creditors has already been introduced and applied in a number of Member States. Where this is still missing, updating of the relevant arrangements to enable public support to credit institutions in full compliance with the State Aid rules should therefore be a priority.

Third, planning of the liability structure of the banks. Burden sharing measures applied to junior creditors over the past years have generated significant capital buffers and savings to the public purse, without producing adverse effects on the funding markets. Analysis of a relevant sample of European credit institutions seems to indicate that many banks are well equipped to cope with capital shortages given the proportion of instruments eligible for burden sharing on their balance sheets. Others might want to follow this example. ■

Bail-in – One size does not fit all

Jesper Berg - Senior Vice President, **Nykredit**

The proposed legislation on bail-in is a leap relative to past EU policy. Only Denmark and Cyprus have seriously applied bail-in of senior creditors, and Denmark quickly retreated. Even in case of tier 2 capital, most countries have not imposed losses on creditors.

There are two objectives. First, to avoid that tax payers are left to foot the bill for distressed banks yet again and that the banks ultimately create fiscal problems. Second, to get creditors to put more timely pressure on bank management to adjust their business model and avoid failure. This is similar to how the no bail-out clause in the EMU text should induce markets to put pressure on irresponsible governments.

The problem in both instances is time inconsistency. There is a risk that, when it comes down to the wire, authorities will bail out be it banks or governments. In the end, the best policy is probably the classic policy of constructive ambiguity backed by a somewhat firmer legislative spine.

We have been successful if prices on bank debt reflect the risk of the institution and the fear of bail-in does not cause contagion if a systemic crisis were to set in again. There should be bail-in for banks that have pursued unsustainable business models, but caution should be applied in a systemic crisis. The US suspended its legislation imposing losses on bank creditors because Ben Bernanke knew from his studies of the Great Depression that you should not let a banking system fail.

There are also business models that by design already have recovery and resolution procedures built in, and where bail-in is not needed. Danish mortgage banks are not deposit takers but instead funded by the issuance of bonds, the payments on which match the cash flows from the mortgages. These already have well established procedures for recovery and resolution.

The bail-in instrument is a welcome addition, but should be applied in respect of the situation and the institution. ■

The new regime for resolution and the Single Market

Stefano Cappiello - Head of Unit Registration, Recovery and Resolution, Regulation Department, **European Banking Authority (EBA)**

The crisis has prompted a world-wide retreat of cross-border banking, including within the European single market. One of the main goals of the new regulatory and supervisory regime is to recover the benefits for competition, efficiency and risk-management that integration of banking markets can bring, when supported by adequate legal and institutional underpinnings. The crisis clearly showed that credible arrangements for cross-border resolution are fundamental to repair the current fragmentation of banking market. The SRM will cater for this within the SSM area, but will not suffice for the whole Single Market–very few of the major European cross-border banking groups have business exclusively within the Euro area. The BRRD offers the opportunity to achieve stronger cross-border crisis management across the whole Single Market, but in order to get to this result we need to intensify our efforts towards the cooperative approach.

Three things in particular are needed if we are not to miss this opportunity. First, to promote trust, common understanding, and rapid action in a crisis, authorities must front load their discussions of what they would do in the event of a bank resolution, through resolution colleges and the resolution planning process, and then act in advance to remove obstacles. Second, Member State authorities must use the opportunity that the BRRD offers to adopt firm commitments to each other through joint decisions on recovery and resolution plans, to minimise the pressure for ring-fencing of capital and liquidity within the single market. The EBA as mediator stands ready to assist with this: the lack of joint decisions would mean the failure of the spirit of the directive. Third, we must establish a legal framework of constrained discretion for resolution authorities, to create the common baseline on which those commitments can be built. The EBA has already begun to act on its mandate to foster recovery and resolution planning, and is now working to develop guidelines and technical standards, mostly to be consulted on in the second half of the year, to finalise the set-up of this new European framework for crisis management. ■

Providing appropriate financing tools for EU SMEs and midcaps

Can we fuel our SMEs with market based funding?

John Moran - Secretary General, **Department of Finance, Ireland**

The engines of growth and employment in our economy are SMEs. They need care now.

Why? The simple answer, jobs.

Inefficiencies in funding enterprises means millions of Europeans no longer have the basic right to have a normal full-time job. This is detrimental to society, our economy and our people, especially young people. It needs to be reversed!

Failure to seek alternative sources of funding will curb our return to growth. The banking crisis and the regulatory reactions have fragmented bank funding. It is now expensive or threatens to dry up completely. When you're experiencing a shortage of fuel you can reduce activity and consume less or you can adapt.

Switching SMEs to market based funding and away from bank funding is akin to switching our vehicles to diesel from petrol. Yes, you may need to change behaviour or require some investment but overall you'll ensure a more efficient and less singularly dependent operation especially as the "petrol" of bank finance has become more costly and scarcer.

Market based finance like diesel was only suitable before for larger engines. New practices allow smaller enterprises to operate with market finance be that in the form of retail bonds, SME markets of securities exchanges or through the use of private placement. Peer to peer and crowd funding will help those at the even lower end of the size spectrum.

The freedom provided by the market based funding means there's more to this new fuel than a simple like-for-like switch. Some Italian companies who listed on the SME equity market are actively courted with offers of funding rather than having to chase their bank in vain.

Changing the rules of the road makes things operate even better. Improving bankruptcy rules, reducing information asymmetries and reducing the costs of doing business across the EU can maximise the distance we travel on this fuel.

Our chosen path should lead us to a Europe with an environment conducive to growth and enterprise financing, with a Banking Union providing fairly priced bank funding across a single EU market, and with savers and investors having direct links to provide alternative funding for SMEs. ■

Supporting SMEs is crucial for sustainable growth and employment

Wolf Klinz - MEP, Committee on Economic and Monetary Affairs, **European Parliament**

SMEs and midcaps are key contributors to sustainable growth and employment. They are often characterised as the backbone of the European economy, which is reflected in the fact that they represent around two thirds of employment and nearly 60% of value added in the EU. Besides their contribution to GDP growth through their overall importance for the European economy, they are also a crucial factor for innovation. However, SMEs and midcaps in many Member States are having great difficulties with accessing capital. Often, they largely rely on bank financing, which made them more vulnerable to the financial crisis. Yet a transition from one source of financing to a mix of financing sources can be very challenging.

Nevertheless, we need alternatives to close the funding gap and to complement the traditional intermediation process by banks, as the lack of alternative equity and debt financing instruments hinders SMEs and midcaps to tap their full potential and play their vital part in creating jobs and driving economic growth.

Both venture capital and private equity can serve as an alternative source of finance, in particular vis-à-vis companies in the start-up and growth phases, as they can provide valuable non-financial support, including consultancy services as well as advice on financial and marketing strategy. Further, there is a strong need to improve access to capital markets through new sources of funding such as initial public offerings, crowd funding, peer-to-peer lending and (covered) bonds or through new market segments.

Policy-makers need to undertake efforts to reduce unnecessary administrative and regulatory burden. Greater attention also has to be paid to the specificities of SMEs and entrepreneurs. The adoption of the Small Business Act for Europe and of the Competitiveness of Enterprises and SMEs (COSME) are steps into the right direction. Moreover, the credit enhancement operations of the European Investment Fund (EIF) and the Competitiveness and Innovation Framework Programme (CIP) are intended to generate additional financing for SMEs. ■

The role of public banks in the financing of SMEs: the challenge ahead

Guido Bichisao - Director Institutional Strategy Department, **European Investment Bank (EIB)**

Public banks have traditionally supported financing to SMEs (including mid-Caps) in recognition of their importance to foster growth and employment in particular in Europe by means of the activity of IFIs or NPBs.

Following the economic crisis and the rapidly rising of default rates on corporate and even more on SMEs together with the tighter capital requirements, commercial banks have reduced their credit appetite and, accordingly, their lending to SMEs.

The action of IFIs and NPBs is therefore facing the challenge of a rising need to share the higher credit risk on SMEs whereas ensuring sound credit risk management to maintain the highest credit standing. A new business model is therefore needed reinforcing the use of four instruments:

- Structural funds: the joint proposal of the SME Initiative by the European Commission with EIB represents an important example of how the use of structural funds could be optimised. With the new MFF and the past experience of a sub-optimal allocation of structural funds, risk sharing instruments using the capabilities of the EIB Group operating in close cooperation with NPBs represents a promising venue to leverage public resources to absorb excess risk and mobilise private capital.
- Securitisation: a loan portfolio risk is tranched so as to allow the allocation of risks with different investor categories reducing concentration and increasing the resilience of the system. Notwithstanding its past misuse, in particular in US, the lesson learned during the crisis could reinforce its management by means of more transparency and standardisation as the example of the PCS labelling demonstrates. The expected reinforcement of the EIF capital acknowledges the importance of the activity of the Fund to guarantee mezzanine tranches of securitisation transactions facilitating the revitalisation of the securitisation market.
- Private equity: equity remains too scarce in Europe considering the undercapitalisation of most SMEs. The development of the private equity market is key to accompany the growth of SMEs. Whereas EIF remains a steady investor in this sector more participants are needed. The Commission proposal for the creation of an ELTIF instrument if limited to equity and quasi-equity investments on SMEs could fill this market gap.

- Regulation for growth: if a reinforced regulation remains essential to ensure an enhanced resilience of the system, thoughts are needed to consider preferential regulatory treatment of instruments involving public money and fostering growth and employment. Public banks are directly or indirectly subject to regulation and their action and related economic impact shall not be impaired by the unwanted consequences of a too strict regulatory framework. ■

Ensuring reasonable regulation of SME / midcap financial instruments

Dr. Elke König - President, **Federal Financial Supervisory Authority (BaFin), Germany**

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Credit photo : Schafgans DGPh BaFin

A balanced SME financing in Europe

Jean Naslin - Head of European and International Public Affairs, **Groupe BPCE**

Europe appears to have emerged from monetary turbulences. Return to sufficient economic growth to relaunch our economies remains a challenge which largely depends on SMEs ability to access finance. Whilst in Europe bank lending remains, and is expected, to remain the primary source of finance, resort to financial markets and to a certain degree of disintermediation will be required if we want to achieve a sustainable return to growth. The question remains on where to strike the right balance.

The ability for banks to continue to serve the economy and respond to their customer expectations hinges predominantly on the optimal calibration of the LCR, NSFR and leverage ratios still under discussion at the BCBS and in Europe with two delegated acts to come, as well as the full implementation of the new supervision and resolution framework with very high expectations from the markets.

Despite that access to liquidity in Europe has significantly reduced, French banks persistently strive to maintain and increase their lending capacities. This should be allowed to continue.

Short of resort to financial markets this would prove impossible and inevitably impact on the cost of lending. Resort to liquidity outside the Eurozone is now a given factor. Some banks are so constrained by the implementation of the LCR that central bank liquidity (ECB's LTRO) is simply not used to finance the economy which is somewhat of a paradox.

Deleveraging and reduced risk appetite calls for targeted alternative solutions and a fresh look at the dueability of new forms of access to finance. Well-structured credit guarantee schemes free up capital and enhance banks total lending capacity. It spreads some of the risk and extends loans to firms that would otherwise find it difficult to access credit. Credit insurance should also be considered as well as promissing development in crowd funding.

A mix of alternative longer term financing sources need to supplement bank lending with new sources of finance where lending capacity is constrained. SMEs should be allowed to access equity and bond listings, or indirectly by securitization of certain debts which, as a more accessible source of financing, will undoubtedly be a favoured solution but again at what cost. Securitization provides an important collateral asset, creating more capacity on banks' balance sheets. This will also be technically a complex process.

The development of alternative sources of funding will however continue to be hindered by the high cost of assessing information about SMEs credit worthiness and potential.

The cost of using exchanges is still very high. There is a general lack of confidence in the quality of the underlying assets which raises information cost and creates little appetite from investors, let alone from SMEs themselves which to a great extent lack awareness and appetite for alternative fund sources at a time where their attention should be primarily focused on filling the order book, innovation, and ultimately job creation and growth.

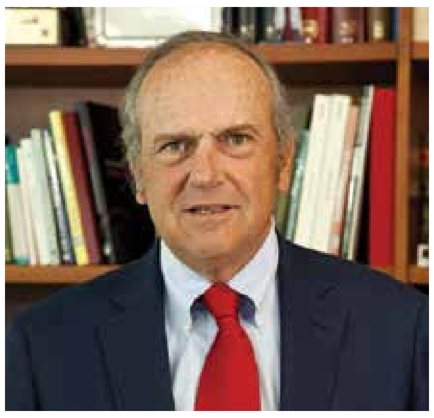
SMEs are very diverse ranging from small firms to the largest SMEs that can more easily access more sophisticated instruments. Firms must be supported and funded at different stages of their development.

Unlike the US and to some extent the UK, the financing of our continental economies still rely heavily on banking intermediation. It is essential that any shift be gradual and proportionate. This must fully account for all stockholders whose interests need to be aligned all with the full support of the initiatives of the European Commission, the EIB, the ECB and national initiatives such as BPI France, the government development bank, all of which to be addressed in Athens. ■

Providing appropriate financing tools for EU SMEs and midcaps

Fostering a renewed and enhanced financing framework for SMEs throughout Europe

Juan R. Inciarte - Executive Board Member, **Banco Santander**



SMEs are the vast majority of EU firms (99%) and employ two thirds of the total workforce; this is why it is worth to dedicate enough resources to create an appropriate business environment for this sector.

Needless to say financing is one of the most important points of such environment, and the main source of financing of non-financial companies in the EU are bank loans (60 to 90% of total vs. 35-50% in US), depending on their size, being the smallest ones the most bank-dependent. Further, in many cases SMEs tend to be customer of just one bank (the one that knows them better).

Big efforts are needed both from private and public sectors in order to provide EU companies a stable, accurate and cheap access to finance.

The banking industry has to focus particularly in: i) being even closer to their clients, ii) understanding and serving its clients' new complex business models, iii) and try to facilitate access to finance for unserved firms, developing new tools, such as specific (positive) credit bureaus that reduce asymmetric information problems.

From the public sector, Institutions and Agencies guarantees will still play a fundamental role in ensuring targeted credit flows, particularly in cyclical downturns, but this will not be enough. Regulators will also need to harmonize as much as possible the concept of SME and the loans granted across European countries in order to assure a level playing field and facilitate a pan-European SMEs' securitization market.

The current crisis has also showed the importance of developing alternative financing channels for SMEs such as a Fixed income market dedicated to SME sector or the development of new products as quasi-equity instruments.

These measures, possibly together with specific fiscal incentives, could increase, in the mid- term, SMEs financing attractiveness for new investors and at the same time will help existing ones – namely banks – to know better their customers and propose adequate financing solutions throughout the cycle. Some local actions are being taken, but we must keep in mind coordination is crucial within the EU, guaranteeing a single market and a real level playing field for SMEs.

Financial fragmentation must be eliminated. It is not conceivable that in a Monetary Union financing conditions for similar SMEs diverge just due to their geographical location.

All in all the different expert groups that worked on SMEs financing solutions agree on many points, that is why possibly the main challenge will be the execution risk.

In this sense, there must be a real pan-European approach to tackle these issues, going beyond Country or sector-level interest. ■

SMEs are the focus of EU policy initiatives but mid-sized companies are increasingly recognised for their important role in growth and employment

Gerassimos Thomas - Director Finance, DG Economic and Financial Affairs, **European Commission**

Mid-caps like SMEs will play a crucial role in EU's economic recovery, growth and employment. A recent PWC (2012) study estimates the number of mid-caps in the EU at 28,000; half of which are innovative.

Mid-cap companies (250-2999 employees) benefit from better name recognition, longer credit history and product track record than SMEs. This reduces information asymmetries and allows them to have better access to finance than SMEs (1-250 employees), including access to capital market financing. But several mid-caps in the EU are facing the challenge to expand and innovate to remain competitive. Those mid-caps need to invest in research and development (R&D) and to pursue an internationalisation strategy with the corresponding needs for equity and debt finance.

Since 2009 the EIB has lent more than €4bn to 1000+ mid-caps in 19 Member States through banks and is expected to lend around €2bn per annum until the end of 2015.

The EU is already supporting mid-caps in cooperation with the EIB under the Risk-Sharing Finance Facility (RSFF) and the Risk Sharing Initiative (RSI) that over 2007-2013 has extended over €2bn to generate over €10bn of lending to R&D projects, including by mid-caps. A recently launched €150mn Growth Finance pilot Initiative will finance directly innovative mid-caps. Under the new financial framework 2014-2020 support to innovative mid-caps will continue under the Horizon 2020 programme and resources will more than double.

On the equity side, the EIF has already invested €5.2bn in venture / growth funds targeting SMEs and mid-caps. An additional up to €6bn will be committed over the next 6 years.

A further development of bond and equity markets access is supported by the Commission via appropriate regulatory initiatives and diffusion of Member State best practices. For example, to expand the means of financing available to mid-sized enterprises and small mid-caps as a complement to banking financing, several Member States (e.g. Italy and Germany) have introduced "mini bonds" to allow issuance of short/medium term ordinary and convertible bonds by unlisted mid-sized SMEs and small mid-caps. In its recent Communication on long-term financing the European Commission (EC) proposes concrete actions in several areas aiming at developing capital markets and including mid-cap capital market financing.

To this end, the EC's MiFID2 proposal will ensure that the definition of SME growth markets minimises the administrative burden for issuers on these markets. The EC will also assess (i) whether further measures could enable the creation of a liquid and transparent secondary market for corporate bonds (ii) the implications and effects of the rules of the Prospectus Directive (iii) whether the eligibility criteria for investments by UCITS should be extended to listed SMEs. ■

The role of stock exchanges in the financing of SMEs - the Greek experience

Socrates Lazaridis - Chief Executive Officer, **Hellenic Exchanges Group**

Since the onset of the economic crisis, the banking system deleveraging which is in progress, is limiting liquidity and stagnating growth in Europe. The only real solution for businesses is accessing equity funds to partly substitute bank lending, in an environment where there is a sharp reduction in global investor risk appetite. The severity of the situation differs according to company size, with large caps having less financing difficulties whereas Midcaps, SMEs and particularly micro-enterprises having great difficulty accessing bank loans and the equity markets.

In Greece, although the economy has recently shown signs of stabilization, banks are still unable to cover businesses' liquidity demands. Consequently, the Greek SME sector, which has historically relied almost entirely on banks for its financing, urgently needs access to alternative sources of funding to support its continued operation and allow growth to take place. Providing additional sources of financing for SMEs and the development of market-based financing solutions for such companies is currently a top priority for Greece.

Putting this in context, in order to support economic recovery, it is imperative to bring into play additional pools of money and several different instruments in order to combine small entrepreneurs with viable business plans and potential investors.

Over the last years, Athens Exchange has been working on a series of initiatives in order to provide solutions to the issue of SME funding, namely the development of listed funds which will attract foreign investment and channel it to SMEs, the promotion of the bond market in order to provide access to debt capital for SMEs and mid-sized companies and the promotion of the alternative market, in order to allow companies to attract investors into their capital through Initial Public Offerings (IPOs).

The financing of SMEs is predominately a local business and requires the active involvement of all national and multilateral stakeholders. Their support and active participation is considered a key factor to having a successful outcome. ■

Combined actions needed to boost IPOs

Magnus Billing - Senior Vice President, President of NASDAQ OMX Stockholm and Head of Nordic Fixed Income and Baltic Markets, **NASDAQ OMX Stockholm**

Securities exchanges ensure efficient fund raising and risk distribution for all sectors of the economy. Therefore it's crucial to increase the appetite for IPOs. However, there is no 'quick fix', and it can't be done as an isolated process. It needs to be a broad effort, involving many stakeholders.

During 2013 NASDAQ OMX Stockholm launched an IPO Task Force with more than 100 stakeholders, aimed at producing a problem analysis and a list of measures, enjoying broad support to improve the climate for IPOs in Sweden.

SMEs became in focus. They create employment and play an important role in the new economy as a whole. Statistics from the growth market in Stockholm, NASDAQ OMX First North, show that First North companies on average increased their workforce by 36.5% annually after the IPO, compared with average annual job growth of 1.5% for all private companies in Sweden.

The ultimate goal for the IPO Task Force has been to create an ecosystem for raising capital in which the stock exchange, private equity firms, retail investors, institutional owners, investment funds, and private owners together provide companies with the best possible conditions to finance growth and create new jobs.

