eurofi

The Eurofi Financial Forum 2014

italia2014.eu

NEWSLETTER // 10-11 & 12 SEPTEMBER // MILAN

FINANCING OF THE EU ECONOMY

Economic and growth challenges in the EU 2
Revitalising securitisation in the EU 6
EU corporate bond and equity markets 9
Long term investment 10

FOSTERING FURTHER EUROPEAN INTEGRATION

Implementing the Banking Union 12
Towards a fiscal union? 14
EU regulatory and supervisory institutions 15

EU BANKING AND RETAIL FINANCIAL SERVICES REGULATION

Regulation of the EU banking sector 16
Electronic financial and payment services 18

EU CAPITAL MARKETS REGULATION

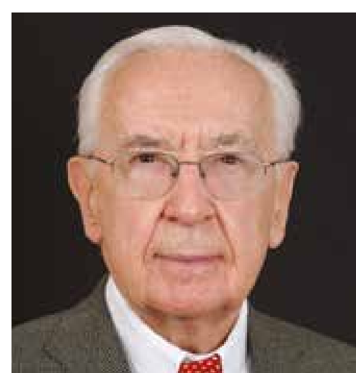
Securities and derivative trading and post-trading regulation 20
Financial Market Infrastructures Recovery and Resolution 22
Asset management and shadow banking regulation 24

FINANCIAL REGULATION AT THE GLOBAL LEVEL

Structural banking reforms 25
Bank crisis management at the global level 26
Global insurance regulation 28
Global market regulations 30

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

Jacques de Larosière - President, **EUROFI**



At a time when Member States are justifiably working to reduce their budget deficits, with constrictive impacts on the eurozone's economy, there is an urgent need to address the reduction in lending to businesses, particularly in the eurozone (-2.3% in June 2014 year-on-year) following 2 and a half years of decline.

Yet the bank-lending channel of the monetary policy, which is seeking to promote growth, has been held back since 2012 by several factors including the updated regulatory constraints of CRD IV and the weak level of profitability of banks.

As it reduces banks' balance sheets securitisation appears to be the most promising instrument to help provide additional sources of financing to SMEs, which are very dependent on bank financing.

... continued on page 8

Can structural reforms relaunch economic growth in the EU?

Pier Carlo Padoan - Minister of Economy and Finance, Italy

Growth remains very low or negative and joblessness is despairingly high in most EU countries. Expected recovery fails to materialize, with risks of growing divergences between and within Member States. Establishing the conditions for an increase in potential growth becomes a key strategy to exit stagnation and make progresses in terms of social cohesion, financial stability and fiscal sustainability. We are at a turning point. What can be done?

The focus on structural reforms is the cornerstone of a new policy agenda that requires looking at both demand and supply issues. Reforms are the key drivers of supply and they are the responsibility of national governments. Reforms and the innovation they spur are the major driver of growth, and productivity especially if the reform effort is wide-ranging at national

... continued on page 4

Regulators at a crossroads

Henri de Castries - Chairman & Chief Executive Officer, **AXA Group**

Public authorities have moved expeditiously to reform the financial sector over the past five years. While the focus has been primarily on banking, progress has been made in other areas too. Examples include the Solvency II framework, which should result in even greater financial soundness of European insurance firms, and the new Insurance Mediation Directive, which will help policyholders get best value for their money.

But despite such major breakthroughs, regulatory momentum shows no sign of slowing down and is entering more questionable territory. In particular, the push on systemic risk for insurance by the Financial Stability Board and the International Association of Insurance Supervisors might do more harm than good, especially if there is no clear understanding of what systemic risk might entail in the insurance industry.

... continued on page 5

Credit photo : Seignettelafontan.com

Setting new priorities for EU financial sector legislation: target growth!

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

The regulatory reforms adopted in the wake of the 2008 crisis have radically changed the European and international banking landscape and financial system. Banks have largely anticipated these changes by substantially increasing their level of core capital whilst at the same time boosting their liquidity reserves and reducing their exposure to risky activities. They have also developed more solid risk management policies and markedly improved their crisis prevention tools. Combined with the implementation of the *Banking Union*, these unprecedented changes are today significantly contributing to making the EU a robust international financial place.

... continued on page 17

How resilient can we say our financial system is 6 years after the financial crisis?

Terry P. Laughlin - President of Strategic Initiatives, **Bank of America**

When talking about the resilience of the financial system now as opposed to 2008, we should not underestimate the immense amount of work and progress that has been made. These measures include intensive and effective supervision, recovery and resolution frameworks, a reduction of interconnectedness in the financial system particularly in the OTC derivative market and increased macro prudential supervision. Large banks have re-evaluated their own business strategies and operating models and introduced higher capital requirements and liquidity levels.

After the financial crisis, the issue of firms seen to be too big, complex or interconnected to fail was right at the top of regulators' reform agendas on both sides of the Atlantic.

... continued on page 5

Financing growth: a priority for European policymaking

Vittorio Grilli - Chairman, Corporate and Investment Bank EMEA, **J.P. Morgan**

The next European Commission and newly elected European Parliament have an opportunity to pursue policies aimed at seizing the full potential of markets-based financing as an engine of growth. Over past years, banks' ability to extend credit to companies has been significantly reduced. The consequences of this are felt particularly by small and medium enterprises (SMEs), which form the backbone of the European economy. Policymaking can spur the creation of a new model for growth and reduce reliance on bank funding by improving the capacity of financial markets to fund the real economy. Capital markets have undergone significant reform and are safer and more transparent than ever before: policymakers can now explore new policies aimed at putting these markets to work for citizens of Europe.

The funding potential of financial markets can be increased by prioritizing certain existing legislative

... continued on page 3

The capital framework should remain risk-sensitive

Jean-Laurent Bonnafé - Chief Executive Officer, **BNP Paribas**

Banks have made in recent years huge efforts to comply in a short period of time with the new regulatory framework, raising capital and deleveraging their balance sheets. According to ECB figures, the EU banking sector decreased in size by about 30 % of EU GDP since 2008. Banks are safer now, but at the same time their capacity to finance the economy has shrunk. The impact of all these regulations is much higher in Europe (where banks provide more than 70 % of the financing of the economy) than in the US where it represents an inverse proportion.

The right balance has to be found between financial stability and economic growth. It is now time – as stated by the Italian Presidency of Europe – to take measures to foster growth. It is also time to stabilize the regulatory environment. No economic actor can perform correctly its role if its legal environment changes every year.

... continued on page 5

Weak investment and laggard growth in the EU despite the very low current interest rates

Ignazio Visco - Governor, **Bank of Italy**

The European Central Bank's comprehensive response to counter the euro area sovereign debt crisis since its intensification in the summer of 2011 has laid the groundwork for the marked improvements of financial market conditions over the last two years. The measures adopted on June 5th by the ECB Governing Council have already provided additional monetary accommodation; they will help consolidate the favorable financing environment and support investment.

Economic growth remains nevertheless moderate and uneven and inflation is still well below the ECB's definition of price stability. The Governing Council stands ready to act against risks of too prolonged a period of low inflation, also using unconventional instruments within its mandate, with a view to safeguarding the firm anchoring of inflation expectations.

... continued on page 4

More monetary easing in itself is not a solution

Ilmārs Rimšēvičs - Governor, **Bank of Latvia**

With bank lending in Europe remaining weak, there are considerable concerns about the consequences of the prolonged lending weakness on the overall investment and growth in many EU countries. There are a number of reasons for the current weak credit growth. Limited number of potential borrowers, low savings, insufficient own funds and continuous repair of balance sheets are just a few examples.

To address the challenge posed by weak lending in the euro area, ECB's TLTROs are designed to boost lending to the real economy and stimulate an upturn in investments and growth. The TLTROs will supply long-term funding to banks thereby easing their financing costs and allowing to improve credit conditions to customers. At the same time, lending development is also closely related to several indirect factors, such as overall economic sentiment, investment environment, numerous structural fundamentals and health of the financial sector. Thereby, more monetary easing in itself would not solve the euro area's growth problem. While the ECB's recent policy actions is a remarkable step to support lending, it is beyond the remit of monetary policy to address impairments that are due to structural shortcomings. More active structural reform agenda is the true remedy in this case.

Effective monetary policy transmission is impossible without a healthy banking sector. Major steps have been taken in the euro area. The creation of SSM, SRM and the ongoing comprehensive assessment will support banking sector's ability to lend. While the current uncertainty about AQR results is negatively impacting lending in the short-term, AQR is designed to boost transparency, repair balance sheets and restore confidence in the market thereby creating the foundation for subsequent credit expansion.

It is broadly recognised that the development of non-bank financing is important to diversify the funding sources. Yet we also have to remain vigilant not to shift some risks to the less regulated shadow banking sector.

Three particular areas of possible measures to strengthen the recovery of the EU economy are: improving the resilience of the banking sector and making the banking union fully operational; diversifying funding for enterprises and fostering more effective credit allocation; promoting structural reforms aimed at enhancing productivity. ■

Long-term financing of the European economy

Marco Buti - Director General for Economic and Financial Affairs, **European Commission**

The financial crisis has forced banks to deleverage, repair balance sheets and to prepare for tighter regulatory requirements. It also had a negative impact on the risk appetite of banks, borrowers and institutional investors, resulting in less willingness to finance long term investments and SMEs.

The European Union has acted with determination to address these issues with the consolidation of public finances and the set-up of improved procedures for the coordination of Member States' budgetary and economic policies. The establishment of the Banking Union and the role played by the ECB have been instrumental in restoring confidence in the euro area.

EU capital markets should be further developed and integrated to accomplish a full Capital Markets Union, in which access to finance will be easier and costs lower, reliance on bank lending reduced and the shock absorbing capacity of the markets enhanced. This will boost the attractiveness of Europe as a place to invest. Improvement in market infrastructures is part of this process and, in this field, major progress has already been booked (e.g. EMIR, MiFID II and CSDR).

As announced by the President-elect, Jean-Claude Juncker, a first priority for the new Commission is to present an ambitious Jobs, Growth and Investment Package, to mobilise up to EUR 300 billion in additional investment in the real economy over the next three years. This requires the right regulatory environment and a climate conducive to growth and job creation.

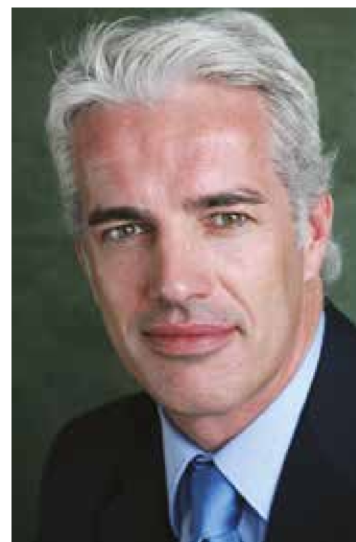
Long-term investment is a critical source of such growth. The Commission Communication on long-term financing sets out a concrete Action Plan to help support long-term investment and to leverage public funding.

We are taking measures to encourage capital market financing, facilitate insurers' involvement in long-term finance (e.g. Solvency II Delegated Act) and to support the financing of economically viable infrastructure projects.

For SMEs, the Commission is examining ways to reduce information asymmetries. Promoting high quality securitisation is one of the ways to increase fresh lending to the economy. There is broad G20 support on this. Much needs to be done to support long-term finance in Europe. We are confident that the Action Plan will allow Europe to stay focused on that target. ■

Rates, regulation and demographics resulting in a new normal for banks and markets

Garrett Curran - Chief Executive Officer, **Credit Suisse**, UK & Ireland



Creating a stable environment for economic growth, whilst implementing austerity, structural reform and the deleveraging of the banking system is clearly a challenge for Euro Area officials. Success is path dependent, and sequencing is key, but very difficult to control. With demographic forces unsupportive, productivity focused investment is critical. The economic impact of bank deleveraging is amplified in Europe where bank credit plays a more substantial role in business and household financing than in the US. EU financial wealth, not only outside of the banking system, but also outside of the more highly regulated trinity of banking, insurance and pensions is minuscule vs US levels. Therefore deleveraging will require the participation of non-Euro Area investors, particularly in the lower tranches of the capital structure.

Low rates, demography induced changes in the liability structure of the financial eco-system, financial regulation, and bank deleveraging have altered market characteristics and the nature of the growth challenge. These forces and trends, and their interactions, do not appear to be well understood yet. Bank balance sheets are smaller and less pliant as new prudential regulation reduces appetite and capacity to warehouse risk. The collective impact of regulation and market developments across banks, insurance and pensions has been to align their asset base more tightly to their increasingly fixed income-like liability streams, reducing risk appetite and trading incentive. The resulting illiquidity and lower base-level volatility also imply greater market disruption from episodic spikes.

Our goal must be to prevent deleveraging from deteriorating growth and inflation to such a point that they become immune to policy stimulus, as happened in Japan in the early 2000s. Whilst there is much to be positive about (recognition of the need for a securitisation revival, stronger & more credible banks post the AQR/Stress Test, EC focus on market-based and longer-term finance), more needs to be done, particularly in respect of macro-economic policy stimulus. We should proceed cautiously with regulation that hampers market liquidity or promotes excessive or unbalanced bank deleveraging at this fragile juncture: notably NSFR – funding costs for equity and FI market making, MiFID 2 transparency rule calibration, Bank Structural Reform, FTT and frontstop leverage ratios. ■

Interest rates will remain low, even if policy makers embrace the 'smart way'

Eric Chaney - Chief economist, **AXA Group**

The unthinkable -10Y Bund yields falling below 1%- happened on August 15th, 16 years after Japanese government bond yields crossed the same line. Bad surprises on GDP growth and rising geopolitical risks were contingent triggers. They should not hide the structural forces bringing down yields. As populations grow older, savings are shifting toward fixed income assets. The triple deleveraging of banks, consumers and governments has been and is still choking growth and inflation. Stricter regulatory capital rules for banks have made sovereign bonds more likable and lending to companies –a risky business by definition- less so. Last but not least, the European Central Bank is missing its inflation target and, worse, has been unable to anchor inflation expectations which, on a rolling five year time span, have steadily fallen from 2% in 2012 to 1% in the latest readings.

A kind of japanisation of the euro area has indeed started. The good news is, policy makers know it; the bad news, their hands are tied up by the institutional and political setup of the euro area. Large scale asset purchases by the ECB, including foreign assets, would meet strong political opposition, and the leeway for fiscal expansion is limited by the fiscal compact. In his Jackson Hole speech, President Mario Draghi has shown the 'smart way' out. Smart quantitative easing, i.e. helping banks to clean their loan books and lend more to SMEs, is possible. Fiscal coordination and expansion too, under the smart condition that supply side reforms make convincing progress in France and Italy. Investment in local or cross border projects conducive to stronger long term growth (infrastructures, education, R&D) could be smartly boosted by leveraging the joint lending capacity and expertise of the EIB and national investment funds (KfW in Germany, CDP in Italy, CdC in France).

Being smart in financial regulation is not forbidden either: reviving the much needed ABS market would be facilitated by further adjustments on the capital insurers are required to freeze in order to buy these assets. Similarly, the collateral universe of euro area central banks could be extended to high quality trade credit (B2B).

But even if policy makers embrace the 'smart way', the political and regulatory clocks are slow to move. In the meantime, nominal interest rates will remain low. ■

Securing the euro area recovery

Poul Thomsen - Acting Director, European Department, **International Monetary Fund (IMF)**

After a number of strong policy actions, the euro area is recovering. But the recovery is uneven and wobbly. Even though financial markets have improved, output and investment remain well below pre-crisis levels. High unemployment, large debt burdens, weak banks, and contracting credit are weighing down domestic demand. This leaves the region too dependent on foreign demand and exposed to external risks, like geopolitical shocks or slow growth in trading partners.

Low inflation is pervasive, making real interest rates too high, stifling demand, and slowing the pace of debt reduction. The more persistent low inflation is, the more the current monetary policy stance is questioned. On the supply-side, rigidities in capital, labor, and product markets are holding back productivity and job creation. At the same time, there is a danger that reform fatigue becomes entrenched, jeopardizing further progress.

To counter these risks, concerted policy efforts are needed to support demand, repair balance sheets, and address supply-side constraints.

Policy needs to prop up domestic demand until lowflation recedes and banks start lending. The ECB's recent actions aim at just that. But if inflation stays stubbornly low, the ECB may need to start quantitative easing, signaling that it will use every available tool to achieve its price stability mandate. The overall neutral fiscal policy stance appropriately walks the fine line between debt sustainability and demand support. However, large negative growth surprises should not trigger further tightening.

Further balance sheet repair should be encouraged. The euro area has made very good progress on banking union, with the SSM and SRM adopted and the ECB's Comprehensive Assessment's motivating bank balance sheet repair. But a common fiscal backstop is still essential to break the link between bank and sovereign risks.

Additional structural reforms should be pursued to raise Europe's growth potential. It will be tough to make growth robust without further reforms. Above all, these include product and labor market reforms to raise competitiveness, lower hiring costs, and reduce youth unemployment, and changes in capital market to enhance risk-sharing and SMEs' access to finance.

The complicated fiscal framework could be simplified and enforcement improved. The ability of the center to fund public investments in the euro area interest, like roads and energy networks, should be enhanced.

Taken together, these actions would help to solidify and strengthen the recovery in Europe. ■

A sound banking system is a prerequisite for growth

Claudio Borio - Head of the Monetary and Economic Department, **Bank for International Settlements (BIS)**

Some seven years on, the global economy has not yet stepped out of the shadow of the Great Financial Crisis. Despite a pickup in growth, it has not shaken off its dependence on extraordinary monetary stimulus. Despite the euphoria in financial markets, investment remains weak. And despite lacklustre long-term growth prospects, debt continues to rise.

The crisis was no bolt from the blue: like many before, it reflected a prolonged and outsize financial boom that ushered in a financial bust and a balance sheet recession. The joint behaviour of credit and property prices plays a key role in such financial cycles. Unlike normal recessions, balance sheet recessions are not only deeper and longer but also much less responsive to aggregate demand policies: undercapitalised financial institutions restrict and, above all, misallocate credit; over indebted borrowers pay back debt; and the major misallocations of capital and labour hidden by the boom emerge with a vengeance.

Different illness, different remedy. Addressing balance sheet recessions puts a premium on balance sheet repair, in both financial and non-financial sectors, and on structural policies. This is the way to establish the basis of a self-sustained and speedy recovery. The issue is not so much boosting short-term growth at all costs but removing the obstacles that hold it back.

What about the European Union specifically? To be sure, not all countries in the EU had a full-fledged balance sheet recession, linked to a domestic financial boom and bust. Countries that did, just like the United States, include the United Kingdom, Spain, Ireland and others in central, eastern and southern Europe as well as in the Baltic region. In others, notably Germany and France, banks suffered losses mainly on foreign exposures. In others still, such as Sweden, the crisis was largely imported through exports, even as domestic credit and property booms continued. And in the euro area, owing to institutional specificities, a doom loop between banks and their sovereign soon threatened. But, everywhere, the scars are all too visible.

Seen from this perspective, fixing the banking system is a critical step. The long-awaited asset quality review and stress tests under way are essential to unblock the system. Together with the completion of the post-crisis financial regulatory reforms, not least Basel III, they would ensure that the financial sector can again support lasting growth. And together with the necessary structural reforms and steps to secure fiscal sustainability, they would at last relieve pressure on monetary policy, which has been overburdened for far too long. As argued in the latest BIS Annual Report, the current policy mix, unless corrected, raises material risks in the years ahead. The sooner we recognise it, the better. ■

A stable and resilient financial sector as a key ingredient for future growth

Roberto Gualtieri - MEP, President of Committee on Economic and Monetary Affairs, **European Parliament**

Excessive risk taking and leveraging has been one of the main causes of the financial crisis. However, on-going deleveraging and diminishing credit supply is one major challenge for future growth in the euro area and the EU.[1] Therefore, various policy initiatives are on the policy agenda to counterbalance these negative effects.

Financial services reform is a major building block. A sound, stable and resilient financial sector capable of providing funding to the real economy is of major importance for growth in the medium and long term. Both the financial reform agenda (internationally coordinated by G20) and the unique project of creating a Banking Union with Single Supervisory and Resolution Mechanisms (SSM, SRM) and a single rulebook (CRD IV and CRR) will change the set-up of financial markets. These reforms will strengthen the resilience of the banking sector by contributing to the necessary balance sheet repair and will have an impact on the credit provision by banks.

The implementation of the financial sector reforms will also necessitate a vast amount of secondary legislation (implementing/delegated acts) that may have a sizeable impact on the funding of the real economy. The overall impact on growth of these reforms is not yet fully understood. One clarification was provided by the Commission Communication A *reformed financial sector for Europe* in May 2014.[2] Ensuring that reforms will contribute to growth will be one of the priorities of the ECON Committee.

The majority of real economy funding in the EU is provided by the banking sector.[3] Small and medium sized enterprises (SMEs) are a main contributor to employment and growth in the EU. However, they have few possibilities to directly access the capital market and are especially dependent on a functioning banking sector. Ensuring cost efficient access for SMEs to finance is therefore of crucial importance. Notably the ECB (e.g. via its collateral framework, non-standard monetary policy measures and reviving securitisation markets) and the EIB Group are contributing to the mitigation of financing difficulties but new bolder steps are required. The ECON Committee shall contribute to the design and the implementation of the "capital markets union" whose creation has been indicated by Jean-Claude Juncker as one of the goals of the new Commission.

In any case, all initiatives aimed to restore the efficient functioning of the banking and the financial sector will not be sufficient to boost economic growth and employment if they are not accompanied by appropriate initiatives to support domestic demand. ■

1. To be noted that deleveraging and balance sheet repair is not only a phenomenon seen in the banking sector. The public sector, corporate sector and private household are equally affected. See IMF Country Report No. 14/198, EURO AREA POLICIES: 2014 ARTICLE IV CONSULTATION–STAFF REPORT; https://www.imf.org/external/pubs/ft/scr/2014/cr14198.pdf.
2. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A reformed financial sector for Europe, COM(2014) 279 final; the Communication and supporting documents can be accessed via the following webpage: http://ec.europa.eu/internal_market/finances/policy/index_en.htm#True.
3. See Finance in an environment of downsizing banks, Speech of Yves Mersch, member of the Executive Board of the ECB, at Shanghai Forum 2014 'Asia Transforms: Identifying New Dynamics'; http://www.ecb.europa.eu/press/key/date/2014/html/sp140524.en.html.

Investment and bank lending to enterprises

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

Despite historically low interest rates and a gradual recovery in economic activity in the euro area, corporate investment has remained lacklustre, also compared with previous recessions. A number of factors have contributed to this weakness, including depressed demand and heightened uncertainty. But to what extent is bank lending playing a role?

Certainly, weak investment has been accompanied by a prolonged period of contracting bank credit to firms. Correlation does not however imply causation. While the decline in bank lending is in part related to supply factors, it is also linked factors on the demand side.

Weak demand for credit is partly related to the necessary deleveraging of the private sector. It also reflects the slow pace of recovery, which had led firm to accumulate higher cash buffers given the discouraging investment environment. At the same time, companies that do need external financing are being discouraged by the still high cost of loans and therefore, if possible, substituting bank loans with alternative sources of funding.

Supply factors are nonetheless still playing a role in the context of still elevated, though receding, financial fragmentation. Perceptions of balance sheet constraints are also curbing credit provision, especially in stressed countries. Although banks' funding conditions have improved significantly and cross-country differences narrowed notably, bank lending rates have remained elevated. Macroeconomic risks can only explain part of this phenomenon. The conclusion to draw from this, therefore, is that fixing the bank lending channel – which is essential for monetary policy transmission – involves action on both the supply and demand sides.

In line with its price stability mandate, the ECB has adopted monetary policy measures aimed at boosting credit supply. The TLTROs, introduced as part of a policy package in June, provide stable term funding at attractive rates conditional – and this is essential – on banks expanding their lending beyond a given benchmark. Moreover, the ECB's comprehensive assessment can be expected to eventually have a positive impact on credit supply.

Credit demand, however, can only be durably improved by policies that boost the outlook for potential growth and hence raise investment demand. This implies an essential role for national structural policies that raise labour participation and labour productivity. ■

Do well, then expand

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

Banking union is an important step towards more integrated financial markets in the EU, however, we are at the very beginning of long way towards homogenous or harmonized pan-European banking system. First and foremost, the fundamental dichotomy exists between euro and non-euro zone countries, were banking regulation significantly differs. However, even if banking regulation has direct effect on real economy, and in this respect the banking union has a potential to have stabilizing effect on Eurozone economies at macroeconomic level, cost of borrowing, collateral and other requirement are deeply rooted in risk assessment and thus - economic development perspectives of each particular country in every given moment. In this respect, existing fragmentation of the EU financial markets reflects existing fragmentation of real economy in the EU.