As a result, action points for the exchange include: more flexible quarterly reporting rules, better calibrated fee structure, simpler and quicker listing process, intraday auctions in less liquid stocks and incentives to promote analyst services. At the same time, other areas were identified, for instance an increased need for smaller companies to use corporate bonds.

Areas where public authorities can contribute are to incentivize equity financing in general and long term holdings in SMEs in particular. Pension fund money has the advantage of scale and also means retail participation. The Swedish government's proposed tax relief on retail investments in SMEs could for instance apply to other long-term investors.

Similar activities as the IPO Task Force carried out in Sweden are currently carried out also in other markets operated by NASDAQ OMX, with the aim of finding ways to boost the ecosystems around each local capital market. ■

SME financing: the securitization way to go

Laurent Clamagirand - Investment Chief Officer, **AXA Group**

We believe the Euro Private Placement initiative currently being developed which aims at helping institutional investors finance SMEs is a strong step in the right direction.

Several initiatives have recently been set up to enable insurance companies to participate in the financing of SMEs across Europe, initiatives that can broadly be categorized into 2 types of approaches. The first can be summarized as banks and insurers establishing partnerships in order to co-finance borrowers. The second is reflected in the establishment of the European Private Placement market that enables SMEs to have access to institutional investors through bonds, a European version of what already exists in the US.

Although these initiatives have allowed some SMEs to diversify their financing with non-bank investors, the snag is that these alternative funding tools are only open to SMEs that have reached a critical size. This is because non-bank investors are not equipped to properly assess the credit quality of smaller borrowers. As a matter of fact, direct financing by insurance companies is currently only possible for larger SMEs.

The positive traction created by the Euro Private Placement initiative should be used to also create a relevant solution for smaller SMEs which we believe should rely on securitization. Indeed, the latter entails that banks remain the original lenders and front the client relationship, an ideal tool to enable insurance companies to participate in financing smaller SMEs for a sizeable amount.

But a fully functional securitization market comes with caveats.

First, detailed and comprehensive information on the underlying assets allowing for adequate risk analyses must be available in a homogeneous and standardized format (including default, recovery, delinquency… data). Second the idea of a European-wide SME securitization label, or the development of a common credit assessment scale for SMEs, could be more than meaningful. It is here key to note that market participants are already active in defining more standardized documentation and products through the drafting of a Euro Private Placement charter on the sharing of best practices.

However, the involvement of institutional investors such as insurers in the financing of SMEs remains highly dependent on further adjustments/points of clarification regarding the current regulatory framework. More specifically, Solvency 2 capital charge proposals on SME loans and SME securitized products remain extremely punitive and potentially uneconomical. And the implementation of the risk retention requirements for securitized products remains unclear (in particular on whether a grandfathering period will be granted). ■

Supporting the financing of long term projects

How to address the EU's policy challenges in infrastructure financing

Wolf Klinz - MEP, Committee on Economic and Monetary Affairs, **European Parliament**

Europe's traditionally high reliance on funding through banks has proven to be a major impediment for the intermediation process of allocating funds. Alternative financing mechanisms have to be established. While sound fiscal policies serve as the underlying foundation, it is crucial for Europe to enter a path of sustainable growth that enhances its competitiveness vis-à-vis other global regions and ensures the creation of jobs. Quality infrastructure is a key pillar in achieving international competitiveness, yet the current state of infrastructure in Europe does not possess the capacity to meet future demands. The European Commission estimates the total cost of EU infrastructure needs at over EUR 1.5 trillion for the period up to 2030.

Several key actions should be undertaken by both European Commission and Member States. First, there is a lack of suitable investment vehicles that pool financing from multiple sources and channel it into long-term investments such as infrastructure. While institutional investors can be served through the Commission's proposal on European Long-Term Investment Funds (ELTIFs), serious effort shall also be put into the creation of appropriate vehicles for private households to allow them to channel their short-term liquidity into long-term investments and to offer them an additional solution to save for their pensions.

Second, Member States need to develop their national infrastructure road maps to provide investors and other stakeholders with detailed information and allow for more certainty and forward planning in respect to future projects. Thirdly, the dialogue between institutional investors, the finance industry and the public sector has to be improved, as public-private partnerships (PPPs) can be an effective and cost-efficient means of facilitating collaboration between the public and private sectors for certain investments, especially in infrastructure projects. Moreover, policy makers need to pay great attention to creating a policy environment that addresses market failures which hinder long-term investments. ■

Policy measures for sustainable EU bond market integration

Konstantinos Botopoulos - Chairman, **Hellenic Capital Market Commission (HCMC)**

Government securities play an essential role in developed economies. They serve as a main source of government financing, a tool for Central Bank monetary policy, a benchmark against which portfolio performance is evaluated, and as collateral in financial transactions. Financial market integration is very important for the development of a deep debt market, but this integration, under the current European environment, and especially under the crisis, has been revealed as being far from complete and lacking the appropriate supervisory structures.

From an economic point of view, three broad categories of financial integration measures could be foreseen. Price-based measures, which capture discrepancies in bond prices across markets and where the main policy goal should be to enhance transparency in order to facilitate price discovery; news-based measures focusing on the impact exerted by common factors on the bond returns, for which more sophisticated measures of bond price co-movements among Eurozone countries could be adopted; and quantity-based measures, which aim at quantifying the effects of various frictions on the demand and supply of bonds and where a way forward could be to adopt more sophisticated measures of bond price co-movements. From a political point of view discussions have already started about "euro-rates" and internal Eurozone transfers to alleviate the discrepancies of growth-sustaining policies between the various categories of countries. In the crisis, but overriding its immediate problematic, a new meaning is being given to "debt market solidarity".

From a legal point of view, harmonization should be seen not as a compromise but as a common goal: national particularities exist and cannot be eliminated, but the

debt market does not function on a national level. Not everything can, or should, be regulated or harmonized; but when you regulate or harmonize, think about the broader picture, the persistent imbalances, not just about today's needs or isolated interests. We try to keep that in mind in our current Presidency's efforts. ■

Public procurement authorities should increasingly exploit capital market funding solutions for infrastructure

Gerassimos Thomas - Director Finance, DG Economic and Financial Affairs, **European Commission**

Since the outbreak of the financial crisis in 2008, the average annual volume of PPPs in the EU declined by a quarter compared to the level achieved in the preceding five years. Bond financing dropped substantially more.

In the face of the challenges posed by constrained public budgets and the tightening of bank lending conditions, the European Commission has made visible efforts to encourage private sector investment in infrastructure via PPPs and capital market (CM) financing solutions. The importance of capital market based financing of PPPs has been recognised as particularly relevant also at G20 level where policy initiatives are expected this year.

2013 witnessed a 50% rebound of project finance volumes at a global level and in Europe and a marked increase in bond financing volumes. But the majority of bond deals were concentrated in few countries with a long tradition of PPP structures where procuring authorities explored CM solutions to take advantage of long tenors and attractive pricing. At the same time, institutional investors showed clear appetite for infrastructure assets in Europe to match their long term liabilities at attractive return rates.

Authorities often cite procurement rules as an obstacle for not pursuing CM solutions. They prefer traditional bank loan offers and are not always prepared to adjust their practices to the specific requirements of such financing option with pricing shifting both in terms of spread and the base rate. But this has to change.

Since its first Communication on PPPs in 2009 the EU has revised its procurement directives twice. The revisions opened possibilities in the use of "competitive dialogue" for complex projects like PPPs and allowed for improved communication between procuring authorities and bidders before final bids. Effectively they eliminated the requirement of submitting fully committed bids before the dialogue phase, thereby putting CM solutions at par with bank funding. This increased flexibility was further strengthened this year by a new Directive on concessions and revised procurement directives which provide an even more flexible framework for PPP contracts and improve further the legal certainty for procuring authorities.

Going forward the Commission, together with the EIB, plans to promote sharing of best practices and exchange of information among procuring authorities. The focus will be on the simplifying measures introduced by the new Directives and their application for CM financing solutions. ■

ELTIFs a sound and innovative tool for long-term investment in Europe

Massimo Greco - Managing Director, Head of European Funds, **J.P. Morgan Asset Management**

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 investors may find this an attractive alternative vehicle for infrastructure investment.

There has been much debate about whether an ELTIF should be an open-ended or closed-ended vehicle. Regardless of the outcome, it is vital to avoid the impression of liquidity where it does not exist. Maturity should 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. However, given that some funds may consist of a number of real assets it may be unrealistic to expect the Manager to be able to dispose of all assets within a fixed life cycle and the proposal should afford more flexibility – e.g. the right to extend the life of the fund or make partial redemption payments as when the underlying investments are realized. While the requirement for investment restrictions is logical (70% of the fund's capital in eligible assets and no more than 10% in an individual real asset or unit of another ELTIF), thought should be given to affording Managers sufficient time to remedy any breach.

There has also been some debate about the sale of ELTIFs to retail investors. This idea raises important elements of investor protection which are currently subject to debate by European institutions. If ELTIFs are made available to retail investors it is vital that proper safeguards are put in place. We remain concerned that amending the proposal to permit sale to retail investors may delay the proposal being finalized in time as it would require implementing considerable changes to accommodate retail-investor specific protections (KID, product suitability, etc.). Perhaps this issue could be broached at a later stage.

We are also concerned that a prohibition on the use of partnerships might impact the ability to use partnership structures for ELTIFs marketed to institutional investors. There may be tax advantages in certain situations if a partnership is used. A feeder fund could be used for retail investors which would itself become a partner in the partnership.

The fact that the European Parliament has voted on its report of the proposal before the elections is promising and we look forward to policymakers continuing to make efforts to find sound and innovative ways to channel long-term investment in Europe. ■

Infrastructure investing. It matters

Dr. Guido Fürer - Group Chief Investment Officer, **Swiss Re**

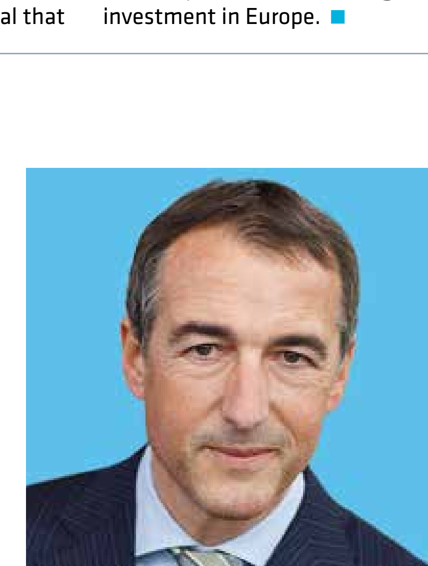
The importance of infrastructure investing for economic growth is well recognised. At its Sydney meeting, the G20 explicitly reiterated its commitment "to creating a climate that facilitates higher investment, particularly in infrastructure and small and medium enterprises".

Specifically, policy action is required to strengthen the role of private capital markets in Europe and elsewhere: global infrastructure bonds need to become a new asset class, market is needed. By increasing the choice of investable longer-term assets, the large asset pool of long-term oriented institutional investors could be tapped. To promote standardisation multilateral development banks (MDBs) should leverage their expertise and credibility by setting up "best practices" enforced by their lending arms.

So far, the progress made in addressing regulatory impediments to long-term investing has been disappointing. A sound regulatory framework is needed to ensure financial stability. Proposed capital rules for financial institutions (e.g. Solvency II) and the large amount of related policy uncertainty aren't supportive for long-term investing or infrastructure investing, in particular.

Attracting long-term institutional investors is crucial for stability and growth: The insurance industry with its core function of transforming risk can act as a stabilizer for financial markets and benefit the wider economy. Given its business model and liability structure, the insurance sector with around USD 25 trillion in assets in the OECD alone is well-suited to exercise this role.

Swiss Re is proposing a joint private-public market ("PPP") initiative. Building on the existing EU/EIB Project Bond initiative, the proposal leverages the catalytic role of MDBs. It also introduces new elements such as pooling of infrastructure projects and institutionalized risk transformation whereby the (re-)insurance industry provides a facility for MDB risk coverage. The recognition by the G20 to enhance "the catalytic role of multilateral development banks" is encouraging in that respect. Now, it is time to turn words into actions. ■



Supporting the financing of long term projects

Infrastructure projects – Improved data is needed to support the reassessment of risk

Gabriel Bernardino - Chairman, **European Insurance and Occupational Pensions Authority (EIOPA)**

Credit photo : EIOPA / Frankfurt am Main

EIOPA reviewed the standard formula calibration for a number of long-term investments under Solvency II. Our analysis covered in particular infrastructure project debt and equity.

Marginal default rates indicate that the risk profile of unrated infrastructure project debt improves over time. At the same time we concluded that reflecting this in the standard formula would pose a number of technical challenges while the resulting investment incentives might be quite limited.

A possible alternative would be to introduce reduced risk charges for individual infrastructure segments. There was actually some evidence to support a slight reduction for unrated availability based infrastructure debt. But the empirical basis was limited and the supporting proprietary data could not be validated.

At the end EIOPA concluded that lower risk charges for infrastructure project finance cannot be recommended at this point in time. One of the main reasons was a lack of reliable evidence. There are a number of initiatives underway to improve data availability which might prove helpful in a potential future reassessment.

Capital charges are not the only factor. Insurers have to acquire the necessary skills to become comfortable with investing in this relatively new and heterogeneous asset class. They may find it also difficult to access relevant performance data and have to learn to manage new risks (e.g. construction and legal risk).

The study was conducted with the input from a range of experts representing industry, regulatory bodies and the academic world. The main challenge EIOPA faced during this research was the lack of comprehensive and publicly available performance data for all types of unlisted infrastructure assets. The access to these data is crucial for EIOPA because as a prudential regulator we need to base our recommendations on empirical evidence.

We are confident that the current calibration will allow for a good alignment between risk and capital management and, therefore, can support the long term growth objectives in a prudent and sustainable way. A review should be made when further data would be available. ■

Engaging long-term investors in financing infrastructure is making progress

Eric Perée - Associate Director, Institutional Strategy, **European Investment Bank (EIB)**

The transition from a bank-dependent financing of infrastructure to a more capital market centred one has been an area of concern since the beginning of the financial crisis. For the last 20 years, banks have developed a large spectrum of dedicated skills and teams for selecting, evaluating, structuring, pricing and managing infrastructure projects over time. There is no doubt that the capital market can provide the financial resources required for infrastructure investments. The real challenge is to make sure that capital market investors make the skills and peoples investments to support their higher involvement in this sector.

According to data compiled by EPEC (European PPP Expertise Centre), progress is being made in attracting capital market financing for infrastructure. In 2013, about 20% of PPP transactions in the EU raised financing from institutional investors. The financing provided was for longer maturity than offered by banks (30 years vs 20 years).

Institutional investors have adopted a variety of ways to provide financing for infrastructure (direct lending, credit enhancement platform, debt funds or soft partnership with banks) but the financing has been particularly concentrated in a handful of with more developed PPP expertise and where there is enough confidence in the stability of the regulatory framework. The recent experience shows that it is possible to secure a bigger role for capital market financing of infrastructure.

It is not for the public sector to select "the appropriate" model for engaging institutional investors, but the challenge for the public sector at this moment is to adjust its own procedures for the tendering of infrastructure and of the key milestones in the financing process so as to facilitate the involvement of capital market investors. ■

Are European banks coming back to infrastructure financing? Perhaps, but the European model is going to differ from the past

Edoardo Reviglio - Chief Economist, **Cassa Depositi e Prestiti Group**

Asset quality review and associated stress test are expected to accelerate European banks balance sheet restructuring. This year might represent a turning point in banks' balance sheets cleaning up, associated with new capital increases. For Spanish banks, for example, 2013 was a landmark transitory year. The same may be true for most of Italian banks this year. However, leverage and balance sheet issues may still keep Europe in a negative lending scenario for some time.

LTRO and other BCE accommodative policy stances will continue to play their positive effects (with some risks associated to trade imbalances, LTRO 3 and Target II). Indeed, internal devaluation is key to regain competitiveness in periphery and for this reason the BCE keeps buying time waiting for political delivery.

Macro and political uncertainty are evident, although there are signs of recovery. Does all this mean that EU banks are coming back to renewed infrastructure investment financing? We should consider that 90% of infrastructure investment in the EU are still financed either by corporates or by Governments. Large corporates have easy access to the bond market. As far as Governments are concerned a more Keynesian approach is probably needed.

Moving from a Fiscal to a Growth Compact should then be the appropriate target for a forward-looking EU policy. However, we cannot expect too much space of maneuver, especially for high debt countries. That is, EU and national policy makers should put all their efforts to re-think and re-launch PFI and PPP (not only for large, but also for smaller public works). Banks are getting ready for a coming back, especially in the construction phase (although CRDIV still inhibits their action and some recalibration should be considered). Pension funds and life insurances are eager to increase their investment in infrastructure (assuming that Solvency II will not make it unjustifiably expensive in terms of regulatory capital).

The EU Commission, the EIB and large national promotional banks are ready to give their contribution in terms of providing longer durations, new instruments and guarantees.

The present context, in view of the forthcoming elections for the European Parliament and the resulting new Commission, offers indeed new challenges and opportunities. Currently, the EU is preparing a Communication on Long-Term Financing (the "Action Plan") which will set the stage for next legislature. A brave policy implementation of the Action Plan is indeed going to be crucial for the transition to a new European model to infrastructure financing. ■

Infrastructure financing: current trends and perspectives

Odile Renaud-Basso - Deputy Chief Executive Officer, **Caisse des Dépôts**

In a period of slow growth, investing in infrastructures is crucial in order to foster growth and increase the attractiveness of a country. It is said that Europe would require 1,500 Bn€ of infrastructure financing up till 2020, mainly in transportation (500 Bn€), telecommunications (270 Bn€) and energy grids (200 Bn€). Therefore, financing becomes the key issue.

To be more specific, short term financing are always available: the issue comes from the ability of commercial banks to provide long term loans. This situation has been exacerbated by tighter prudential rules.

In order to remedy this financing gap, public institutions like Caisse des dépôts or European Investment Bank are playing an increasing role. Their loans have a longer maturity than commercial ones and are overall less costly. These institutions can also lend directly to the purchasing authorities, which allows them to choose the best route between PPPs and conventional procurement.

Another alternative to commercial bank loans lies in bond financing. For years, it has been described as a tool tailored for big projects, given its transaction costs and lengthy process. But, in the course of 2013, the Marseille bypass ("L2"), has been bond financed by Allianz, for a mere 165 M€. It shows that bond financing can be flexible and adapted to medium–size projects. It introduces new players on the market, the insurance companies.

For larger projects, the financial structuration will increasingly require a combination of public subsidies, equity, long term investors' loans, bonds and commercial banks' loans. This blending of various facilities may look overcomplicated at first sight. But one has to keep in mind that some big PPP deals have required the syndication of up to 10 lenders, sometimes more!

In conclusion, diversifying the source of financing is the best strategy in order to cope with the uncertainties of the financial market and provide long term resources for infrastructure projects. ■

A holistic approach toward unlocking financing for long term investment

Thomas Groh - Deputy Assistant Secretary, Insurance Division, Directorate-General of the French Treasury, **Ministry of Economy and Finance, France**

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EU banks' deleveraging: is there long term growth without banks?

Prof. Christos Gortsos - Secretary General, **Hellenic Bank Association**

One of the main consequences of the recent international financial crisis was that several credit institutions based in the EU were exposed to insolvency and/or faced liquidity restraints. This caused:

- the re-capitalisation of several credit institutions by public funds;
- the implementation of resolution tools;
- the intervention of the European Central Bank in order to preserve the liquidity of the banking system (including the Emergency Liquidity Assistance of the Eurosystem, as a lender of last resort);
- as well as the adoption of stricter supervisory and prudential regulatory measures, in force since 2014, in order to preserve the stability of the EU banking sector.

As a result of the new regulatory framework, credit institutions will have to increase their capital basis and/or deleverage their balance sheets. Deleveraging will be necessary from a prudential point of view, but there must be no underestimating of the negative effects thereof on the real economy. We may be confronted with a credit-less recovery, even though commercial banks currently provide over 80% of financial intermediation in Europe.

The EU is currently seeking to complement the role of credit institutions and bridge the funding gap in project finance market by taking up a number of new initiatives and create new financial instruments under a harmonised regulatory environment in order to encourage other actors, such as institutional investors, insurance and pension funds, multilateral development banks and other private sector investors to channel financing to EU long-term investments.