Speaking of financing the real economy, unlike United States, where close to 80% of external financing of enterprises comes from equity and debt securities, in Europe bank loans are still the main source of external financing. Sure, most of European countries have system of development banks, partly taking care of development needs of enterprises, especially SMEs and micro-businesses, which often are government and EU financed or partly financed ventures, delivering subsidized development loans. This means that at least part of lending goes through national business support policies, which are far from being harmonized and which might, on one hand, witness the market failure, and on the other hand mean, that fragmentation of financial market will last for some time.

At this point we think that one should work on strengthening the progress reached so far and transform banking union regulations into functioning and effective banking mechanism. "Do well, then expand", this basic management principle should apply to the European banking union, in parallel looking for new ways how financial markets can support business via innovative financing mechanisms like securitization or other new financial instruments. ■

Financing growth: a priority for European policymaking

Vittorio Grilli - Chairman, Corporate and Investment Bank EMEA, **J.P. Morgan**

continuation of page 1

proposals and by launching a number of new initiatives. Firstly, it is important to revive the securitisation market. Securitisation, when appropriately regulated and well supervised, is a channel by which banks and non-bank lenders can fund their own lending. It frees up room on balance sheets and enables capital to be lent again as well as allows for increased portfolio diversification and better risk management opportunities.

Policymakers should consider promoting policies that will revitalize the European securitization markets, particularly for SME loans.

Secondly, policymakers should promote long term investment. Regulatory fragmentation among Member States has held back large scale and long-term capital commitments required for operating efficient investment pools for long-term assets. The proposed Regulation on EU long term investment funds (ELTIFs) can lead to the creation of an attractive alternative vehicle for investing in long-term investment assets. Europe should prioritize completion of an agreement on the proposal between the European institutions, although remaining questions around product suitability (for retail) and early redemption will need to be resolved for ELTIFs to meet the regulatory objective.

Thirdly, development banks can play a growing role for SME financing. New mechanisms can help promote the role development banks play in SME financing, and policymakers should consider whether current public sector support may be inhibited by fragmentation and under-funding relative to the size of the European economy.

Finally, the development of a private placement market in Europe will create opportunities for mid-size companies to borrow from the market at lower costs. As disclosure and reporting requirements for bond issues have increased, the cost of access to capital markets has dramatically risen. The creation of a formal "private placement" market would allow companies to tap sophisticated investors at lower costs.

After five years of legislative changes, Europe's financial markets are looking increasingly strong, safe and transparent. Time has come for Europe to put the markets to work to help spur economic growth. ■

A single market in capital for Europe

Benoît Cœuré - Member of the Executive Board, **European Central Bank (ECB)**
& Chairman, **Committee on Payment and Settlement Systems (CPSS)**

A key policy objective in recent years has been the reintegration of financial markets in the euro area – but what does this really mean?

It cannot mean simply that prices on euro-denominated financial assets converge. We saw substantial price convergence in the euro area in its first decade, only to be faced with a sudden fragmentation of financial markets when the crisis hit. Convergence can be a welcome process if risks are being more accurately priced; but it does not in itself guarantee deep and resilient financial integration.

True financial integration is therefore something more – it involves constructing a genuine single market in capital, which has two components. The first is efficient allocation: credit is allocated without reference to location. The second is effective diversification: financial markets help firms and households cushion local shocks, which is especially important in a monetary union. On both accounts, however, there is still much to do.

Credit allocation in the euro area remains very much influenced by the location of borrowers, rather than their creditworthiness per se, in particular for SMEs. This reflects relatively low cross-border retail banking integration. Diversification is constrained by home bias in the holding of equity and limited mechanisms for private risk-sharing.

Banking Union can in principle help on both fronts, by creating the conditions for a more integrated retail bank market and better risk-sharing for banks in resolution.

A greater role for capital markets will however also be key to a more efficient and diversified financing mix, by increasing market contestability between banks and non-banks and by supporting access to finance for SMEs.

Bank deleveraging in the euro area is already boosting capital market financing. The key challenges now are, first, to even out access to capital markets across jurisdictions, which requires a harmonised framework for cross-border securities trading in the EU – a "capital markets union".

And second, to foster securitisation, which would provide smaller firms, for whom relationship lending will continue to be important, with a way to diversify their funding sources. ■

Can structural reforms relaunch economic growth in the EU?

Pier Carlo Padoan - Minister of Economy and Finance, Italy

continuation of page 1

level and is simultaneously undertaken across countries. Benefits from reforms in terms of growth and jobs, however, take time to materialize, especially in absence of a supportive macroeconomic environment. This is why at a time of crisis, when negative short term considerations dominate private sector expectations, a coordinated reform effort is needed to restore confidence.

Structural reforms must be embraced also as a valuable tool to address persisting macroeconomic imbalances. The asymmetric EU current account rebalancing - with debtor countries moving out of deficits without creditor countries reducing their surpluses – signals an excess of saving over investment. In fact, investment levels remain below their already modest pre-crisis figures across the whole Euro area. Country specific structural measures may help narrow the current EU saving-investment gap in a number of ways, including – on the investment side - by removing obstacles to productivity increases and cost of capital reductions.

Financial market integration complements structural reforms. Even if investments are reinvigorated by country specific structural reforms, their funding rests on a truly European financial market where credit and capital can freely flow across national borders and where banks are complemented by markets in the provision of credit to the private sector.

Moreover, countries' driven structural reforms cannot happen in a vacuum. Investments in infrastructures that, like transports, energy and the digital agenda, span the entire continent require, by the subsidiarity principle, EU interventions. The new EU Commission President, has recently indicated in euro 300bn the size of the infrastructures investment gap that must be filled in the next three years. We share his sense of urgency. The time for action on structural reforms and investments is now! ■

Spain: Deleveraging or Rebalancing?

José Abad - Chief Economist and Head of Research and International Relations,
Instituto de Crédito Oficial (ICO), Madrid

The ***stock* of domestic loans** to Spanish firms has fallen by 40% from the all-time peak reached in 2009. And while slowing down, the pace of contraction is still taking place at 2-digit rates. However, as terrible as these statistics may sound, they also paint a distorted picture of financing conditions in Spain.

If we also take into consideration securitized loans, loans transferred to the SAREB, loans by foreign banks, securities other than shares and loan loss provisions, the ***stock* of total corporate financing** would have cumulatively contracted by "just" 15% since 2009 and would be currently falling at a much lower speed (less than 5% y-o-y).

Furthermore, looking across sectors, while the stock of financing to firms in the real estate and construction sectors would be down by 1/3, financing to firms outside these two sectors would account today for 70% of GDP, slightly higher than in 2009 and well above pre-crisis levels!

Also, the recent pick-up in the *flow* of credit (new SME loans are up by 5% YTD), in combination with firms increasingly putting their cash surplus (+4% of GDP currently vs -11% of GDP in 2007-08) to work, is being translated into a **strong rebound in business investment** (+11% y-o-y in Q1).

Overall, what we observe in Spain is not a deleveraging process per se but a demand-driven **rebalancing process** in the composition of activity at the macro level which is having its reflection on credit dynamics. Not least, while residential investment accounts for just 4% of GDP (down from 12% in 2007), total exports account for 34% of GDP (up from less than 27% in 2007).

As Spain's national promotional bank (NPB), the objective of ICO is that of making such a rebalancing process as smooth as possible by improving funding conditions for SMEs, particularly when exporting or investing abroad, while promoting the development of alternative funding sources, such as venture capital.

At the international level, **increasing cooperation among NPBs, and well as between NPBs and the EIB Group**, is badly needed. By increasing their cross-border operations, NPBs could play a key role in reducing financial fragmentation, particularly for SMEs, across the Eurozone. ■

The nutcracker: Targeted quantitative easing

Rumi Masih - Managing Director and Senior Investment Strategist, Investment Strategy and Solutions Group (ISSG), **BNY Mellon**

Since the financial crisis, monetary policy has tended to favour the bulk purchasing of mainstream financial assets. However, if the goal is to restore economic health, this is the equivalent of cracking a nutshell with a sledgehammer. Monetary easing, if co-ordinated with regulatory and structural changes, need not involve the use of such blunt and unwieldy tools.

More accurate quantitative easing (QE) can have two benefits. Firstly, borrowing conditions may be improved amongst the sectors of the economy that are more likely to borrow and then make real investments. Currently, we see a situation in which those sectors that can borrow are often the ones who don't want to. Secondly, well-executed QE not only buys financial assets, but also encourages others to buy those assets; particularly if aligned with regulatory changes that make the asset class more desirable.

For the first of these outcomes, increased granularity can occur in both the financial asset type bought, and the area of the private sector that is the ultimate investee. By controlling monetary easing along these lines, corporate lending can be directed to the parts of the private sector most likely to increase demand.

For our second outcome, a mixture of monetary policy with structural and regulatory measures can act as a remedial cocktail of drugs. Asset purchases can boost liquidity and price discovery, and so help to bring more obscure markets into the mainstream. It is not only real economy actors who would benefit from this; investors would be able to better diversify and have a clearer understanding of what they own, reducing systemic financial risk.

An ideal target for this medicine (already acknowledged by policy-makers) is the securitized asset market, where asset purchases would have traction to the real economy. These purchases could be coordinated with structural measures to increase confidence and reduce information asymmetry, such as joint ECB/BoE proposals to create 'qualifying securitizations', ESMA-promoted improvements in documentation and disclosure, or Europe-wide harmonization of securities issuance rules and accounting standards.

This is not to say that 'conventional' QE is ineffective: by our estimates, just the possibility of the ECB buying bonds has driven European sovereign yields lower by thirty basis points this year. Sledgehammers will certainly crack nuts. But bringing asset-backed securities in from the cold would be welcomed by investors, as well as giving central banks a greater bang for each buck of balance sheet they choose to use. ■

Weak investment and laggard growth in the EU despite the very low current interest rates

Ignazio Visco - Governor, **Bank of Italy**

continuation of page 1

Between 2007 and 2013 both public and private investment declined by 20 percent in real terms in the euro area as a whole; the fall was even larger in stressed countries: in Italy, for example, the figures are 31 and 26 percent respectively. Weak growth is partly due to a slower recovery of private investment than in most financial crises of the past. Moreover, despite the broad agreement that productive investment is a necessary complement for fiscal consolidation to be growth-friendly, actual fiscal consolidation has often implied massive cuts in public investment, which may cast a shadow on future potential output.

Reviving investment - public and private, national and European - is critical at this juncture in order to strengthen the recovery. Investment is the linkage between supply and demand. Accommodative monetary policy has been supporting capital expenditure by maintaining favorable financing conditions. But other causes have played a relevant role in holding back investment, offsetting the stimulus expected from the very low interest rates: unsatisfactory output dynamics; widespread uncertainty about prospective demand growth; deleveraging by overindebted firms. Difficult access to credit, because of balance sheet repair in the banking sector, and higher cost of capital in stressed countries, owing to financial fragmentation, also bear major responsibilities for postponements and cutbacks in investment by firms.

Monetary policy must be complemented by other measures at both a national and European level to create a business environment that is more conducive to a stronger and sustained resumption of investment. Along with country-specific structural reforms on the supply side, broader economic policy action is required to accelerate the building up of infrastructure, both tangible and intangible, indispensable to the formation of a true Single Market. ■

Restoring competitiveness, job creation and growth in Europe

Pierre Gramegna - Minister of Finance, Luxembourg

At this important juncture of the business cycle, Europe needs a meaningful approach to re-launching and consolidating growth. Much of our time in recent years has been devoted to correcting the failures of the past, mostly out of urgent necessity. Unsustainable public finances and inadequate financial regulation have been important factors contributing to the outbreak of the economic and financial crisis and addressing these shortcomings were of an utmost priority.

Today, with uncertain growth perspectives looming at the horizon, unemployment in Europe remains too high and lending to firms in Europe too constrained. Dedicated structural reforms are necessary and this calls for decisive action by all stakeholders.

The upcoming launch of the SSM, preceded by the rigorous health check of the banking system, can help regain the necessary confidence in our banks and thus alleviate concerns on scarce financing to firms across Europe. Alternative means of financing should also be gradually developing to further ease the pressure, but further policy action is needed to support such developments.

These are all necessary, but not sufficient conditions to restoring growth. Both private and public investments are important elements supporting our economies. European institutions such as the EIB or the Commission can and should play a key role here, with the necessary support of the governments. Restoring the competitiveness of our economies will also be key to tackling these important challenges. It will require ample creativity, bold decision-making and steadfast implementation in Europe in order to spur growth and job creation.

European policy-makers therefore face an enormous challenge today. We are increasingly paying attention to all these issues in the relevant fora – as a matter of priority – and will continue to do so with the incoming Commission. Despite the difficult tasks that lie ahead I am confident that the EU will be able to devise a decisive strategy and implement much-needed policies to restore our competitiveness, job creation and growth. ■

The capital framework should remain risk-sensitive

Jean-Laurent Bonnafé - Chief Executive Officer, **BNP Paribas**

continuation of page 1

Stability and confidence are essential to allow economic actors to invest and to encourage individuals to work, consume and invest.

The RWA framework for example is regularly questioned; some advocate it should be replaced by a leverage ratio and stress tests. While a leverage ratio as a backstop makes sense, it would be a huge mistake to make it the main capital driver. Banks do take risks; it is their very nature and purpose. Risk management should therefore be at the heart of the steering of a bank, and the minimum capital requirements should be adjusted to each bank's risk profile, reflected by its internal model, back-tested and checked by the competent supervision. As such for supervisors this approach is not more complicated than performing stress tests in a relevant and consistent way. If the leverage ratio becomes the primary trigger, this would incentivize banks to change their risk profile to a much more risky one to increase their profitability for the same balance sheet size. The current RWA framework represents 30 years of experience and progress which should not be thrown away. It can certainly be improved further as is the case in Europe for example, where major initiatives have been taken to make RWA more robust and comparable. A Single Rulebook has been established by the EBA for the 28 EU countries, a Single Supervisory Mechanism has been set up by the 18 Eurozone countries which will decide on internal models as from 4 November and which will conduct a transversal audit of internal models in 2015. Significant divergences between RWAs will and should remain as they reflect the various risk profiles and business models chosen by the banks. Europe is showing the way, evidencing that harmonization of practices and rules is possible and that supervision and regulation can be strengthened. ■

How resilient can we say our financial system is 6 years after the financial crisis?

Terry P. Laughlin - President of Strategic Initiatives, **Bank of America**

continuation of page 1

A significant number of UK and US policymakers believe the too-big-to-fail problem is now a thing of the past. But with key details on how resolution mechanisms will work still unclear, some believe that optimism may be misplaced. Even if a global standard is eventually agreed, there are doubts it will prevent individual regulators from making their own rules or push them to get rid of existing ones, such as the Fed's capital requirement for foreign banks.

The EU could be classed as still being in the recovery stage following the crisis and the European Commission's proposals on separating trading and deposit taking activities, which go even further than national initiatives in France and Germany, could potentially hamper the speed of that recovery. It is crucial that the universal banking system remains intact to avoid any potentially negative consequences as far as the financing of the real economy is concerned.

The FSB proposal on Gone Concern Loss Absorbing Capacity (GLAC) also needs to be mentioned as this is a key tool for regulators tasked with increasing resilience of the financial sector. The use of GLAC is to provide sufficient resources for a firm to be resolved, maintaining critical functions without taxpayer support or causing severe systemic disruption.

GLAC should allow a firm to absorb losses and replenish its required equity capital if it reaches the point of non-viability to a level that would be credible as a standalone institution, and enable the recapitalized firm to regain market access. It has been suggested that GLAC (which includes regulatory capital) should double the minimum required Basel 3 equity of 7%, plus any applicable buffer requirement (so 7% above regulatory requirements).

The industry has expressed concerns that GLAC may be applied by national supervisors ahead of the actual parameters being agreed. Regulators want additional loss absorbing capacities to be introduced ahead of agreement on the actual levels required. Concern also exists around the positioning of external GLAC within cross-border groups, which could trap capital in subsidiaries and lead to an inefficient use thereof. However, the concerns of host regulators with regards ensuring an ability to re-capitalise local entities is also recognised and a balance between the two needs to be achieved.

Banks around the world already have to hold far more capital from 2016 as a result of new rules to strengthen them post the financial crisis and we want there to be sufficient capital available to recapitalize the banks that are carrying out critical economic functions to a level where they can regain and maintain market access. ■

Regulators at a crossroads

Henri de Castries - Chairman & Chief Executive Officer, **AXA Group**

Credit photo : Seignettelafontan.com

continuation of page 1

Policymakers have reached a crossroads. It has been reported that the capital standards for some insurance firms could be higher than Solvency II's advanced risk-based requirements, as in banking. Yet even further tightening of the most modern and ambitious standard for insurance looks more arbitrary than economically justified, particularly as the business model of insurance is fundamentally different from that of banks. Rather than fostering a global level playing field, it might hurt the European insurance industry without justification, and especially the five European firms that have been designated 'systemic'.

Regulators should closely examine the business model of insurance and assess how best to tailor regulation to the role of insurance firms in the economy. That role is evolving rapidly, for example, as insurers have to master big data to design protection against new threats, such as climate risks or cyber risks. At the same time, they have to provide innovative solutions that fit the needs of societies in both ageing advanced economies and emerging market economies. And they are being asked to strengthen their support for growth and jobs by supplying the long-term credit from which banks are retreating.

To meet these challenges, insurance firms must be able to count on a coherent regulatory framework that matches their business model rather than being derived from banking rules. This need not mean less regulation but it does demand a framework based on an in-depth understanding of the economic role of insurance in modern societies.

Insurance firms play an essential role in managing risks and protecting firms and people – and they have a clear long-term orientation that is focused on sustainability. Regulation should support that role. ■

Solving financial fragmentation within the EU

Slavka Eley - Head of Home Host Coordination Unit, **European Banking Authority (EBA)**

Prior to the financial crisis banks took advantage of the single EU banking licence to extend their business across borders, putting capital to work with allocative and operational efficiencies. Mergers and acquisitions saw the creation of several large truly European banking groups and, over the course of a decade, state dominated banking systems in Central and Eastern Europe were transformed into market functioning banking systems.

The financial crisis has impacted cross border banking in sometimes unexpected ways. The greatest ex-ante concern was that "foreign" banks would simply "cut and run" during difficult economic times. Possibly thanks to initiatives such as Vienna 2, this risk appears limited within the EU. Instead, the imposition of national ring fencing, at times uncoordinated and occasionally unwarranted, has been a focus of concern. Whilst robust supervisory actions to strengthen a banking group are needed, ring fencing raises concerns including:

1) uncoordinated supervisory measures which may impact other markets without proper mitigation actions being put in place, hence risking a "tit for tat" regime of ever increasing national measures;
2) unilateral action by one national supervisor, especially if not related to the risks posed by that group, which can impact the allocative efficiency of capital and liquidity resources within a banking group with unintended consequences.

The EBA has sought to raise, and mitigate, these concerns using all tools at its disposal, for example:

- promoting effective ex ante coordination and discussion of specific national measures to ensure proper planning and understanding amongst home and host supervisors;
- putting colleges to the fore of discussions about measures banks should take to strengthen their capital positions following the EBA's 20111 capital recommendation ensuring that those measures were agreed by all relevant supervisors;
- actively mediating where disagreements exist in the supervisory treatment of cross border banking groups;
- developing the Single Rulebook and a common approach to supervisory risk assessments to promote informed supervisory discussion on how to address possible banking risks.

The EBA will continue its efforts to promote a Single Rulebook and common supervisory culture, for example rolling out the common SREP Guidelines in 2015 and working with both supervisory and resolution authorities in colleges of cross border banking groups to ensure full and effective discussion and joint decision making. While welcoming the establishment of the Single Supervisory Mechanism (SSM), the EBA remains mindful that it will need to play an even greater role on supervisory convergence and cooperation across the EU.

Most cross-border banking groups will in fact continue to have operations both within and outside the Eurozone and as such will continue to make joint supervisory decisions in EU colleges. Hence, the role of the EBA will be fundamental to reduce the risk of further financial fragmentation in the EU single market. ■

Revitalising the market for securitised loans in the EU

Dario Scannapieco - Vice President, **European Investment Bank (EIB)**

SME securitisation is still suffering from the economic and financial crisis. The near-collapse of the European structured-finance market during the crisis has profoundly affected SME securitisation in Europe.

Since the end of 2011, the outstanding volumes have decreased by around one third and reached a level of EUR 174bn at the end of 2013. Compared to the US where securitisation has reached a market volume of EUR 2.2 trillion last year, the European market is comparably small and characterised by a high degree of uncertainty.

What can be done to revitalise the securitisation market? A first important step towards restoring investors' confidence in European ABS is to remove misalignments of interests and information asymmetries between issuers and investors, including greater transparency to ensure the accurate pricing of credit risks. Several financial regulations as well as a number of public sector initiatives in the EU have been implemented recently to address this concern.

However, there are a number of remaining structural roadblocks that should be addressed. In this context, it is crucial that public development banks, the European Commission and European agencies engage in a close dialogue with regulators, both in response to public consultations as well as on a bilateral basis to ensure that the capital requirements framework is consistent with the quality of the assets it applies to.

A particular focus should be put on the promotion of simple structures and well identified, transparent underlying asset pools with predictable performance ("high-quality securitisation") in order to revitalise the securitisation market.

One initiative which the EIB Group has launched recently to contribute to the revitalisation of the securitisation market is the EIB Group Risk Enhancement Mandate (EREM) which aims to further enhance access to finance for SMEs and small midcaps by providing a range of targeted capital market instruments, including ABS credit enhancement. Under the umbrella of this initiative, the EIB Group provides credit enhancement for senior and mezzanine tranches of securitisation backed by SME loans, including guarantees. ■

What is needed to launch a large and deep EU securitization market especially for SME loans?

Jonathan Faull - Director General, DG Internal Market and Services, **European Commission**

In the current context of funding constraints in Europe securitisation is an important instrument bridging banks and capital markets.

As indicated in its Communication on long-term financing, published in March 2014, the European Commission actively supports the recovery of safe and sustainable securitisation markets in Europe, including SME asset backed securities (ABS).

EU authorities and the private sector have already taken many concrete actions to enhance investors' confidence. Despite these actions, there is no substantial recovery of this market so far. Further efforts should therefore be made.

In Europe there is now a broad consensus to develop a prudentially sound and operational distinction between the different types of securitisation instruments. Not all these instruments are the same. For that purpose, a number of initiatives have been launched at EU level.

The primary objective of these initiatives is to identify high quality securitisation instruments. A detailed list of potential identification criteria is under discussion, notably in the insurance sector. These criteria mainly concern i) the structural features, ii) underlying assets and related collateral characteristics, iii) listing and transparency features and iv) the underwriting processes of these instruments. This approach appears promising and the Commission is exploring the possibility of incorporating such criteria in EU legislation.

In addition, securitisation may help in alleviating the financing situation of SMEs as it may allow banks to refinance their exposures to SMEs, freeing additional funding capacities to generate new loans. Our initiatives will contribute to the development of securitisation instruments backed by SME loans/assets in the EU. However, developing this market segment still requires addressing specific technical issues.

One of main hurdles is the absence of standardised and continuous credit quality information on SMEs as there is a lack of third-party assessment for these entities. There is also a significant degree of heterogeneity among underlying assets of SMEs which may generate a bias in investors' perception. Indeed SMEs loans may be seen as riskier than other asset classes. In this context, all initiatives from the private sector – such as discussion at EUROFI level - may help to overcome these difficulties and to develop EU-wide SME ABS markets. ■

Beyond the regulatory aspects of securitization

Delphine d'Amarzit - Assistant Secretary, Financial Sector Department, Directorate-General of the Treasury, **Ministry of Economy and Finance, France**

Much has been said about regulatory changes needed to develop a European securitization market. In this respect, the recent regulatory initiatives, including the latest drafts of the Solvency 2 and LCR regulation circulated by the Commission, constitute a very interesting first step by stating several principles to define a "high quality securitization". While defining and establishing high quality standards with appropriate regulatory treatment is essential to allow the development of a sound, safe and transparent securitization market, these changes might not be enough on their own to get the market off the ground.

Beyond the regulatory aspects, operational aspects also have to be considered. In particular, securitization requires specific IT infrastructures that some banks may still be lacking.

The development of information disclosure requirements, imperative to foster a transparent market in which investors conduct their own due diligence, can compound this issue. Since such IT investments take time, these operational features may in practice constitute a real bottleneck in reviving the securitization market. Such issues should be addressed by banks as early as possible in order to avoid "show-stoppers" and unnecessary limitations of market potential. Clear communication and predictable processes will be key in this regard, so that banks see for themselves the benefits of investing in their IT systems.

Moreover, the economic equation for securitization is not always clear-cut. Due to inherent internal and external costs, securitization may be relatively expensive compared to other funding options. More fundamentally, the economics of securitization requires that the underlying assets cover these costs and a fair remuneration of the risks taken by the investors, whose baseline funding cost and benefits associated with the loans are different from those of a bank.