Nevertheless, credit institutions' experience on efficient capital allocation and credit risk assessment retain them as the most important players in the EU economy. Henceforth, the focus should be on the development of banking models suitable for enhancing the financing of SMEs and investment projects of large corporations, necessarily based on the rebuilding of confidence to the banking sector. ■

Addressing vulnerabilities in asset management activities

Richard Berner - Director, Office of Financial Research, **U.S. Department of Treasury**

The financial crisis demonstrated that regulation must focus on the stability of the entire financial system, and not just on each entity. Assessing and monitoring financial-system vulnerabilities should be grounded in this macroprudential perspective, so we can identify weaknesses and associated risks wherever they arise.

Systematically identifying vulnerabilities requires that we ask uncomfortable questions. It also requires an analytical framework that looks across the system. When considering how asset management might generate, transmit, or amplify systemic shocks, we should begin with the activities of asset managers as our starting point.

A focus on activities will help us:

1. Understand the basic economics of the diverse business models found among these firms, and thus of the vulnerabilities that these diverse models may present;

2. Analyze all the parties to financial transactions (e.g., securities borrowers and lenders), and the relationships connecting them, rather than on just one part of the system; and,

3. Recognize that financial innovation and regulatory arbitrage may cause activity to migrate away from traditional venues toward other, potentially less transparent, more vulnerable, or otherwise more problematic, new homes; a focus on activities helps us understand these vulnerabilities, regardless of where and by whom those activities occur.

An activities-based framework does not tilt the scales toward any particular remedy; indeed, it offers targeted analysis that better informs our choices. Nor does it dictate how or at which level to mitigate risks. Activities can be aggregated up into firms, or separated out, depending on what makes sense.

An analytical focus on activities also helps us better appraise hidden risks to the financial system, such as reinvestment of cash collateral in securities lending or reaching for yield in less-liquid asset classes. It also enables us to pinpoint gaps in the data needed to analyze those risks, where, for example, risk-taking might involve separate accounts. And it enables us to assess vulnerabilities that result from the collective behavior of many market participants, even if any single entity involved in a risky activity might not appear materially important. ■

Systemic risk starts with leverage

Barbara Novick - Vice Chairman, **BlackRock**

The asset management business model is fundamentally different than that of other financial institutions. Asset managers act as agents on behalf of clients rather than managing assets on their own balance sheet. They are neither the owner of the assets that they manage nor the counterparty to trades or derivatives.

In addition, asset managers are much less susceptible to financial distress than banks. Asset managers do not fund their business using the short-term credit markets and, therefore, they are not exposed to the type of liquidity squeezes that banks and broker-dealers may encounter.

Likewise, asset managers have strong revenue streams from fees on assets under management and have the ability to significantly adjust expenses if revenues decline. Importantly, even if an asset manager does go out of business, clients can easily reassign their assets to another manager as the assets of each client and each fund are held by a custodian, not the asset manager. It is a straightforward process without systemic implications.

Risk is not correlated to the size of either a fund or a manager. Many of the world's largest funds are index funds which are unlikely to pose systemic risk. Looking back, Reserve Primary Fund was a $65 billion fund that created systemic risk. Large asset managers are less likely to go out of business because they have more diverse businesses that can withstand changing markets and investor preferences.

Leverage is a better indicator of where risks may lie. For example, Long Term Capital Management managed a $5 billion hedge fund that was highly leveraged and this fund experienced distress due to investment losses coupled with a mismatch of funding. While leverage alone is not directly correlated with risk, reviewing the amount of leverage together with the funding source of that leverage and any fund redemption provisions to mitigate a "run" would enable regulators to identify potential sources of systemic risk.

It is worth noting that U.S. Investment Company Act and UCITS funds, as well as separate accounts do not use significant leverage. ■

Addressing systemic risk in the asset management sector

David Geale - Head of Savings, Investments & Distribution, Policy, **Financial Conduct Authority (FCA)**

Central to the international debate are the questions whether asset managers themselves pose systemic risk, whether they merely touch upon arrangements that contribute to systemic risk or whether one should change perspective and focus on their funds.

Looking at it purely from the asset management company's perspective, so far, the data acquired on a global level does not enable us to fully assess whether the sector as a whole or an individual asset manager poses a threat to financial stability or not as the case may be. In addition, as a securities regulator, we believe further consideration should be given to market integrity, whether linked to financial stability issues or on its own.

Identifying sources of future systemic risk constitutes a significant challenge for regulators. The FCA therefore welcomes the work undertaken on an international level, in particular the FSB's work which is undertaken jointly with IOSCO on non-bank non-insurer (NBNI) global systemically important financial institutions (SIFIs). We are all aware of the main differences between a bank and an asset manager: whilst banks invest their own money, asset managers invest as agents on behalf of their clients. While losses directly impact the bank's capital, losses to a collective investment vehicle will flow through to their investors.

In the case of retail funds, while such losses would be unwelcomed, they would most likely not cause systemic problems. These fundamental differences require a sector-specific approach when assessing and addressing systemic risk.

Identification of sources of future systemic risk requires data. The recent initiative by the European Commission on securities financing transactions will also enhance transparency within the asset management sector. It will be necessary to analyse this data, including that received via the AIFMD reporting requirements, as it will be vital to assess systemic relevance of the sector before jumping to any hasty policy conclusions. ■

Systemic risk in investment funds – Fact or spectre?

Greg Brisk - Global Head of Risk and Compliance, Investment Management, **BNY Mellon**

BNY Mellon manages $1.6 trillion of assets in our multi-boutique investment management business. Because we are already a G-SIB, we would likely not be materially impacted by the proposed changes. Nevertheless, we have significant reservations about the proposals as the risks and case for additional regulation are far from established.

Policy makers now appear to acknowledge that Asset Managers themselves do not present inherent systemic risk, therefore questions needing to be addressed include:

- Are they concerned with market impact in the event of forced selling? If so, are the controls imposed by exchanges to cease trading in disorderly markets already sufficient?
- If they are concerned with counterparty exposure, is this because counterparty's credit risk controls are inadequate? If so, would this not be for the BCBS to address?

- Do they fear the sheer volume of assets under management by some managers? If so, much more evidence-based analysis is necessary regarding the homogeneity of assets, strategies, co-variance and the ability/motivation of asset managers (as distinct from owners) to create systematic risks.

What then, exactly, is the problem we are trying to fix? Given their 'agency' role managing client assets rather than acting as principal, the disorderly failure of asset managers is improbable and in any event they can readily be replaced. Size, similarly, is simply not comparable: whereas banks leverage their balance sheet 10-12 times and depend on 8-10% capital as a buffer before insolvency gives rise to counterparty loss, most funds don't employ leverage and 100% of assets are available to back obligations to counterparties.

The focus then should be on what features (e.g. leverage) in funds might create pockets of systemic market or counterparty risk and whether additional regulation, e.g. extending existing rules from retail funds to institutional products, is warranted on systematic grounds. ■

Systemically important asset managers

Sophie Gautié - Head of Strategy, Corporate Development and Public Affairs, **BNP Paribas Securities Services**

In a context where the scope of systemically important financial institutions is being broadened beyond banks to encompass, for instance, market infrastructures or insurance companies, it is quite understandable that regulators also seek to apply similar criteria to asset managers in order to understand to which extent they may be a source of systemic risk.

Risk mitigation in the asset management sector has in effect been a key focus in the EU and in the US over the last few years, both at the asset manager and at the product level, and has already led to key regulatory developments, such as the Alternative Investment Fund Manager Directive and the revision of the UCITS Directive (in the EU), as well as proposals to regulate Money Market Funds (in the EU and in the US).

More specifically, EU rules clearly identify and segregate the roles and responsibilities of the depositary, whose mission is independent from the asset manager and focused on investor protection. The latest rules have extended the role of the depositary to all EU investment funds, be they UCITS or alternative funds. The have also further enhanced the asset protection role of the depositary by introducing i) the obligation for the depositary to restitute assets held in custody, ii) extensive oversight duties for other assets and iii) a new obligation to monitor all cash movements.

With regards to Money Market Funds, new rules are also under discussion to mitigate the risk of runs in case of stressed conditions with notably intense debates on conversion of CNAVs in VNAVs and opportunity to introduce cash buffers. All these evolutions definitely contribute to limiting systemic risks in the asset management sector.

Furthermore, depositaries ensure full independence by operating with clients on an arm's length basis (service level agreements) and, when lodged within a Global Systemically Important Financial Institution, they not only benefit from the group financial strength and stability, but also fully comply with resolution and recovery rules for banks in order to provide continuity of business.

At the same time, it is crucial to ensure that there is no regulatory loophole in the provisions adopted with regards to the depositary regime. Otherwise, some market participants may circumvent the new framework and the investor protection objective would not be reached. In this respect, we welcome the recently adopted UCITS V text, which stipulates that a depositary is not exempted from its restitution obligation when delegating custody to an Investor CSD and look forward to AIFMD being clarified in a similar fashion. ■

Addressing systemic risks in the asset management sector

Targeted changes to EU investment fund rules

Steven Maijoor - Chair, **European Securities and Markets Authority (ESMA)**

Via the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD), all EU investment funds (or their managers) are 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 funds sold to professionals (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) are well known and have been subject to extensive debate at EU and international level. While it should be noted that MMFs are already subject to ESMA's guidelines of May 2010, it is equally clear that more needs to be done to tackle the potentially systemic nature of these funds.

Another set of activities that has been under close scrutiny by regulatory bodies recently are securities financing transactions (SFTs). The Commission's recent proposal on SFTs aims at mitigating the risks arising from SFTs and improving the transparency of these activities.

ESMA's guidelines on ETFs and other UCITS issues of December 2012 already took action to address those risks by recommending better disclosure of SFTs and setting out qualitative criteria for collateral received. To some extent, therefore, the UCITS legal framework (as supplemented by ESMA's guidelines) 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.

However, the Commission initiative is an important next step in that it specifies in detail the information to be provided by UCITS and AIFMs, thereby ensuring a common approach and greater comparability, and strengthens the safeguards around re-use of assets received as collateral. ■

Securities regulators must step up to the plate as a policy framework for 'systemic' markets is badly needed

Paul Tucker - Senior Fellow, Mossavar-Rahmani Center for Business and Government, **Harvard Kennedy School and Harvard Business School**

If solving the problem of too-big-to-fail financial institutions is the most important challenge in underpinning financial stability, endemic regulatory arbitrage is close behind. While rules-based regulation can help guard against giving arbitrary powers to unelected regulatory agencies, it is the meat and drink of a shape-shifting industry. As banks are re-regulated—with greater constraints on the structure of their balance sheets and on the types of asset they hold—the substance of banking will inevitably re-emerge elsewhere. Policymakers could find themselves in a game of catch-up, which they will be doomed to lose unless they can be nimble and flexible. If they respond only once each incarnation is obviously systemically significant, we will be lucky if stability can be sustained.

Around the world, there will have to be institutional and cultural change if regulatory agencies are to rise to this challenge. Something like the following package is needed.

First, the authorities need to identify which markets are especially important to the real economy, or to the financial system itself. Key questions will be whether there are ready substitutes if a market closes; and whether the liquidity of each systemically relevant market is resilient. A framework of that kind would have focused attention on the ABS markets and the associated ABS-repo markets well before the crisis. It might also help decide whether there could be meaningful threats to stability from asset-management practices and structures.

Second, securities regulators will need to adapt their priorities, as they typically have jurisdiction over capital markets, asset managers and many manifestations of shadow banking. Given their historical mission and cultures have been centered on the vital importance of honesty and efficiency rather than on preserving systemic stability, their statutory objectives probably need enriching. Legislators can affect incentives by asking searching questions about risks to stability when regulators testify. ESMA can help set the tone.

Third, macro-prudential authorities need to be endowed with wide and flexible powers to take action to forestall threats to stability—whether structural or cyclical—from anywhere in the financial system. Between them, the authorities need a range of policy measure for systemically relevant markets, covering infrastructure, settlement periods, the dealer community, credit rating agency practices, warnings about risks given aggregate patterns of issuance, and minimum collateral requirements for the secured-financing markets.

Some of that is in train. But it has not been articulated as a coherent whole based on clear economic principles addressed to real-world vulnerabilities.And parts of the package would be novel—for example, a new macro-prudential approach to the functions of the listing authorities, agencies that need to make a much bigger contribution to preserving stability. If over-issuance makes markets fragile, they will be more likely to close under pressure. There is not yet a clear framework for thinking about that. One is needed. ■

Is there a need for a recovery and resolution framework in the asset manager sector?

Frédéric G. Bompaire - Head of Public Affairs, **Amundi**

Regulators have taken steps to enhance stability of the financial system. In that view the "too big to fail" issue has been dealt with in order to reduce the moral hazard that preexisted. Everybody is happy to consider that major banks and insurance companies are so important that it is necessary for them to prepare a resolution framework. What about asset managers (AMs)?

Asset management is a totally different story where the risk is not that the management company defaults. Contrary to banks, AMs do not hold clients assets on their own balance sheets. They manage their clients' money in the framework of an explicit mandate and are closely controlled both in-house and by the supervisor.

Risk control is part of the asset management process and a culture of risk has developed. Regulations have put many limitations on the type of assets that an AM can invest in and the maximum level of risk it can get exposure to. Most prominently, leverage is very low. Furthermore an AM relies on prudentially regulated partners and does not retain any asset itself; the depositary acts as custodian and controller and bears the risk of safe keeping. Through a chain of segregated accounts the AM makes sure that clients' assets will be preserved.

Nevertheless, it is not inconsistent to consider that large funds or large AMs have a potential impact on financial stability. If the risk is probably not one of default it is true that the risk of liquidity/run exists. And it may spread from one fund to another and from one firm to the next. Accurate valuation and cut out mechanisms to prevent contamination are the most important tools for stability in case of crisis. Resolution framework is not the key issue in an industry where clients may redeem if they are not satisfied.

Organization of an ordinate liquidation for a fund facing a run, portability of the management to a new manager, existence of a minimal amount of capital to put some skin in the game are among others the questions put on the table. ■

Guillaume Eliet - Deputy Secretary General, **Autorité des Marchés Financiers (AMF)**

As the FSB and IOSCO are consulting on methodologies to identify Systemically Important Financial Institutions (SIFI) outside of the banking and insurance sector, a forthcoming challenge for international standard setters will be to design the appropriate policy measures that will apply to those entities designated systemic, including a framework for their resolution and recovery.

In 2011, the FSB published its Key Attributes of Effective Resolution Regimes for Financial Institutions, setting out the features that national resolution regimes should have in order to resolve a failing SIFI without exposing taxpayers to losses or stalling economic activity.

Whereas the FSB-IOSCO consultation suggests there may be systemically important entities in the asset management industry, these Key Attributes are silent as to their application to investment funds or asset managers.

A first step is therefore to determine whether a particular investment fund and/or asset manager may be globally systemic. This is the aim of the ongoing consultation.

Should any of them be designated a SIFI, the Key attributes may apply although further work would be needed to tailor them to the specificities of that industry since they have not been developed with asset management activities in mind.

Not all resolution measures developed for banks are equally relevant for the asset management sector: investment funds and asset managers differ from banks both with regard to the activities they undertake and the way they operate. As client assets are not held on the balance sheet of the asset manager but safeguarded by third party custodians, they are not available to claims by general creditors of the manager.

In addition, investment funds are not "resolved" as such but liquidated with investors bearing any potential loss. Further thought is therefore needed to tailor the approach, possibly building on existing regulatory regimes. ■

SFTs represent a critical tool for the financial industry and the real economy

Guido Stroemer - Managing Director, Global Head of Repo, **UBS AG**

Securities Financing Transactions (SFTs) and equivalent financing structures are used actively by a broad spectrum of market participants: central banks, pension funds, investment funds, insurance companies, corporates and banks to fulfil essential liquidity management and investment management objectives. A healthy primary issuance market relies without doubt on a deep and liquid SFT market that supports effective price formation of assets in liquid secondary securities markets. The European Commission draft proposal to deliver enhanced SFT transparency and reporting via trade repositories is conceptually sound, consistent with FSB recommendations, and its implementation will require a robust and cost effective infrastructure solution for all SFT market participants. It however requires consistency with other SFT reporting requirements in the EU, and in third countries, considering its extraterritorial reach.

In regard to enhanced transparency and disclosure in SFT reporting to investors in investment funds, the proposal creates a new layer of reporting in addition to existing requirements under the UCITS Directive and AIFM Directive.

On the rehypothecation of client assets, explicit written consent and increased disclosure of potential risks will provide greater awareness, which will mitigate uncertainty and boost confidence in rehypothecation as a yield enhancement tool for investors. However, the proposal has to clearly differentiate between "re-hypothecation" and "re-use" of collateral. The two terms are often used interchangeably. Rehypothecation relates to the discretionary right that a pledgor may grant to a pledgee, and "re-use" refers to the transfer of the legal title of the underlying securities from seller to buyer.

Given the crucial role of SFTs to the wider financial system and the overall economy, the industry and regulators alike are keen to nurture a transparent SFT market to prevent the build-up of systemic risk and protect financial stability. ■

CSD regulation and TARGET2 - Securities - The upcoming challenges

Wim Hautekiet - Chief Executive Officer, **BNY Mellon SA/NV**

In the (admittedly specialist) world of post-trade processing, major change is underway. There is a common perception that post-trade processes in Europe are costly and inefficient, especially in comparison with the United States. CSD Regulation (CSDR) in 2014 and TARGET2-Securities (T2S) in 2015 will be major market-changing events; they have the potential to improve significantly the current situation. But this is not the end of the story. There are major challenges ahead of us.

Challenges of Implementation
CSDR and T2S will bring about a new competitive environment, and major challenges of implementation. The adaptation to T2S will be a major project; CSDR will generate many requirements (including a change in settlement cycles, settlement discipline measures, and additional capital and liquidity needs). BNY Mellon plans to seize the opportunities of CSDR and T2S, and is thus well aware of the size of the implementation effort.

Unfinished business
CSDR and T2S are deliberately limited in scope. They solve some of the underlying problems; they leave others untouched. They focus on settlement matters i.e. on the relationship between buyer and seller; they leave largely untouched the relationship between issuer and investor. National requirements governing the issuer/investor relationship will continue to hamper the evolution to a true single market.

Temptation to regulate infrastructure/ intermediaries
Given the reality of both ambitious regulatory objectives and of difficulties in tackling the underlying problems, there is a temptation for regulators to try and achieve their objectives by imposing obligations on intermediaries and infrastructures.

There are many examples of such an approach, including AIFMD and UCITS V, the EU Financial Transaction Tax, the planned revision of the Shareholder Rights Directive, and the settlement discipline aspects of CSDR. Such an approach is risky. Infrastructures and intermediaries may, or may not, be able to deliver. If they are not able to deliver, then a problem arises.

The jury is still out with respect to the workability of the settlement discipline measures of CSDR. At times - during the CSDR discussion - an outcome that would have caused the settlement process in Europe to grind to a halt seemed a possibility. ■

TARGET2-Securities (T2S) complements the future CSD regulation (CSDR) from the operational perspective

Jochen Metzger - Head of the Department Payments and Settlement Systems, **Deutsche Bundesbank**

The timely advent of CSDR is highly welcome. The Eurosystem's future T2S settlement platform will complement the European legislation and provides for further harmonisation of the post-trade industry from the operational perspective. Although the CSDR will be adopted in the very near future, there is still a considerable amount of work to be done. Detailed work is needed to define the Level 2 Regulatory Technical Standards and Implementing Standards.

In cooperation with the ESCB and with due consideration given to the stakeholders' views, ESMA shall submit, draft technical standards to the EU Commission by nine months from the date of entry into force of the CSDR.

From the T2S perspective, in particular, the standards on the settlement date and on CSD links are relevant. A significant innovation under CSDR is the definition of the intended settlement date (ie. T + 2 for transactions executed on trading venues) and the further refinement of the CSDs' measures preventing and addressing settlement fails. The introduction of T + 2 is beneficial because it not only reduces the settlement risk but also the cost related to the use of central counterparties.

As T2S provides for seamless transactions between CSDs on the T2S platform, the likelihood for fails due to different settlement dates and other frictions between currently separate CSD processings will decrease. T2S virtually merges the current complex (and nevertheless incomplete) web of links among CSDs into a single securities settlement system.