Regulatory aspects matter, and we fully support the current international and European initiatives. But other operational aspects also deserve our attention, if we do not want them to become the next roadblock. ■

Securitisations, part II: The devil is in the detail

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

Credit photo : EIOPA Frankfurt am Main

European securitisations keep suffering from the bad reputation they acquired during the financial crisis 2007-2009. At the same time, the real economy in a number of European countries is faced with a difficult funding situation. In view of these two factors, a number of initiatives have been started to facilitate investments in securitisations. One of them is the idea to create a specific category of securitisations by formulating a number of criteria on structural features, underlying assets, transparency etc. and to introduce a regulatory treatment that reflects such features (e.g. via lower capital requirements).

Given the large differences that could be observed in the risk profile of securitisations, a more granular approach is clearly justified, and EIOPA fully supports the taken initiatives. But to ensure a successful outcome a number of prerequisites have to be met:

First, the capital requirements have to be commensurate with the associated risk. Neutrality with regards to all assets in terms of risk/capital charge ratio is a precondition for sound regulation.

Second, given the potential utility of securitisations there might be the temptation to expand the scope of qualifying securitisations by relaxing criteria. It is important to ensure that the risk profile of qualifying securitisations is really lower. After investors "burned fingers" during the financial crisis, it will be difficult to raise again renewed interest in this asset class. Policymakers as well as market participants, both from the supply and demand sides, have to get it right this time; otherwise we all together might be contributing to another disappointment, which we cannot afford. If we fail, we will not get a third chance.

Third, the introduction of a category with the better risk profile and the very strong political support for the asset class should not result in complacency by investors. There is still the need for due diligence. Blind trust in a category is as undesirable as blind trust in external ratings. Didn't we see enough of it in 2005-2007?

Fourth, a balance has to be found between the risk sensitivity of an approach and the costs of its implementation. Higher granularity may result in a better reflection of risk, but it will also increase complexity. In a similar vein, more principle based criteria promise a more nuanced assessment but introduce ambiguity.

It takes these four steps to succeed, but the reward of doing so is certainly worth it. What is stopping us to do it, and most important, to do it right? ■

Creating a well-functioning securitisation market in the EU

Lars Overby - Head of Credit Market and Operational Risk Policy Unit, **European Banking Authority (EBA)**

A well-functioning and prudentially sound securitisation market in the EU would strengthen the resilience of the financial system by providing an alternative funding channel. Furthermore, it would provide a useful tool to effectively transfer credit risk and accomplish risk-sharing in the financial system. Both aspects would enable banks to better perform their crucial role of supplying credit to the economy.

Capital requirements on securitisation structures should be calibrated in such way that they cover the risks and potential losses stemming from such instruments. It is important to keep in mind that the securitisation process itself generates additional risks, most notably model and agency risk. Hence complete neutrality between the capital charges for underlying assets and those for the corresponding securitisation exposures - i.e. same assets in a securitised format - is neither prudent nor desirable.

The risk introduced in the securitisation process may also differ depending on the transactions. For instance, simple, standard and transparent securitisation transactions with certain desired risk characteristics on the underlying assets could reduce the modelling risk and the asymmetry of information between originators and investors. Identifying these characteristics would at least provide more investor confidence in securitisation products.

The EBA is currently undertaking a review of the EU securitisation framework, the results of which will be submitted for public consultation later this year. This work will provide relevant input to whether and how to grant regulatory recognition to simple, standard and transparent securitisations. So far, the prudential framework has followed a one-size fits all approach, with no differentiation across segments of the market.

While this might have adversely affected the development of safer and sounder forms of securitisations, it should also be noted that any differentiation in the prudential treatment has the potential to trigger regulatory arbitrage. This risk may not be particularly pronounced at the moment, but as history tells us, such regulatory arbitrages are likely to occur in periods of risk complacency. ■

A consistent policy framework can help to boost Europe's securitisation market

Spencer Lake - Group General Manager and Global Head of Capital Financing, **HSBC Bank plc**

Europe needs a well-functioning, liquid ABS market to address a funding gap resulting from reduced banking sector capacity following post-crisis reforms and to allow risk transfer from banks to the institutional investor market.

A robust framework for high quality or 'qualifying' securitisations should focus on aligning incentives between originator and investor, notably risk retention requirements; on originators providing transparent, comprehensive, consistent and regular information so investors can analyse and monitor the risks; and removing disincentives to buy-side participation in the market that may result in asset allocation distortion, increasing asset-liability mismatches.

Risk retention and data disclosure are already addressed in existing rules. More alignment is needed between prudential rules and initiatives aimed at reviving investor demand for ABS.

Changes proposed to the composition of the LCR buffer to include certain ABS would bolster demand and promote secondary market liquidity. More important is increasing buy-side participation in 'qualifying' securitisations. In 2013, insurers and pension funds accounted for only 10% of investors, indicating a major source of untapped capital – a result of punitive requirements under Solvency II. Even with recently proposed improvements, capital charges for ABS would remain high, linked to an overstatement of the risk associated with the long-term liability structure. Tax incentives should also be considered to broaden the institutional investor base.

Bank capital requirements also need recalibrating. Despite proposed changes, these remain punitive, particularly when considered against the strong historical performance and low default rates of the European ABS market.

Another challenge is to wean banks off central bank funding, which does not address fundamental impediments to SME lending – a key policy objective – and redirect them towards capital markets. SME loans present challenges due to lack of standardisation, lower credit profile and lack of historical default data – hence the involvement of the EIB and EIF in supporting SME securitisations. Development and promotion of a functioning securitisation market, alongside creation of an EU credit registry, could be significantly more effective in stimulating SME lending. ■

How to revive the market for securitised loans in the EU

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

More than 70% of the European economy is financed by banks. Even more so in the SME sector where banks are and will remain essential. After several years of forced deleveraging due to new regulations, it is fundamental, to enable an adequate financing of the economy, that prudential rules impacting bank loans are stabilised. Complementarily, it is also important to favour the development of securitisation. To achieve this purpose there are four key conditions.

At first, regulation should not introduce penalties against securitisation. For capital requirements, issuers should be encouraged to use quality pools and investor-banks to invest in high quality securitisations (HQS). At the moment, Basel proposals imply a capital multiple for holding all tranches of securitized loans compared to the underlying pool, thus deterring issuers, and the floor is too high, thus deterring investor-banks. For liquidity requirements, banks should be able to include HQS as "High Quality Liquid Assets" in their liquidity coverage ratio. Insurance companies should be incentivised to invest in senior tranches; instead, Solvency 2 pushes them to invest directly in the underlying pool, a riskier proposition.

Second, an appropriate skin in the game with a sufficient retention rate should be foreseen to avoid repeating past errors of the subprime activity where originators had no incentive to originate good credit. For the same reason, HQS label and benefits should be reserved for originators that are regulated and follow responsible lending practices.
Third, reliance on rating agencies should be diminished. The crisis showed the inefficiencies of external ratings, especially in Europe (sovereign ceiling issues) and for the SME sector (methodological issues). In the US, the Dodd Franck Act removed external ratings in a regulatory context, whereas European regulations are reinforcing the role of ratings, contrary to the wishes of the G20. An alternative to external ratings developed by the banking industry with inputs from BNP Paribas exists: the Conservative Monotone Approach (CMA).

Last but not least, to reduce further and sufficiently the balance sheet of European banks, securitisations of residential mortgages and consumer credits should be encouraged. To do so, a form of government sponsored guarantee should be provided. In the US, guarantees from GSEs enable large scale securitisations; a similar guarantee mechanism from a European institution would lower the cost of financing and bring confidence to investors. ■

Asset managers ready for secure securitizations

Yves Perrier - Chief Executive Officer, **Amundi** & Member of the Executive Committee, **Crédit Agricole S.A.**

Securitization is one of those words that people try not to use any longer. It refers too much to excessively complex structures that enjoyed top class ratings and failed. Financial crisis and securitization have been assimilated, on the dark side of the shadow banking.

This perception must change. First, the experience of securitization in Europe is not as bad as on the other side of the Atlantic Ocean, probably more because the market was less mature than because European actors had higher ethical standards. Second, there is a need to develop off bank's balance sheets financing and, third, institutional investors are looking for a good risk /return profile and asset managers want to supply them with new secured investment solutions. Securitization can help to achieve these goals.

In order to attract investors, securitizations must at least offer three characteristics:

- The structure must be safe and understandable: on one side it implies that legal and financial teams are not too innovative and do not go too far in the "optimization" process; on the other side the link to the real economy has to be evident so that the investor can understand the purpose of the financing and the economic reasoning behind the structure;
- The credit risk can be easily assessed : the investor must be in a position to gain a clear view of the risk stemming from the underlying loan portfolio; for that purpose our analysts require a large access to information, more and more at the level of individual loans; it is particularly so for SMEs loan portfolios where statistical approach of diversification has to be accompanied by an analysis of individual situations;
- The price has to include a premium for lack of liquidity: securitization is largely a buy and hold market; price must show a premium that will benefit to investors that are ready to take a longer term view.

Eventually, securitization is a good tool to finance SMEs or more globally the economy and should expand, provided that investors are not prevented by excessive regulations from taking some risk. Amundi has developped an expertise in this specific asset class. ■

Revitalising the EU securitisation market: turning wishful thinking into reality

Deborah Shire - Head of Structured Finance, **AXA Investment Managers**

As key long-term investors holding €8.6tn of assets under management in 2013, EU insurers welcome the increase in momentum on long-term financing and most particularly the ECB's appeal for a better functioning securitisation market. Given that their long-term liabilities enable them to hold long-term assets that support the real economy, insurers are indeed ideally placed to invest in high-quality securities, the most promising instrument to provide new funding sources for businesses in the Single Market.

Regulatory obstacles are important. High Solvency II capital charges for securitisations act as a barrier to a well-functioning securitisation market in the EU. Recent developments point in the right direction as the approach of separately identifying "good quality" (i.e. "qualifying") securitisations is needed and welcome, but the definition of the high quality "Type A" is restrictive and the calibrations proposed are too high.

Regulators should rather adopt a principle-based approach around three pillars: (i) the underlying pools of assets should be homogenous, granular and have measurable risk profiles; (ii) securitisation structures must be simplified and standardised; (iii) transparency obligations should complete the framework. Compliance with such principles for "qualifying securitisations" should be checked and assessed by an independent, private or public body and could be rewarded by the granting of a label, which could become compulsory and delivered before any new issuance.

Such harmonized standards and improved data availability would ultimately make the asset class more attractive for investors. A qualitative approach also carries the benefit of not discriminating against non-senior tranches of high-quality securitisations, in accordance with the ECB view that a quality designation should apply to all tranches.

Other important steps could be taken to revive securitisation. A more liquid secondary market would for example limit cases of balance sheet volatility and thus increase the attractiveness of securitisations. Price volatility could also be reduced via the implementation of an effective market making and of specific liquidity crisis solutions, or even via a "last recourse buyer" with specific programs (such as the asset purchase program in the US or the program on European Covered Bond).

Market participants agree with public authorities that a well-functioning securitisation market would be a fundamental asset to strengthen long-term financing and growth in the EU. It is now high time we convert this unanimity into concrete actions. ■

Finetuning regulation could harness securitization for Europe's economy

Neeraj Sahai - President, **Standard & Poor's Ratings Services**

A well-functioning, transparent securitization market could help boost funding to the European economy. S&P's recent research on global banks shows lending capacity is more constrained in the Eurozone than almost any other part of the world.

However, European banks have made very limited use of securitization in recent years to transfer economic risk and free up capital for more lending to SMEs and other businesses.

For securitization to serve as a viable, large scale mechanism for funding the real economy, regulation will likely have to evolve. A number of proposed changes to banks' and insurers' capital and liquidity requirements treat securitizations unduly conservatively, we believe, relative to their historic credit performance and compared to other asset classes such as covered bonds and whole loan portfolios.

For example, in proposed revisions to the Basel securitization framework, the risk weight for a typical AAA-rated tranche is up to eight times higher than under current regulations. And in the latest draft calibration of Solvency 2, insurers investing in a AAA-rated securitization would incur capital charges that are more than 17 times higher than those for a similarly-rated covered bond.

Counter-intuitively, an insurer holding a AAA-rated commercial mortgage-backed security could require more than four times as much capital as another insurer holding the same portfolio of mortgage loans backing that security but without any credit enhancement.

Risk retention rules may also be hindering certain segments of the securitization market. They are a particular burden, for instance, for collateral managers in leveraged loan CLOs, as few have the balance sheet capacity to retain significant portions of the CLOs that they oversee.

Hopefully, the ECB and Bank of England's focus on defining "qualifying securitizations" could be a step towards levelling the regulatory playing field for simple, transparent securitisations and reviving market demand for them. ■

Revamping the SME ABS market in the EU: time is crucial

Giovanni Gorno Tempini - Chief Executive Officer, **Cassa Depositi e Prestiti Group (CDP)**

After two years of talks, the SME ABS securitization market in the EU may finally take off. The ECB in June gave a clear message that it is time to move. To be successful, however, each of the main actors (regulators, policy makers and the market) need do their part, possibly fast.

Two general conditions seem to be crucial. First, the model originate-to-distribute, which had characterized the pre-crisis securitization, need to be simplified and better regulated.

The practice of excessive slicing and repackaging of loans into ABS, with too complex and opaque structures, was one of the main reason for the global financial crisis. So the ECB calls for the promotion of simple schemes and well identified and transparent underlying asset. At the same time, the FSB has adopted new strategies to ensure a more transparent and resilient shadow banking system, of which securitization markets are a key building block.

Second, from the point of view of capital charges, regulators should create so called "condition of neutrality", which means that capital charges for holding on the book a loan have to be at least equivalent to the ones required for holding a tranche of junior notes – skin in the game.

Capital treatment for AAA ABS was risk weighted 5% after the crisis (and this was one of the reason for the subprime bubble). It was proposed to be increased to 20%, which contributed to drain the securitization market after 2008. In December 2013 it was suggested to be brought down to 15%. Still too high. A similar problem – as EIOPA keeps stressing – strongly limits the insurance companies as major ABS investors.

According to recent estimates by Bruegel Institute (2014) the potential EU market for ABS is worth roughly €3 trillion, of which €1,6 of RMBS (Real Estate Mortgage Back Securitizations), €1.1 of large NFC (Non-Financial Corporations), and 325 bn of SME ABS. They are, indeed, very large volumes. However, if the process ought to be successful – both for the unlocking the Eurozone credit markets and for enhancing the ECB monetary policy stance - time is crucial. Regulators, policy makers and the market, should make an extra effort to set the right conditions now. ■

Building securitisation markets to last – The way forward

Greg Medcraft - Chairman, **Australian Securities and Investments Commission** and Chairman, **International Organization of Securities Commissions (IOSCO)**

Securitisation markets globally have contracted significantly since the Crisis of 2007-2008.

Recovery has been slow with revival limited to some geographic and product markets. Revival is now evident in US markets, in parts of Europe and in the Asia-Pacific – but not to pre-Crisis levels. Cross border activity has also fallen away.

Activity has been largely in structurally simple, easy to understand homogeneous asset classes.

A recent survey undertaken by an IOSCO-BCBS Task Force on Securitisation Markets (TFSM) (led jointly by David Rule from the Bank of England and me) sheds light on why investors and issuers have been slow to re-engage in these markets.

Put simply, investors lack confidence in securitisation as an investment class.

The Crisis-generated negative perception of securitisation as an asset class has lingered. Concerns about the impact of regulatory reform, uncertainty about when reforms will be implemented and what they will involve, and the absence of a level regulatory playing field with similar asset classes, have together also played a role. Investors – and particularly non-bank investors – have found the risk return profile they are looking for in other, better priced asset classes.

What steps can we take to help revive securitisation markets which last?

An active and urgent response to this question is critical. Industry, and particularly the SME sector, are increasingly turning to the capital markets as an alternative to funding from the banking sector. I passionately believe securitisation is a technology which can deliver financing solutions. It has done so very effectively in the past. It can – and will – do so again.

The key to revival is about restoring – and maintaining – investor trust and confidence in securitisation as an investment class.

As investors – and non-bank investors in particular – told us in the recent TFSM survey – this trust and confidence is more likely to come with a reduction in product complexity, with improved disclosure and standardization. These features will help investors to better understand and assess with confidence and ease the risks (be they asset, structural, fiduciary or liquidity risks) and returns of the products they are offered.

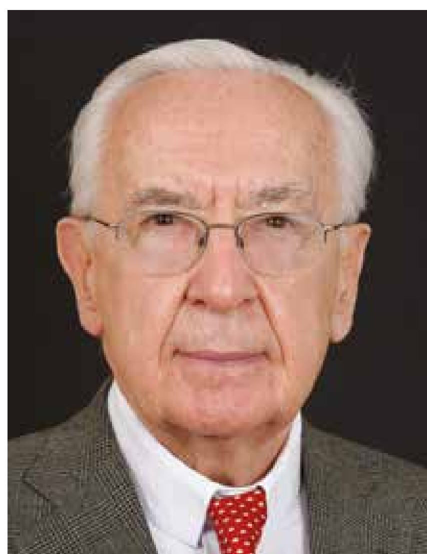
The Official Sector has a role to play by working with investors and issuers to define the features or criteria of those securitisations which will lay a foundation for restoring trust and confidence. We in the TFSM are working to develop these criteria around what we are describing as simple, transparent and consistent securitisations.

Consultation on our work later this year will be an opportunity for industry to provide input on these ideas. I encourage industry to support this work by participating in this consultation. ■

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

Jacques de Larosière - President, **EUROFI**

continuation of page 1



Relaunching the securitisation market nevertheless requires strong actions in order to restore sufficient confidence among investors and policy makers. This requires offering investments that are not only transparent and predictable, but also positioned on assets with a low exposure to asset bubbles, or to economic contingencies.

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

For this, we propose to renouncing the dangerous practices that developed before the financial crisis by creating products that are structured with a simple, transparent and demanding approach making it possible to eliminate potential legal risks, align the interests of the originating banks with those of investors, and also eliminate the risks associated with the modelling approaches implemented for structuring these products.

We propose to restrict securitised assets part of this new category, to loans to high-quality SMEs, conforming with a criterion (companies with a three-year default rate of less than 0.4%) stricter than the one set by the European central banks for accepting them as security for refinancing operations. We indeed assume that it is essential that the quality of the underlying bank loans be unquestionable.

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

In addition, the potential investors for this type of product - insurers, pension funds, funds, banks - must be able to participate in such a market. For this, as stressed by the EIOPA, their regulations must be calibrated based on the specific risks associated with these very high-quality assets, which have nothing in common with the financial products that were behind the financial crisis.

Consequently the current proposal for delegated acts under Solvency II, which would otherwise compromise their economic viability, should take into account the risks relating to PHQS-type securitisations. Provided that very strict requirements are set we believe that PHQS should be required a regulatory capital charge similar to the level that would be applied for the underlying assets they hold.

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

Given the dire situation of their economy, Europe's legislators and regulators need to implement the measures enabling the PHQS offer to develop, now. ■

EU corporate bond and equity markets

Maximising the potential of European SME Growth Markets to deliver growth and jobs

Luca Peyrano - Head of Continental Europe – Primary Markets, **London Stock Exchange Group**

A platform to help SMEs to prepare and structure for external investment coupled with a more diverse range of funding sources is needed to support the growth of Europe's 22 million SMEs. On the one hand, SMEs often lack enough aspiration, confidence or understanding about growth financing strategies and need help to make themselves attractive to investors; on the other hand, debt and equity finance work together but debt on its own is often not suitable for SMEs as they may not be able to meet interest payments, require significant capital prior to revenue generation or lack credit-worthiness.

Therefore, two policy priorities are key parts of the solution:

1. Support for SMEs to transition up the funding escalator
The Commission has identified growth coaching programmes, such as Borsa Italiana's ELITE, as a model which can be tailored to individual member states and to help SMEs to transition up the funding ladder.[1] ELITE is neutral with respect to financing outcomes and measures its success through business growth not the number of IPOs. The Commission has committed to producing an assessment of best practices on helping SMEs access capital markets and their work deserves to be acted upon by policymakers alongside the Commission-backed European IPO Task Force, reporting later in 2014.

At the same time, action is needed to re-catalyse SME advisory ecosystems of issuers, investors, advisors, entrepreneurs, academics and innovation centres. As they grow, SMEs use a mix of bank finance, seed capital, business angels, venture capital and public markets. Each type of funding depends on each other, as they must be confident that they can exit their investment to reinvest in the next generation of entrepreneurs. Helping such ecosystem understanding the "equity chain" is crucial to secure a more efficient mechanism of capital allocation.

2. A tailored regulatory and fiscal regime for SME Growth Markets

The new SME Growth Markets under MiFID II should be supported in the 2015 Prospectus Directive review, to make it easier for SMEs to access a wider investor base at lower cost. There are at least 15 equity markets across Europe tailored for SMEs, home to 1700 companies valued at €180bn. Producing a prospectus imposes high costs, so this requirement should be abolished for certain classes of SME issues (e.g. secondary issues).

Moreover, boosting the post IPO profile and liquidity of SMES is key to reducing the cost of capital. Incentives are needed for brokers and others to produce research and the ability to disseminate it, especially to retail investors – who should not be dissuaded from backing growth companies by regulatory or conduct of business barriers.

Finally, the Commission should assess the impact on the cost of capital of the tax bias against equity. Tax has a critical impact on investment (equity is taxed four times, debt is tax deductible) so a Commission assessment would inform national fiscal decision making. ■

1. European Commission Communication on Long Term Financing of the European Economy, March 2014, section 5 page 11

Deepening EU regulation to promote capital market corporate financing

Gérard Rameix - Chairman, **Autorité des Marchés Financiers (AMF)**

Credit photo : Franck Dunouau

Capital market financing is growing and currently accounts for circa 30% of corporate funding in Europe. This trend is expected to continue due to prudential constraints, deleveraging and reshaping of the banking model. After the post-crisis regulatory agenda focused on transparency, robustness and resilience, there is a clear trend towards initiatives dedicated to consistency of sectoral rules, growth and sound long-term financing.

In the field of equity, while some true improvements (visibility, passport) might ensue from recent initiatives such as ELTIF or EVCF and SME Growth Market labels, the European legal framework should go one step further in setting proportionate requirements for SMEs, especially with regards to prospectuses and financial information. Corporates might benefit from a better integration of marketplaces in Europe; however such evolution remains contingent upon competitors' initiatives. We also have to carefully assess the impact of the new inducements' regime to avoid the emergence of a two-tier financial analysis, which would have a direct impact on the issuers' ecosystem. Furthermore, any desirable reform of the existing tax bias in favour of bonds would require unanimity of Member States.

Corporate debt markets have been expanding for the past few years but did not really act as a catalyst for issuance and trading practices. In the primary markets, a higher degree of standardisation of issuance contractual terms for bonds and private placements could be an interesting path to explore. The high yield segment is dynamic in a low interest-rate environment and does not really need specific incentives. In the secondary markets, there is still room for improving banks' involvement so that transactions take place on transparent venues ensuring a more reliable price formation mechanism.

On the governance side, it is also necessary to enhance regulatory convergence in the interpretation and enforcement of rules as well as in regulators' operational practices. In that respect, ESMA's standing committees play a crucial role in building this common culture and policy. ■

Nordics market dialogue serves SMEs well

Magnus Billing - President, **NASDAQ OMX Nordic**

In 2013 NASDAQ OMX Stockholm launched an IPO Task Force, after a year-long dialogue with market participants about what could be done to ameliorate the listings climate in Sweden.

The work came to focus on SMEs, which the group identified as the main providers of potential growth and job creation going forward.

All of the measures recommended by the Swedish IPO Task Force within the control of the exchange have been implemented, with encouraging results. A number of identified actions to improve conditions for SMEs' possibilities to raise capital on public markets still remain to be effectuated. One example is putting in place meaningful incentives for investors to take risk in SMEs in the long term. Simultaneously, the macro climate has improved in parts of the Nordic region. These factors combined contribute to the fact that NASDAQ OMX as per the end of Q2 enjoys the second place in numbers of listed companies in Europe.

The IPO Task Force initiative rapidly grew to encompass other Nordic markets. Interestingly, but perhaps not surprisingly, SMEs remained in focus.

The Danish and Finnish IPO Task Forces also identified multiple initiatives, including a set of new best practices for the listing process, tailor made prospectus for smaller companies and an optimized approval process at the FSA. There has also been a focus on incentivising investor attention on SMEs, increased analyst coverage and a push to improve liquidity in SMEs.

I am currently discussing our findings also at European level, in particular as a member of the European IPO Task Force, recently set up by FESE, European Issuers and EVCA. Possibly, some of the findings may serve as inspiration beyond the Nordics. One example is incentivising analyst coverage of SMEs. Such measures are important and could potentially have great effects on the visibility of and investors' attention on SMEs.

NASDAQ OMX will continue its broad dialogue with market participants, enlarging the scope of questions raised in order to improve and develop SME equity markets. ■

Stimulating corporate bond and equity markets: the Italian experience

Giuseppe Vegas - Chairman, **Commissione Nazionale per le Società e la Borsa (CONSOB)**

Since 2000, as a reaction to corporate scandals and financial crises, legislators all around the world have given in to the temptation to over-regulate. A single-rule book, consolidating the European directives and regulations on securities markets in a plain language, along with a deeper coordination in supervisory practices over member countries, are now needed. Coordination in supervision would rule out arbitrage over national oversight approaches. The most effective way to do this is to centralize supervisory responsibilities at the European level, creating a financial union, similar to the Banking union.

In order to further develop EU corporate bond markets in Italy "Mini-bonds" were introduced to allow issuance of short/medium term ordinary and convertible bonds by unlisted SMEs. Also in Europe they could be a viable alternative to banking financing for SMEs and a new investment opportunity for investors.

New bank loans to SMEs could be made available by revitalizing the European securitization markets, severely hampered by the financial crisis. Investors' confidence may be rebuilt by enhancing transparency, encouraging the issuance of "plain" ABS, and strengthening the rules on risk-retention by the originators (in line with the initiative of the ECB and BoE).

Moreover, the support of growth in Europe needs a further development of the credit funds sector. Other innovative forms of non-banking intermediation are developing, such as the collection of venture capital on online portals (crowdfunding).

The Italian legislator has been the first to regulate equity crowdfunding and Consob has recently issued the secondary regulation, in this way creating a reliable environment for investors, not too onerous for webmasters and accessible to companies using portals.

To help the development of EU corporate bond and equity markets it is fundamental to fully harmonise the legislation concerning the taxation of financial transactions.

For this reason it is important to speed up the process of enhanced cooperation in this field among eleven European countries in order to achieve the implementation of a common system of financial transaction tax as soon as possible. ■

Towards more market-based financing for the European economy

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

The financial crisis has impeded the ability of the European banking sector to provide the capital that the real economy needs to finance its recovery. We therefore need the capital markets, in particular the equity and bond markets, to step in and bridge a possible funding gap. This has partially been addressed through MIFID II which enhances the transparency of equity and bond markets and introduces the new SME growth markets, which are designed to minimise the administrative burden for issuers in this sector.

However, as the Commission Communication on Long term financing of 27th of March 2014 sets out, further action is required. The Commission will therefore undertake a study to determine whether additional measures are required to enhance the trading of corporate bonds in the EU and facilitate the creation of a transparent and liquid secondary market. By the end of 2015, the Commission will also assess the implications and effects of the Prospectus Directive rules, in particular the disclosure regime for SME issuers and companies with low market capitalisation. And the Commission will explore whether the eligibility criteria for UCITS could be extended to securities listed on SME growth markets. Whether European Long-Term Investment Funds (ELTIF) should be permitted to invest in listed SME's is an area that is being debated in the negotiations on the Commission's ELTIF proposal.

The Commission has therefore set out a range of measures, ranging from concrete legislation to plans to explore new ideas, to enhance the European bond and equity markets. These aim to diversify the way in which investment is financed in Europe and make the capital markets a more effective and resilient conduit for channelling funds to the real economy. ■

Retail investor confidence is the key to European financial markets development

Jean Berthon - President, **Better Finance for all**

According to a study conducted at the request of the European Commission and the FSUG in 2012 by OEE and IODS, the relative weight of foreign investors (including European) in European listed companies almost quadrupled, from 10% in 1975 to 44% in 2012. In the meantime, the weight of households was divided by almost three, from 28% to 11%. But, considering European investors rather than only national ones as domestic, the picture is quite different: at the end of 2011, non-European investors accounted only for 22% of market capitalisation holdings and the share of intra- EU cross-border investments in overall cross-border investments decreased from 48% in 2001 to 43% at the end of 2011, after a peak at 50% in 2004 and 2006.

Some lessons to be drawn from these figures: first, the increase of the weight of foreign (including European) investors since 2001 is only the fact of non-European investors which perhaps demonstrates the failure of the single market.

Worse, the share of direct investment by households collapsed, despite the privatization campaigns, due probably to strategies of key market players which prefer to channel savings towards investment funds or structured products much more remunerative to them but far less attractive to individuals.

Another cause of these problems, are the barriers to shareholder engagement that were reported in the study published by EuroFinuse in 2012.

So if we consider that more integrated European financial markets and more cross borders detention by European should be favoured, because of the increasing role of financial markets in the financing of our economies, it is necessary to develop the single market approach by harmonizing rules and taxes, to restore individual investors confidence by facilitating the access to capital markets for retail investors, suppressing the financial transaction tax, limiting or banning HFT and removing the barriers to shareholder engagement. ■

A TLTRO especially dedicated to infrastructure: A proposal

Franco Bassanini - President, Cassa Depositi e Prestiti Group (CDP)

The ECB has recently launched the TLTRO as a new line of liquidity earmarked for medium-term bank financing to the real economy. The liquidity injected in the economy is expected to be great and the effect on the economy is supposed to be positive. The risk of a "improper" use of the facility by banks, i.e. "carry trade", is probably not high thank to the strict "by laws" set by the ECB.

According to the guidelines published by the ECB, the infrastructure sector is eligible for bank loans financed through the TLTROs liquidity. This is very important, since infrastructure have great potential to foster the process of structural adjustment and growth in the Eurozone.

An "Infrastructure-Targeted Longer-Term Refinancing Operations" (ITLTRO) could then be also introduced. It would be characterized by longer maturity (more in line with the horizon of infrastructure projects and therefore able to reduce the refinancing risk and the uncertainty about the pool of financing institutions), specific mechanisms to reduce capital absorption (i.e. guarantee schemes), and reduced haircut on collateral (so as to unfreeze more liquidity).

Long-term Investors (LTIs) – like the Promotional Banks (PBs) of the Eurozone – would be the ideal candidates to be admitted to the measure, due to the nature of their business model, featuring a typical attitude for infrastructure financing.

PBs can ensure the effectiveness of the measure (liquidity will be totally transferred to the firms) and its enforcement, due to their monitoring activity based on bank-firm contracts. If PBs would be admitted to the facility, ECB would be exposed with counterparts (PBs) with creditworthiness higher, on average, than commercial banks. Commercial banks should be also admitted to avoid market distortions. The measure could be established as a direct lending facility and not as a second floor (i.e. intermediated) tool. The BCE may also introduce a special "track" for collateralized TEN-T, TEN-E and CEF initiatives and/or for those co-financed with EIB loans or Euro Project Bonds. ■

Involvement of re/insurers in the financing of infrastructures and implications of Solvency 2

Philippe B. Brahin - Head Group Qualitative Risk Management, Managing Director, Group Risk Management, Swiss Reinsurance Company Ltd

The importance of infrastructure investing for economic growth is well recognised. Policy actions are required to accelerate the development of infrastructure as an asset class for re/insurers in Europe. By increasing the pool of investable longer-term assets, the large asset base of long-term investors can be activated. Furthermore, leveraging the expertise and credibility of international financial institutions will help to promote standardization.

With regard to Solvency II, further progress is required in addressing regulatory impediments to long-term investing. The capital rules, notably under the standard formula, have to be more supportive for long-term investing and infrastructure in particular.

The EU Commission is currently finalizing the Solvency II draft Delegated Acts (DAs). An adoption of the DAs by the Commission will be followed by a three months period for objection by Parliament and Council. The DAs are expected to include a clause requiring a review of the calibration of the standard formula within 3 years after its launch.

The review is expected to include a new calibration for the use of long-term infrastructure, taking into account the experience of the insurance industry. EIOPA expressed clear interest to follow up on infrastructure calibration and the industry is keen to work with regulators and policymakers to ensure appropriate treatment of infrastructure investments.

Swiss Re is engaged in many industry initiatives to make infrastructure more accessible to institutional investors: infrastructure investments needs to become an asset class. Key objectives are to increase transparency and harmonization of project pipelines, structures, financing and performance. Further availability of best practices, benchmarking, as well as performance data, are also needed to increase the supply of projects and improve public and private investor confidence in the sector. ■

European priorities for long-term investments

Alessia Mosca - MEP, European Parliament

Long-term investments are central to economic growth and to the creation of jobs, and they are essential for the start and successful implementation of major projects in key sectors for our development, such as infrastructure and research.

Unfortunately at the moment the system of long-term financing is totally lacking, for several reasons: firstly, because of the global financial crisis and the sovereign debt crisis in the European Union, the European financial sector has been unable to converge savings towards the needs of long-term investments. Limited public finances, then, have prevented the member States to invest in infrastructure. In addition, both private investors and institutional ones still suffer a significant lack of confidence and high-risk aversion. Finally, the heavy dependence on commercial banks for the financing of long-term investments excludes many SMEs, the true backbone of the European economy, from accessing to credit.

The actions to be implemented in this new legislature to reverse this trend and facilitate long-term investments are various: first of all, on the regulatory side, you need to solve the current fragmentation of the bankruptcy codes in force in the Union, which often discourages cross-border investments and limits investors' capability to recover their money in case of failure of a project. So: certainty of the law. In this sense, it will be a great help when the Banking Union will be completed.

We need, then, to find new sources of funding to supplement those provided by commercial banks and fill the funding gap for SMEs. One possibility is the expansion of national and regional development banks, which may, among other things, be a valuable stimulus to private investment.

Finally, in this list of proposals with no claim to completeness, I should mention the TTIP: I believe in fact that this agreement, as well as other trade treaties that EU is signing with major economies in the world, will bring significant investments that will give oxygen to our economy. ■

Solvency II calibration for infrastructure will not allow significant involvement by insurance companies

Xavier Larnaudie-Eiffel - Deputy Chief Executive Officer, CNP Assurances

Infrastructure provides services that are essential to a well-functioning economy. Insurance and pension funds have a role to play in long term investment and growth and should so be participating in financing infrastructure. So it is a key issue that Solvency II regulation helps to facilitate insurance companies to invest in long term assets. However the current proposal for calibrating the capital charge for infrastructure is not favorable to ensure that insurance could be sufficiently involved.

In December 2013 EIOPA released a technical report indicating that calibration for infrastructure is adequate, considering the lack of solid data in the area (historical yields…).Initiated at the request of the European Commission, this document aimed to evaluate the need to revise the standard formula used to calculate solvency capital ratios.

According to the proposed calibration in Solvency II, there is today no specific capital charge for infrastructure (neither for equity or debt): what is asked to Insurance is to implement the capital charge of a similar investment (duration, rating), that does not take at all into account any specificity of infrastructure.

Nevertheless, it is clear that infrastructure investment reduces interest risks for insurers that have long term liabilities linked to retirement products. They also provide higher yields than sovereign debt.

Furthermore capital charge, based on credit risk, essentially linked to rating and duration of the investment, is not appropriate for infrastructure:

- the rating of an issuer essentially reflects its probability of default and does not usually take into account any level of loss in case of default,
- However, if infrastructure loans could face risks that lead to restructuration or losses, they usually show far better recovery rates than corporate issuers of the same ratings.

These key points are not taken into account in today's Solvency II calibration and if this calibration is not reviewed, financing infrastructure by all insurers would be dramatically penalized in the future. ■

Helping ELTIFs successfully channel long-term investment in Europe

Massimo Greco - Head of European Funds Business, J.P. Morgan

We support the European Commission's long-term growth agenda and see ELTIFs as a tangible and credible step in achieving this policy goal. We believe that institutional and retail investors may find this an attractive alternative vehicle for infrastructure investments.

Infrastructure covers an exceedingly wide span in the risk-return spectrum. On one hand, core infrastructure, i.e. mature assets with established operations and demand patterns, enjoy quite predicatble and stable cash flow streams. Greenfield and development projects, on the other hand, can be volatile as infrastructure projects tend to be large scale, involve complicated engineering works and are unique in the sense that demand forecasting is challenging. Infrastructure assets mature very slowly; it may take a decade or more for a development project to complete its demand ramp-up period and become a core asset. It is also important to highlight that not all development projects produce core assets in the end.

For ELTIFs to successfully meet the financing needs of infrastructure projects as well as investor expectations, it is vital to avoid the impression of liquidity and stability where it does not exist in the development stages of infrastructure projects. Investors need to be aware that they are investing in illiquid assets under development. This also brings into question the suitability of ELTIFs for retail investors and raises important elements of investor protection which are currently subject to debate by European institutions.

Longer duration assets, such as infrastructure equity assets, offer an alternative source of financing. That being said, professional investors would need a more flexible regulatory framework adapted to their particular needs in order to invest in those types of long-term projects. Diversification across either geographies or infrastructure sectors (or preferably both) is one characteristic that mitigates some of the risks of developing projects for the investors. Maturity should also allow for flexibility to avoid forced selling in potentially difficult markets or for the fund to go into "run-off" for a long period before maturity. Ultimately, investors need and seek a stable and predictable regulatory environment – this becomes even more important in the case of illiquid investments, in which the link to a particular jurisdiction is of longer duration.

We understand that the Italian Presidency of the EU Council has made ELTIF a policy priority during its mandate. We look forward to policymakers starting negotiations and continuing to make efforts to find sound and innovative ways to channel long-term investment in Europe. ■

Funding infrastructure for growth – what to do?

John Moran - Board Member, **European Investment Bank (EIB)**
& Former Secretary General, **Irish Department of Finance**

Is the Eurozone heading into stagnation while borrowing costs are at all-time historic lows? Is Europe losing ground on other economies? The OECD forecasts productivity growth in the Eurozone of 1.5% will lag that of the United States at 1.9% over the period of 2014-2020.

Highly indebted governments running primary deficits have limited room to invest despite historically low rates. Current yields suggest rates may already be running ahead of the adjustment process so government priorities must remain structural and fiscal reform. A way of catalysing private sector investment into Europe is therefore be required. Worryingly, recent numbers show a recent retreat of some US investors.

Can anything be done?

With Alberto Giovannini, I had the honour of co-chairing such an analysis for the European Union. The full list of recommendations are set out in our report "Finance for Growth".

Member States and the new Commission and Parliament must now act on these recommendations. Regulatory rules must also be designed not to work against this imperative.

Firstly, capital requires top-class business environments so structural reforms to ensure best practices are adopted by all member states are a key priority. Fewer national differences means less costly local due diligence and thus easier and cheaper capital from outside the EU. An annual due diligence review might even be offered by the EC.

Better funding, also requires better available information – historical information on projects consistently across all member states, a data warehouse tracking covenant performance, a real-time database of infrastructure in planning and procurement phases.

Within Europe, moves can be taken to facilitate the development of new cross border investment funding by creating new pan-European vehicles and also removing national barriers such as taxation or bank lending preferential treatment.

Public procurement practices can also be streamlined and made more non-bank funder friendly.

But finally, let's not waste the finance. No more "motorways to nowhere". The EC, EIB and national governments should work together to establish and communicate national investment plans over a three year horizon with each national plan developed not as a silo but holistically across the EU so that the collective impact of the plans is an even greater improvement in European productivity. The availability of EIB financing and their key role in catalysing capital markets funding could be predicated on convergence with these plans and on progress by national governments in business environment structural reform. ■

Diversifying the financing of small and medium infrastructure projects

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

In the recent years, the long-term funding of big infrastructure projects has been regarded as the main issue, due to their political visibility. However, small and medium infrastructures represent more than 2/3 of the total infrastructure investment and have up to now a limited access to market-based financing. In order to address this gap and diversify the funding sources, a wide array of financial tools has to be investigated, drawing experience on recent infrastructure deals in France.

A straightforward approach would be to provide financing through direct loans, in addition to public subsidies. EIB and CDC have implemented such a scheme for a very high speed broadband network project in Haute-Savoie: the two public institutions loaned each 36 M€, alongside with public grants amounting to 63 M€.

However, such a scheme relies heavily on public funding, and arrangements allowing for higher leverage of public spending have to be sought. The EIB project bonds meet this additionality objective and have recently proved their ability to finance medium size projects: the Axione deal will allow to raise 190 M€ on the capital market, with a credit enhancement provided by the EIB. This is the third project bonds deal in Europe and the first involving digital infrastructure.

Another interesting scheme, involving banking and insurance financing, has been applied to the Cité Musicale project. At the completion of the project, the refinancing of the commercial banks construction loans will be subscribed for by insurance company (Allianz).

In order to finance smaller projects, the creation of securitization vehicles should also be looked into. Sponsored by public banks, they would issue investment grade bonds, backed by a portfolio of

selected infrastructure projects. In order to attract long term investors, these debt funds would also provide a credit enhancement, through bonds subscribed by their public sponsors.

These various financing techniques should ease the access of infrastructure projects to capital markets. ■

Creating the right conditions for attracting long-term investment in Europe

Barbara Novick - Vice Chairman, **BlackRock**

For Europe to unlock the economic potential of long-term financing, we need the right products and regulatory framework to attract private capital.

An important starting point is to recognise the critical role played by asset owners in allocating capital and to develop an understanding of their specific investment needs. Although some believe asset managers have discretion to allocate assets, in fact, the primary control over asset allocation decisions rests with the asset owners – such as pension funds, family offices, charities, endowments, and individual savers and investors – and each of these asset owners have different investment objectives and operate with different regulatory and accounting concerns.

Ideally, regulatory, accounting and tax rules would be aligned to encourage capital to be allocated to long-term asset classes like infrastructure and SME loans. Accounting treatment for pension plans, regulatory capital for insurance companies, and passports for offering funds across borders are just a few of the areas worth reviewing. It is important that asset owners are encouraged to make these allocations through appropriate prudential treatment for long-term assets (for insurers, banks and pension funds), and the right incentives (e.g. investment eligibility and appropriate tax treatment) to invest in vehicles like the ELTIF or the ability to offer non-bank loans to unlisted companies.

Creating new investment vehicles, such as the current initiative on ELTIF, could help channel funding that has already been allocated to long-term asset classes if they are constructed in a way that appeals to asset owners. Additional efficient and specific fund structures that give greater ease of access into specific types of long-term investments – for example, securitisation, infrastructure and non-bank direct lending – should also be encouraged.

Perhaps even more fundamentally, we need to ensure that Europe is generating more attractive investment opportunities by creating contractual certainty and a coherent regulatory framework for the projects themselves to avoid excessively high risk premia, and creating accurate and standardised data to allow asset managers to perform effective due diligence and risk monitoring.

The greater the policy focus on creating a comprehensive framework, the greater investors' ability will be to invest in long-term assets. ■

Long Term Funds ("ELTIFs") for individual investors?

Guillaume Prache - Managing Director, **Better Finance for all**

We are definitely living in strange – *"unconventional"* the ECB would say – financial times!

After all, ELTIFs are mainly meant as packaged portfolios of loans (to infrastructure/housing projects and to SMEs) and of real assets.

With this initiative, the EU seems to accept as fait accompli that banks are no longer - and will not be – delivering adequately one of their core services, i.e. long term lending to the real economy, in particular unsecuritized lending to infrastructure projects and to SMEs.

Assuming that professional asset managers have the competence and experience to step into commercial banks' shoes and originate and manage portfolios of such loans may be a bit of a stretch. But deciding to sell these packaged long term / SME loans & real assets to individual investors is yet another and bigger challenge.

Besides, we do not believe the solution to an identified financial need is to add yet another specific legal category of product. The European retail investment landscape is already planted with too many and often too complex products. Even the CEO of Goldman Sachs advocated in 2009 for less complex financial products (although he and many others obviously forgot about it since then). There is indeed already a plethora of retail "AIFs[1]" including AIFs already specifically dedicated to long term investments[2]. How adding yet another legal category will make a real difference?

We believe there are more effective initiatives to be taken to develop long term retail investment in Europe (revive the retail equity markets - mid/small caps in particular, and increase pension funds' and life insurance asset duration to name a few), but if the EU regulators still decide to have ELTIFs sold to retail investors then we would recommend to :

- sell the same ELTIFs to all investors – retail or not, and ban funds of funds;
- grant ELTIFs most favored long term retail investment product tax regime in every EU Member State;
- apply the product disclosure rules of UCITS funds;
- make listed small cap equity an eligible asset class.

- The last word to a quite successful individual investor named Warren Buffet: *"Never invest in a business you can't understand."* This is why we fully support a high threshold for minimum investments in ELTIFs: those should be "advised" only to qualified and very financially literate investors. Besides, what applies to investors applies also to retail distributors. I doubt a lot of them have the competence to adequately sell packaged Infrastructure/SME loans & real assets. ■

1. AIF: "Alternative Investment Fund". ELTIFs will be part of AIFs.
2. For example, there are already no less than 10 different long term retail AIF legal categories in France alone, funding anything from property, to innovation, to company stock, to local unlisted SMEs or to forests.

Eurofi would like to thank very warmly
the lead sponsors of this event for their support

LEAD SPONSORS

Without a true capital market union the European single market for financial services will not be complete

Wolf Klinz - Founding Partner, **3C Consulting and Capital Co.Ltd.**

Years after the G20 agreed to regulate every financial product and every market participant in every jurisdiction the same way, it is obvious that this ambitious objective has not been met. There are still differences betwenn the USA and Europe. The EU has even seen trends towards renationalisation in the financial services sector after the crisis. Can the obstacles holding back further integration of the European financial system be overcome and will the Banking Union help to achieve this?

1. Obstacles to further integration: Whenever member states of the EU implement European legislation, they try to account for national specificities (not the least because they consider themselves sovereign). Since company and civil laws differ in most MS, differences in regulation cannot be avoided completely. Hence regulatory arbitrage persists.

The protection of the (particularly retail) investor is a goal shared by all EU MS. However, not all MS wait until the EU has agreed on a common approach, but rather move ahead with national regulatory legislation. Hence we see some MS ban short sales, HFT or certain bank structures, while others hold back – another source of fragmentation.

MS refuse categorically to seek agreement on a harmonised corporate tax base, let alone tax structure and rates. Financial market related taxes continue to differ between MS and allow tax arbitrage. The € facilitates offering financial services across political borders in the Eurozone, but risks to provoke a rift between the Eurozone and the rest of the EU. Historically most of the EU MS have been bankcentric: 70% of the financing of industry, commerce and infrastructure is bank based as opposed to 30% in the US. This bank focus is primarily national or even regional and does not support the European integration of the financial sector.

2. The Banking Union is the right way forward. The Banking Union is a crucial step towards creating a true European financial services market. In fact, the Banking Union is so important, that it should have been decided right after the crisis and not only years later. The implementation of the Banking Union has to deliver in practice what the rationale of the project promises in theory. The Banking Supervision seems to be up for a good start in November this year. The Single Resolution Mechanism, however, is still very much MS based. Hopefully its implementation will not be slowed down by national political interference. The mutualisation of the depository guarantee schemes is not in sight.

The Banking Union will not be sufficient to complete the integration of the European financial system. A true capital market union has to be established. That will enable the EU to reduce the toxic links between banks and governments and generate the funds needed to finance growth, infrastructure and the creation of jobs. ■

Enablers and obstacles to further integration of the European financial system

Alex Wilmot-Sitwell - President Europe, the Middle East and Africa, **Bank of America Merrill Lynch**

The effects of the financial crisis on the European Union's (EU) financial integration have been undeniable. The level of cross-border debt securities held by Euro area banks has decreased by more than 20% in the past 5 years while cross-border interbank lending positions within the Euro area have halved since 2008.

When put forward in 2012, one of the goals of the EU's Banking Union (BU) effort was to reverse this trend and promote financial integration in Europe. Legislation such as the CRR/CRD4 Package, the Recovery and Resolution Directive, the Single Supervisory/Resolution Mechanism (SSM/SRM) is meant to ensure high standards of prudential supervision, enable a better identification of emerging risks, help counter financial imbalances and allow for orderly resolution. All these are essential for well-functioning, integrated financial markets.

Although the benefits of the BU could be far-reaching, a flag needs to be raised in terms of implementation. The EU needs to make sure rules are implemented consistently and do not harm those countries outside the BU. Regulatory uncertainty and a lack of proper implementation could have a disruptive effect within the Eurozone and the EU more widely.

Global financial services are regulated through an international framework of regulatory standards, which the BU follows to a certain extent, as agreed by organizations such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). We need to be mindful however that deviating too far from the original standards could lead to further fragmentation of financial systems across the world, and place the EU at a potential competitive disadvantage relative to third country jurisdictions.

Other examples of obstacles to financial integration in Europe are the Financial Transaction Tax (FTT) and proposed reforms relating to derivatives activity and banking structure. Our concerns on the FTT relate to proportionality and extra-territoriality. Evidence collected demonstrates that the tax would adversely affect countries outside of the enhanced cooperation procedure as well as countries outside the EU as a whole. Regarding derivatives reform, consistent clearing obligations and rules for the treatment of third country Central Counterparty Clearing Houses (CCPs) need to be enforced across jurisdictions and practical implementation needs to be seamless with mutual recognition and substituted compliance seen as key. Last but not least, while the CRR/CRD4 and BRRD have been broadly welcomed as necessary steps for dealing with "Too Big to Fail" (TBTF), the current proposals on bank structure have been widely challenged. At the moment they raise more questions than answers on a TBTF solution and the promotion of greater financial integration.