Therefore, the way how Level 2 standards will deal with CSD links in detail is very important. In a nutshell, the integration of the CSD link network and the inclusion of the Eurosystem's TARGET2 payment system will provide first and foremost for the pooling of cash liquidity, but also for securities, and collateral holdings. The Eurosystem fosters a further increase of the post-trade efficiency by offering T2S auto collateralization and client collateralization features and by its openess towards domestic and cross-border triparty collateral service providers in the context of its credit operations. ■

EU derivatives' reporting goes live

Verena Ross - Executive Director,
European Securities and Markets Authority, (ESMA)

February 2014 marked the starting point for EU derivatives reporting. Since then, financial and non-financial firms have been reporting millions of derivative transactions on a daily basis to the six trade repositories (TRs) available in Europe. This is a key step in implementing the European Market Infrastructure Regulation (EMIR), the EU rules implementing the G20 commitments.

Regulators are now having access to derivatives data which will enable them to develop a clearer picture of the risks associated to those markets. Of course, these are still early days for Europe and some issues still need tackling. It is indeed important to keep the big picture in mind, sound and transparent derivatives markets will ultimately benefit financial markets, investors and the economy as a whole.

So far, reporting has gone well. However, given EMIR covers both financials and non-financials, some issues remain in terms of on-boarding, legal entity identifier (LEI), harmonisation of codes, and improving data quality. We see the number of new clients of the TRs and of pre-LEIs issued continues to rise. Besides solving teething problems at firms' level, dual reporting in a multi-TR environment adds another level of complexity.

ESMA has worked on common formats and reconciliation between TRs. It provides the basis for two firms to the same derivative transaction reporting to two different TRs. At the start the focus was on ensuring firms' readiness to report. The focus now moves to further improving data quality and ensuring access to that data: having multiple TRs means that different authorities have to connect to different TRs; and effective and appropriate information exchange requires further attention.

On a global level, exchange of and access to data is equally important. However, we still need to go some additional steps until we can put the different pieces of the global derivatives puzzle together. We now need to consider the three options the FSB has put forward. The full global view on derivatives may not yet be there, but we have made important steps forward and derivatives markets are surely coming "out of the dark into the light". ■

The main challenges in the definition of CSDR level II technical standards

Joël Mérère - Executive Director, **Euroclear SA/NV**

CSDR deals with the rather technical domain of securities settlement, so Level II standards will be absolutely key in making the overall CSD legislation work properly and not result in unintended market consequences. In addition, the design of some standards will have to take into account that, for a large number of CSDs, settlement will be outsourced to one common technical platform, namely T2S.

ESMA has to develop 32 standards many of which should be straightforward. However, the creation of a new, wide-ranging and harmonized Settlement Discipline Regime across the EU is much more complex. This is the one part of the CSDR which affects all market participants and their clients, and it will require a lot of market effort to deliver a realistic and effective regime. The concept is easy to understand: a CSD participant that cannot deliver the securities on due date will have to pay a penalty to the buyer and, if the fail is for an extended period, will also be subject to a mandatory buy-in. But, as is quite often the case in our industry, the devil will be in the details. Securities will need to be subject to specific regimes based on liquidity and/or the type of the transaction.

In addition, because CSDR is still not law, T2S markets are now facing a timing issue: could a new SDR be implemented before T2S goes live? A general consensus in the markets is that this is not technically feasible.

In addition, as long as standards have not been agreed, it is practically impossible for CSDs to commit to a launch date for the new regime. This leads to the legitimate

question of whether this new regime should be implemented in each of the CSDs joining T2S or, whether it would be more cost-effective (and safer) to implement it only once, and centrally in T2S. ■

FMI Reforms: securing the benefits through standardisation

Juliette Kennel - Head of Market Infrastructures, **SWIFT scrl**

The vital role played by FMIs in the EU post-trade market is recognised in recent regulatory measures such as EMIR and CSD-R. More widely the 24 CPSS-IOSCO 'Principles for FMIs', issued in 2012, clearly demonstrates the focus on ensuring robust and operationally sound FMIs, not just in the EU, but globally. In addition, the imminent arrival of T2S, which aims to drive down the cost of post trading in the EU, is also reshaping the European Securities landscape.

What more can be done to help ensure that all of this change and cost actually enables the financial community to benefit from a safer and more efficient post trade environment?

One key element in making post trade operations safer and more efficient is the adoption of internationally recognised communication standards, such as standardised messaging formats. The importance of messaging standards was recognised by CPSS-IOSCO, who devoted one of their 24 Principles for FMIs to this topic, and it is also included as an Article in the recently agreed text of the CSD-R. T2S quite rightly chose to take a standardised approach to messaging right from the beginning, which means that all direct members of the system must use the open ISO 20022 standard for all of their communications with T2S. The regulatory push for standardisation, together with the practical choices made by T2S, provides an opportunity to remove one of the remaining barriers that have traditionally made EU post trade processes more expensive and less efficient than they need to be. The global regulatory focus on FMIs means that the EU is now facing increasing competition from other markets pushing forward with developments to optimise their post-trade processing. Asian FMIs are already adopting ISO 20022, and DTCC in the USA now offers corporate action processing using ISO 20022.

In practical terms significant further progress could be made if all CSDs in Europe used the opportunity of the changes they need to make for T2S connectivity to also offer ISO 20022 based messaging for access to their services – domestic and cross border, i.e. not just for their T2S related messaging. This will help to deliver a more competitive, safer and more harmonised EU post trade process that is fit for the 21st century. ■

Financial Market Infrastructure reforms

Recovery and Resolution Plans for CCPs ensure prudently organized and operated financial markets

Thomas Book - Chief Executive Officer, **Eurex Clearing**

In light of the recent financial crisis, various bodies have enacted substantial changes to regulation to safeguard and improve the stability and workings of the financial sector, including rules which serve to disentangle and appropriately risk manage derivative exposures via CCPs.

The introduction of both bank and non-bank recovery and resolution plans is of critical importance to ensure that financial markets are prudently organized and operated. It needs to be ensured that CCPs have practical and carefully considered recovery and resolution plans which promote the integrity of the markets and provide robust clearing arrangements.

The efforts in the recovery and resolution plans need to serve to create positive ex ante risk management incentives and an improved level of preparedness in the event of an extreme crisis. Furthermore the complexity of multi-jurisdictional and cross-border concerns poses a challenge that makes it necessary that a pragmatic approach in recovery and resolution planning is adopted.

Ideally, the CCPs would interact primarily with their primary regulator or resolution authority, and that such authorities, while naturally reserving the right to intervene early if deemed appropriate, would provide an indication of the boundary between recovery versus resolution. A large range of possible recovery and resolution tools will add a flexibility which can help adapt to the particular crisis at hand, and to distribute any potential losses in an equitable and less disruptive way.

A particularly important mechanism which improves market and Financial Market Infrastructure integrity is the ability of CCPs, their regulators and resolution authorities to enact recovery and resolution tools to ring-fenced asset classes or market segments separately, enabling the remaining healthy portion of the cleared spectrum to continue operations. ■

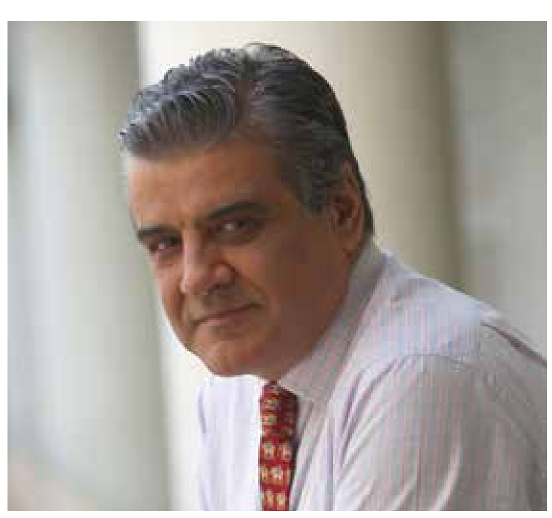
Post-trade reforms: implementation is the key

Carlos López Marqués - Deputy Director International Affairs, **Bolsas y Mercados Españoles (BME)**

During the last years, the European financial sector has witnessed an intense raid of reforms in the Financial Market Infrastructures. Some of them have completed the legislative process and have entered into force, while others are still pending on level 2 developments. In either case, their suitability to cope with the various inefficiencies of the post trade environment in Europe remains to be properly assessed and this will take some time as well as some risks.

The first indications suggest a mixed blessing. EMIR has started with elements of uncertainty in some areas. The timeline imposed on the implementation of the technical standards was too short for many ESIs to choose their Trade Repository, the on boarding and the preparation for a correct reporting. Many relevant issues such as entities identifiers, Exchange Traded Derivatives reporting and other standards are not solved yet. Consequently, a very low amount of operations is being reconciled amongst TRs to date.

CSD Regulation level 1 text has been finally agreed at the time this note is being written, putting ahead an impressive level 2 work. The resulting technical standards will determine sensitive issues such as settlement discipline, access conditions between infrastructures or risk assessment. In particular, they will set the flexibility of the tools used to guarantee the smooth functioning of settlement, so that they should be as general as possible and applicable to any CSD, whether it uses T2S or not.



The implementation timeline is also of the essence. Considering the already open reforms in some jurisdictions, like Spain, and the systemic importance of CSDs, a transitional period could be considered in order to avoid clashes with projects carried out in parallel, as T+2 adaptation or migration to T2S.

We must welcome the new framework in the post-trading area being, at the same time, very careful with how the new regulation will be implemented, in order to amend any inefficiency that can possibly arise in the near future. ■

Recovery and resolution of CCPs and CSDs

Kay Swinburne - MEP for Wales, Rapporteur on recovery and resolution of non-bank financial institutions, Committee on Economic and Monetary Affairs, **European Parliament**

Recently there have been legislative initiatives which seek to increase the efficiency and safety of post-trade functions: harmonising settlement processes in CSDR and in the case of derivatives, EMIR, which seeks to channel more activity through central clearing houses and created trade repositories. Together with the imminent introduction of the ECB's Target2Securities system and in the interests of managing risk in a more transparent way, the importance of these functions has therefore increased, making them critical market infrastructure.

Like all critical functions it is important to consider how these will continue to function in extreme circumstances. In EMIR there are rules for how the central clearing process should work in times of stress caused by the default of a general clearing member, which allocates losses in a specific hierarchy. However, this does not foresee a situation where the CCP reaches operational difficulty and so cannot continue to function normally without intervention beyond the default fund contributions of members and the regulatory capital of the CCP itself. Any future recovery and resolution regime must focus on what happens at the end of the default waterfall, ensuring that those who have no control over the risk management structures of a CCP are not used as an extra backstop before resolution authorities have stepped in.

As many new regulatory initiatives are putting more stress upon CSDs due to their role in collateral management processes, it is just as important to focus on their crisis scenario planning as for CCPs. Both are potentially new hubs of systemic risk that require a thought out way of managing future problems.

Pre planning for the demise of a business is not easy, but where the interests of the broader market are at stake, it is incumbent upon the operators of such critical market infrastructure to have comprehensive plans in place and for the appropriate legislative framework to exist.

Legal certainty at times of market stress improves market confidence and pre-planning may help prevent contagion across venues and markets. ■

Resolution and recovery of CCPs: some important questions

Andrew Gracie - Executive Director, Special Resolution Unit, **Bank of England**

As mandatory central clearing of OTC derivatives becomes a reality, the key role of CCPs in European and global financial markets will become even more apparent. With this, the possible consequences of CCP failure are brought more sharply into focus.

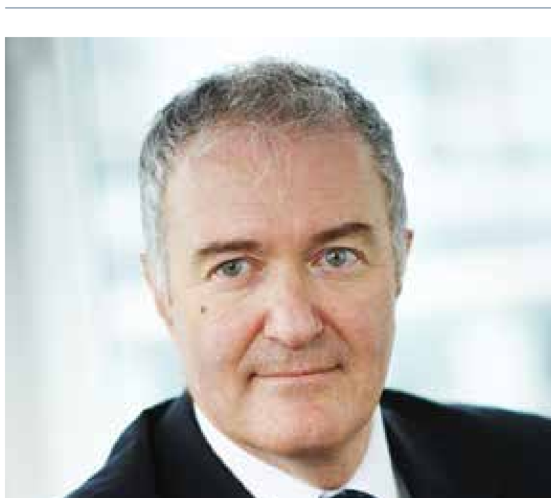
The implementation of EMIR will raise standards in European CCPs, reducing the likelihood of failure. Some CCPs have gone further, extending the default waterfall to allocate uncovered credit losses and introducing other recovery-like measures. Stronger supervision and recovery tools are positive, but not enough. It is vital to have effective resolution arrangements for CCPs. The European Commission's intention to introduce a legislative proposal on CCP recovery and resolution is therefore welcome.

There has already been some discussion of resolution and recovery of CCPs by international bodies (including the Commission's own consultation in 2012) and industry, but some important questions remain. What is the most effective way to resolve multi-asset class CCPs? How should links between CCPs be treated, for example through interoperability, or where service companies provide services to multiple CCPs in a group? How do you ensure shareholders bear losses appropriately in resolution, and more broadly ensure losses are allocated in a way that limits use of public funds?

And once continuity of a CCP's critical functions has been achieved, what then? How should the CCP be

restructured? Should positions and collateral be portable between CCPs, as they are between clearing members?

These are important questions to consider for an effective resolution regime. Further, all systemically important CCPs should develop recovery plans, provide information to enable authorities to agree resolution plans that operationalise preferred resolution strategies, and be subject to resolvability assessments. The Commission's proposal will be an important step towards this. ■



Settlement efficiency and the safety of post-trading markets: a major step forward

Patrick Pearson - Acting Director, Financial Markets, Directorate General Internal Market and Services, **European Commission**

The efficiency and safety of post-trading markets will take a major step forward over the next year with the adoption of the Regulation on central securities depositories (CSDR) and the operational start of the Target 2 Securities platform (T2S).

As a single settlement platform with 24 participating CSDs, T2S will deliver a single rulebook for post-trade processes across 21 EU markets, improving the safety and efficiency of cross-border settlements.

CSDR will apply across the EU. It will increase safety by reducing settlement risks throughout the EU by reducing settlement periods and harmonising settlement discipline rules. It will also introduce strict prudential requirements for CSDs. Efficiency constraints will also be addressed, e.g. by introducing access rights between CSDs and other infrastructures, resulting in a better choice and reduced costs for investors and issuers alike.

To create a single settlement market, CSDR also introduces a freedom of issuance (the right for the issuer to choose the CSD in which to register its securities). In such a case, the law under which securities are constituted will not change. While the CSDR does not prescribe a common conflicts of law rule on proprietary aspects of securities, other national and EU rules will continue to apply. ■

Key steps to improve the supply and use of collateral

Nadine Chakar - Executive Vice President, Global Collateral Services, **BNY Mellon**

Collateral is emerging as a pre-eminent tool useful for helping to manage risk and exposure in the global financial system. A serious debate continues as to whether or not there is a shortage of collateral. Questions remain about the overall supply of collateral, the quality and proportion available for "highest and best" use, and the proportion that is actually usable – and not already tied to existing requirements. Collateral estimates still vary. These practical steps could improve the supply and usability of collateral:

Abolish collateral intake restrictions: Eurosystem's May 2014 abolition of the "repatriation requirement" is a positive step that will be further strengthened as CCPs abolish their related individual restrictions. Tri-party settlement interoperability: We view settlement interoperability between tri-party providers as a major benefit. Current discussions focus on interoperability for CCP-cleared repos in general collateral "baskets". These discussions should be broadened.

Regulatory developments: Making high quality assets available as collateral makes sense. One way for asset owners to do this is to ensure collateral mobility in a secure and transparent legal environment. The recent Commission Proposal for a Regulation on Securities Financing Transactions may be a positive step in this direction.

Another way is to eliminate the overlapping rules and regulations that impose unnecessary segregation in securities accounts through chains of intermediaries. Under the Financial Transaction Tax (FTT) it is unclear whether Securities Lending transactions will be exempt from regulation.

If they fall under the FTT, the availability of collateral transformation capabilities required to match the right quality of collateral from asset owners to those with exposures will be impacted. AIFMD and UCITS V limit the ability of buy-side firms to use external collateral managers to increase efficiencies. This directly impacts collateral mobility.

The justification for such segregation is the minimisation of the legal risk in securities holding chains. The right way to solve this problem is to create a secure and transparent legal environment. ■

Collateral – Transforming financial interconnectedness

Verena Ross - Executive Director, **European Securities and Markets Authority, (ESMA)**

Collateral is in high demand since market participants increasingly rely on it to mitigate counterparty and liquidity risk. As its use is rising, so is the interconnectedness of global financial markets.

The resulting risks are not trivial. Clearly, collateral immediately interlinks diverse groups of market participants, including banks, CCPs, brokers, and investors. Greater encumbrance of bank assets limits the claims of unsecured creditors.

At times of market stress, locating re-used or re-hypothecated collateral assets may become problematic, and procyclicality risks grow once eligibility standards are tightened or haircuts and margins raised.

Even at aggregate level, the availability of collateral cannot be taken for granted. For the moment, the financing needs and recent improvements in conditions on EU sovereign debt markets point at sustained issuance activity.

Moreover, new market practices linked to collateral management, such as collateral optimisation and collateral swaps can facilitate access to and sourcing of high quality collateral. But both supply of and demand for collateral may change substantially in the prevailing environment of financial market uncertainty.

Market participants and authorities need to be acutely aware of these risks. With respect to UCITS ESMA has already taken steps to strengthen the requirements on management of collateral in the context of OTC derivative transactions and efficient portfolio management techniques, such as securities lending and repo transactions. In addition, safeguards have been put in place on aspects such as collateral quality, diversification, re-use of cash collateral, haircut policy and stress testing.

Finally, the EU Commission has recently proposed measure to improve the transparency of Securities Financing Transactions. These are important steps. But sound risk management by market participants remains the key to managing the collateral transaction chain as it develops. ■

Mobilisation of collateral – How Eurosystem initiatives fit with market initiatives

Daniela Russo - Director General, Payments & Market Infrastructure, **European Central Bank (ECB)**

Smooth mobilisation of collateral has always been a priority for the Eurosystem. With the introduction of the euro, and in the absence of adequate alternatives at that time, the Eurosystem developed a solution for cross-border mobilisation of collateral – the Correspondent Central Banking Model (CCBM). The CCBM today continues to be the main channel for collateral mobilisation on a cross-border basis in Eurosystem credit operations.

The Eurosystem is now introducing two significant enhancements to the CCBM. First the abolition of the repatriation requirement in May 2014, implying that assets will no longer have to be returned to the issuer CSD before being brought to the Eurosystem. This will allow counterparties to opt for a more consolidated approach to the management of their collateral and reap the benefits of collateral optimisation services offered by the private sector.

Second, integration of triparty collateral management services in the CCBM. Triparty collateral management services are an optimisation service offered by, inter alia, major (I)CSDs and allow clients to efficiently manage their collateral assets. Currently such services are supported at domestic level and during September 2014, the Eurosystem will go-live with support also on a cross-border basis.

With these enhancements to the CCBM, the Eurosystem is supporting more efficient collateral management across the euro area for Eurosystem credit operations and for collateralised operations at market level. Efficiency of collateral management will be further enhanced in 2015 with T2S, the integrated platform of the Eurosystem for settlement of securities transactions in central bank money.

Finally, the Eurosystem is promoting and facilitating a number of market developments to support the effective functioning of the EU repo market. ■

SSM and T2S support a more effective use of collateral in EU financial markets

Emerico Antonio Zautzik - Head of Directorate General for Markets and Payment Systems, **Banca d'Italia**

A resilient and effective use of collateral in financial transactions is a cornerstone of the process aimed at restoring confidence in European financial markets. This process will receive strong support from the implementation of the Banking Union and of Target2-Securities (T2S).

The Banking Union will encourage a wider circulation of securities by severing the link between sovereign issuers and national financial issuers, which was a major cause of the crisis-induced home bias across national jurisdictions in the European financial system.

The Single Supervisory Mechanism will reduce fragmentation across national supervisors by ensuring common practices and allowing a wider exchange of information on financial institutions. The Single Resolution Mechanism will guarantee certainty to the resolution procedures of cross-border collateralized transactions.