Before looking to further financial integration it is worth taking a step back to focus on the consistency of rules and how they form a cohesive network tasked with mitigating risks in the sector. This way unintended consequences can be quickly addressed and financial institutions are more able to pursue their activities in a safe, predictable and competitive environment. ■

Banking Union will reduce financial fragmentation, but divergences in funding costs will remain

Michel Madelain - President and Chief Operating Officer, **Moody's Investors Service**

During the crisis, euro area financial conditions significantly diverged between member states, developments referred to as 'financial fragmentation'. Since 2012, fragmentation has declined, largely because of the ECB's commitment to preserve the monetary union and its associated actions to help harmonise banks' funding costs.

Fragmentation can impair the cross-border functioning of the financial system and the transmission of monetary policy. Unchecked fragmentation could even, in extreme circumstances, break the monetary union.

Banking Union addresses some causes of fragmentation by providing a level regulatory playing field, enhancing transparency about banks' financial health, loosening the bank-government nexus and providing a resolution mechanism to reduce contagion.

However, financing conditions are unlikely to converge fully in the near future, and differences in lenders' and borrowers' creditworthiness will justify differentiated cross-country spreads. Moody's baseline credit assessments, which measure standalone creditworthiness of banks, are currently 2 notches lower on average for banks in peripheral countries than in core countries, reflecting weaker operating environments and fragile funding and liquidity markets. Moreover, during the last six years, corporate bond default rates in peripheral countries have been seven times higher than in core countries. Non-performing loan rates also remain significantly higher in peripheral countries than in core countries, illustrating differences in credit risk within the euro area. While we expect faster growth in some peripheral countries than in parts of the core, differences in the assessment and pricing of risk are likely to remain within the Eurozone.

Differences in financing conditions further reflect structural issues in the euro area. Without full fiscal union and mutualisation of potential costs associated with economic shocks, different market yields will reflect different risk profiles. A return to the financial convergence of the pre-crisis years is not warranted. In fact, we may not be far from the 'new normal'. ■

Supervising diversity

Jesper Berg - Managing Director, **Nykredit Bank**

From afar, everything looks the same. It is only close up that the differences show. One of the major challenges in any union is to combine equal treatment with respect for differences. This will also be a challenge in the banking union.
If you are part of an economic institution, you are tempted to base your work on numbers. Numbers have the added advantage that they appear objective. Thus, for the Single Supervisory Mechanism as well as the rule setters at the European Banking Authority, there is a strong temptation to base both their supervision as well as rule setting on metrics and "one size fits all" definitions.

The problem is that one size does not fit all. The European universe of credit institutions is very diverse. It is much more diverse than the universal bank paradigm according to which the Basel framework is modelled. We have public-sector banks with very high capital ratios but very low leverage ratios. We have cooperative banks that by nature have no access to equity markets. We have standalone mortgage banks that have a deposit deficit relative to their lending of 100 pct, as they do not take deposits and where all assets are encumbered as they serve as collateral for covered bonds. We have many national specificities that reflect differences in tax laws, bankruptcy legislation and social safety nets.

The diversity of institutions has served Europe well. Public-sector banks ensure financing of public-sector projects, when public finances are strained, cooperative banks are the true relationship banks in Europe who serve even the most rural areas in Europe in good times as well as bad times, stand-alone mortgage banks have proven a pillar of stability, where properly structured.

The single market, the rule setting and the supervision need to respect these differences. If not, they will, in their quest for harmonisation, face the wrath of the general public that depends on the differences. ■

The banking union should trigger more regulatory convergence

Roar Hoff - Executive Vice President, Group Risk Management, **DNB**

The finalisation of the CRR / CRD IV opened up for significant national discretion regarding capital requirements through the macro-prudential toolbox (systemic risk buffer, O-SII buffer, countercyclical buffer). The scope of Pillar 2 has also been widened. This could potentially undermine the single market through the introduction of national capital requirements that do not reflect actual differences in risk, but rather some regulators' ambition to introduce strict capital requirements. This development should be avoided.

National authorities will often claim that they know best what is needed to maintain financial stability in their countries. In many ways this is indisputable, however, national authorities are not necessarily the best to assess the relative risk that faces its own banking system compared with the situation in other countries.

International bodies like the ESRB and the EBA should play an active role in harmonising the use of macro-prudential measures and Pillar 2 requirements. The current EBA draft guidelines relating to SREP are a step in the right direction. Guidelines for assessing or quantifying systemic risk should also be prepared. The Basel Committee has developed a guide for setting countercyclical buffer rates. Similar tools should be considered for setting the systemic risk buffer and the O-SII buffer.

Under the banking union the ECB will have supervisory responsibility for the largest banks in the euro area, making it the most important bank regulator in Europe.

The ECB practices will most likely be used as benchmarks for local regulators with respect to small banks as well as for regulators outside the euro area. The ECB should therefore be transparent and open about its role as a regulator, which would be of great help to us all. ■

Banking Union: benefits from cross-border banking integration and risk-sharing

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

How will Banking Union be welfare-improving? An enhanced supervisory framework and a unified resolution framework should improve financial stability. Not less important will be the impact of Banking Union on cross-border banking integration and private risk-sharing as it aims at eliminating the link between banks and their national sovereigns.

The first decade of the euro area saw European banks beginning to develop cross-border business strategies. In principle this should have deepened credit market integration and improved the smoothing of income shocks across countries through diversification. But the way banks integrated, which was short-term and debt-based, in fact produced little genuine risk-sharing. In the event of a shock, some jurisdictions faced a "sudden stop". And even those banks that had integrated through acquisitions, and so should in principle have been insulated from a fragmenting financial system along national borders, sometimes found their internal funding markets disrupted by supervisory ring-fencing. The cost of backstopping banks fell largely on national fiscal authorities, contributing to the infamous bank-sovereign nexus.

Banking Union can improve risk-sharing by dispersing the costs of bank failure in a crisis event and enforcing a level-playing field in bank creditor protection.

In a crisis event, the new resolution framework shifts the costs away from sovereigns and onto the private sector. And through the resolution fund, it spreads those costs more evenly across the euro area banking sector. Insofar as this weakens the bank-sovereign nexus, it should help reduce financial fragmentation and in turn support the deeper integration of the banking sector.

In general, risk-sharing will be improved through a more robust integration of credit markets. Banks will be able to develop genuine EU-wide balance sheet strategies, thereby exploiting cross-border economies of scale. A single supervisor will create a set of homogenous standards, reducing the compliance costs of operating across borders. And because the single supervisor will take a European view, the fungibility of liquidity within banking groups should increase.

In short, if all goes to plan, Banking Union promises a more stable and prosperous euro area. ■

Banking union: from 1.0 to 2.0

José M. González-Páramo - Global Economics, Regulation & Public Affairs, Executive Member of the Board, **Banco Bilbao Vizcaya Argentaria (BBVA)**

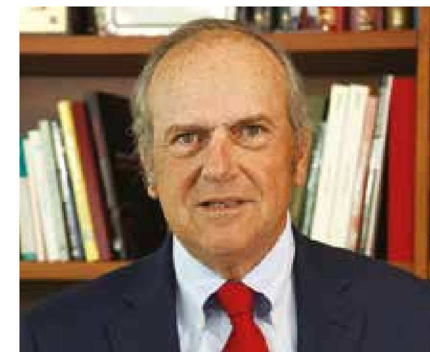
The trend towards fragmentation in EU financial markets from 2010 to 2012 was incompatible with the euro. The European authorities successfully counteracted this trend through monetary policy measures and declarations – in particular Mario Draghi's famous "whatever it takes" - as well as with the banking union project. As is well known, some of these elements, like the Single Supervision Mechanism, have an immediate application, whereas others, like the Single Resolution Fund, will require a gradual process. But some of the beneficial effects are already perceptible and market player's expectations of a breakout of the euro have been almost totally dispelled.

The ultimate objective of banking union is, however, more profound than simply overcoming fragmentation: a true single market for financial services in which not only wholesale markets are integrated (like they were to a significant extent in the mid-2000's, before the crisis) but also the retail segment. In the endpoint, financial consumers should be able to operate freely with any financial institution of the Eurozone and benefit from the ensuing competition and efficiency gains. This would require moving at a certain stage from banking union 1.0 to the 2.0 version, one in which all Eurozone banks will *inter alia* share a common Deposit Guarantee Scheme. This step will require a degree of fiscal union beyond what is possible with the present Treaty.

Progress in the European construction has always been the result of an ambitious vision of long term objectives accompanied by a politically realistic roadmap and a policy of gradual steps. The progress made towards banking union over the last two years is impressive, but we should keep in mind the vision of the endpoint: a market in which consumers and corporates operate with Eurozone banks without regard of where their headquarters are located, in the same way as US households and companies operate with US banks today. ■

We are making history

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



These are historical times for Europe. Despite the difficulties and some initial skepticism, the institutional architecture of the euro is today close to completion. We are only two months away from the effective start of the Single Supervisory Mechanism (SSM): the main pillar of the European Banking Union.

The outcomes of the comprehensive assessment will be key to restore the confidence in the banking system and to solve the 'legacy assets' issue before the SSM starts operating.

Significant progress has been made in the implementation of the Single Resolution Mechanism (SRM), to be operative by January 2015.

Banking Union is key to break the vicious circle between sovereign and banking debt. It is a catalyst to foster a more integrated European financial sector. Europe needs a strong financial sector that generates confidence in investors and customers alike.

A European banking sector that is efficient and profitable, customer-orientated, innovative and cross-border. This is the best way to support economic internationalization and competitiveness and the integration of Europe's economies and markets.

Achieving a common supervisory culture will be a transformational change not only for banks but for Europe as a whole. It will contribute to a level playing field among European banks and foster competition, which in turn will result into a better allocation of financial resources within the region.

A healthy, solvent and well-integrated financial sector is essential to provide European businesses with all the support they need to grow and occupy positions of leadership. In this way European citizens and companies will all benefit from better and cheaper banking services. ■

Regulatory priority is ... a regulatory truce

Giovanni Sabatini - General Manager, **Italian Banking Association (ABI)**

For the European commercial banks, as for other EU industries, the real top priority is the return to growth of the European economy. As to the regulatory side, we noted that from January 2009 to the end of July 2014, 252 documents concerning regulatory matters in the banking sector were issued: 118 in our national jurisdiction, and 134 in the EU frame.

Almost all of them were followed by a legislative, regulatory or administrative act that banks had (or still have) to implement in their internal rules. Some were adjustments to existing rules, others true revolutions, like the realization of a Banking Union, whose complexity can be measured in hundreds of pages.

A substantive part of the new rules was necessary but the continuous flow of new measures has raised the regulatory uncertainty up to a point which is detrimental for the efficient functioning of the banking sector and the role it plays in the European economy.

Now, with the adoption of so many rules and near accomplishment of the Banking Union, a 'comprehensive assessment' of the new regulatory body and its effects on the real economy is needed.

Regulators provide us with deep analysis of the impacts that any new rule will have on the economy. Often these impacts are underestimated due to not taking into account interactions occurring among the different rules.

In the meantime, we have been experiencing a sharp decrease in banks' profitability. The average ROE of the EU banking sector has drifted from 10% in 2007 to -1.55% in 2012. Preliminary estimates for 2013 show that the data has not improved that much.

That indicates the real priority for the banking sector: dedicate more resources to restoring profitability by increasing incomes and reducing costs, pursuing the completion of the process for the adoption of measures concerning the Banking Union, but refraining from launching new regulatory initiatives on an industry whose reduced lending capacity ends up hitting other sectors' enterprises.

Only by recovering a good profitability, can banks continue to serve their customers as they have been doing till now. New regulations make sense only if imposed on banks which are healthy: let's complete the reforms undertaken, let's implement them in the banks' DNA, not modify them for some years, let's evaluate the global effects of these measures. Only then, if needed, will we proceed to adopt new regulations.

Finally, as rules per se are not sufficient to ensure financial stability but need to be complemented by an effective and efficient enforcement, before adding new layers of regulations, let us see the SSM at work. ■

European supervision for a European banking system

Luigi Federico Signorini - Deputy Governor and Member of the Governing Board, **Banca d'Italia**

While banking regulation in Europe became more and more harmonised with each new version of the CRD/CRR, supervision was until recently basically national. National supervisors operate in a national legal framework, have their own supervisory culture, answer to a national public opinion, and have legitimate national priorities. This makes the single market less than perfectly integrated at the best of times; when times get tough, it will seriously endanger it. The crisis brought this point dramatically to the fore. Cross-border interbank lending dried up; big banks went under; while cooperation between authorities did not stop, indeed increased, during the crisis, national reactions led to a retrenchment within borders. The efficiency and stability benefits of the single market were largely forgone.

With the creation of the SSM and the SRM, the institutional response to the fragmentation of markets during the crisis has been impressive. While still largely reliant on national authorities' activity, European supervision and resolution will function as one system, and bring down many barriers to intra-European cross-border banking. Thus it will create the conditions for a more efficient allocation of capital, better liquidity management and better risk diversification within and among banking groups. Cross-border M&A activity will also be eased, which means that the market structure may change–though it is too early to say how rapidly and to what extent.

The work is not all done. The ECB has built its supervisory structure *ex nihilo* with remarkable speed and is working with national authorities to start the SSM in a few weeks; the resolution authority must follow suit. The framework is complex, with many authorities and potentially overlapping or conflicting responsibilities; it must be made to work effectively. It is also incomplete: a single deposit insurance scheme should eventually be created; further harmonisation of civil and bankruptcy law will help the SSM work best. EBA must ensure that the single market does not stop at the euro area's border. Some obvious lessons of the past have been learnt, but the future still has many non-trivial challenges in store. ■

Banking Union – A force for change in EU banking

John Berrigan - Director for Financial Stability and Monetary Affairs, DG Economic and Financial Affairs, **European Commission**

The creation of the Banking Union is a seminal event for the EU banking system. The longer-term (or steady-state) impact of the Banking Union is difficult to predict with certainty, as this will depend on a range of factors, which will emerge only of time, e.g. the number of participating Member States, the relative proportions of the banking system subject to direct and indirect supervision within the Single Supervisory Mechanism (SSM), the effectiveness of the new resolution framework etc. However, it is easier to assess the likely shorter-term effects of Banking Union as we await the imminent results of the ECB's comprehensive assessment and look forward to the early phases of an operational SSM and SRM.

The fundamental rationale for creating the Banking Union is to revamp the cross-border banking model within the EU single market. So, we can expect that a successful start to the Banking Union will begin to reverse the process of financial fragmentation that has characterized the period since the financial crisis in 2008/9. Improved quality and uniformity in banking supervision provided by the SSM across all participating Member States should encourage banks to resume their cross-border activities, while the existence of the SRM – operating on the basis of a new EU resolution framework which adequately protects taxpayers from bank failures - should provide national authorities with the confidence to accommodate such cross-border activities. On this basis, Banking Union should stimulate more cross-border banking.

A key condition for Banking Union to revamp the cross-border banking model will be the restoration of investor confidence in the quality of participating banks' balance sheets. To this end, the ECB's Comprehensive Assessment will be crucial and may also bring more immediate change in the EU banking system. The Comprehensive Assessment, which will include a rigorous asset quality review and stress test, is now well-advanced and has already triggered a wave of bank recapitalization. While the results of the Assessment will not be known for some weeks, the possibility that some banks will require capital reinforcement clearly exists. Such banks will have sufficient time to seek private sector solutions, with any subsequent public intervention being subject to EU state-aid rules and commensurate restructuring. Alternatively, some of these banks may opt to reinforce their capital position via consolidation with other banks, although the implications for competition and resolvability would need to be carefully assessed. ■

Key steps towards a fiscal union in Europe

Marco Buti - Director General for Economic and Financial Affairs, **European Commission**

Over the past years, European policy-makers have taken strides to fight the crisis and build stepping stones for a more resilient EMU architecture. Yet, further EMU deepening towards fiscal union is warranted over time, and steps towards it can be envisaged in the shorter-term.

The institutional shortcomings of our current set-up stem from the persistent challenge of implementing sound and consistent policies across countries, as well as from the still under-developed channels of adjustment to heterogeneous developments. Important progress is being made with the enhanced economic and fiscal governance, the emergence of safety nets to preserve financial stability and the gradual build-up of banking union. But this remains an incomplete construction as it runs against the limitations of a setting of common monetary policy with still largely decentralised fiscal and economic policies.

The Commission Blueprint of November 2012 laid out a clear sense of direction towards full fiscal, financial and economic union. It made the case for even stronger governance combined with deep common tools for risk-sharing and deeper pooling for sovereignty. For the final stage, the vision of the Blueprint requires a change in EU Treaties and can be pursued only in the long run.

In the near term, we can try to take steps in that direction within the present institutional and legal framework. These can include: sound and smart implementation of the revised governance framework; the implementation of a fully-fledged banking union; the exploration of avenues for better sharing risks; reflecting about the role of market discipline without reigniting existential fears about the integrity of the euro area; a better interplay between budgetary requirements and structural reforms; and possible evolutions of our governance system in order to streamline it and increase its effectiveness.

We can also give thought to the necessary institutional and Treaty changes in the medium to long-run in order to put the political contract in par with the needs and realities of deeper integration. ■

Now is the time for greater euro area fiscal integration

Sylvie Goulard - MEP, Coordinator of the ALDE group,
Economic and Monetary Affairs Committee, **European Parliament**

Greater fiscal integration is definitely one of the tools which may boost EU economic growth. Yet while it is in the interest of the whole EU it can only be achieved, both for economic and mainly political reasons, from the euro area as the core. Several options exist and have been suggested by groups such the Glienicker Gruppe or the Eiffel Group. The idea of a specific euro area budget is on the table. Many hurdles remain before this option could become a reality, but it would address issues that are specifically linked to the existence and functioning of the euro (absorption of asymmetric shocks) and would enable resources to be raised in order to improve training, increase worker mobility, create a euro area unemployment benefit, investment in infrastructure.

Partial common issuance of debt is another option which triggers lots of legitimate political, democratic, legal and economic questions. Given the recent debates, it would appear more productive to look at the option of issuing common bonds that would be used to finance long-term projects rather than the option of the pooling of existing national debts.

However, although greater fiscal integration is a necessary step, alone it is insufficient. In order to have growth you need to build a resilient system. For that you also need the confidence of the citizens, implying that democratic accountability must also be strengthened.

This should be achieved on two levels: firstly make some international technical fora (FSB, Basel Committee etc.) more transparent and accountable. A unified external representation of the Euro zone, as proposed by JC Juncker, on the basis of article 138 of the Treaty, could help. Secondly, a clearer role is needed for the European Parliament and/or a Euro zone Parliament, to control the decisions taken by the Eurogroup.

Yes there is work ahead but there might also currently be sufficient momentum to advance progress: the installation of the new European Parliament - which is faced with an ever greater imperative of delivering to citizens - and the new European Commission may, and should, be a time for taking and implementing the right choices. ■

Towards a fiscal union for the Euro area

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

The euro area has taken a number of steps during the crisis to create a more integrated economic and fiscal union. Its institutional setup was overhauled. Arrangements have been made to strengthen fiscal policy coordination in order to bolster crisis prevention capacity. The economic governance framework was substantially revamped to put national budgetary policies on a sound footing. In addition, Member States pooled resources to establish a permanent fiscal backstop through the European Stability Mechanism. Finally, Member States created the banking union, including a common supervisory structure, resolution authority and resolution fund.

Next steps

The current debate on fiscal union is based on the report titled "Towards a Genuine Economic and Monetary Union" by the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup issued in 2012. This report has also been included in the programme of the designated Commission President Jean-Claude Juncker. While a number of measures have already been completed since the report was launched, further steps are envisaged to achieve fiscal union. These steps would give more fiscal capacity to the euro area level.

A first step is an incentive-based arrangement allowing Member States to engage in contracts with the Commission. Member States that implement reforms contributing to the functioning of the EMU, or addressing labour and product markets weaknesses would in return receive a financial 'carrot' instead of a 'stick'. This should result in more vigorous structural reforms enhancing the growth potential of the Eurozone.

A further step in the medium term along the roadmap will have to focus on risk sharing between Member States, in line with the subsidiarity principle. This requires some clearly rules-based mechanisms and observing the principle of subsidiarity to help countries address economic fluctuations.

A third step for more fiscal union was assessed by the Tumpel-Gugerell expert group, which analysed various options for joint-debt issuance - especially through eurobills - and a potential debt redemption fund that could assist distressed countries. Their analysis outlines economic benefits of more integration and underscores that such initiatives require very strict controls to cover an inherent moral hazard risk. The benefits of these proposals will be more apparent again when the current buoyant liquidity and eased market financing dissipates.

A Long-term perspective

In the very long-run, when confidence in national and local government fiscal responsibility becomes fully anchored, solutions that would lead to an even larger degree of fiscal centralisation – based on a European or euro area budget - may gain some traction. This central budget could be limited and complement national budgets in areas with strong cross-border effects (such as network infrastructure or defence). Further measures towards the fiscal union require policy-makers to strengthen, under all circumstances, the democratic procedures legitimising such a setup. The implementation of any measure of that sort would require a deeper revision of the EU Treaties and profound legal and institutional reforms. ■

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

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

The crisis revealed the Monetary Union to be dangerously incomplete, jeopardizing global economic stability. As Jean-Claude Trichet has said, EMU always needed the E as well as the M. That wasn't so surprising given research on previous currency unions, but that earlier literature and the pre-EMU debates did not focus on the vital importance of banking union. While much has been done to unify supervision and resolution, a vital lacuna of strategic significance remains. The monetary union employs two kinds of money: central bank money and private-bank money, ie deposits. Both need to be homogenous. The former is: by definition, the ECB issues the euro area's central bank money. But the private deposit money, comprising most of the money used in the euro area, is not homogenous. That is because the deposit-insurance regime in one member country is not the same as in another, so that a retail deposit in one country is not the same as in another. This is fundamentally inadequate for a sustainable monetary (and banking) union. Without a collective deposit-insurance scheme, the monetary union will remain fragile: an incipient fracture in the credit system will persist, even when the current crisis has finally passed. As the Bank for International Settlements 2012 annual report suggested, banks domiciled in euro area countries need to be euro-area banks. A euro area deposit-insurance scheme should be funded by the banks themselves, in order to ensure that defaulters contribute something. A funded scheme can also shield the taxpayer somewhat, but I recognize that this would be a step towards some kind of a fiscal union.

That is why this apparently technical issue is truly strategic, substantively and in what it signals.

In the US, the deposit-insurance regime is part and parcel of the fiscal union. The euro area needs to debate what kind of fiscal union it should have, and through what staged-process it could move there. The issues are profound, requiring thorough technical and public exploration before political decisions could be taken. A decent first step would be an expert commission, completing the work of the 1980s'Delors group on EMU.

Fiscal unions come in lots of varieties. On possible route would be a union of rules, where control over fiscal policy in a euro-area member country was transferred to 'the centre' if certain debt or deficit thresholds were breached. That seems to me likely to create political resentment at tension in the event of a country suffering a crisis that's not of its own making.

Another possible route would involve some kind of collective insurance against the costs of cyclical unemployment. This has the key feature of the people of the euro area helping each other out, but with discipline on member-country governments. That discipline comes in two forms. First, there would be no subsidy for structural unemployment, underlining the incentive for necessary supply-side reforms.

Second, there would be no bailout for insolvent states. The US established in the mid-19th century that the people of America would not bail out bankrupt State governments; the Federal government would not stand behind the government of, say, California. The euro area needs to establish the same. But a 'no bail-out' rule means nothing unless it is clear how a member state government could go bankrupt in a reasonably orderly way. As with bank resolution, that too needs some technical ground clearing. It was absurd that government insolvency threatened euro area membership, threatening EU membership.

I offer these thoughts as a citizen outside the euro area. But the whole of the EU, indeed the whole of the world economy, badly needs the euro area to have firm foundations. ■

Why is consistent global regulation and supervision so important but also challenging to achieve?

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

Regulators, when regulating financial markets, not only need to regulate local market players and local transactions, but also foreign market players active in their local market and transactions with a foreign component. In today's interconnected global financial markets, these international elements are very important in all the world's main financial centres.

Not regulating these foreign market players and transactions would result in a failure to meet regulatory objectives such as investor protection, stability and avoiding regulatory arbitrage. However, they are typically already subject to the regulation of one or even more other jurisdictions. As a result, market players and transactions may become subject to multiple regulatory regimes, which can be overlapping, inconsistent and conflicting.

While the community of regulators around the world is striving to achieve consistent international regulation and supervision, one of the most prominent issues is the fact that legislation is established by independent sovereign states or, in the case of the EU, by co-legislators representing citizens and the 28 heads of governments. Political processes take local characteristics of financial markets into account, and it is not a secret that legislation sometimes reflects local political interests. Hence, local exemptions for certain market participants create consistency problems at global level.

How can we address these challenges? The first step is for regulators to be more proactive in identifying broad risk areas, which potentially require future regulatory action. Then to develop at international level, in a timely way, sufficiently granular standards. Having granular standards available on time, will help reduce the development of differences when an activity becomes subject to regulation across the globe. An example where this has worked fairly well is the area of credit rating agencies and I am optimistic that it will also achieve good outcomes in the area of margin requirements for bi-lateral clearing.

This will not make regulations identical but it should facilitate the second step which is the reliance on foreign equivalent regulatory systems when they achieve the same regulatory outcomes. This mechanism is the standard European Union approach to international coordination issues in many pieces of financial regulation, which avoids fragmentation and supports the global nature of financial markets. ■

Towards a more integrated EU insurance supervision

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

The creation of the SSM is certainly a historical step for banking supervision in the European Union. As for the way forward for the insurance sector, I see an evolutionary rather than a revolutionary development. We need to build on the important EIOPA achievements and, step-by-step, reinforce its mandate and powers in order to improve the quality, consistency and convergence of EU insurance supervision. In this sense, the implementation of Solvency II is a great opportunity.

Credit photo : EIOPA Frankfurt am Main

The EU legislators should consider extending the current power of EIOPA to conduct an inquiry into a particular type of financial institution, type of product, or type of conduct, in order to support the independent assessment of supervisory practices. EIOPA's power to ban or restrict financial activities is due to be brought to life under the PRIIPs Regulation. We need to build on that. It would also be of added value to grant EIOPA a centralised oversight role in the field of internal models. In the medium term, as part of a step-by-step approach, consideration should be made to assign EIOPA an enhanced supervisory role for the largest important cross-border insurance groups.

In order to be beneficial for all European citizens, insurance supervision should become more consistent and coordinated. This will help to avoid regulatory arbitrage, will ensure a level-playing field and enhance the long-term potential of the insurance market in the EU. ■

The ESRB, the ECB and the SSM: synergies or conflicts of interest?

Prof. Rainer Masera - Dean of the School of Business, **Università degli Studi Guglielmo Marconi**

The ESRB (2010) was created following the indications of the de Larosière Report (2009) and tasked with the macro-prudential oversight of the financial system in Europe: its primary goal was to maintain financial stability and contribute to the identification, prevention and mitigation of systemic risk. This required monitoring macroeconomic developments which could endanger the sustainable contribution of the financial sector to economic growth.

The ESRB started its activities shortly before the Euroarea entered into a systemic crisis arising from the intertwining of bank and sovereign risks in many countries, but failed to recognise the vicious loop between banking crises and public finances. It was left to the ECB to identify the immediate threat to financial stability and act accordingly. The crucial distinction between idiosyncratic vs. endogenous/systemic risk and the problems posed by fallacies of composition were also encountered with the transposition process of Basel III in the EU. The dangers to economic recovery of "bad" de-leveraging and of the drying up of credit flows, notably to SMEs, were not adequately signalled by the Board.

These two instances show that the ESRB should develop a comprehensive flow-of-funds approach to detect and monitor financial imbalances leading to systemic risk. Admittedly, its complex organisational structure (the decision-making General Board comprises no less than 65 members) makes it very difficult to reach timely decisions on risk assessment, warnings and recommendations.

Under these circumstances, the creation of the Banking Union and the SSM may well increase difficulties for an effective role of the Board. The AQR and the stress testing of Eurozone banks, as well as attendant macro-prudential responsibilities, belong primarily to the ECB. It is also not clear how the Board will interact with the Resolution Mechanisms.

All in all, a necessary condition for the Board to play a significant role is the streamlining of its decision-making process and the redefinition of its powers as a result of BU, hopefully focusing on an effective interplay with the EFC and the ESM. ■

Towards a Fiscal Union?

Jean-Marie Andrès, Didier Cahen, Marc Truchet – Eurofi

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The economic convergence process within the Euro area could be complemented by joint European investments in public goods such as network industries and R&D, as a way to bolster Europe's growth potential and to even out drops in public investment in economies hit by shocks. Yet, this should be achieved by prioritizing spending and should not undermine efforts that remain necessary to bring down debt levels. This action would be consistent with proposals by the upcoming President of the European Commission who has proposed a €300 billion public-private investment programme to help incentivize private investment in the EU economy.

There are however several different options for achieving deeper fiscal integration. Four main options for achieving deeper fiscal integration in the Eurozone have been proposed: a common budget, an insurance mechanism against strong cyclical fluctuations, a common unemployment insurance scheme, and an equalisation of interest burden via a European debt agency.

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

Transitioning to sustained growth

Jaime Caruana - General Manager, **Bank for International Settlement (BIS)**

Weak growth is the key challenge to the EU economy. Returning to a sustained growth track requires policies that facilitate two important transitions: a transition to growth that is less dependent on debt, and a transition to a more reliable and resilient financial sector.

Overcoming the financial crisis will require addressing real sector rigidities. The EU economy must find a new balance: productive resources must shift from sectors that over-expanded, fuelled by abundant credit during the boom, to more productive sectors that will drive future growth. This means more flexibility: workers who change jobs and new firms that replace failed ones. The key that will unlock this dynamism is policies focused on structural reforms in labour and product markets. Finance plays a supporting role in this transition. Financial flexibility means a balance between the role of markets, which have integrated more rapidly in the European Union, and banks, which remain the bedrock of the European financial system. Development of market-based instruments and closer integration of banking, a process that suffered a setback in the crisis, will improve flexibility.

Financial sector flexibility is founded on reliability and resilience. Wobbly banks do not lend, so the priority is to ensure that banks are robust, are seen as robust, and remain robust. The challenges of this transition are clear for European banks and supervisors: dissipate market uncertainty by addressing decisively balance sheet weaknesses and building ample buffers, build an effective prudential framework covering both micro and macro risks, and complete the banking union project with resolution and deposit insurance frameworks that deal transparently with troubled institutions. Accomplishing this in the presence of several sovereign fiscal authorities requires compromises and careful design. Progress is being made. By avoiding past shortcomings, the AQR promises to restore confidence in banks. An effective Single Supervisory Mechanism will place European banks on a firmer footing and will contribute to integration. The first elements of a resolution framework are emerging.

The benefits to the European economy from completing the job are clear. ■

Economic growth required!

Dr. Andreas Dombret - Member of the Executive Board, **Deutsche Bundesbank**

Particularly in Europe, banks are still in the process of addressing the weaknesses that were uncovered during the crisis: asset quality was lower and more volatile than expected, while liquidity risks were higher.

At the beginning of the crisis, US banks suffered even more than those in the EU. However, with regard to profitability they have now outpaced their EU peers. To a large extent this is the result of the positive macroeconomic environment in the US, which offers banks sufficient earnings potential.

In order to respond to new regulatory requirements, banks need the support of investors and clients, particularly when it comes to increasing the amount and quality of capital or improving liquidity profiles. As an investor's incentive is to seek out attractive yields, banks' profitability is key to success in this regard.

Figures show that banks are well on track to fulfil these regulatory requirements. However, several banks still face challenges: poor asset quality, low interest rates and weak growth. Combined, these challenges act as a drag on profits. In addition, major structural changes have appeared on the horizon: demography, new technical opportunities and gateways to and for customers, and new players in the market such as PayPal and Google. To respond to these challenges, European banks and supervisors alike have to act – for instance, by redesigning their business models or by adapting the supervisory architecture respectively. In this context, European banking supervision and the preceding comprehensive assessment of the largest banks will also provide an impetus for necessary adjustments.

However, the leadership of US banks in terms of profitability

underlines the importance of macroeconomic growth for bank profitability. In order to return to sustainable profitability and fulfil regulatory requirements, banks therefore need balanced economic growth right across Europe. This sets the objective for EU policy makers: to prepare the ground for economic recovery by fostering the necessary reforms in, for example, the labour markets or the public sector. ■

Change was necessary, careful implementation and assessment even more so

Sylvie Goulard - MEP, Coordinator of the ALDE group,
Committee on Economic and Monetary Affairs, **European Parliament**

The crisis has hit the economy and citizens, particularly the weakest ones, hard. Change was necessary both as a political sign to citizens and to improve the resilience of the EU economy. Therefore, the EU acted: the creation of the European Supervisory Authorities and the ESRB, Short Selling, MiFiD, CRD 4, Market Abuse, BRRD, Banking Union….

The wave of level 2 measures is now hitting the shores. The individual aim of each piece of legislation was targeted and legitimate and still is. However the cumulative impact of all of them, as well as their interactions, may have been underestimated. Both because the legislative process and the fear of facing a new crisis have added complexities. Having to deal with so many issues in a limited timeframe makes the challenge even tougher. Now the time has come to implement the thousands of pages of legislation and to particularly focus on the implementation with level 2 measures. Where necessary the undesired effects, be it the excessive burden for industry or the shortage of funds to finance the real economy, need to be corrected. Responses lie in those implementing measures, in the reviews to come, in the on-going legislation, such as Money Market Funds, Benchmarks or European Long Term Investment Funds but also in complementary legislation.

Securitisation (to fund SMEs) is certainly one issue to look at, as are ways to improve the perception of the specificities of the euro in international fora, to stop the fragmentation of the internal market, and to better explain the EU to foreign investors. The latter implies that the EU banks which are ill or weak should be cured in order to restore confidence in the EU banking sector as a whole. In this regard, the first steps of the Banking Union will be key and thus we all know the importance of the Assets Quality Review. The legislative process undertaken at EU-level in the next years will be closely watched. It has to be efficient and balanced in terms of achieving a resilient, inclusive and performing economy. The proposal on "structural measures improving the resilience of EU credit institutions" (follow-up of the Liikanen report) is likely to be a crucial test. ■

Non-risk based measures - the new guiding star in banking regulation?

Sabine Lautenschläger - Member of the Executive Board
& Vice-Chair of the Supervisory Board of the SSM, **European Central Bank (ECB)**

Many market observers and regulators see non-risk based measures as state-of-the-art, transparent and simple backstops to existing prudential requirements. And quite a few consider the leverage ratio to be superior to risk-based capital ratios, taking the view that the latter are more likely to understate the risks stemming from a build-up of excessive leverage.

While I am convinced that the leverage ratio has its merits as an additional tool for supervisors assessing banks' capital adequacy, I also believe that some of the current enthusiasm is not entirely justified. Firstly, the leverage ratio is by no means a new concept. In some ways it goes back to the roots of Basel I, which was dismissed by the Basel Committee on Banking Supervision for creating incentives for risky banking activities.

The same is true for the leverage ratio: when applied rigorously as a binding constraint for business, it favours the substitution of low-risk assets with high-risk ones. Judging from the Basel Committee's intense discussions, and keeping in mind the different accounting standards used, one can hardly argue that the leverage ratio is an easy-to-calculate panacea that renders the complexity of assessing a bank balance sheet a thing of the past.

When incorporating the leverage ratio into our supervisory toolkit, we should not turn a blind eye to risk-based approaches, but ensure that their central role in prudential regulation remains reliable and credible. The Basel Committee's work on balancing risk sensitivity, simplicity and comparability, such as the reviews of the standardised approach to credit risk and the trading book, help greatly here. At the European Banking Authority level, benchmarking exercises have also supported the drafting of harmonised standards for model validation methods and have helped identify areas for improvement vis-à-vis the risk weights resulting from the application of the internal ratings-based approach by banks.

To stay on target in an inevitably complex world of financial risks, banking supervisors are well advised to regularly recalibrate their sophisticated navigation instruments and, of course, to check their compass once in a while. ■

Removing regulatory uncertainty: a key policy priority

Jordi Gual - Chief Economist and Chief Strategy Officer, **Group "la Caixa"**

EU institutions start a new political cycle as the European economy appears to be on the mend. However, the recovery is tentative and patchy. In the wake of the ECB's review of European banks, weak credit growth is perceived as a drag for the economy. It is, therefore, critical to avoid policy mistakes and lingering regulatory uncertainty.
The contraction of bank lending within the Eurozone is both a supply and a demand-side phenomenon. As economic growth returns, nurturing loan demand and better credit quality, it is fundamental to ensure that supply-side constraints do no restrict bank lending. Over the last years, the accelerated implementation of the Basel III agreements has hindered loan supply, an effect that had been underestimated by the official quantitative assessment models. Those models were based upon simplifying assumptions which have not been borne in practice. In particular, they assumed no credit rationing and full access to capital markets, and both assumptions have proved untenable. The ex-ante assessments also considered a gradual introduction of the new requirements, but some Member States have introduced them much faster than planned. In a context of regulatory uncertainty, financial markets have also demanded accelerated compliance.

Policy makers should be extremely cautious with regards to the ongoing regulatory program. The priority must be to complete the calibration and the introduction of the already approved regulations and to assess their impact over the coming years.

The regulation of the banking industry has already been significantly strengthened, with a non-negligible procyclical impact on

economic activity. Removing regulatory uncertainty should now be the priority. The introduction of a regulatory moratorium would foster the recovery of bank lending. Anticipating no further regulatory requirements, banks would be willing to take on more credit risk and the financial markets would be willing to accept it. ■

Time to pause in the regulatory reform agenda

Etienne Boris - Senior Partner, **PwC**

Regulatory reform was a legitimate and necessary response to the shortcomings of the banking system revealed by the financial crisis.

The magnitude of the changes is such that it is having pervasive impact on all aspects of the business. New regulations are imbedded in policies and procedures at a very operational level. Individual behaviors change. To illustrate, the leverage, liquidity and capital ratios are managed as "scarce" resources not only at a global level but down to the deal level; the Basel committee proposal to move the Interest Rate risk in the Banking Book from pillar 2 to a standard pillar 1 capital requirement will impact lending decisions.

The complexity and quantity of regulatory change put employees under undue and endless stress adding human risk to risks resulting from the very complexity of regulations and to non-compliance risk. Fear of sanctions adds to employee potential excessive risk aversion.

The change underway is profound and far reaching with risk of unintended consequences.

Widespread concern over the unintended effect of regulation is increasing. Uncertainties are numerous; there are complex interactions between the different pieces of the new regulations and across jurisdictions, important banking activities are moving to the non-banking sectors. The banking system does not have the capacity to operate efficiently with so many moving parts. The growing prescriptive nature of regulation is a key factor influencing the markets, paving the way for potential distortions, herd behaviors, wrong incentive and potential threat to financial stability. New business models that are being driven by regulation create new risks such as asset bubbles. Regulation should fully recognize the critical importance of governance, culture and behaviors. According to the 2014 Banking Banana Skins the excessive weight of new regulation could damage banks and hold up the economic recovery. The cost of more regulation may well exceed the benefits.

Regulatory action was necessary. It is now time to pause. ■

Setting new priorities for EU financial sector legislation: target growth!

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

continuation of page 1

In this context, what should be the key priorities of the new European Commission in the field of financial services? In our view, the new Commission should focus on four key areas:

Firstly, it should move away from purely *"constraints-based"* financial reforms towards more *"growth-orientated"* measures. To achieve this, the Commission should refrain from adding new layers of regulatory constraints on financial institutions and final users (e.g. financial transaction tax) and rather focus on the implementation of the recently adopted G20 reforms. The objective should be to help financial institutions comply with the new rules, whilst at the same time allowing them to fulfill their role in terms of financing the economy and supporting growth. In this context, it is important that the so-called "level 2" rules, or "technical standards", remain fully in line with the *"spirit"* of the level 1 framework legislation. Over-prescriptive regulation is never good: it typically adds cost and complexity to businesses and their final customers without necessarily improving the quality – nor the safety - of financial products or services.

Secondly, together with the European Central Bank and the European Supervisory Authorities, the Commission should pursue its work towards the finalization of *the Banking Union*, including the *"single rule book"*. What we need here, is a *"smart"* single rule book, one that can enhance the harmonization process of banking and financial rules across the EU, whilst at the same time respecting those national specificities which have been designed in the best interest of clients and which have demonstrated a prudent conduct of business.

Thirdly, the Commission should pursue its efforts to preserve the diversity of the European financial landscape whilst defending – at the global level- the importance of the European bank-led financing model and the key role of universal and cooperative banks in this process.

Finally, policy makers should aim to strike a better balance between, on the one hand, the need to secure a safer financial system, and on the other hand, the need to promote sustainable economic growth. European financial firms need to remain competitive and innovative within a framework of long-term and stable growth. Crédit Agricole fully supports the recent initiatives put forward by the Commission to promote long-term investment and infrastructure financing. We also strongly support regulators' efforts aimed at relaunching healthy securitization markets. These constitute, indeed, vital channels to re-boost the financing and growth of the European economy. ■

Managing the leverage of the financial system for growth and stability

Douglas Flint - Group Chairman, **HSBC Holdings plc**

Some commentators argue that increasing the ratio of capital to bank assets carries little or no additional funding cost. They argue raising bank capital reduces the risk that the bank will fail so equity investors will settle for lower returns and the effect on the economy and bank will be neutral.

This might work if these were the only factors to consider. But the world is not that simple: we have introduced distortions to the price of funding such as tax incentives and deposit insurance. Our investment pools are separate by geography, industry and asset class so the supply of equity finance for banks is not infinite. And we cannot escape the underlying mathematics of tail risks – the benefits from each new tranche of equity are not the same, as the reductions in risk of failure become progressively smaller. Ultimately, there will be an inflection point beyond which investors will deploy their capital elsewhere in the economy.

This would have little impact if banks simply acted as intermediaries for depositors and investors' money. But banks create new money through lending (see Bank of England, *Money creation in the modern economy*) and the volume of credit in the economy can have a major impact on both financial stability and economic growth. The crisis was the result of unrestrained credit expansion during a prolonged period of stable interest rates. Conversely, as we saw in the second phase of the financial crisis, less lending was a constraint on economic activity. The volume of credit needs to be managed and, like an inflation target, any goal should be both symmetrical and subject to democratic oversight.

How is this achieved? It is clear from the crisis that credit volumes cannot be managed simply through monetary policy and a single interest rate target. Credit volumes need to be managed using macroprudential tools, targeted where there is asset price distortion – both bubbles and dips. We need a framework to determine when these tools should be used – based on leverage, measured not just in banks as they are not the only source of equity and risk, but across the system as a whole including households and corporates. This approach would also apply for asset classes where discrete risks arise. And unlike the bank leverage ratio, this may actually recognise asset classes where the risks are genuinely low because it counts the 'skin in the game' from the owners of those assets. ■

Banking regulatory requirements and the flow of finance to the EU economy

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

The financial crisis and the costs it imposed on the EU economy showed that a fundamental reform of the banking sector and the wider financial system was absolutely necessary. Our reforms have been guided by the clear objective of building a financial system that better serves the real economy and facilitates sound growth in Europe.

At the same time considerable efforts have also been made to strike the proper balance between ensuring financial stability and facilitating an adequate and sustainable flow of finance to the real economy. Recent Commission analysis shows that many impediments to the flow of finance in Europe have in fact little to do with regulation, and that higher capital and liquidity requirements for banks are unlikely to have a significant impact on bank lending to the economy.

The most recent results from ECB lending survey are promising. For the first time since 2007[1] banks are easing their lending standards in Q2 2014. These results support our view that the reform process has also been mindful of the potential costs of regulation. Rules have been made subject to observation periods or phased-in and, where required, appropriately adjusted.

But these remain preliminary findings. The Commission will conduct an in-depth review of the impact of the Capital Requirements Regulation (CRR) on long-term financing. In fact the CRR foresees two reports for submission to the European Parliament and the Council by end 2015. In the meantime, full implementation of the CRD IV package is continuing and some major challenges still lie ahead. For instance, the new liquidity standards in our prudential regulations will have to balance the need for banks to withstand liquidity shocks while allowing them at the same time to engage in maturity transformation by lending to finance needed long-term investments. While the role of banks remains fundamental, there is a need to further develop EU capital markets. We need to promote the development of alternative funding sources, as identified in the Commission's March 2014 Communication on long-term financing[2]. ■

1. The Euro Area Bank Lending Survey. 2nd quarter 2014; July 2014; ECB; https://www.ecb.europa.eu/stats/pdf/blssurvey_201407.pdf?da48b686a17b77a3521c30083610656f
2. Communication of 27 March 2014 (COM (2014) 168) from the Commission to the European Parliament and the Council on Long-Term Financing of the European Economy; http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0168&rid=1

Next steps in improving regulation

Koos Timmermans - Vice-Chairman, **ING Bank**

As a result of the implementation of Basel III, individual banks and the banking sector as a whole have become more resilient. Capital and liquidity buffers have been strengthened significantly and with the BRRD a solid framework will be in place to deal with bank recovery and resolution. Also, bank's internal processes have been strengthened and capital and liquidity have become an integrated part of bank's strategic planning processes.

Despite the good progress that has been made, the different rules together result in a number of unintended consequences. Firstly, there is still a misalignment between the interests of local regulators and the European economy as a whole.

Local regulators limit the transferability of capital and liquidity between banks of the same group in different countries, in order to optimise the solvency and liquidity of the local unit. As a result of this a subsidiary in a liquidity-rich country would ultimately put its excess liquidity at the ECB, while the subsidiary in a liquidity-poor country would have to fund itself in the professional market. This makes bank lending in the liquidity-poor countries unnecessarily expensive and interest rates in the liquidity-rich countries unnecessarily low. Although this current approach is understandable from the national point of view, it is clearly sub-optimal for the European financial sector and the European economy as a whole.

Secondly, there is the impact of the revaluation reserve on bank solvency. Through the direct impact of the revaluation reserve on a bank's solvency ratio, bank solvency has become very sensitive to changes in interest rates; especially in the current low interest rate environment. In combination with the LCR, where banks are required to hold a liquid asset buffer to cover for potential outflows, this can have a significant negative impact on banks' lending capacity.

Based on EBA data, we can roughly calculate the impact on lending capacity of a 100bp upward shift in interest rates. Per Q4-2012 a group of 357 European banks held EUR 3.739 bio of liquid assets on a balance sheet total of EUR 33.000 bio. The average composition of the liquid asset buffers is such, that roughly 60% (EUR 2.200 bio) of the liquid asset buffer consists of interest rate risk sensitive securities (government bonds, corporate bonds, etc).

The market value of this part of the liquid asset buffer will be impacted by changes in the level of interest rates and the total change in market value will be reflected in a bank's solvency ratios. Assuming an interest rate sensitivity of -/- 1% for a 100bp upward movement in the interest rates, implies that in such scenario the solvency of this group of banks will drop with EUR 22 bio. Assuming an average leverage ratio of 4% for this peer group, this means that the lending capacity of this group of banks declines by EUR 550 bio in case of a 100bp upward movement of interest rates.

It is clear that in a scenario of economic growth, which is normally accompanied by an increase in interest rates and an increased demand for lending, banks could face great difficulty facilitating economic growth by providing credit to the economy. This is a clear example where new regulation, i.e. LCR, on a standalone basis makes much sense, but has severe negative consequences when looking at entire capital- and liquidity framework.

One of the most important priorities while making the banking sector more resilient, is to minimise the impact on the real economy. Corporates – especially SME – and households are still very dependent on banks as source of their lending.

Full transferability of capital and liquidity would be a logical next step in the integration of the financial sector in Europe, one that would have a positive impact on the cost of bank lending in liquidity-poor countries. Also, addressing the negative impact of increasing interest rates on bank's lending capacity is important to ensure that banks can continue to lend in a scenario of economic growth.

It is important to address these issues, in order to ensure that the banking sector can continue to be an enabler of economic growth rather than to becoming a decelerator of economic growth. ■

Regulators need to assure the right balance between the strengthening of banks' resilience and their ability to lend to the real economy

Dr. Karl-Peter Schackmann-Fallis - Executive Member of the Board,
Deutscher Sparkassen- und Giroverband (DSGV)

One of the major challenges in the context of the calibration of the upcoming regulatory requirements will be to assure the right balance between the regulatory aim to strengthen the resilience of the European banking sector and the ability of the financial system to channel funds to the real economy, in particular to SMEs. SMEs do not only need long-term bank lending, but also an expansion of bank lending to pave the way for a strong economic recovery.

The new liquidity management requirements for banks will, the way they are designed now, potentially discourage long-term financing. It is therefore paramount to adapt the calibration of international standards to the specificities of the European context:

- *LCR:* The definition of liquid assets should be broadened and the instruments to be included into the buffer of liquid assets enhanced in order to diversify the HQLA buffer. Therefore, instruments such as covered bonds, credit claims and asset-backed securities of good quality should be included or given better treatment in the buffer.
- *NSFR:* The observation period should be fully used to review unintended consequences on corporate financing. In the current set-up, this ratio would strongly reduce the maturity transformation capacities of banks and limit their credit intermediation role.
- *Leverage Ratio:* As currently designed by the Basel Committee, it would eventually have an undesirable side effect on the market making of government and corporate bonds which runs contrary to the Commission's objective to develop capital markets in Europe.