On the technical side, the implementation of T2S will allow an optimisation of the use of the existing collateral supply and foster recourse to collateral management services. T2S will allow a more efficient cross-border settlement in the EU, thus supporting easier mobilisation of collateral from where it is generated to where it is needed.

Given the expected wide range of T2S participants, the delivery of collateral to Eurosystem NCBs and CCPs will become swifter and more efficient. Tri-party collateral management services will be supported by the platform, thus facilitating interoperability among different service providers. Hence, T2S will reduce the current fragmentation of collateral pools among CSDs: the securities held at different CSDs in T2S could become, de facto, a single pool of collateral. Finally, T2S will bring greater competition among custodians and collateral management service providers, enabling better quality and wider access to these services by market participants. ■

The risk of a collateral shortage and how custodians can be part of the solution

Stefan Gavell - Executive Vice President, Global Head of Regulatory, Industry and Government Affairs, **State Street Corporation**

Over the recent years, different studies have investigated the future demand for collateral. Whilst the findings differ in terms of magnitude of a possible shortage of collateral in the system, all papers agree that demand will significantly increase. This will be driven by a number of changes; above all, regulatory change is a key driver by introducing central clearing for derivative contracts as well as the requirements for uncleared derivative transactions as proposed by BCBS-IOSCO. Similarly, the introduction of the Basel III Liquidity Coverage Ratio will have a similar effect.

Global custodians can be an important facilitator in this new world, standing in between potential sources of pools of high quality assets held by pension funds, collective investments and sovereign wealth funds and the users of collateral.

Agency securities lending, for example has long been an effective vehicle for both providing liquidity to the market, as well as a low-risk source of additional return for collateral providers. However, new and upcoming regulation needs to be carefully calibrated to ensure that the ability to provide these important services is not hampered. This is particularly the case for the remaining final elements of the Basel III framework (leverage ratio and capital requirements) and the BCBS large exposure recommendations. Similarly, the ESMA guidance on Article 47.3 EMIR limiting global custodians' ability to hold collateral on behalf of CCPs is a further impediment to the efficient provision of relevant services in this area.

Furthermore, ensuring as much consistency and coherence between different pieces of regulation is important. We also support plans to further increase transparency and more certainty around ownership of securities via the Securities Law Legislation as it will bolster investor confidence.

State Street hence welcomes the opportunity provided by Eurofi to discuss these important matters with the regulatory community. ■

Collateral mobility and securities financing

Patrick Pearson - Acting Director, Financial Markets, Directorate General Internal Market and Services, **European Commission**

The post-crisis changes in EU funding and derivative markets together with the recent financial reforms have incentivised the use of collateral as key risk mitigant. This has increased collateral demand, which coupled with a stagnant supply, has highlighted the effects of EU collateral fragmentation. In this respect, more transparency is needed to understand how collateral markets work and what the risks of nascent collateral optimisation techniques are before developing effective and efficient policy tools.

On 29 January 2014, the Commission adopted, a proposal for a Regulation on the transparency of securities financing transactions (SFTs). Collateral mobility heavily relies on the use of SFTs. However, these transactions have been a source of contagion, leverage and procyclicality during the crisis. The proposal sets out measures to enhance regulators' and investors' understanding of STFs and rehypothecation. The proposed Regulation is in line with 2013 Recommendations of the Financial Stability Board and will provide valuable data on the collateral used in SFTs.

The Commission closely follows developments on collateral to identify the barriers to collateral mobility as well as the risks of new collateral management practices. This work is also linked to cross-border issues in collateralised transactions. ■

Collateral mobility and transparency: a continued regulatory focus

Jo Van de Velde - Head of Product Management, **Euroclear SA/NV**

It is well-known how EMIR, Dodd Frank and Basel III are leading to increasing collateral flows across the various market players worldwide including CCPs, credit institutions, asset managers, corporate treasurers. Collateral management has now become global. Efficient collateral mobilisation, allocation and transformation have become key contributors to the successful implementation of the G20 objectives for OTC derivatives and banks' capital.

In response, Euroclear is rolling out its Collateral Highway, a solution that offers open inventory management, rapid collateral mobilization and optimised collateral allocation. The open architecture of the Collateral Highway allows interoperability with existing collateral management systems of agent banks and other CSDs. Our Collateral Highway connects multiple entry points (collateral sourcing) and multiple exit points (collateral receivers) worldwide. Last year, Euroclear's Collateral Highway mobilised close to EUR 800 billion of collateralised transactions daily.

Against this background, it is only natural that regulators require a better view on collateral flows, part of which take place in the so-called shadow banking system as repos and Securities Financing Transactions (SFTs)) are used by non-bank entities. The recent Commission Proposal "Regulation on reporting and transparency of SFTs" proposes mandatory reporting of SFT transactions to trade repositories and requires rehypothecation to take place by collateral transfer, rather than by pledge. The implementation may be challenging for the market: SFTs are currently not always identifiable at the level of settlement systems and the proposed 18 month implementation timetable seems stretched. Euroclear however, is well placed to consider offering support in the repo trade repository area. ■

Regulatory concerns about excessive asset encumbrance

Adam Farkas - Executive Director, **European Banking Authority (EBA)**

The use of secured funding alleviates refinancing risk and is a natural part of banking. Moreover, access to secured funding and more diversified access to liquidity are likely to impact the stability of a bank positively. However, over-reliance on secured funding and increasing levels of asset encumbrance may pose risks to individual banks and ultimately to the global financial system as a whole.

Several risks stem from excessive asset encumbrance. Firstly, it may increase structural subordination of unsecured creditors and depositors. Secondly overreliance on secured funding may increase funding and liquidity risks in the medium term. Finally, it increases the sensitivity of the liquidity profile of the institution to market values of collateral.

The negative implications of excessive asset encumbrance can therefore constitute a threat to the regulatory objectives of financial stability, depositor protection, the resolution and bail-in framework and the reduction of systemic risk.

EBA's recently published draft regulatory standards on supervisory reporting and guidelines on asset encumbrance disclosure will help monitoring and controlling the regulatory concerns explained above. Supervisory reporting will create harmonised measures of asset encumbrance across institutions, which will allow supervisory authorities to compare the reliance on secured funding and the degree of structural subordination of unsecured creditors and depositors across institutions.

It will also allow supervisors to assess the ability of institutions to handle funding stresses and can be incorporated into crisis management, as it will allow for a broad assessment of the amounts of assets available in a resolution situation. Asset encumbrance disclosure by institutions is of vital importance for market participants to better understand and analyse the liquidity and solvency profiles of institutions, and thereby increases the market discipline of banks. ■

Regulatory considerations and collateral implications

John Rivett - Managing Director,
J.P. Morgan Agency Clearing, Collateral Management & Execution

Since the first G20 summit in November 2008, regulations continue to evolve across jurisdictions. Understanding these rules and their impact on financial stability and efficient collateral management is of key importance to policymakers and the industry.

There are three key issues that impact collateral management:

1) Collateral can be subject to varying haircuts and valuations depending on the instrument type or clearinghouse, broker or counterparty receiving it. Given these variables, market participants need strong analytical tools to review the collateral inventory and the relative value of each collateral component efficiently.

2) Collateral segregation is intended to enhance the safety of assets in the event of insolvency. The differing models and associated costs will impact the utilization of segregation models.

3) The re-use of collateral can be a useful tool for liquidity and financing. Whilst demand for quality, highly liquid collateral is expected to increase, certain regulatory developments may restrict the re-use of collateral, requiring market participants to acquire and deploy additional collateral. The recent European Commission's proposal for a Regulation on Transparency of Securities Financing Transactions is of particular importance when considering these issues. The proposal introduces conditions for rehypothecation of collateral along with reporting requirements via a repository.

In addition, it is anticipated that by the ninth G20 summit in Australia in November 2014 mandatory clearing will have commenced in Europe; the BCBS will have developed internationally consistent, risk sensitive rules for capital treatment for banks engaged in shadow banking activities and will provide an update on reform implementation; and the FSB will have completed recommendations on minimum standards on methodologies for calculating haircuts on non-centrally cleared securities, developed information-sharing process within its shadow banking policy framework and proposed standards for global data collection regarding repo and securities lending markets.

We continue to navigate the complex regulatory environment and stand ready to work with policymakers and regulators to appropriately consider the various rules to ensure collateral assets are mobilized and optimized when and where needed. ■

Towards a proportionate implementation of Solvency II

Sandrine Lemery - First Deputy Secretary General, **Autorité de Contrôle Prudentiel et de Résolution (ACPR), France**

The risk-based and harmonized approach of Solvency II is a great progress for the European insurance market. It is also a major overhaul for insurance regulation in Europe and has raised concerns among small and medium-sized insurance companies that can be addressed through proportionality and preparation.

Proportionality is a guiding principle of Solvency II. It is not so much about size, but about nature and complexity of the risks taken or borne by a company. It affects all three pillars: quantitative requirements, including valuation, can be calculated using simplified methods; governance requirements are principle-based and can be met with commonsense solutions including for small structures; exemptions from reporting requirements, notably quarterly, are provided for. Solvency II is the opportunity for companies to allocate commensurate resources to their risks.

So the period from now until 2016 is crucial for every company, major insurance player or smaller company. Many initiatives aim at preparing for Solvency II, such as the guidelines issued by EIOPA on pillars 2 (governance and ORSA) and 3 (reporting). On pillar 1, EIOPA plans to publish, at the end of April 2014, some technical specifications reflecting final provisions that will allow all companies to prepare in advance on quantitative requirements.

In France, ACPR is fully committed to working closely with companies. After a first exercise in 2013 and before European reporting preparatory exercises, insurance companies will as soon as 2014 provide Solvency II reporting templates and full ORSA; moreover, whereas EIOPA preparatory guidelines involve only companies above a given threshold in terms of size, the French authority has invited every (re)insurance undertaking or group to take part. This reporting will more generally foster a constructive dialogue on the three pillars between the French supervisor and all undertakings around their preparedness to Solvency II. ■

Lessons learnt from Solvency II more rules than principles

Burkhard Balz - MEP, Vice-Coordinator of the EPP Group in the Economic and Monetary Affairs Committee, **European Parliament**

Every legislative act has its history and its lessons to be drawn. One outcome of the Solvency II and Omnibus II process is a clear shift from a principles-based to a rules-based approach.

The initial approach relying on principles was supposed to better suit the fragmented European insurance markets by leaving some flexibility to reflect their specific characteristics. While the Omnibus II Directive was meant to amend Solvency II on a technical basis, it became soon obvious that the financial crisis called for a more comprehensive adaptation of the framework.

The intensive review of the contents of the Directive did not intend to lead to a conflict with the already agreed principles or to broadly deviate from them. It however led to a more detailed Directive that gives more weight to rules and essential technical parameters.

On the one hand, a rules-based framework limits the leeway for undertakings and supervisors to interpret and apply the requirements. It therefore makes an early involvement of EIOPA, together with the national competent authorities, and a stakeholder participation even more important. I still consider it as a very helpful exercise to initiate a thorough, but time wise restricted impact assessment during the Omnibus II negotiations.

On the other hand, a rules-based approach further increases the legal certainty for the requirements set in the basic legislation that is the benchmark for the subsequent delegated acts and technical standards.

The approach therefore helps to enhance the democratic accountability and it provides a clearer guidance to the Commission for the work on the technical specifications. A more precise legislation that at the same time reflects the difficult market conditions underlines the responsibilities of the legislators themselves. The European Parliament has been increasingly active in exercising its control rights and it will continue to do so in respect to the Solvency II delegated acts. The trend towards a more rules-based system can be generally observed in the European legislation on financial services. To assess the interplay and coherence of the rules will be a major task of the next legislature. ■

Global capital standards for insurers: a threat to Solvency II?

Mario Nava - Director Financial institutions, DG Internal Market and Services, **European Commission**

While the newly-agreed Solvency II framework for insurance regulation is being implemented in the EU, international discussions are going on regarding, not one but two global capital standards for insurers. At the instigation of the FSB, the International Association of Insurance Supervisors (IAIS) is working first of all on a new capital standard for Globally Systemically Important Insurers (G-SIIs), and subsequently on another one, with a different calculation and a lower level, for non-systemic Internationally Active Insurance Groups (IAIGs). Both capital levels are to be applied from 2019. The Commission takes these global standards very seriously.

EU insurers are understandably concerned about the interaction between different capital standards, EU and global. The Commission, which is deeply involved in the international discussions, insists that global rules be, if not identical with ours, then compatible, which for us means modern and risk-based, with fair value principles used.

The first test, and our current priority, is the calculation basis of the capital requirement for G-SIIs, known as BCR. The details of BCR are due to be finalised in autumn 2014. A good result on BCR will presage well for future discussions on requirements for IAIGs. However, it cannot be avoided that for an individual G-SII or IAIG, even a global capital standard broadly compatible, but not identical, with Solvency II could still give a required capital level somewhat different from the Solvency Capital Requirement set by Solvency II (either higher or lower).

The second test is the definition of G-SIIs and IAIGs. IAIS listed 9 G-SII insurers in 2013, but is still working on a list of G-SII reinsurers. The definition of IAIGs is not set, but will probably include activity in at least three jurisdictions, and also a size threshold. In this context, we consider that the EU is manifestly a single jurisdiction. ■

Europe must safeguard the competitiveness of its insurers, globally

Alban de Mailly Nesle - Chief Risk Officer, **AXA Group**

The Solvency II framework will introduce a common playing field for the single European Insurance market. It will help the European Insurance industry to maintain and even strengthen its global foothold.

To safeguard the role played by the European insurance industry on the international economic scene, it is essential that the European Union recognize local regulatory regimes as equivalent or provisionally equivalent with the Solvency II framework when calculating the total capital of insurance groups. Even if some countries are deemed equivalent (or provisionally equivalent), insurance groups will still manage their risks on the economic basis which is promoted by Solvency II.

The industry welcomes the forthcoming Level 1 Directive. This directive envisages that certain supervisory regimes of third countries be recognized as equivalent or provisionally equivalent. Nevertheless, the political agreement reached that recognizes this – possible and/or provisional – equivalence is not yet transposed into the Delegated Acts and should be amended.

Indeed, the Delegated Acts impose criteria that eliminate any real possible choice by the insurance group's supervisor as to the choice of method used to calculate group solvency. As a result, group supervisors of Europe's internationally active insurance groups would be led to require the use of the Accounting Consolidation method instead of the Deduction and Aggregation method – not only at home but also with regards to operations in equivalent and provisionally equivalent countries. Yet only the Deduction and Aggregation method leads to capital requirements for European insurance groups, in countries recognized as equivalent or provisionally equivalent, similar to those required from their local competitors, thus leading to a level playing field.

In order to ensure alignment with the Directive's intention, we suggest that when the Commission deems the solvency regime of a third country either equivalent or provisionally equivalent, Article 321 of the draft Delegated Acts not apply to undertakings of that country and Deduction and Aggregation method may be applied in relation to them.

The Delegated Acts must enable equivalence to be used in accordance with the political decision expressed in the legal Level 1 text. This is the only way to maintain the strength and global presence of European insurance groups, a critical European asset given the high degree of economic and financial openness that characterises the European Union. ■

Solvency II supervisory tools will be effective, but also challenging to apply

Alberto Corinti - Member of the Board of Directors, Italian Insurance Supervisory Authority, **IVASS**

Solvency II aims to align risk management best practices with regulatory compliance. This has led to an innovative regulatory framework which, to be successfully enforced, will require evolved supervisors' attitude and skills.

It is clear that the complexity of the regime and its principle based approach will be challenges both for companies and supervisors. In this context, the conceptual approach adopted with regard to financial requirement will pose one of the main challenges.

Solvency II intends to provide supervisors with early warning signals about the firm's solvency, which are based on its potential ability to dismiss liabilities toward policy holders at market value before the firm's available capital breaches minimum thresholds after predetermined stresses. Inevitably, this approach leads the solvency ratio to vary over time, also as a result of short term market distress.

Regulators are including mechanisms to soften the effects of market induced volatility on insurers' balance sheet. However, it is likely that the volatility of Solvency II quantitative signals cannot be fully avoided. It is therefore essential that supervisors are able, both in terms of formal powers and actual capacity, to correctly interpret the ratios and take consequent actions that, in particular, distinguish firm's actual solvency gaps from short term, market induced effects. Solvency II ratios, as any other stress test results, should be analyzed considering their objectives and assumptions, in combination with other information on the firm. Supervisory interventions should be timely and effective but also proportionate and not pro-cyclical.

The challenge will be to enable, at national as well at EU level, a correct, unequivocal and harmonized interpretation of SII reports. This, even more than the sophistication and complexity of the regime, will be one of the main implementation challenges. To be faced appropriately, it requires remarkable supervisory skills and sufficient resources. ■

The (Re-)calibration dilemma

Carlos Montalvo Rebuelta - Executive Director,
European Insurance and Occupational Pensions Authority (EIOPA)

In the current economic situation insurers are seen as relevant actors regarding economic growth and financing of the real economy, putting the focus on the capital charge for types of assets, and its appropriateness. Moving towards a risk based framework in Insurance, regulatory capital requirements have to reflect actual risks and how they are managed. Such a framework must be neutral so that investments with the same risk should be subject to the same capital charges. It should not create obstacles, nor provide artificial incentives.

It is tempting to propose specific treatments for individual assets in the standard formula, as it will result in higher risk sensitivity. But this has a price: complexity of calculations will increase. A more granular approach might also reduce the number of observations available and, for relatively new asset classes, there may be a short record of historical performance data, thus data quality and credibility becoming an issue. Furthermore, capital requirements have been developed for a number of years. What are the odds for significant new insights into the risk profile for individual asset classes? It is time to move on. With regulatory uncertainty identified as a high risk for insurers, clarity regarding capital requirements is key. This doesn't exclude a future revision, always based on evidence.

EIOPA has shown that it will do it, as it has been the case in the field of Securitisations, where we suggest a more granular approach in this field. EIOPA developed a number of criteria on the structure of the securitisation, quality of underlying assets, underwriting process and the transparency for investors. As a result, we suggest that securitisations meeting all these criteria have a lower risk profile and capital charge than those which do not.. Calibrations cannot be carved in stone, nor can evidence be thin ice. It would certainly be wrong to downplay the influence of regulatory capital requirements on investments decisions. In the end insurers will only invest if it makes economic sense, and this is how it should be. ■

Solvency II details must remain true to regime's goals

Xavier Larnaudie-Eiffel - Deputy General Manager,
CNP Assurances & Chief Executive Officer, **CNP International**

A political agreement was reached between the European Parliament, Council and Commission in November 2013 on changes – through the Omnibus II Directive – to the forthcoming Solvency II regime. At the centre of the discussions on Omnibus II was the issue of the treatment of long-term guarantees. The agreement reached, while not an ideal solution, was welcomed by the insurance industry as a workable compromise from which to develop the technical details of the new regulatory regime.

Included in the agreement on Omnibus II were a number of measures to ensure that Solvency II correctly assesses the available or required capital for insurers offering long-term guarantees backed by long-term assets. This long-term perspective can reduce or eliminate insurers' exposure to short-term market volatility, so the measures seek to ensure that the risks to which insurers are exposed are not overstated and that artificial volatility is not introduced into the balance sheet, since both would place unnecessary additional costs on the industry.

It is vital that the European Commission now ensures that the technical details being developed – the Delegated Acts – reflect the intentions of the politicians, so that the new regime can work as planned and does not unintentionally harm the EU's insurers or their customers. Of particular concern to the insurance industry is that the wordings and calibrations should work correctly for a sector that has long-term liabilities and offers products with long-term guarantees. Notably, they should not penalize insurers' investments in equity or infrastructures.

The Delegated Acts are currently being drafted by the Commission for presentation to the European Parliament and Council. Through Insurance Europe, the European (re)insurance federation, the industry has put forward workable solutions so that Solvency II can be applied, as planned, from 1 January 2016.

Implemented correctly, Solvency II will be a state-of-the-art, risk-based regulatory regime. It will promote consumer confidence and it will safeguard the European industry's ability not only to offer a wide range of innovative products at appropriate prices and to compete internationally, but also to support European growth through investment in the real economy. ■

The Greek insurance market welcomes the implementation of Solvency II

Alexander Sarrigeorgiou - Chairman of the Board of Directors, **Hellenic Association of Insurance Companies**

In the insurance industry, confidence and solvency are conditions necessary for growth. For the Greek Insurance Market exiting a severe economic crisis and carrying the negative impact of past insolvencies, these elements are even more critical. The implementation of the new regulatory framework, applied through the European Directive Solvency II, comes to ensure capital efficiency though risk based management and to create robust structures and operations by imposing rules and procedures in corporate governance and reporting.