Currently the Basel Committee is also working on a fundamental review of the Standardised Approach (SA) for credit risk with the aim to reduce the use of external ratings and simultaneously raise risk sensitivity. We are worried that the new SA will entail new administrative burdens, especially for small- and medium-sized banks, which are generally strongly involved in SME lending. Negative impacts on the lending capacity of these banks may be the result. ■

Innovation and competition: main drivers of the new legislation on payments

Emerico A. Zautzik - Director General for Markets and Payment Systems, **Banca d'Italia**

In the financial sector, as in other sectors, the validity of a regulatory framework can be measured by its resilience with respect to changes in the external environment. In the world of payments, the most relevant changes are now linked to the spread of services on the Internet and via mobile, to the establishment of new business models on the web, to new user habits.

The security of payment transactions is a vital requirement to support the confidence of the consumers in the most advanced services. A further requirement refers to speed and simplicity, in particular for transactions of small amount.

PSD2 will need to confront all these aspects. In order to manage, in a dynamic and harmonized way, the innovations proposed by market agents it is crucial to ensure technological neutrality of the legal solutions and to define stringent and reasonable rules for security issues. The development of payment solutions tailored to the needs of the user can be promoted by a proportionate approach to risk.

Competition is another key issue. The goal of PSD1 in this regard has not been fully attained yet: fair competition has been hindered by regulatory uncertainties that may have encouraged regulatory arbitrage. European legislators must remove these limitations with PSD2. The strengthening of competences of the host country supervisory authorities, the review of the exemptions applicable to telecom and web operators, the new discipline of the services offered by *third party providers* are all moving in this direction.

In the field of payment cards, the regulation on interchange fees is an opportunity to foster competition among all operators and to improve the conditions applied to customers. This opportunity must not be missed.

Taken together, the proposed legal acts should form a more stable and modern framework of rules, able to attract the most innovative operators in the payment market, in full compliance with the rules of an open competition.

The Italian Presidency will seek full convergence of Member States on the legislative package, with the awareness of the importance of the reform to achieve the objectives of growth and integration of the European single market. ■

Emerging security threats increasingly require a coordinated European response

Denis Beau - Director General Operations, **Banque de France**

The European landscape of electronic payments has changed considerably with the entry of new actors and an influx of innovative payment solutions. Although necessary in order to answer evolving users' needs in the wake of the rise of e-commerce, these changes have introduced new vulnerabilities and security weaknesses in the processing chain of electronic payments. As the European retail payments market becomes ever more integrated, it is of the upmost importance that these emerging security threats be addressed in a coordinated manner at the European level.

Much attention has been focused in recent years on the security of payments made over the internet which is more exposed to risks of fraud than proximity payments. The need for a coordinated European response to those risks was the driving force behind the creation in 2011 of the European forum on the security of retail payments (SecuRe Pay), which brings together national central banks and supervision authorities.

Building upon the groundwork of national authorities or committees involving the major stakeholders, such as France's Observatory for payment card security (OSCP), this forum published a set of harmonized recommendations for the security of internet payments in 2013 with the goal of having them enforced by February 1st, 2015.

Noting that the high fraud rates of internet payments is mainly due to the use of static data easily reusable by fraudsters, the forum notably called for the wide scale adoption of strong payer authentication, a measure promoted by the OSCP since 2008. It is therefore quite welcomed that strong authentication measures are foreseen to become a legal requirement in the reviewed Payment Services Directive currently under consideration by European authorities.

It is important that the same cooperative approach be taken when addressing the security risks linked to innovative solutions, such as the involvement of third party payment service providers (TPP) in the payment chain. On this particular topic, and although discussions are still ongoing, a European consensus is

emerging on the fact that TPPs should be subject to licensing, which is a step in the right direction. A similar approach could be taken for actors providing conversion services for virtual currencies. ■

Card fraud: high interchange is not better security

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

The value of fraudulent card transactions within SEPA amounted to 1.3 billion EUR in 2012. Looking into the details, 60% of the value of fraud (and growing strongly year-to-year) resulted from card-not-present (CNP) payments, mainly internet payments. If we take into account that 3.5% of the EU retail trade is currently transacted online, part of it by means of cards, this is a high figure. As card fraud at the POS and ATMs in the EU has been mitigated thanks to introduction of EMV ("chip and PIN"), fraudsters shifted to other countries with lower security standards. Furthermore, much of the fraud happens outside SEPA: 2% of SEPA card transactions are done outside the area, but they account for 25% of all card fraud.

These figures lead to several observations. First, is a card payment a good choice for an internet transaction? There are safer, often less costly and more convenient solutions to do online payments than cards. Yet, in a market of unregulated, high interchange fees, providing high and easy income, there is little incentive to offer compelling alternatives to card payments. Second, as fraud goes where the security is weaker, be it to CNP payments or card payments outside the EU, our answer should be to step up the overall security of internet transactions and this is what we propose in PSD2. On the other side, as payments are increasingly global, we need to encourage others to follow the same route.

Attempts to link the card fraud discussion to the matter of interchange fees levels are not convincing in theory and not supported by facts. Interchange fees are not the tool to address the issue of fraud and cannot be justified by the need to compensate banks or their clients for incurred losses. Otherwise, there would be no incentive for the card systems and banks to fight fraud, plain and simple. As an example, one may observe that in those markets, where high interchange fees are explained as necessary to tackle fraud on signature cards, investments in the security of card transactions, e.g. in EMV implementation, are actually blocked for years. ■

Reform Policy: A positive push in payments

Gottfried Leibbrandt - Chief Executive Officer, **SWIFT**

The policy intent behind the current slew of payment market reforms is rightly centred on ensuring safety, transparency, innovation and competition.

Meeting the resulting challenge isn't to be underestimated; it will require agility, innovation and creativity. As a provider of vital services to the payments industry, SWIFT is working to that very end; we are innovating and adapting our services and solutions to enable our community to adapt to these regulatory changes.

In the area of safety, for instance, we see initiatives such as the CPSS-IOSCO principles, focused on ensuring that payment market infrastructures are resilient and quickly able to recover essential services. SWIFT not only believes it meets the new requirements that the CPSS has set for Critical Service Providers to market infrastructures, but we also recently developed a service designed to offer market infrastructures additional operational resilience.

The Market Infrastructure Resiliency Service (MIRS) is a generic payment settlement service which is hosted and operated by SWIFT and designed to keep key functions of Real Time Gross Settlement (RTGS) systems operating in the event of a major outage.

Transparency is meanwhile manifested in the AML Directive, which will implement the latest FATF requirements. Here, SWIFT has already implemented the related data requirements in our message standards, and we are also enabling our community to manage the financial crime challenge with a range of new services including: sanctions testing, sanctions screening and a KYC registry.

And in innovation and competition, there is PSD II, which seeks to open up access, widen consumer choice and encourage new market entrants. The same policy push is also ensuring that real-time low-value payments systems are now gaining momentum; this move is not without challenges, not least on the technology front, but here too SWIFT is actively pursuing new solutions.

With messaging services, standards, technologies and ancillary services supporting both domestic and international payments, SWIFT not only welcomes the policy goals, but is proud to be working to help the industry meet them. ■

Eurofi would like to thank very warmly the support sponsors of this event

SUPPORT SPONSORS

BlackRock® BNY MELLON DTCC Goldman Sachs HSBC

Remittance payments and their contribution to the EU economy

John Dye - Executive Vice President, General Counsel and Secretary, **Western Union**

Money transfer operators provide consumers with a fast, secure and convenient way to transfer funds. At Western Union we offer services to more than 200 countries and territories. The size of the global remittance market will reach $600 billion by the end of 2014 and is expected to grow by 7-8% in the coming two years.

Remittance services are used by individuals to support relatives. They are also used by NGOs to support projects all over the world. What might be less known is that a significant part of the business caters for SMEs engaged in international trade.

Remittance transactions are often one-off transactions involving small sums of money but they play a crucial role in fostering financial inclusion by ensuring that underserved consumers have access to formal financial services. The EU regulatory framework needs to stay proportionate in order not to overburden such remittance transactions, thereby fuelling an already sizeable informal remittance sector.

An important element of the remittance business model are 'agents': partners across the globe where consumers can make or receive payments. At Western Union, two thirds of the agent network consists of financial institutions, with the remaining part being non-financial companies, such as local convenience stores.

As the EU develops its regulatory framework for payment services the rules for these agents need to be proportionate to the type of service they are providing.

This aspect should be addressed with reference to the current revisions of the Payment Services Directive (PSD) and the 4th Anti-Money Laundering Directive (AMLD):

- We believe that there is no need for separate PSD fit and proper requirements where a regulated EU financial institution acts as agent.
- The EU should introduce an effective home/host cooperation framework for the supervision of agents, without adding new local reporting requirements.
- A properly authorized and supervised payment institution should be able to open and maintain bank accounts.
- The concept of a Central Point of Contact in the AMLD should be applied flexibly and in a proportionate manner.
- The ESAs should take into account the specificities of the remittance sector when drafting future guidelines under the AMLD or revised PSD. ■

Challenges to adopt PSD 2 and concerns for banks

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

There is unfinished work to be done with important questions left open requiring further debates.

Much has already been done in order to better protect the account holding consumer and begin to balance the liability issues raised by the intervention of third party payment providers in the value chain in particular where it comes to the provision of clear, transparent and comprehensive information and their duties and obligations.

There are still some very critical issues left open concerning the selection of third party payment services providers to effect a payment transaction and how Payment initiation and use of Payment Account information will be treated as well as unintended consequences in case of fraud with a single key stroke or in the event of a loss as a consequence of any given failed transaction. Banks should not be expected to bear the cost of the payer's choice.

For the sake of fostering competition and develop e commerce the Commission proposal was prepared to allow free use of account holders[1] credentials to access their payment accounts, gather and re-use account history, and initiate payments. The Parliament has rightfully limited the type of information and data to be collected (only one-time credentials may be shared by the account holder and the third party) although still underestimating implications of developing technologies such as search engines.

What is at stake is consumer protection and the trust that consumers place in the security of e-payment transactions allowing for a competitive market place conducive to innovation.

Banks play a central role in clearing payment transactions and should continue to do so, acknowledging that payers should be allowed to engage with merchants and related service providers as they deem suitable provided they are appropriately informed and indeed protected against any unintended consequences. ■

Payment card system: the dangers of too low interchange fees

Rémy Weber - Chief Executive Officer, **La Banque Postale**

Multilateral interchanges fees (MIF) are necessary to enable issuing banks to maintain affordable card prices for consumers. If consumers had to bear their real share of the cost of the payment card system (substantial and continuous investments for innovation and safety), they would prefer using other (and facially free) payment instruments, like cash. But cash is less efficient than cards for all economic players. Reducing the cost of cards for consumers is therefore essential to ensure broad card issuing and wide use. Yet, low prices can be guaranteed by issuing banks only if they receive contributions from the merchant banks: it is the very purpose of MIF.

Excessive MIF discourage merchants from accepting cards. It is true. But drastic reduction of MIF will have damaging effects on consumers. And the problem is that the European Commission is currently working on a MIF cap too low to ensure the system balance. If such caps are indeed applied, consumers will necessarily support increased bank costs. And debit cards users (among them are the most vulnerable people) will especially suffer this, if the cap for debit card (0.2%) is lower than the cap for credit card (0.3%).

Moreover, there is no analysis demonstrating that merchants would pass on the cost savings from lower MIF to consumers by reducing their prices. Consumers would therefore be losing out on both sides.

One of the draft regulation objectives is the development of payment cards in the European Union. I agree with this target. But it will not be reached if the MIF caps are too low, as consumers will not buy cards.

So what is the right level for card MIF? It probably differs from one country to another, as domestic payment markets are very different in Europe: number of cards issued, percentage of merchants accepting cards, presence of domestic payment systems, universality of the card, consumers habits on cash usage, transfers or checks…

So a 0.5% cap for debit and credit cards can both prevent merchants from too high costs and consumers from damaging consequences, thus giving Member states sufficient flexibility to determine their optimal MIF levels according to the specificities of the country. ■

A unique opportunity to expand financial offer to consumers beyond traditional limits

Fernando de la Rica - Head of Loans and Payment Systems Director,
Banco Bilbao Vizcaya Argentaria (BBVA), Spain

New digital technologies and Internet expansion have created an environment in which companies of all sizes have access to the international market, enabling them to grow faster, improving their economic efficiency and profitability. Consumers have easy access to new digital services that are offered from all across the world. E-Commerce is just one example where convenience and competitive prices are the reasons behind fast growing figures.

We have witnessed a broad range of industries transformed by new technologies, and financial services is one of the next to go through a deep transformation process which has already started including new non-bank competitors that have gained relevant position in every part of the banking value chain. Niche players like Paypal or even "Internet giants" like Google, Facebook or Amazon, are entering financial services in one way or another offering easy, user-friendly ways to offer payments process at competitive costs. Virtual currencies and alternative online-payment networks as Dwolla or Ripple are also starting to thrive, while traditional networks still deal with off-line clearing and settlement process. All these new players have a growing customer base and in many cases, they operate globally from geographies where regulation is laxer or even non-existent involving manifold risks.

Yet the potential of e-commerce and digital economy and the opportunity it provides for economic growth cannot be fully exploited unless a trustworthy environment is defined for the different stakeholders, companies, consumers. Thus, regulators should tackle the big challenge to ensure security, privacy, consumer protection and systemic stability in a digital world and, at the same time, leave space for fair competition and innovation, promoting transparency and benefit customers. Regulation in this area must be international in scope, as e-commerce is truly global and inconsistencies in national regulations may hinder its development.

For banks shifting from "place" to "space," from the physical to the digital world is a matter of survival and at the same time a unique window to expand banking beyond its

traditional limits. BBVA´s digital banking strategy includes, nevertheless, the development of new channels and distribution models, offering new digital products, adapting internal processes, human talent, organizational structures and corporate culture, all of them geared toward excelling on the customer experience front with an innovative, convenient and secure experience. ■

Eurofi would like to thank very warmly the regional partners for their support

REGIONAL PARTNERS

Europe moves forward: SEPA this year, T2S next year

Jean-Michel Godeffroy - Chairman of the T2S Board & Co-Chairman of the PSSC, **European Central Bank (ECB)**

Cross-border infrastructures and harmonised processes are preconditions for the achievement of effective financial market integration, an important target on the European agenda. Though they rarely make headlines, these preconditions are essential for our currency to work smoothly. I am happy to be witnessing very good progress in this field.

The first step was the establishment of TARGET, the large-value payment system launched in 1999 to support the creation of a money market for the euro and the implementation of the single monetary policy in the euro area. Its successor, TARGET2, opened in 2007.

Big changes are now taking place on two fronts: retail payments and securities settlement. Since 1st August, all credit transfers and all direct debits in the euro area have followed a single set of SEPA standards. Next year will see the launch of T2S, the new platform for securities settlement in central bank money. Today, money can be transferred with equal efficiency from Lisbon to Helsinki, from Aachen to Arlon or from Paris to Marseille. Tomorrow, with T2S, the same result will be achieved for securities.

In both cases, the euro and the Eurosystem have been the catalysts for market integration. However, SEPA and T2S are also available to European countries that have not adopted the euro, if they so wish.

Rome wasn't built in a day – and neither will Europe be! In order for both SEPA and T2S to fully deliver their benefits, continued efforts are needed on the part of both the authorities and the industry. On the SEPA front, much remains to be done, for card payments and also for new payment procedures such as electronic invoicing or mobile payments. A fully efficient T2S requires harmonised standards and practices for securities processing. To allow market participants to contribute, the Eurosystem has set up dedicated Europe-wide governance arrangements with stakeholders from the payments and securities sectors: the European Retail Payments Board and the T2S Advisory Group. European market integration will continue to be a success if public authorities and market participants continue to work hand in hand. ■

The European financial system: an unfinished project

Alberto Giovannini - Chairman, **MTS**

In Europe the drive to make the financial system more efficient dates back many years. The original approach was that of the single market. Controls on capital movements among member states were disbanded. Later, the Financial Services Action Plan aimed at achieving what the simple liberalization of investment flows could not, by delving into the details of individual regulations (the equivalent of tackling non-tariff barriers in international goods trade). Along the same logic, the initiatives in the clearing and settlement area were also inspired by the observations that a number of different barriers provided a hindrance potentially preventing securities trading across EU member states. The recent financial crisis has exposed many failures of associated with a fragmented supervisory regime and, in the case of the Euro-Area, of a potentially incomplete union, limited to the currency. This prompted a new wave of regulatory initiatives.

Some of the recent reforms have tremendous transformational potential. Among them, the Target 2 Securities project, providing a single settlement engine in Europe is certainly one of them. The Single Supervisory Mechanism which creates a regulatory level playing-field for the European banking system will also change in a fundamental way the structure and functioning of the financial system. But these have not stopped the initiatives of national and European authorities: the current project being talked about is the Capital Markets Union (a concept parallel to that of the Banking Union).

The project of the Capital Markets Union responds to the desire to improve the financial system and make it a strong pillar supporting a vibrant, innovative economy, and to facilitate access to financial resources by all actors in the economy, including small enterprises, complementing the functions of the banking system. Ideally, it should create a framework of rules covering securities law, bankruptcy rules, capital markets regulations, secondary markets designed to allow the development of a uniform securities market, which means a market that can issue and trade large sizes, therefore supporting liquidity.

What are the challenges? The main one is that individual member countries have very different financial systems, different practices and different degrees of efficiency. Hence, they do not all have the same incentives to embark in wide ranging reforms.

Another significant challenge is that the governance of financial markets by public authorities needs to account for the fact that private actors normally operate globally, therefore requiring strict and solid cooperation among national authorities, including exchange of information. My perception is that there is still a lot to be accomplished on this front. ■

Financial Market Infrastructure - The way forward

James Cunningham - Managing Director and Senior Advisor, Office of Public Policy and Regulatory Affairs, **BNY Mellon**

Financial market infrastructure is undergoing major change. The list of new legislation is intimidating: MiFID2/MiFIR, EMIR and CSDR, amongst others; and we should not forget other initiatives such as TARGET2-Securities.

The size and impact of these measures explain why many observers are calling for a halt to new initiatives.

But as regulators and market participants work their way through these measures, they will see gaps and shortcomings, and will identify areas for further work.

This further work falls into three categories.

The first is the category of competition. More work is needed to open up markets, and to lower barriers to entry. The new legislation has positive effects, in particular by increasing access rights. But the approach of creating separate regulatory categories for market infrastructures, of mandating the use of market infrastructures, and – very justifiably – of imposing high prudential and conduct of business requirements, has the effect of raising barriers to entry, and of privileging incumbents.

A second category covers topics that have been largely untouched by the new legislation. One such topic is securities law. The liability regime set out in AIFMD and UCITS V may, or may not, be an appropriate measure to tackle legal risk in non-EU countries; but as a measure to deal with legal risk in EU countries, it is absurd; we do need to ensure that the legal regimes in all EU countries fully recognize the role of intermediaries in custody holding chains, and safeguard the rights of end investors.

Another such topic is tax procedures. Despite excellent preparatory work by the European Commission and by the OECD, we have seen little progress in this area. This is doubly disappointing. Idiosyncratic national tax procedures place heavy burdens on end investors, on intermediaries and on market infrastructures; they inevitably have the effect of discriminating against individuals, and other small investors. They should be part of an agenda to achieve fairness in taxation.

A third category covers the technical implementation of the new legislation. Three topics that need particular attention are the topics of pre- and post-trade transparency, of settlement discipline, and of mandatory segregation of securities positions. In these last two cases, we see a tool that is effective in achieving specific objectives being used to try and achieve broader objectives, with – unsurprisingly – sub-optimal effects. ■

Delivering on the objectives of MiFID II

Edwin Schooling Latter - Head of Market Infrastructure & Policy, **Financial Conduct Authority**, UK

The objectives behind MiFID II were clear: to make markets more efficient, resilient and transparent, and to strengthen the protection of investors. The framework legislation agreed earlier this year represents a significant step towards achieving those objectives.

Resilience will be advanced by new requirements for circuit breakers and on firms using algorithmic trading strategies. There is to be a comprehensive regime of pre and post-trade transparency for the trading of all financial instruments. This will be backed by enhanced proposals to ensure that market data is made available on a reasonable commercial basis. Improvements to transparency and data access also support an efficient price-formation process.

On investor protection there are important enhancements to existing MiFID provisions on inducements and best execution. There are also explicit new provisions on the control of the design and distribution of financial instruments, and the remuneration of sales forces.

MiFID II will be implemented on 3 January 2017. Getting from here to there will be testing. Firstly, there is still a very significant amount of complex policy work that has to be done to complete the implementing measures and provide interpretative guidance. Secondly, the breadth and depth of the practical changes required of both firms and regulators is such that it will require considerable planning.

To meet its objectives the changes required by the legislation have to be deliverable, and delivered, on the ground. In some areas, such as aggregated disclosure of costs and charges, transaction reporting, position reporting and transparency obligations, there will be significant systems implications.

To make sure they can implement on time firms need to begin the initial phases of their implementation planning now. A strategy of "do nothing" until all the technical standards are completed will put firms at significant risk of being unable to comply in time. Regulators will need to support firms in their planning through education about the new obligations and an open dialogue to identify issues and seek practical solutions. ■

Application of clearing to diverse asset classes

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

Centralised clearing has been applied to a range of different types of products during its long history, including exchange traded derivatives, more recently securities, and most recently OTC derivatives. Each of these product types has different characteristics, clearing properties and competition considerations.

For securities, which are homogenised products, and have a considerably shorter settlement cycle than many derivatives, regulators have approached competition between CCPs through interoperability.

This policy decision does not read across to exchange traded derivatives (ETDs) for two structural reasons. First, ETDs are individually designed by trading venues; and second contracts require life cycle event management throughout their tenor which may be measured in years. Competition in exchange traded derivatives comes about as a consequence of different trading venues creating competing products.

OTC derivatives have different considerations. First, OTC contracts are typically traded under standard ISDA terms; second, regulatory reform is forcing market participants that trade in OTC markets to clear. As a consequence, regulators have realised that this creates a significant dependency, particularly where certain OTC contracts may be reliant on a single CCP to underpin them. If the CCP fails, aside from the financial consequences for the participants, the market may become illiquid and systemic risks similar to those which emerged in 2007/8 may reoccur.

The policy solution to this should be encouragement for more than one CCP to service each OTC derivative class; and also to ensure CCPs have robust and viable resolution and recovery plans. This policy objective will need to be weighed against the inherent advantage of centralisation of risk which benefits both direct and indirect users by optimising margin correlation benefits. The author believes that the

market will find the best solution to this problem, subject to close monitoring by relevant authorities. ■

What are the main challenges ESMA is facing in defining MIFID and MIFIR's level II standards? what are the main next steps?

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

ESMA's MiFID II/MiFIR consultation process is an important step in the biggest overhaul of financial markets regulation in the EU for a decade. The reform of MiFID is an integral part of the EU's strategy to address the effects of the financial crisis and aims to bring greater transparency to markets and to strengthen investor protection. These changes are key to restoring trust in our financial markets.

MiFID II/MiFIR introduces changes that will have a large impact on the EU's financial markets, these include transparency requirements for a broader range of asset classes; the obligation to trade derivatives on-exchange; requirements on algorithmic and high-frequency-trading and new supervisory tools for commodity derivatives. It will also strengthen protection for retail investors through limits on the use of commissions; conditions for the provision of independent investment advice; stricter organisational requirements for product design and distribution; product intervention powers; and the disclosure of costs and charges.

ESMA must now translate the Level 1 of MiFID II/MiFIR requirements into practically applicable rules and regulations to address the effects of the financial crisis and to improve financial market transparency and strengthen investor protection. It will do this based on as much analysis of concrete data as possible and by holding extensive consultations with all stakeholders.

ESMA considers that many of the changes introduced by MiFID II/MiFIR are designed to enhance transparency, create sounder financial markets and stimulate firms to place consumers at the centre of their business models and product designs. ESMA's challenge is to ensure that a robust supervisory model is built around these objectives and that the relevant Level 1 provisions are adequately implemented while at the same time ensuring the feasibility and cost benefit balance of any proposals.

ESMA is now in the process of reviewing over 400 responses to its Consultation Paper and over 300 to the Discussion Paper. Following this review, ESMA will deliver its final technical advice to the Commission and hold another consultation round for the technical standards by the end of the year. ■

Will MiFID II / MiIFR help capital markets to better serve the EU economy?

Dominique Cerutti - Chief Executive Officer and Chairman of the Managing Board, **Euronext**

Well-regulated infrastructures which are orderly and transparent should be the aims of any legislative proposal. It is absolutely right for policy makers to require minimum standards of safety and prudence in the way in which business is conducted. It is also legitimate for them to prohibit and take actions against abuse which can result in loss and damage to market confidence. One size fits all solutions would stifle innovation and choice.