The Hellenic Association of Insurance Companies (HAIC) fully supports both the new framework and the efforts of the Supervisory Authority in the matter, as we consider that through these, the credibility of the industry will be enhanced. HAIC is ready to support the efforts of the supervisor, the Bank of Greece; we consider however, that three key points must be given particular attention:

- The implementation of the regulatory framework should not, by any means, augment bureaucracy for companies, increasing the cost of the products thus making it more expensive for the average – already underinsured - citizen, to buy insurance coverage.
- The average greek company is small, well below what is considered critical mass. Therefore, while absolutely maintaining the intent of the new framework, the principal of proportionality must be applied where appropriate.
- Finally, the same rules should apply for everyone operating in Greece, regardless of their origin, in order to prevent new distortions in the market. Therefore, it is critical that the supervisor ensures through immediate and intensive action that the new framework is applied by all players at all times. ■

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IAIS committed to developing a capital and supervisory framework for IAIGs

Catherine Lezon - Deputy Secretary General,
International Association of Insurance Supervisors (IAIS)

Insurance markets are increasingly global, with around 50 internationally active insurance groups (IAIGs) accounting for more than 50% of the global market. However, insurance supervisory approaches are still fragmented, which impedes supervisory effectiveness and efficiency and generates additional regulatory compliance costs.

The IAIS' mission is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability. The IAIS seeks to promote global supervisory language that is clear, consistent, comparable and measureable.

Since 2010, the IAIS has been developing a comprehensive framework for the supervision of IAIGs, which is commonly referred to as ComFrame. Following the Association's announcement in July 2013 that it considers a sound capital and supervisory framework for the insurance sector essential for supporting financial stability and protecting policyholders, we committed to develop a risk based global insurance capital standard (ICS) within ComFrame by the end of 2016.

The ICS aims at providing an objective, globally comparable measure of capital adequacy requirements for IAIGs and G-SIIs across jurisdictions at the group-wide level.

This will enhance supervisory cooperation and coordination by increasing the understanding and confidence among group-wide and host supervisors. ComFrame and the ICS will be adopted in late 2018 after a field testing phase during which they will be further refined and calibrated.

Further, in 2013, the IAIS completed a methodology for identifying Global Systemically Important Insurers (G-SIIs), on the basis of which the Financial Stability Board (FSB) identified an initial list of G-SIIs, as well as G-SII policy measures including recovery and resolution planning, enhanced group-wide supervision and higher loss absorbency requirements (HLA).

As a foundation for HLA for G-SIIs, the IAIS is developing as a first step straightforward, basic capital requirements (BCR) to apply to all group activities, to be ready for implementation by G-SIIs in late2014. HLA requirements, initially based on the BCR until a more comprehensive framework is established, will be developed by end-2015, to apply from 2019 to G-SIIs designated in 2017. ■

Global regulation: an approach for market development and financial stability

Manuel Aguilera-Verduzco - President,
Insurance and Surety National Commission (CNSF), Mexico

The financial crisis has shown that the insurance sector has become a more relevant part of the financial system. This increasing relevance implies a bigger, more interconnected and more sophisticated industry, that requires regulation to be adapted accordingly. In this sense, the recent initiative of the International Association of Insurance Supervisors (IAIS) to develop and introduce an insurance capital standard (ICS) as a comprehensive group-wide risk based capital standard, is the correct decision at the right moment.

An international harmonised solvency system will be a key element in creating the foundation for a regulatory scheme that could deal properly, on one hand, with the challenges that multinational activity of insurance groups is posing to national supervisors and, on the other, with the need to maintain financial stability and enhance economic efficiency in the financial markets.

Considering these trends, Mexican financial authorities decided to conduct a deep reform in the insurance regulation area by implementing a full Solvency II type regulatory system that will be in force in April 2015. Taking advantage of the significant progress made in insurance regulation in Mexico since the 1994-95 crisis, it was decided to move towards an internationally accepted solvency regime that could deal with two main challenges that the Mexican financial system is facing.

First, to increase protection to consumers by applying a risk sensitive solvency regime that could support the sound development of the insurance sector in the long run and, at the same time, to incentive an efficient use of capital in this industry.

And second, to implement a state-of-the-art regulatory system that creates an environment to attract new domestic and foreign investment to the insurance sector as a mean to increase penetration and, therefore, to provide more insurance services to Mexican consumers.

The most significant future expansion of the insurance industry will take place in the emerging markets. A global regulation framework will prevent regulatory arbitrage and will strengthen cooperation between supervisors for the benefit of policyholders. ■

Global capital standards must acknowledge difference between banking and insurance

John C.R. Hele - Executive Vice President and Chief Financial Officer, **MetLife**

The global capital standards now under development must acknowledge the significant differences between the risk profile and business models of the insurance and banking industries.

Applying bank-style capital rules to insurance companies may have unintended consequences by restricting their ability to fund long term investments and capital projects. These kinds of investments are at the core of an industry that must match long term liabilities with long term assets. These are also the investments that provide significant benefits to society and should be encouraged, not discouraged, by policy and regulation.

With every effort to improve regulation comes the risk of added complexity and unnecessary costs rather than creation of the consistency and transparency we desire. Consistency is important to avoid market distortion and the increased cost of compliance that will make it more difficult and expensive for consumers to acquire needed financial protection.

As new capital standards are being written, it is essential we take advantage of the opportunity to provide affected industries with certainty while reconciling multiple and sometimes conflicting regulatory and prudential frameworks around the world. New standards should also take into account and, where appropriate, align with existing local or regional regulatory regimes. Regulators must resist embarking on a cycle of ever increasing capital costs, especially for those activities everyone agrees are non-systemic.

Finally, an effective resolution regime must take into account the unique profile of an insurer and rely on existing insurance resolution and bankruptcy frameworks before resorting to any additional resolution authority. ■

Aligning global capital standards with Solvency II

Nick Kitching - Head of European Regulatory Affairs, **Swiss Re**

As the European Union finalizes Solvency II, the IAIS has accelerated its agenda on a global capital standard for insurance. The timetable is very ambitious and the IAIS are expected to deliver the first part of the global capital standard by September 2014.

The global capital standard work is a key pillar in the IAIS' wider initiative to establish a global framework for the supervision of internationally active insurance groups that addresses the shortcomings exposed by the crisis.

This initiative can help to modernise and harmonise regulation and supervision at a global level with the greater consistency and more effective global supervisory practices delivering real benefits for supervisors and international groups.

An intention of the global capital standard, particularly the basic capital requirement, is to establish a simple measure that avoids too much granularity, complexity and risk sensitivity and provides an effective basis for comparing companies.

However, the risk is that the different levels of sophistication, risk sensitivity and scope create another layer of supervision that conflicts with the most advanced and tested regimes, particularly Solvency II and SST.

It is important that the global capital standard avoids this risk and is consistent with Solvency II, SST with sufficiently flexible to accommodate existing and future group regimes that follow similar economic and risk-based principles. The long-term nature of insurance business, benefits of diversification and the use of internal models to measure and manage risks need to be effectively recognized in any capital standard. ■

Systemic regulation of insurance: the challenges ahead

Christian Thimann - Member of the Executive Committee, **AXA Group**

continuation of page 1

In an efficient regulatory framework, capital charges are calibrated on underlying risk, and capital surcharges on systemic risk. For the insurance sector, the specific nature of systemic risk and its transmission channels still need clarification. In the case of banks, important channels of systemic risk come from institutional interconnectedness through the interbank market, from liquidity shortages or from maturity transformation. But in contrast to banks, insurers are stand-alone operators, structurally liquidity-rich and aiming for asset durations broadly in line with their generally longer-term liabilities.


Credit photo : Patrick Messina

The direction of possible risk is another key consideration: is the focus on 'firm-to-system' transmission, as generally discussed in regulatory fora, or on 'system-to-firm' transmission, as discussed in most analytical studies? The policy responses are unlikely to be the same in both cases.

These are only some of the questions that would benefit from clarification. The Eurofi High-level Seminar provides an occasion to make some progress. ■

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Defining global insurance regulations


Credit photo : EIOPA/Frankfurt am Main

Global capital standards will reinforce the international level playing field

Gabriel Bernardino - Chairman,
European Insurance and Occupational Pensions Authority (EIOPA)

The introduction of global capital standards in the insurance field should help prevent regulatory arbitrage, increase financial stability, guarantee a level playing field and strengthen international supervisory coordination, for the benefit of the economy at large, including financial institutions and consumers.

In this context, the development of a Basic Capital Requirement (BCR) has the main objective of creating a first layer of comparability at global level, allowing its use as a basis for the calculation of Higher Loss Absorbency (HLA) for the Global Systemically Important Insurers (G-SIIs).

The BCR should be kept simple and straightforward in its presentation, therefore relying on a factor-based approach. However, it is inappropriate to use a single factor solution, similar to the banking sector Leverage Ratio. Insurance balance sheets are far more complex than banking ones.

As for the development of the Insurance Capital Standard (ICS), we would need an evolutionary approach. The basic sound principles of Solvency II should be applied internationally. This means that the international capital standards should incorporate the fundamental principles underlying Solvency II: a total balance sheet approach, clear and transparent target criteria for calibration of capital requirements, explicit recognition of risk diversification and consideration in capital requirements of all the material risks to which the group is exposed.

But, that does not mean that the ICS needs to be as granular as Solvency II. A step-by-step approach that will allow for the use of calculations with different levels of sophistication and progressively create more commonality at the level of calibration could be envisaged.

In this context, Solvency II could be viewed as a practical implementation of the ICS, but going forward we should be open to make adjustments to it if that is needed. Groups should be subject to only one capital regime. ■

Global insurance standards: involvement of EU level and coherence necessary

Burkhard Balz - MEP, Vice-Coordinator of the EPP Group in the Economic and Monetary Affairs Committee,
European Parliament

The legislative process on Omnibus II is now near the finish line. Having the lengthy and difficult discussions on the European level in mind, concerns rise that international developments might lead to a divergent, multi-layer set up of standards in the insurance regulation. The timing of the global agenda for the development of capital standards indeed seems to be rather tight. We have seen how long the Basel process in banking has taken. Solvency II needs some time to run. It tackles long-term risk, and any adjustments in the legislation may only be evaluated in a mid-term or long-term perspective.

From a European side, there is certainly no appetite for an early review of the rulebook that was just agreed. It was already a tremendous work to come to solutions with 28 Member States bearing in mind their national specificities and different structures of long-term products. A common, credible solution on an international level might be even more challenging. A minimum solution might be the most obvious approach, but bears the risk of being questioned under cost-benefit-aspects. It is certainly not in our European interest to oblige undertakings to fulfill various sets of capital standards that are not even linked in their basic methodology. Coherence with the Solvency II principles is therefore absolutely necessary.

The Commission together with EIOPA should remain strongly engaged in the regulatory dialogue with our global partners. The evolvement and outcome of the discussions is also of particular importance with regard to the assessment of the Solvency II third country equivalence. The European Parliament has a legitimate demand in being regularly informed. An appropriate consultation process and involvement of the EU institutions as well as stakeholders has to be ensured. Better financial regulation is not necessarily linked to the pure amount of directives and regulations. Better regulation is based on the quality, effectiveness and efficiency of legislation. The different pieces have to form a puzzle in the end. And international standards should fit in here as well. ■

Why systemic importance has a different meaning in insurance than in banking

Yann le Pallec - Executive Managing Director, EMEA Ratings Services, **Standard & Poor's**

In its quest to minimise future risks to financial stability, policymakers expanded the scope of systemic importance beyond the banking world. The predicament of AIG during the financial crisis probably has much to do with this in our view. However, AIG's profile was unique and its bail-out funds were mainly targeted at its shadow banking activities.

Other insurers have ventured into shadow banking activities in the past, particularly at times when traditional insurance profit margins were eroding. Some insurers also own banks or are owned by banks. We think it is appropriate that such insurers' activities should be scrutinised by regulators with financial stability considerations in mind. However, much of the machinery of banking groups' oversight (including group-wide SIFI designation, capital loadings and resolution plans) is also expected to be applied to insurers with limited recognition of their different business models, which generally do not result in liquidity stress or amplify contagion, and failed insurers can be resolved in an orderly manner.

Although insurance industry successfully argued that the traditional insurance model was not systemically risky, the FSB nevertheless designated nine of the largest global providers of traditional life insurance products as G-SIIs. This implies that named G-SIIs are involved in material 'non-traditional or non-insurance' (NTNI) activities and/or are materially interconnected with the financial system, in the FSB's view. However, there has been limited transparency on these assessments. Furthermore, the scope of NTNI has been drawn well beyond shadow banking.

Standard & Poor's differentiates between global and domestic systemic importance. We continue to recognize systemic importance in our bank ratings (by adding support notches), but not in our insurance ratings. This reflects our view that whereas many banks can expect to receive government support under stress, insurers cannot. ■

Insurers business model and systemic risk – A limited risk

Axel P. Lehmann - Group Chief Risk Officer and Regional Chairman Europe,
Zurich Insurance Group Ltd

The financial crisis highlighted the need to address systemic risk posed by financial institutions and establishing financial stability in the global economy. Using public funds to rescue firms is an unacceptable practice that incentivizes excessive risk taking, creates a large hidden public liability and angers the public.

Insurance, while not the culprit of the crisis, plays an important role in the global economy and as such is not immune from the measures being discussed around financial stability. Traditional insurance for natural catastrophes, accidents or death does not pose a systemic risk as these risks are idiosyncratic, conditioned on an event and independent from economic developments.

Indeed, traditional insurers with their long-term oriented investment model of matching their assets and liabilities have a stabilizing effect on financial markets. Nevertheless, insurers can become systemically important by engaging in "bank-like" activities that may be considered non-traditional or non-insurance activities. One example is the insuring of credit risk by issuing credit default swaps. As credit risk has a systematic component it cannot be pooled as traditional insurance risks. In addition, it creates a strong linkage to other financial institutions.

Measures to address systemic risk in the financial system, should recognize that unlike banks, insurers have different business models with unique characteristics. Size and diversification are strengths because they allow efficient risk pooling and spreading of risk. Furthermore, insurers may fail over many years because most payments are conditioned on a clearly defined loss event and thus resolvability over a weekend is not necessary.

Hence, regulation should not penalize insurance in general or create unnecessary additional resolution requirements. Instead, measures should focus on risk-based capital requirements that require insurers cover the risks of systemic activities with sufficient capital. Regulation should focus on sound risk management practices and asset-liability management to ensure an insurer is capable of meeting their obligations as they become due and that policyholders are protected. ■

Legal challenges and how to solve them

Felix Hufeld - Chief Executive Director,
Federal Financial Supervisory Authority (BaFin)

Currently international standard setters in the financial area are working on solutions for financial reforms. While some of them are representing authorities like IAIS, BCBS and IOSCO, others as FSB and G 20 consist of legislators.

But what happens if supervisors agree on rules that have to be set in law by legislators to implement them? A good example is the direct supervision of important insurance groups. If the IAIS comes to an agreement, jurisdictions need their legislators to implement the respective rules otherwise it does not work. The EU Commission is the lawgiving body in the EU. So it is possible to reach a maximum harmonization of new regulations in the EU, e.g. Solvency II. The problem is that the EU Commission is banned from the IAIS Executive Committee by IAIS By-laws.

In spite of this problem some ideas of bodies that have no legislative function should be picked up. The IAIS has made a significant step by developing a methodology for identifying G-SIIs.

In Germany, the suggested measures, such as the development of resolution and recovery plans can be based on the Financial Conglomerates Act. In addition, the development and implementation of Systemic Risk Management Plan and Liquidity Risk Management Plan should be seen as strengthening risk man-agement. This applies also for intensifying the supervision of G-SII by implementing a Crisis Management Group.


Credit photo : Schafgans DGPh BaFin

During the public consultation of ComFrame which started in October 2013, valuable comments re-garding Module 1 (Scope of ComFrame) and Module 3 (The Supervisors) have been received and are being considered by the IAIS. The first round of ComFrame's field testing is expected to start in March 2014 with the dispatch of a data call, followed by analysis and implementation of the results by the end of 2014. Besides, the IAIS is further converging towards a proposal for a Basic Capital Re-quirement (BCR) that can be tested in 2014. ■

G20 Commitments: addressing implementation inconsistencies

John K. Hughes - EMEA Head of Regulatory Reform, **Bank of America Merrill Lynch**

Strong progress has been made in implementing the G20 commitments, especially in the US and EU, but not without creating material issues for market participants.

These issues arise from local inconsistencies in implementing the G20 mandates, and in how local rulebooks apply extra-territorially. The cross border impact has caused decreased trading volumes, increased complexity and costs for global banks and clients, and a client pressure towards regionalisation. While some inconsistencies should be expected due to differences in legislative procedures and regulatory roles, they must be identified and resolved as the efficacy of these global reforms is at stake.

The EU and the US must resolve their differences expeditiously and demonstrate effective models of cooperation and substantive results to fast-emerging countries and regions. These are becoming less inclined to follow inconsistent EU and US rules, leading to potential further market fragmentation.

We think the following three examples need to be addressed.

Counterparty identification masking - a problem both under CFTC rules and EMIR: Firms are currently forced to decide between home or foreign enforcement risk, or cease business. Instead, the names of clients in these jurisdictions should be masked until regulators agree Memoranda of Understanding for data sharing.

EMIR Portfolio Reconciliation requirements: Asian clients must agree to the reconciliation process in order for EU-incorporated banks to fulfil their obligations. These banks may have to stop trading with a counterparty that is not subject to the regulation.

Reciprocity: this re-emerged in the final level one MiFIR/D 2 text in the context of third country access. While well intended, reciprocity is wide reaching in practical terms and greatly diminishes the regulation's potential, not least with the EU's largest trading partner.

As we look at the impact of these issues and others such as SEF trading, it is clear that we must develop a consistent framework for the cross border implementation of derivative reforms.

BofAML welcomes the recent creation of the IOSCO Task Force on Cross Border Regulation, for which we must set high expectations to resolve these issues and lay a better path forward.

Additionally, we would like to make a procedural suggestion; the EU ESA's lack a CFTC-like power to issue 'No Action Letters'. These have been very useful in the US to allow time extensions and mitigate adverse or unexpected impacts that are recognized only during implementation. Similar flexibility could be very useful in Europe, too. ■

Making OTC derivatives markets safer - completing the job in 2014

Mark Chambers - Member of Secretariat, **Financial Stability Board (FSB)**

Completing the agreed G20 reforms to OTC derivatives markets is a key FSB priority in 2014. This work consists of three broad categories:

- completion of remaining international standards by the November 2014 G20 Summit
- completing and implementing national reforms
- ensuring reform implementation is effective in meeting the G20 objectives.

Remaining international standards (such as banks' capitalisation of CCP exposures and FMI recovery and resolution toolkits) are on track to be finalised by end-2014, and legislative frameworks to implement reforms are in place in almost all FSB member jurisdictions. Implementation is most advanced in trade reporting: by end 2014 almost all jurisdictions will have some trade reporting requirements in effect. For central clearing: most large market participants' interest rate and credit derivative transactions are being cleared; client clearing is increasing monthly; and several large OTC derivatives markets (including the EU, Hong Kong, Japan, Singapore and the US) plan to have specific central clearing mandates in place by end-2014. Only a few concrete steps to promote trading on exchanges or electronic platforms have been taken, such as the CFTC requirements in the US. The EU's recent progress on settling MiFID II / MiFIR is a key step to driving more on-platform activity in coming years.

Differences in trading platform requirements are a recent example of why timely resolution of cross-border issues is vital. The progress and understandings between EU and US authorities as well as the ongoing dialogue of the OTC Derivatives Regulators Group are encouraging. This latter group will provide regular updates to the FSB and G20 meetings over the course of 2014 to maintain momentum in resolving cross-border issues.

Beyond reform design and national implementation, the FSB is increasingly focused on the effectiveness of reforms in supporting the G20's underlying objectives of improved transparency, mitigation of systemic risk, and protection against market abuse. An example is the FSB study group analysing whether the design and quality of transaction reporting can facilitate data aggregation within and across trade repositories. As the OTC derivatives landscape evolves in response to reforms, the FSB will continue to consider if further reform adjustments or international coordination are needed. ■

Regulatory convergence key to G20 derivatives reform

Andrew Douglas - Managing Director of Government Relations for Europe & Asia, **The Depository Trust and Clearing Corporation (DTCC)**

As jurisdictions around the globe continue to implement G20 commitments designed to improve the safety and transparency of the global over-the-counter (OTC) derivatives markets, it remains unclear whether policymakers will succeed in coordinating their efforts into a harmonised system of cross-border oversight.

The recent go-live of derivatives trade reporting under EMIR offers a timely example of cross-border regulatory divergence. Despite common commitments and the widespread belief that reporting to trade repositories can meaningfully improve the transparency of the derivatives marketplace, there remain considerable differences at the most basic levels of this obligation across jurisdictions.

For example, in the EU all derivatives – OTC and exchange-traded – must be reported to a trade repository by both counterparties to the trade on a T+1 basis. Meanwhile, US rules dictate that reporting take place in real-time, though the obligation applies only to OTC trades and only one counterparty is required to report. These are fundamental differences that will inevitably complicate efforts to aggregate derivatives data for the purpose of generating a comprehensive view of global exposures.

The regulatory divergence seen in global trade reporting regimes can in part be attributed to the flexible approach adopted by policymakers seeking to account for local market conditions. But this flexibility, ironically adopted in the name of achieving regulatory consistency globally, has nevertheless added to the list of cross-border challenges confronting policymakers today.

A common approach to resolving these differences is essential and progress has unquestionably been made thanks to ongoing regulatory dialogue. But until policymakers can act in a more collegiate fashion, overcoming sentiments of regulatory competition and the challenges posed by the lack of a common regulatory lexicon, the success of the G20 commitments will remain in doubt. ■

Update on recognition of third country CCPs to provide clearing services in the EU

Steven Maijoor - Chair, **European Securities and Markets Authority (ESMA)**

ESMA has received more than 35 applications for recognition from CCPs established in third country jurisdictions. Recognition by ESMA is required in order for such CCPs to provide clearing services to clearing members and trading venues established in the EU.

Certain conditions have to be satisfied before ESMA can recognise a third country CCP, including that the non-EU CCP is subject to an equivalent regulatory regime as the EU, that there are equivalent provisions regarding anti-money laundering and combating the financing of terrorism, and that the authorities responsible for supervising the third country CCP have established cooperation arrangements with ESMA.

The decision on whether a third country CCP is subject to an equivalent regulatory regime as that in the EU will be taken by the European Commission. In October 2012, the European Commission requested ESMA to provide technical advice on the equivalence of the regulatory regime for CCPs in a number of non-EU jurisdictions. Following receipt of ESMA's advice, the Commission is currently preparing its equivalence decisions, although as yet no equivalence decisions have been taken by the European Commission.

With regards to the applications themselves, ESMA is currently waiting for further information to be submitted by the applicant CCPs, in order for ESMA to be able to consider their application files complete. Once complete, ESMA will have nine months in which to take a decision on the application.

While progress in recognising these non-EU CCPs is currently in the hands of the non-EU CCPs and the European Commission, the process of recognition cannot be delayed indefinitely. An ultimate deadline for third country CCPs to become recognised is provided for in the EU's recently promulgated Capital Requirements Regulation, which will introduce higher capital requirements for exposures to non-EU CCPs which are not recognised by 15 June 2014 (with a possible extension to 15 December 2014). Furthermore, with EU CCPs having moved to compliance with the new EMIR requirements, ESMA is conscious of the risk of regulatory arbitrage between EU and third country CCPs. ■

Cross-border implementation and global consistency of regulatory requirements of OTC derivatives and bank requirements

Paul Swann - President & Managing Director, **ICE Clear Europe**

The implementation of the financial reform agenda has highlighted with unprecedented clarity the need for regional policymakers in the major jurisdictions to develop reforms together to ensure consistency. Although the G20 communiqué included a commitment to avoid regulatory arbitrage, no mechanism was put in place to achieve that and, with the best intentions, jurisdictions have diverged. Why else do we discuss this topic at every Eurofi seminar?

Faced with the reality of divergent rules, the concept of "equivalence" has been created. This has a political and a technical dimension. Politically it is important to recognise that other jurisdictions have created analogous laws and rules. Without this recognition cross-border business would stall, which is an outcome that no-one wants. However there is a tension between the desirability of declaring 'equivalence' and the reality that some rules are genuinely diverse in conception or effect. If the rules were truly equivalent, policymakers would be indifferent to which set of rules market participants choose to apply, and they clearly are not.

A system of recognition as equivalent serves two purposes: first it preserves international business and avoids fragmentation along regional lines. Second it encourages policymakers to align legal frameworks where they can. Yet it also creates the potential for impasse if regional policymakers cannot agree to resolve differences. For now, it is sufficient as a means to move forward. But it is not a long term structure.

The next challenge for policymakers should be to strengthen the international policymaking architecture. If there are ways to make rules more consistent at the formative stage, the process of granting equivalence need not be so fraught. No-one expects rules to be identical: different legal systems, democratic processes and supervisory structures will see to that. But as globalisation continues to intensify, and financial markets reflect and underpin that, regulation must also keep pace.

And policymakers have a duty to develop common answers to key policy questions, then resist the temptation to reopen those discussions during regional implementation. This will not be easy or quick, for it is a process of developing a shared respect for international agreements, which relies on every signatory remaining faithful to them. But it is necessary. ■

Providing for a coherent regulatory package – beyond national borders

Dr. Elke König - President, **Federal Financial Supervisory Authority (BaFin), Germany**

Credit photo : Schafgans DGPh BaFin

The global financial crisis exposed regulatory weaknesses across the board, and so the work that was and is still needed to repair this is similarly large-scale. The big challenge is putting together the various bits and pieces into a comprehensive, stable and coherent regulatory whole. When looking at any regulation, the question then is whether it will have unintended side effects and create false incentives.

Some side effects are obvious – for these, no impact assessments are needed. In the wake of the financial crisis the prime concern was closing the gaps in banking regulation that had been uncovered. It was inevitable that one of the results would be an attempt to dodge the new rules by moving on to greener pastures, i.e. less stringently regulated places such as the shadow banking sector, which therefore also needed and still needs appropriate regulation.

Equally as important as having a coherent regulatory framework is implementing it uniformly over national borders. When the G20, faced with the havoc wreaked by the crisis, entrusted the Financial Stability Board (FSB) and the global standard setters with the task of carrying out a general overhaul of the regulatory system, this move enjoyed far-reaching consensus internationally. Now that the work of regulation has been completed in large part and it is time to focus on its implementation, the common front risks being eroded in certain areas or by some countries. Redundant regulation that hampers the financial industry, go-it-alone national approaches, deviating and in some cases differing rules – all that undermines the idea of a level playing field.

Now, the FSB in particular has an onus to act. Together with the standard setters it must ensure that the G20 measures to regulate the financial markets are implemented fully, timely and uniformly. That is by no means an easy task, but one that can be fulfilled and is well worth the effort. Peer reviews are a powerful tool. Neither should the effectiveness of bilateral negotiations conducted in a spirit of trust be underestimated. The European Commission and the U.S. Commodity Futures Trading Commission (CFTC), for example, have indicated recently that they expect to resolve the remaining cross-border issues regarding OTC derivatives soon. ■

The path towards stable transatlantic financial market

Michel Barnier - Member of the European Commission responsible for Internal Market and Services

Financial markets are at the heart of our economies. If there is one industry which is globalised and inter-connected, and where regulatory inconsistencies can harm the wider economy, it is the financial industry.

In response to the financial crisis, the EU and the US embarked on a major overhaul of the financial regulation with the view to creating stable and resilient financial markets.

The responsibility for stable finance lies with all of us, regardless of nationality. This is why we have invested so much effort in designing the G-20 reform of global financial system. The G-20 standards give us direction and guidance. But they are not sufficiently precise to ensure coherent legal frameworks, which we need for financial markets to work efficiently and seamlessly.

The EU and the US already have regulatory discussions within the framework of the Financial Markets Regulatory Dialogue (FMRD).

However, in the post-crisis era where we have fundamentally upgraded financial regulation on both sides of the Atlantic, we must upgrade the mechanisms for regulatory co-operation.

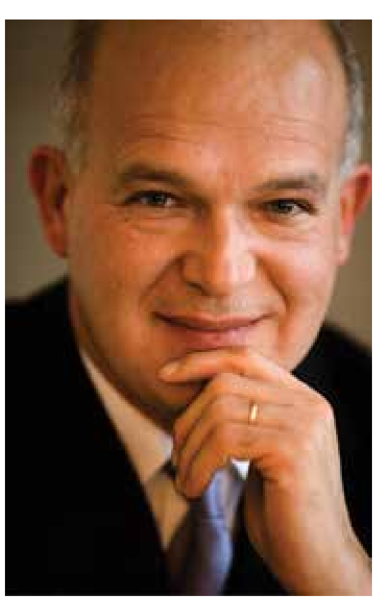
The EU therefore proposed that the Trans-Atlantic Trade and Investment Partnership (TTIP) establishes a framework for regulatory cooperation in financial services.

The EU proposes to establish a transparent, accountable and rules-based process which would commit the two parties to work together towards strengthening financial market regulation and financial stability.

The benefits of transatlantic cooperation are clear. We would strengthen financial stability, as potential problems would be spotted together and addressed jointly. We would significantly reduce instances of regulatory arbitrage. Furthermore, we would improve investor protection and the ability of the integrated financial system to provide financing to the real economy. ■

New rules should promote a level playing field in the banking sector

Séverin Cabannes - Deputy Chief Executive Officer, **Société Générale**



Much progress has been made in the implementation of G20 pledges, which was an essential task to rebuild confidence in the world financial system. However, risks of regulatory inconsistencies remain across regions.

Going forward, it is crucial that such risks be addressed, in order for banks to compete on a level playing field, and for European banks to be able to finance the economy in a competitive way. Much is at stake for Europe: having strong banks is a matter of economic sovereignty.

Among some of the most striking examples of regulatory discrepancies are the Fed rules for non-American banks operating in the US. By forcing foreign banks to comply with specific capital and liquidity requirements at their US operations, these rules will prevent them from managing their liquidity and capital positions on a global basis, thus creating a competitive disadvantage for European banks.

Uncoordinated structural banking reform proposals also threaten to create an unlevel playing field. Some national initiatives, such as the recently approved French banking law, have managed to strike a balance between preventing excessive risk-taking in market activities and the need to finance the economy. But going further, as envisaged by some in Europe, by ring-fencing market-making, would hinder the ability of European banks to help their clients raise money or hedge their risks on capital markets, at a time when Basel III rules are prompting the emergence in Europe of a more disintermediated financing model.

International comparisons between banks can also be misleading: five out of the world's ten largest banks are European according to the size of their balance sheet, but behind that metric lie radically different business models and accounting rules. For example US banks can sell off their prime mortgage loans to state-backed agencies like Freddie Mac and Fannie Mae something European banks can't do.

Instead of launching new reforms that risk further deepening differences between banking models, ensuring a fair implementation of the Basel III framework, and putting the European banking union firmly on track, which will be key in cementing confidence in the European financial sector and in restoring its growth potential, are now priorities. ■

Unintended consequences resulting from inconsistencies in RRP regimes

Andrew Simmonds - Group Head, International Balance Sheet Management & Group Projects, **Standard Chartered Bank**

Internationally aligned RRP regimes will have substantial benefits, but only if they are based on a clear set of consistent principles and national regimes are coordinated to avoid unintended consequences.

The FSB recognises the "unintended consequences" of the recent banking reform in a report ("Monitoring the effects of agreed regulatory reforms on emerging market and developing economies") published in September 2013. Any such deviation from the internationally agreed principles creates a less effective regulatory environment within which financial institutions have to operate. There are many examples but this article highlights two.

The first relates to Article 50 within the EU Bank Recovery and Resolution Directive ("BRRD") that highlights the different national approaches to the scope of liabilities eligible for bail in. The US for example focuses on capital and long term unsecured debt issued from domestic holding companies to comprise the necessary Loss Absorbency Capacity. The BRRD adopts a much wider scope for bail in covering all liabilities, with a few limited exceptions. Since Article 50 enshrines Europe's desire to ensure equitable treatment of creditors wherever located, it consequently imposes on all EU Bank branches outside EU a legal requirement to insert contractual amendments in third country liability contracts. This creates substantial regulatory, operational and financial friction and potentially material commercial disadvantage for such EU banks relative to non-EU competitors.

The second example is where inconsistent loss absorbency requirements increase systemic fragility. RRP regimes have been accompanied with requirements for higher loss absorbency to ensure a firm can be recapitalised post failure. But the level of required recapitalisation expected is different across jurisdictions.

The lack of a commonly agreed standard will oblige each local regulator to stay in step with the highest prevailing recapitalisation requirement and so push minimum levels ever upwards. Banks will compensate by holding as little capital above the minimum requirement merely to limit the high costs of recapitalisation and the financial system will be rendered less shock absorbent as a result.

As Asian and other regulators proceed to introduce RRP regimes, they should reflect and consider the potential unintended consequences resulting from the application of national rather than global standards for capital and loss absorbency. ■

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New commission, old challenges

Michel Madelain - President & Chief Operating Officer,
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It is likely that the key priorities for the forthcoming EU Commission will have much in common with those of the current. In his last State of the Union speech, President Barroso emphasised that while Europe has come a long way, the crisis is not over and the job is not finished. We agree.

The resolution of the crisis, and a return to long-run financial and economic stability, will rest on progress in three areas: structural economic reform to enhance medium term growth; reduction of public and private sector debt burdens to sustainable levels; and institutional reform to enhance the cohesion and integration of Eurozone fiscal and economic policy.

There has been progress on each. Recent rating actions have reflected reforms in Ireland, Spain, Portugal and elsewhere to improve competitiveness, enhance financial sector resilience and reduce the government footprint. But significant challenges remain, including in parts of the euro-core, to lift medium-term trend growth. Public sector debt growth has slowed and in some cases reversed, and household, corporate and financial debt burdens have declined. But debt burdens remain high in many countries and the deleveraging process continues to impede growth. Regulatory integration proceeds apace with the Banking Union. But earlier plans to achieve fuller fiscal and economic integration have to date been largely scaled back to a revamp of coordination and surveillance processes.

Looking further back, the priorities set out in the Europe 2020 initiative – smart, sustainable, inclusive growth based on economic reform and enhanced R&D and education – are no less relevant as the crisis diminishes than they were at its inception.

The new Commission will want to promote further progress in all of these areas, speeding up the pace of structural reforms and completing the Banking Union. Like its predecessor, it will need to balance restoring the health of the financial sector through tighter prudential standards vs preserving the flow of credit for growth. Over the long term, stability and growth may be complementary. But over the shorter term, with recovery in sight, policymakers' choices on e.g. banking, insurance and financial services regulation, infrastructure financing or the development of SME finance will affect the real economy.

Moody's does not make policy recommendations; we only assess the credit implications of policy choices. From that perspective it is clear that, however important are the achievements to date, much remains to be done. ■

Long term investment, sustainable growth and jobs: try saver protection!

Guillaume Prache - Managing Director of Better Finance For All,
The European Federation of Financial Services Users

"Households are the main source of funds to finance investment". So says the Green Paper on the long term financing of the EU Economy. But it then points out that those households have been shying away from equities and prefer short term savings.

However Households have mostly long-term saving goals (home purchase, children education, retirement, etc.). If their share of the ownership of the EU economy has indeed gone down from over 40% to 13% in the last four decades while that of EU investment funds has gone up from 5% to 25 % (financial capitalism replacing economic capitalism, as illustrated – for example – by the *"Kay Review"* in the UK), it is often because they have been pushed to do so by intermediaries, by the fragmentation and *"re-intermediation"* of capital markets, by market abuses estranging them more and more from capital markets, and by tax incentives.

If they happen to use short-term savings for long term needs, it is because of the *"often poor performance of intermediaries to deliver reasonable returns"* (dixit EC) for "packaged" long term products such as pension funds and the like, and again by tax incentives.

What to do then for households to provide adequate long-term savings for the real economy: ensure they get a reasonable return or at least do not become poorer in real terms. How?

First: return capital markets to their natural participants – end investors and non-financial issuers: promote equities and shareholder engagement, and improve the governance of listed companies and investment intermediaries.

Second: improve and harmonise saver protection for all long term and pension investment products, and provide access to unbiased financial advice.

Third: further improve European financial supervision and the enforcement of existing investor protection regulations.

Fourth: stop tax discrimination against EU savers. Adding insult to injury, the IMF proposes to strip savers of 10% of their net financial worth. *"Let's tax vice instead of ransoming virtue like it is done in modern republics"* (Albert Camus, Nobel Prize of literature, 1957). ■

Financial market regulation needs to support growth and job creation

Hans-Ole Jochumsen - President, NASDAQ OMX Nordic & Executive Vice President, Transaction Services Nordics, **NASDAQ OMX**

Europe is slowly showing signs of recovery. Growth and job creation is a key priority for politicians all across Europe. Thereby it's also crucial that growth and job creation are the overall objectives when regulating the financial markets.

The main function of the securities exchanges is to secure efficient fund raising and risk distribution for all sectors of the economy. Research shows that IPOs create jobs.

Furthermore it allows companies to grow independently, and thereby it supports the retention of intellectual property gains in the local economy. It also gives investors, including retail investors, a possibility to take part of the productivity gains in different industries.

That's why it would be important to see regulatory measures hit the right targets and incentivise IPOs. Regulators need to acknowledge that the securities exchanges are part of the solution. Transparent markets have helped contain the crisis.

Although the MiFID agreement is broadly a good thing for financial markets, there are some key issues to iron out to ensure that regulation is hitting the target and supports SME growth. The Commission is focusing a lot on refurbishing securitization, which was the very core of the financial crisis, but there is currently not enough attention paid to fund raising.

The long term trend, as shown by the OECD research paper, is that the number and volume of IPOs is declining. Europe must prioritize IPOs and promote incentives for companies to go public.
Some specific measures need to be addressed:

- Initiatives to promote active investment and ensure that pension funds to a significant extent invest in high performing EU listed companies and SMEs.
- Tax incentives for investments in listed SMEs.
- Foster the use of EU structural funds to support funding of SMEs not only in the seed phase but also when they grow and want to tap public markets.

With a common goal of achieving growth and job creation, I'm convinced that Europe will recover and that the exchanges will be a vital part of this challenge. ■

Much has been done, more is to do

Sylvie Goulard - MEP, Committee on Economic and Monetary Affairs,
European Parliament

The situation is improving but we should not allow this to blind us: there is much more to do. The biggest challenges are probably to realise the financing needs of the real economy and to reduce inequalities. This challenge raises a wide range of further stakes. Long-term investment has been the concept continuously repeated by political leaders and investors and yet little has been achieved concretely, with perhaps the exception of the famous and painful "Omnibus 2" dossier with the long-term guarantees package in the field of insurance. The proposal on European Long-term Investment funds was presented late in the mandate and more work needs to be done by the two co-legislators.

Another stake is to make the financial system more consumer-friendly, which would enable it to attract more funds and to soften the near-dogmatic risk aversion which currently hangs in the air. Risk-free products do not cover the funding needs nor the expected return on investments of consumers. Diversification of funding, information, transparency and proportionate risks are a combination which needs to be focused on in order to fuel more funding. To revive the internal market it is essential to move from words to actions: even Member States that used to be in favour of the internal market now use this argument to build fences. The recognition of clusters within the EBA sadly illustrates this. The revival of the internal market would also help to reduce the fragmentation that is harming Europe's SMEs the most.

Finally, one must really break the links between the financial services industry and political leaders: this means that work is needed on governance and on sovereign debt financing.

For the past 5 years, the Commission has spared no efforts to act and produce proposals, even though one may have preferred speedier actions on some issues, sometimes bolder proposals or even (the threat) to withdraw the proposal if the legislative process would have significantly transformed the ambition of its original proposal. At the time of writing these lines, a number of critical issues like Indexes and Benchmarks or the Money Market Funds have not been settled. This is a sign that continued or renewed efforts are necessary.

Besides the content of the financial industry legislation to come, the new Commission will have other types of challenge: to continue and deepen its close cooperation with the new Parliament, pressure the Council to face reality and live up to the commitments of the European Council and last but not least to receive the recognition by the citizens of the effectiveness and legitimacy of European decisions. ■

Protect investor rights, foster economic growth

Barbara Novick - Vice Chairman, **BlackRock**

Investors need to trust that their rights will be observed, that the investment advice they receive is in their best interest and that the structure of capital markets will support their investment. Investors' trust in the financial system was shaken by the 2008 crisis, which revealed weaknesses related to the quality of advice, the sale of products inappropriate to investor needs, and lack of transparency and information. Today, they are equally concerned by challenged liquidity in a variety of markets and proposals that would use client money to prop up failing central clearing counterparties. At a time when investors are bearing increasing responsibility for their financial futures, not investing is simply not an option–both for the financial security of investors and the overall health of the global economy. As such, investors need a robust regulatory regime that protects their rights and fosters the efficient functioning of capital markets. Importantly, protecting investors does not mean prohibiting them from taking on investment risk. Rather, it means proper risk management and understandable disclosure.

Effective regulation to foster economic growth and build greater resilience to market volatility must take the needs of end-investors into account. BlackRock believes the key regulatory building blocks include transparency, investor protection, and facilitating responsible growth of capital markets, while preserving consumer choice and assessing benefits versus implementation costs. Rather than focusing on whether investment in liquid or illiquid assets is the best way to drive economic growth, the focus should be on ensuring that investors can manage both long-term and short-term liabilities. Sustainable growth will come from capital markets which are consistently able offer a suitable mix of instruments, from corporate bonds to infrastructure, to meet investors' needs. The greater the policy focus is on delivering a supportive regulatory framework, the greater investors' ability will be to invest in assets which support long-term growth. ■

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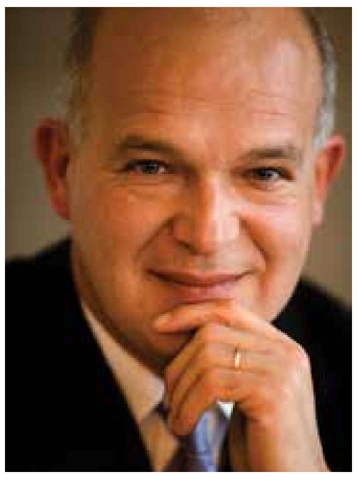
Suggesting key priorities for the forthcoming EU Commission

GR 2014 eu
Hellenic Presidency of the Council of the European Union

Building the right regulatory framework to support growth

Séverin Cabannes - Deputy Chief Executive Officer, **Société Générale**



The 2009-2014 mandate of the European Commission has been marked by the intense reshaping of the European banking sector: the Commission delivered on most of the G20 commitments to reform the European banking sector and has laid the groundwork for the banking union, which will be a cornerstone to strengthen European economies.

Europe top challenge is now to foster its growth potential, to create new jobs and reduce unemployment. While the current reforms have strengthened the European financial sector solidity and reduced drastically the systemic risk in Europe, any future reforms should focus on growth and employment.

A first challenge will be to concretely implement the banking union. It represents a huge technical, organizational and reputational challenge for Europe. The banking union will be a key to restore and reinforce European growth potential. Moreover, to accompany European firms in their international development, pan-European financial institutions must be able to emerge among the circa 9000 banks in Europe. The forthcoming Commission must encourage this evolution through an adequate regulatory framework and the deepening of the single market. If not, the only alternative would be for European firms to work with larger American or Asian banking groups.

A second important step will be to accompany the transition towards a new financing model for the European economy. Indeed, regulatory reforms encourage greater reliance on capital-market financing. Since early 2009, the substitution of bank credit in the financing of non-financial institutions by alternative debt instruments is clearly visible. However, access to funding remains potentially problematic for institutions or corporates unable to tap capital markets (as SMEs).

The construction of a high quality, unified, securitization market in Europe will be a key in this new context. The Basel III driven evolution of the European corporate sector financing mix could become more difficult to accommodate if inappropriate regulations limit the capacity of universal banks to provide holistic financing solutions to their clients. Moreover, the project of establishing a tax on financial transactions (FTT) in some European countries will hinder the development of capital markets and ultimately reduce European financing capacity and growth potential. ■

Regulation is not a substitute for good governance

Etienne Boris - Senior Partner, **PwC**

The financial system has been reinforced as banks reacted to the crisis and through new regulations. Tightening bank regulation was necessary. Yet, confidence is not fully restored and it will not be by piling up additional regulations. Excess regulations create a false sense of security and ignore the critical importance of governance, culture and behaviors.

In the EU some 30 pieces of legislation have been introduced since early 2010. The new Capital Requirements Regime stretches to some 436 pages of text, 686 articles, and 198 implementing measures or guidelines. The new MiFID II regime will require over 100 implementing measures. That's without Solvency II, AIFMD, CRA, BRRD, Corporate Governance code of conduct and many other principles, recommendations, guidelines, etc. The whole regime in Europe has undergone a fundamental, quintessential overhaul. Those regulations generally cover quantitative criterions. Yet, as recognized by behavioral economics and finance, human behaviors are not always rational but influenced by emotional choices. This is also recognized in the FSB thinking: *"At the crux of this supervisory*

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IORP Directive review should be top priority for European Commission

Xavier Larnaudie-Eiffel - Deputy General Manager, CNP Assurances & Chief Executive Officer, **CNP International**

Insurance companies are, like pension funds, important providers of occupational pensions. Both insurers and institutions for occupational retirement provision (IORPs) offer long-term guarantees and engage in long-term investments. It is therefore important that both types of providers are subject to appropriate rules, in order to guarantee a high degree of protection to policy holders.

For insurers, such high policyholder protection standards will result from the forthcoming Solvency II framework that will introduce a common European risk-based regulatory regime for insurance companies as of 2016. Solvency II will cover all activities of insurers, including in the occupational pensions area.

On the other hand, a review of the IORP Directive is long overdue. Beneficiaries could thus be exposed to different levels of risk from similar products with a long-term guarantee, depending on the type of provider and legal context.

Solvency II can be used as a basis for the review of the IORP Directive, provided that the outstanding issues in Solvency II are appropriately resolved and that the specific characteristics of pension funds are taken into account. Such an approach would not only lead to a high level of protection for all beneficiaries of occupational pensions, but would also ensure a level regulatory playing field for insurers and pensions funds.

The revised IORP Directive should include quantitative, qualitative and reporting elements - the first, second and third pillars of Solvency II. While all pillars are essential, the third should not be neglected, as providing high-quality information will allow policyholders to make informed decisions about their retirement plans. Any differences in providers or products should be made apparent to the beneficiaries periodically, in a clear and understandable way.

Given the imminent introduction of Solvency II, it is of the utmost importance that the European Commission treats the review of the IORP Directive as a priority. ■

Recommendations for the future EU regulatory regime for retail payment services

Giovanni Angelini - Senior Vice President and General Manager for the European Union, **Western Union**

In times of rapid technological advancements and related changing consumer behaviour it is important to adhere to guiding principles when refining the future regulatory regime for retail payments. Amongst these principles are legal certainty, consistency, proportionality, technological neutrality, the promotion of the Single Market and the fostering of financial inclusion.

Specific initiatives to strengthen the future EU retail payments market should include:

- Creating a common supervisory framework for non-bank payment providers. The competences of EBA and of the ESA Joint Committee should be enhanced. I welcome EBA's role under the revised PSD and AML Directives. The EBA needs to be given the resources to effectively fulfil these new functions and specific non-bank stakeholder groups should advise it on payment and AML matters.
- Giving the European Retail Payments Board (ERPB) political focus. The ERPB should start its work swiftly and have broad and balanced representation of all EU payment sectors. The ERPB should ensure the consistency of policy objectives, promote legal certainty and evaluate whether the EU payment regulatory framework meets its objectives.
- Preparing for the increasing digitalization of commerce and payments. The rising digital economy needs adequate online identification procedures which are readily available to both account-holding as well as transactional PSPs. EU-wide harmonized electronic identification and –authorization tools need to be developed to better support the growing field of digital non-face to face transactions.
- Holistic approach to EU remittance regulation. Remittance services are affected by a multitude of regulatory initiatives at EU and international level (e.g. FATF). The compliance bar is rising in various areas: AML, data protection or security requirements to name just a few. How do these rules interact and what market impact to they have? Many non-bank remittance operators have lost their bank account or cannot open one. What incentives are being created for stakeholder in the remittance market? It is time for a holistic approach to remittance regulation, starting with the European Commission which should identify a unit in charge of remittances. ■

Don't shoot into your own foot, Europe!

Karl-Peter Schackmann-Fallis - Executive Member of the Board, **German Savings Banks Association (DSGV)**

A flood of regulation threatens the role of European banks as intermediaries between depositors and the real economy. In post-crisis European politics we observe an increasing tendency to turn away from conventional and traditional models of financing the European economy and a preferred orientation by policy makers towards capital market oriented systems as they are dominant on the other side of the Atlantic. I plea to continue our successful Continental European financial culture.

We feel that European legislation and regulation is trying to deliberately implement elements into the European financial system that have a detrimental effect on the European way of financing. In the last couple of years we have seen a continuous disadvantaging of traditional corporate finance by "punishing" balance sheet-based supply of financial products to the real economy, an increasingly heavy regulation on bank loans, soaring capital requirements, liquidity standards with a tendency to "punish" corporate finance and the essential banking function of maturity transformation, an unmasked sympathy for capital market driven forms of finance (as expressed in the EU-Commission's Green Paper and recently by the Commission's Communication on long-term-financing of the European Economy), aiming at "pushing back" the house bank principle.

These policies could threaten the smooth functioning of European finance, could cause tremendous problems for the real economy, especially for financing the small and medium sized enterprise sector, and could ultimately undermine the economic basis for our European social and economic model.

We are not against opening alternative ways of finance in Europe by using capital market based instruments. But we plead to regard these purely as complementary elements, opening up and widening the opportunities on the basis of a European Economic Model and its mainly bank-based financing of the economy that has developed over centuries and that has facilitated the development especially of our SME sector very well. We should not saw off the branch we are sitting on, Europe should not shoot into her own feet. ■

What should be the main priorities of the forthcoming EU Commission in the financial services area?

Pervenche Berès - Chairwoman and MEP, Committee on Employment and Social Affairs, **European Parliament**

The main priority of the upcoming EU Commission in the field of financial services has to be the structural reform of the banking sector and to prevent the excessive concentration of risks within a few "too big, too complex and to interconnected" banking institutions. To this respect, the recent proposal of the Commission is going in the good direction but has been put on the table too late: I consider that it would have been necessary to propose it earlier in 2010 in the aftermath of the financial crisis.

I hope that a new progressive majority in Europe will be sufficient to get from the European Commission an ambitious proposal on mutual societies which have proved to be resilient during the massive economic and financial turmoil we experienced, notably due to their specific democratic governance and their long term approach. Regulations of the European supervisory authorities have to be revised in order to ensure a more direct and comprehensive intervention at the community level to ensure a level playing field approach aiming at preventing fragmentation of the markets and at enhancing the effective protection of retail investors.

From an institutional perspective, I can only hope that the European Commission will now demonstrate a more proactive attitude with respect to the defense of the interests of retail investors and consumers, as I have experienced it with the proposal for regulation on Key Information Document for Investment Product (KIDIP), where its initial choice was to limit the scope of understandable information for the only packaged - and complex- products!

Finally, time has come for a genuine change of institutional paradigm for the Commission by stopping to act as the general secretariat of the European Council which has demonstrated the failures of its intergovernmental logic: due to the so-called efficiency and reactivity of governments, the European Union only get a non-satisfactory "too many, too late" process unable to close the gaps of the banking and the financial regulation and to achieve the rebuilding of the financial market allowing a long term financing of the real economy. ■

Ensuring reasonable regulation of SME / midcap financial instruments

Dr. Elke König - President, **Federal Financial Supervisory Authority (BaFin), Germany**

Credit photo : Schafgans DGPh BaFin

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Small and medium-sized enterprises (SMEs) are the backbone of the European economy. Traditionally, they are financed primarily through their principal banks. Like the SMEs themselves, these banks benefit from the privileges of the "package for small and medium-sized enterprises" which has been enshrined by the Basel Committee on Banking Supervision in the Basel II framework and which lives on – without any fundamental changes – in Basel III. The European Union is even more generous than the Basel Committee: in the implementation of Basel III, it effectively exempted loans to SMEs from certain aggravations posed by the new accord.

Despite these privileges, since the global financial crisis many of these companies have started – voluntarily or unvoluntarily –to look at other financing forms in addition to traditional bank loans. More and more companies are therefore turning to the capital markets – which basically is to be welcomed because this broadens their financing basis. That said, resorting to the capital markets involves high costs. For small companies, the limits of what is feasible are quickly reached. The bigger the company is, the more it is able to cope with the cost burden. For midcaps, it may well be rewarding to carefully establish the know-how and capacities needed for such a move.

However, coupons on the market for SME bonds are witnessing an increasingly larger spread. As far as their size, industry and financing requirement are concerned, issuers are also becoming increasingly heterogeneous. Added to this is that in Germany a number of economically distressed companies with questionable or little diversified business models have been seen tapping the so-called gray market or issuing bonds which, despite seemingly good ratings and the well-sounding label "Mittelstand", have defaulted within a short time.

The financing of SMEs therefore also affects investor protection. Transparency and comprehensibility of investment offerings are, thus, key and a lot of discussion takes place right now in Europe and Germany. What possibilities might be considered? For one thing, the ad hoc obligation could be expanded. A prospectus obligation for offerings hitherto exempt from such publication requirement might also be helpful. A product classification might show investors how complex and risky an offering is and the investment horizon for which it is suitable. Moreover, certain products may be distributed only via authorised institutions or undertakings.

Markets for SME loans need to broaden for sure, but we also need to consider the soundness of offerings from the private investors' perspective. ■

Financing the recovery: issues and policies

George Provopoulos - Governor, **Bank of Greece**

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What can policymakers do to restore adequate financing conditions for the economy?

In the short term, a key policy action is to ensure that banks resume their role as financiers of corporate activity and investment, especially in those parts of the corporate sector which rely more heavily on banks.

Given the limited amount of resources, it is important that they are used to finance high-productive, export-oriented firms and sectors in order to improve allocative efficiency of economic resources. To the extent that creditless recoveries are suboptimal outcomes associated with impaired financial intermediation, policies should aim at recapitalizing weak banks, addressing market fragmentation and relaxing credit constraints of banks to cushion the effects of deleveraging on the economy.

As a long-term strategy, developing market standards will allow equity and bond markets to gain ground. This will increase available funds for long-term investment, contribute to long-term sustainable growth and increase the resilience of the corporate sector during periods of banking sector stress. The development of a deep EU securitization market for corporate loans will provide capital relief to banks, improve risk sharing and increase banks' lending capacity. ■

A holistic approach toward unlocking financing for long term investment

Thomas Groh - Deputy Assistant Secretary, Insurance Division, Directorate-General of the French Treasury, **Ministry of Economy and Finance, France**

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The financing of long term investments is a multifaceted issue. We must address the long-term financing challenge in a comprehensive way, taking into account all the issues at stake.

On the supply side, a crucial aspect relates to the ability of the financial system to effectively and efficiently channel household savings to long-term investments. Financial regulation, provided that it is well-designed, should not restrain long-term investments.

This encompasses many topics, from the ability of banks to arrange these transactions and contribute to their financing to enabling capital market financing and ensuring institutional investors' effective ability to step in as long-term financing providers (within an prudential framework that effectively reflect the specificities of these asset classes and through the development of the necessary skills and expertise to manage these assets and the related risks). This also includes the availability of suitable financial hedging products that play an important role in some areas (such as project finance) or the need to ensure that accounting standards to the long-term investors are congruent with their business model.

However financial regulation is only one of many influences on the provision of long-term finance.

On the demand side, there is a need for ensuring a strong pipeline of viable long term investments. Other key factors such as regulatory and fiscal predictability, legal certainty (and contractual enforceability), etc. are often pointed out by practitioners and appear to strongly affect demand factors.

From a more comprehensive perspective, long-term financing issues (especially green growth) also relate to price signals such as tax incentives or could require targeted public schemes designed to unlock private financing consistency in a consistent and sustainable manner. ■

Promoting growth-orientated financial reforms: a universal bank perspective

Jean-Paul Chifflet - Chief Executive Officer, **Crédit Agricole S.A.**

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Last but not least, banks have increased transparency, strengthened their corporate governance and improved crisis prevention and management tools, thereby anticipating the new "banking crisis resolution" regime that regulators and policy-makers are currently shaping up.

Clearly, all these improvements are welcomed steps. However, it is equally critical that the right balance is struck so that regulatory reforms do not end up unduly hampering the financing of the real economy. Indeed, whilst adjustment is necessary, it also bears a cost and generates market uncertainty. This is particularly true for liquidity which remains a critical issue for banks and the financial system as a whole. In this context, it is important in our view that regulators and policy-makers move from purely "constraints-based" financial reforms towards more "growth-orientated" measures. In order to achieve this, authorities should consider the following priorities: First, give sufficient time to financial institutions to implement the complex set of G20 reforms. Before adding a new layer of regulation, authorities should take stock of existing rules and ensure these have been correctly and consistently implemented.

Second, make sure proper impact assessment studies (cross-sectoral and cumulative) are conducted to estimate the benefits and costs of regulation, not just on the financial sector, but on the economy as a whole. The impact of the liquidity ratios (LCR and NSFR) as well as leverage ratio should be assessed as a priority since their final calibration is likely to have a very far-reaching impact on the financing of the real economy. As a general principle, liquidity and capital requirements should be assessed against the risk profile of financial institutions, in line with the Basel 2 philosophy. The interaction between Basel 3 and the Solvency 2 regime should also be carefully looked at.

Third, preserve the diversity of the European banking and financial landscape through proportionate rules and careful consideration of the specificities of European banks' business models.

Finally, policy makers should aim to find a healthy balance between safe financial systems and economic growth. Financial firms should remain competitive and innovative within a framework of long-term and stable growth. In this context, a special focus should be put on the re-launch of healthy securitization markets, a key channel to re-boost the financing and growth of the European economy. ■

Regulation is not a substitute for good governance

Etienne Boris - Senior Partner, **PwC**

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approach is an understanding, by both the financial institution and the supervisor of the institution's risk culture, in particular whether it supports appropriate behaviors and judgments within a strong risk governance framework".[1] Experience, competencies, courage and diversity that are crucial to good governance need to be assessed by supervisors. A safe and sound corporate governance, culture and appropriate behaviors do not result from an accumulation of quantitative rules.

The quality of governance and in particular the composition of Boards is impacted by regulations and codes of conducts. As shown by the 2013 PwC Annual Corporate Directors Survey, regulations didn't prove successful in increasing investor protections or increasing public trust in the corporate sector. Also, an analysis of Boards' composition of 15 major European Banks shows an increased proportion of specialists. They have doubled in the last 10 years from 15 to 30% at the expense of experienced senior executives. The proportion of experienced decision-makers in complex and international environments is decreasing at a pace that is ominous for the quality of governance.

Regulatory stability is needed while more focus is put on reinforcing the importance of quality-governance, culture and behaviors. Recognizing the crucial importance of such qualitative soft criterions for financial stability and assessing them imply that supervisors must take responsibility for making such judgments. That goes beyond assessing compliance with rules and is a challenge not to be underestimated. The architects of the EU single supervisory mechanism must fully recognize this as the proximity required to make sound judgments will naturally be challenged. In a context of general sense of deresponsabilization characterizing our modern society, this clearly is a gauntlet we collectively need to pick up. ■

1. FSB, Guidance for more effective supervision of risk appetite and risk culture at Financial institutions (18 november 2013) – Consultation open until 31 January 2014

Europe's next challenge: financing growth

Michel Barnier - Member of the European Commission responsible for Internal Market and Services

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The completion of the Banking Union is the core element of the EU's response to reducing fragmentation. To foster alternative sources of finance the Commission will publish in March a Communication on long term financing which will present a set of actions in order to: mobilise private sources of finance, making better use of public funding, developing European capital markets, improving SMEs access to financing, attracting private finance to infrastructure delivering on the Europe 2020 objectives, and enhancing the framework for sustainable finance. ■