Most of the financial reforms currently being pursued in the EU meet the test of addressing demonstrable market failures but they don't necessarily help directly the best financing of the economy. With MiFID II/R, policy makers have identified clear market failures and have determined a policy response based on the costs and benefits of different policy options.

In contrast, some other items have made their way onto the regulatory agenda without having passed the test of addressing a demonstrable market failure. These items pose considerable dangers for the system as a whole because they run the risk of imposing damaging without addressing any manifest weaknesses in the operation of the market.

For example, while requiring mandating open access between EU trading venues and CCPs within MIFIR might seem superficially attractive, it has the capacity to undermine the continued ability of proven market infrastructures to both manage financial risk at the clearing level and maximise liquidity at the trading level. Another example relates to market data relies on the undocumented assertion that market data costs in Europe are too high. Consequently, the proposed approach fails to take account of the characteristics of the market and would not, if imposed, deliver any of the supposed benefits. Finally, there is also great doubt that the SME Growth Market would not fragment the scarce liquidity available for this type of firms.

Overall, the proposed framework introduced by MiFID II is likely to improve the current situation but its objectives of fostering more safety, resilience, and efficiency in EU capital markets should remain paramount to the level 2 process. Thus regulators and legislators must ensure these objectives, central to strengthening the capital markets' financing of the real economy, are met. At the same time, I urge regulators to also ensure that proven infrastructures are not be undermined by proposed reforms which, whilst well-intentioned, may produce some unintended consequences and thus undermine the benefits of MiFID II. ■

Priorities of EU Commission in the securities and derivatives trading and post-trading areas

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

MIFID II represents a key step to creating a safer, more open and responsible financial system. Having agreed this legislation, our first priority is to ensure that it is implemented on time and as intended. The timetable is challenging but achievable. ESMA has already completed the initial consultation for the level 2 implementation rules, which we aim to have in place at least 6 months before the legislation comes into application. This should allow sufficient time for market participants to adapt.

However the implementation of MIFID II cannot be considered in isolation; securities and derivatives markets are both global and interrelated. G20 commitments, in particular in relation to derivatives, are implemented in Europe through MIFID II but it is inevitable that other jurisdictions will move at different speeds. To avoid dual regulation, the St Petersburg G20 communiqué agreed that regulators should defer to each other when justified by the quality of their respective regimes. However the challenge is not just to realize this once all the final legislation is in place, but also to ensure a smooth transition in the intervening period. As the 'Path Forward' agreement sets out, the European and US authorities are working to ensure a transition to a safer financial system without fracturing international capital markets.

In relation to CSDR, the first challenge is that CSDR will come into force close to the launch of T2S. The contemporaneous implementation of two major harmonisation initiatives may be a challenge for CSDs, their participants and markets. Secondly, CSDR introduces a new, more European supervisory framework for CSDs which will change the way in which supervisors work, such as by requiring cooperation arrangements and the involvement of ESMA. These challenges are however an inevitable consequence of regulatory change. The changes to CSDR and T2S have long been foreshadowed and the benefits of more efficient and safer settlement in the EU will outweigh the current implementation challenges. ■

Challenges remain in the implementation of post-trade regulation

Marc Antoine Autheman - Chairman, Euroclear

Much welcome progress has been made with the recent finalisation of the CSD Regulation (CSDR), although the current post-trade regulatory agenda is not yet quite complete. We still await the precise technical standards that will underpin the CSDR, as well as further details of how Recovery and Resolution mechanisms will be applied to Financial Market Infrastructures.

The most uncertain element of the CSDR remains the design and implementation of a European settlement discipline and buy-in regime covering a wide range of asset classes, many of which have never before been subject to such a regime. This is a topic that affects all users of securities markets. Settlement rates in the EU are already in excess of 98% by value, so any regime must be proportionate. And the consequences of new fines on asset classes such as funds, or on financing transactions such as repos, must be fully understood before the rules are applied. The industry is already working together with ESMA and other authorities to ensure that the most efficient model is applied.

There is also a very real capacity challenge for the post-trade industry. Over the next three years, 24 CSDs and their clients will migrate to Target2-Securities (T2S), the largest IT project ever attempted in the post-trade world. It would not be prudent to expect the industry to implement a complex new settlement discipline regime at the same time as migration to T2S; especially when Europe will also have only recently moved to a T+2 settlement period. A phased approach to these initiatives is essential to preserve market integrity and reduce systemic risk.

We strongly support the introduction of a consistent settlement discipline regime across the EU, but its consequences – both desired and unintended – must be carefully considered. We must all ensure that the final regime improves market efficiency, and does not impose unnecessary burdens on clients or create wider inefficiencies. ■

About EUROFI

The European Think Tank dedicated to Financial Services

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

MAIN ACTIVITIES

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

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

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

Events and meetings:

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

Research and documentation:

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

Central Counterparties and other financial market infrastructures – finding an answer to the financial crisis

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

Credit photo : Schafgans DGPh

In reaction to the global financial crisis the European Union introduced the European Market Infrastructure Regulation (EMIR) to make it compulsory for standardised OTC derivatives to be cleared through Central Counterparties (CCPs). It was clear from the very beginning that it would at some stage also have to finish the job and create a cross-border resolution regime for these CCPs. CCPs require authorisation, are subject to regulatory requirements and, in particular, they make the financial market more transparent and reduce the number of bilateral business relationships. They therefore offer more security – on the one hand. On the other hand, care must be taken to ensure that new systemic risks do not build up there and that we – as was the case with the banks – do not get sucked into a too-big-to-fail and moral hazard maelstrom.

The EU is now finishing the job. The Commission is working on a draft Directive for the resolution of CCPs and other financial market infrastructures (FMIs). The Financial Stability Board (FSB) also has this item high on its agenda, which is a good thing and makes sense for, as we all know, the world does not end at the borders of the EU.

This is not a simple regulatory exercise when one considers how important FMIs are; many of their functions are of such great importance that the financial market would no longer function if a FMI were to fail. These functions – so vital for the market – must be maintained without using taxpayers' money and even if all recovery attempts have failed.

There are still many questions that remain unanswered, such as: When has a recovery failed? When does resolution begin? What are the triggers? How can we remove the obstacles to effective resolution such as complexity of firm structures? What resolution instruments do we need? What about recovery and resolution planning? Colleges can provide good services in this field. But are they as well designed for issuing extremely urgent resolution orders? Or do we need more efficient structures? Should there be separate resolution authorities? Or should the supervisory authorities themselves carry out the resolution – possibly through a special resolution unit? How should we deal with a cross-border failure? Do we need a European resolution authority? What do we have to keep in mind while creating a global resolution regime for FMIs? There are still a lot of questions to be addressed and it will take time to come to satisfactory answers – as we all know from banking regulation. But this has to be a key priority. ■

RRPs for Financial Market Infrastructures: users need strong visibility and predictability

Laurence Caron-Habib - Head of Public Affairs, Strategy and Corporate Development, **BNP Paribas Securities Services**

The recent regulatory developments have pushed Financial Market Infrastructures (FMIs) into a very prominent role for ensuring the stability of the financial markets. It is therefore of upmost importance that FMIs are robust and operationally sound, and have appropriate tools in place to deal with default management. Recovery and Resolution Plans are the ultimate means to ensure that financial market stability is preserved despite and beyond any FMI's potential or actual demise.

The future framework for FMI Recovery and Resolution should include minimum pre-requisites. Firstly, it should ensure that the non-defaulting users are not dragged into the default management process by pure contagion. Moral hazard among users must be appropriately disincentivised.

Secondly, it should guarantee a high level of ex ante transparency, so that the users are fully aware of the risks they may have to support in the case of recovery or resolution. Notably they must know precisely the trigger for the initiation and for each subsequent step of the default management process, as well as which tools would be used in each phase and how exactly the losses would be allocated. Transparency on the delineation between recovery and resolution is particularly crucial for the users' exposure risk assessment: the location of this breaking point in the waterfall process will determine the scope of members' potential liability. In any case non-defaulting users must be ascertained not being submitted to unlimited liability.

Thirdly, users should be involved in the process of defining and implementing the recovery and resolution measures, and have their say on the identification of the critical functions.

The proposal expected from the European Commission at the end of this year will focus on CCPs only. However, the basic principles listed above should apply to CCPs and to (I)CSDs likewise. As (I)CSDs have been authorized to perform some banking services according to the new CSD Regulation, it is also required that comprehensive plans are in place to manage times of market stress resulting from difficulties they may face. ■

Recovery and Resolution of CCPs – EU legislation won't come soon enough!

Dr Kay Swinburne - MEP, ECR Coordinator, Committee on Economic and Monetary Affairs, **European Parliament**

Legislation on the recovery and resolution of CCPs will take at least 2 years after initial publication by the Commission to get through the political processes and technical stages before implementation. Yet, arguably to reduce systemic and investor risk, it should already be in place before the vast majority of derivative contracts in the EU are mandatorily cleared through CCPs.

EMIR has put in place measures, which seek to ensure CCPs operating in the EU are sound, and encourages positive incentive structures as well as good risk management practices. However CCPs must be able to withstand not just the last crisis but future crises as well.

The immediate goals of a CCPs' management in times of distress may be different to that of its clearing members and different again to the clearing members' clients. Therefore the recovery tools utilised at any time should be dependent on the cause of the current crisis, possibly differentiating between those originating due to a CCP mispricing an asset class or other mismanagement and those caused by a general market failure beyond their control.

Additionally, while the dispersion of losses over the widest number of market participants in order to limit the possibility of taxpayers having to step in can, and arguably should be a line of defence for a Resolution Authority, this should not be an option for a CCP as a recovery tool.

Whereas resolution measures involving end-customer assets being handled by public authorities will require in some cases new legislative measures, the same is not true of recovery plans and various recovery tools. In order to ensure a stable clearing operation in advance of EU wide legislation, a CCPs' management, the clearing members and their clients should already be discussing market solutions that work for market participants in the many different scenarios that could cause difficulties for a CCP.

In any event, if a CCP were to reach the end of the default waterfall, the clearing members and their clients should know exactly what measures will be taken by the CCP and what financial burden will fall where. Clear rules should have been agreed following extensive scenario planning and in consultation with all three parties involved. Importantly, these need to be communicated in advance to all involved so market panic can be reduced.

Legislators will have to listen to competing interests from across the spectrum as the debate becomes more heated in advance of the Commission's first draft that is due early next year. However, EU Capital Markets as a whole will benefit from having participants agree to mutually beneficial principles that are in-line with emerging global guidelines that stand up to scrutiny. Adopting sensible principles for recovery across the critical market infrastructures in advance of final EU legislation means the whole market will benefit from safer, more resilient CCPs in the long run. ■

The Eurofi Financial Forum 2014 Newsletter

Eurofi President
Jacques de Larosière

Secretary General & Publisher
Didier Cahen

Associate Publishers
Jean-Marie Andrès
Marc Truchet

Editorial Coordinator
Virginie Denis

Graphic Studio
Initial Production
www.initialproduction.be

Establishing a framework for CCP resolution

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

FMI resolution, including of CCPs, must be about ensuring continuity of their critical services. Whilst one might want to achieve this by moving assets and positions from the failing CCP to another – in effect extending the concept of porting from clients to clearing members – this option does not credibly exist today. Even if two CCPs have enough overlap in contracts and membership, they may well be suffering from the same market shock; the concentration of positions in the surviving CCP could be significant; and there will doubtless be other barriers to a transfer over a resolution weekend. A transfer would take weeks and months, not hours and days. And for many CCPs, there may simply not be a ready substitute at the point of resolution.

So to ensure continuity of service, a failing CCP must first be stabilised. The focus of the debate has largely been about loss allocation in resolution. This is of course necessary, and should respect the distribution of claims in insolvency.

But to have continuity the CCP must also be recapitalised, without recourse to public funds. And to aid market functioning and stability, we should aim to find a way of avoiding, where possible, imposing large liquidity calls on clearing members in already distressed markets, or writing down operating liabilities.

There is no European legislative proposal yet on FMI recovery and resolution. But when it does come, it must be consistent with the FSB's Key Attributes. And it must recognise that the largest CCPs are global in reach and so the resolution co-ordination framework must reflect this.

The issues of global reach and limited substitutability of CCPs point to a much deeper debate about the market structure, especially where there is mandatory clearing. An important debate, but one that could take time to play out. For now, we must face up to the reality of CCPs as they are, as well as what we might want them to be, in designing a resolution framework that delivers continuity and stability. ■

Transparency, continuity of service key to R&R planning

Larry Thompson - General Counsel, **The Depository Trust & Clearing Corporation (DTCC)**

The post-crisis landscape has put the risk management practices of central counterparties (CCPs) under the microscope...and with good reason. They are a crucial component of the financial system because of their role in reducing counterparty risk and limiting contagion across global financial markets. But with the percentage of financial transactions cleared through CCPs expected to increase dramatically in the coming years due to new regulatory mandates for OTC derivatives, their ability to manage additional risk is critical to the safety of the system.

A number of regulatory initiatives are being implemented to buttress these infrastructures against risk concentration, including the development of recovery and resolution plans for a failing CCP. This is critical because we have witnessed the devastating effects of a CCP failure without such safeguards. When the Hong Kong Futures Exchange's clearinghouse collapsed during the 1987 market crash, the impact was catastrophic but largely restricted to the HK capital markets. However, in today's world of more global and interconnected markets, the impact of a major CCP failing has the potential to bring down the financial system as a whole.

Given the systemically important role played by clearinghouses, it is prudent to take appropriate steps to ensure continuity of service by focusing on the recovery of a CCP on the brink of failure.

How this is accomplished will differ according to the entity, as each CCP is unique in its governance, in the pre-existing risk management tools and loss-allocation processes that they employ and the nature of the losses themselves. Furthermore, the diversity of financial markets and products that infrastructures serve adds additional complexity to the issue. As such, it is the primary responsibility of the CCP to take the lead in designing and implementing an appropriate recovery plan in coordination with its stakeholders.

Recovery planning is not one-size-fits all, yet regardless of the mechanisms employed by a recovering CCP, it is vital that the recovery tools are agreed by all stakeholders beforehand so the process is transparent and clearing members have a clear understanding of their financial obligations. ■

Recovery and resolution plans for CCPs ensure prudently organized and operated financial markets

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

Across the main jurisdictions, policy makers and regulatory authorities have made great strides towards ensuring that financial market participants' potential defaults will no longer lead to the choice of either a public bail-out or a disorderly failure and its accompanying negative externalities. These go hand in hand with the new regulatory regime for safer financial markets, which includes the upcoming clearing obligation start. As part of this drive, FMIs, and CCPs in particular, have had consideration applied to how recovery and resolution frameworks apply to them.

As CCPs are not the same type of entity as, say, banks, and it is important that their recovery and resolution plans reflect their role as a risk manager across their participants' positions. Furthermore, the recovery and resolution plans must be flexible, as they would only be used in circumstances of the most dramatic market stress given the scenarios CCPs already incorporate in their usual course of business.

During the course of the coming year, the industry expects to see global standards and hopefully jurisdictional rule-making in this domain. Such rules are widely expected to address how losses arising from risks other than member defaults (such as fraud, or operational risk) are covered, who the resolution authorities of the CCPs are, and which tools are included amongst the recovery and/or resolution package.

Once completed, the recovery and resolution planning for CCPs will strengthen important features of the clearing landscape and promote systemic stability. In particular, they should ensure that the competitive CCP landscape is not distorted by perceived public support, strengthen and clarify the recovery options, and ensure that resolution is enacted only by choice in a controlled manner.

These plans will complement the standards for micro-prudential CCP risk management, rounding out the regulation and enhancing the macro-prudential aspects of the CCP market structure. As such, at least for the centrally cleared portion of the markets, a holistic and actionable mechanism exists to tackle and future crises; even if in the most extreme of cases they overwhelm a CCP's risk mitigants' calibration levels. For such scenarios, the ability of a CCP and its resolution authority to decisively act from a central point, based on accurate information, cannot be underestimated as a beneficial tool for equitable and orderly crisis management. ■

Defining an appropriate CCP recovery and resolution framework

Jean-Marie Andrès, Didier Cahen, Marc Truchet – Eurofi

Defining an appropriate recovery and resolution (R&R) framework is the main forthcoming legislative challenge for Financial Market Infrastructures (FMIs) in the EU after the adoption of EMIR and the CSDR. Following a consultation paper published in 2012 by the EU Commission on the R&R of non-banks and proposals made at the global level in 2013 by CPSS-IOSCO regarding FMI recovery and by the FSB regarding FMI resolution, the Commission is expected to publish a proposal for the R&R of CCPs in the coming months. The EU Parliament adopted a self-initiative report covering the R&R of non-banks at the end of 2013. Measures have also been proposed in the UK.

The proportion of centrally cleared OTC derivative transactions is expected to strongly increase in the coming years with the implementation of EMIR. This will provide many benefits for the market in terms of risk management and netting, but it will also increase risk concentration within CCPs. Interdependencies will also expand in the financial system between CCPs and their members and among interoperating CCPs. The failure of a CCP is a very low probability risk but it is not to be fully excluded and would have extremely severe consequences for the market.

EMIR already requires the implementation of risk management policies, capital requirements, disaster recovery arrangements and the establishment of a default waterfall including pre-funded loss-absorbing mechanisms. Most EU CCPs have additional rules in place such as "rights of assessment" which are an unfunded obligation to replenish the default fund similar to a bail-in tool. But since ordinary bankruptcy rules, which focus on creditors, are not adapted for such entities that provide critical services for the market, these EMIR measures are due to be completed by a specific recovery and resolution (R&R) framework providing additional crisis prevention and management tools in case the resources mandated in EMIR are not sufficient. Several key questions remain to be solved in this perspective.

Distinction between ordinary risk management procedures, the recovery and the resolution phases

A first question is clarifying the measures that should be part of the recovery phase of a specific R&R framework, in addition to the ordinary risk management actions already mandated in EMIR. Suggestions have been made that the recovery phase should be triggered when the collateral posted by the defaulting member is insufficient to recover losses and when the viability of the CCP is threatened.

A second issue is how far recovery should be pursued once the ex ante agreed loss-absorbency measures are exhausted before triggering resolution. Many stakeholders believe that ensuring the continuity of the critical services provided by the CCP should be the main objective of an R&R process. This means first attempting to recover a CCP in financial distress (unless it is clear from the outset that this is impossible) and if this is not successful, transferring positions to another entity. When the market considers that losses are too high and that there is no point in continuing certain business segments then this is a resolution situation. Defining clearly when this move should happen is a key challenge.

Other participants, mainly from the buy-side believe that once the ex ante agreed loss-absorbency measures are exhausted the best course of action is to resolve the CCP, with a fast liquidation of positions, in order to return remaining margins to non-defaulting members and avoid penalizing them or their customers, rather than using additional resources (e.g. customer margins) to support a failing CCP. Two factors are put forward by these participants: (i) first the loss of confidence there is generally in a failing CCP, making its recovery unlikely beyond a certain stage as participants may leave the CCP in such a case, (ii) secondly the difficulty of transferring positions to another CCP or bridge entity in a short period of time. Augmenting pre-funded and pre-agreed loss-absorbency tools in order to strengthen the defences of CCPs has been proposed as an alternative to recovery instruments, although the effectiveness of such approaches is questionable in the view of some participants.

Finally, some participants think that a distinction should be made between the different types of products cleared by the CCP i.e. tools may vary depending on underlying cleared products and it should be possible to isolate products from each other in case of recovery as it could facilitate the effective implementation of the recovery itself.

Loss allocation tools in the recovery phase and the extent of the commitment of participants

Another issue is defining the tools that may be used for allocating losses and possibly continuing the core activity in a recovery context and the extent of the commitments of different participants. Recovery plans should provide the right incentives in order to increase the likelihood of recovery and be sufficiently predictable and transparent. Haircuts on variation margins (VM) in order to distribute losses to a large participant base and buy time for an orderly reorganization of the CCP are favoured by many stakeholders as they can be implemented fast. The pro-cyclical effects of VM haircutting are however stressed as well as the fact that the possibility of such haircutting might deter clearing members from increasing their exposure to CCPs. Some have also suggested using additional cash calls and partial tear-ups but such tools may be more appropriate in a resolution phase as they are not so predictable. Haircutting the initial margin of non-defaulting members has been rejected in the consultations recently conducted and drawing additional funds on shareholders seems unlikely at such a stage.

Moreover stakeholders generally suggest that recovery regimes should not give rise to open-ended liabilities that would potentially create incentives for participants to leave the CCP, which means defining precise triggers for activating the resolution process. The degree of flexibility that might be left to CCPs in the design and implementation of recovery plans in order to potentially adjust tools to specific circumstances also needs to be defined.

Resolution tools and authority

Two main options are envisaged for resolving a CCP: transferring the positions to another CCP or bridge entity or liquidating the positions. Many observers argue that transferring positions is difficult to achieve in a short timeframe particularly in a cross-border setting unless it is prepared in advance. Suggestions have been made that a CCP resolution could contain a recapitalization plan to potentially re-start the operations of the CCP on new grounds once positions have been liquidated.

Another issue is the nature and the role of the resolution authorities of cross-border CCPs given the speed of reaction that is needed when executing a resolution process and the possible fiscal implications. The way to handle the R&R of a cross-border CCP operating in countries with different rules also needs defining.

Whether central banks should play a role in the recovery or resolution of CCPs, either as a liquidity provider or as a backstop, is another issue that needs to be decided, taking into account the possible moral hazard this may generate and whether this may create obligations in terms of the supervision or location of the CCP.

A further issue is the coherence that is needed between the R&R frameworks of CCPs and of their clearing members - many of which are likely to be G-SIFIs.

Which issues remain to be addressed in the asset management and shadow banking areas in the EU?

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

The EU investment fund sector is subject to an extensive regulatory framework. Via the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD), all investment funds (or their managers) are now subject to oversight at EU level.

The approach taken in the EU is based on a distinction between relatively strict safeguards and prescription for funds that can be marketed to retail investors (i.e. UCITS) and greater flexibility, at least with respect to such elements as eligible assets and leverage, that is appropriate for the funds sold to professions (i.e. AIFs).

Notwithstanding this comprehensive coverage of the EU fund sphere, there is a need to introduce specific rules in relation to certain entities and activities. In particular, the issues around money market funds (MMFs). On 13 September 2013, the European Commission adopted its proposal for a Regulation on MMFs. This proposal is subject to extensive debates with the co-legislators.

Another set of activities that has been under close scrutiny by regulatory bodies are securities financing transactions (SFTs). The Commission's proposal on SFTs aims at mitigating the risks arising from SFTs and improving the transparency of these activities. To some extent, the UCITS legal framework (as supplemented by ESMA's guidelines on ETFs and other UCITS issues) is already broadly in line with the proposal on SFTs. In addition, the AIFMD foresees disclosure of similar information by AIFMs both at the pre-investment stage and in the context of regular reporting.

Finally, earlier this year the FSB and IOSCO issued a consultative document with a view to establishing assessment methodologies for identifying non-bank non-insurer (NBNI) global systemically important financial institutions. The objective of this methodology is to identify NBNI financial entities, including potentially some global asset managers, whose distress or disorderly failure, because of their size, complexity and interconnectedness would cause significant disruption to the global financial system and economic activity across jurisdictions. ESMA is following the global discussions, as it will need to be considered how to implement the final methodology in the EU. ■

Financial regulation reform: looking forward

Barbara Novick - Vice Chaiman, **BlackRock**

The 2008 financial crisis gave regulators and market participants ample reason to step back and evaluate many aspects of the financial market ecosystem. This review has resulted in myriad new regulations covering bank balance sheets, cash products, market structure, alternative funds and more. Looking forward, we need to step back again. This time we must assess how new rules are working and the cumulative impact on end investors (e.g. pension plans, insurers and individual savers) to ascertain if any changes are needed and what gaps remain to be addressed.

We believe the best approach to regulating risks in asset management requires industry-wide changes. For example, the solution to OTC derivatives exposure did not involve regulating a handful of the largest swap dealers, since the business would simply have moved to different market participants. Likewise, if reforms to money market funds (MMFs) were applied to only the largest ones, clients would move their assets to other non-affected MMFs. Not surprisingly, US and EU regulators comprehensively changed the ecosystem for swap markets by instituting reporting, clearing and mandatory trading on regulated platforms; and changes to MMFs are expected to apply to all MMFs, not just the largest ones or those sponsored by large asset managers. This horizontal approach is needed to avoid creating gaps that would inevitably lead to regulatory arbitrage and it will improve the financial ecosystem for all market participants.

BlackRock considers markets and products from the perspective of an asset manager acting on behalf of our clients. As such, and recognising that many changes are already underway, we have identified areas that warrant deeper analysis and potentially changes in regulation:

- Address reduced liquidity in corporate bond secondary markets
- Ensure CCPs are not too big to fail
- Review fund product structures with the intention of adopting best practices across a number of features
- Extend analysis of levered products to include ETFs, CLOs, REITS etc.
- Address perceived data gaps (e.g. separate accounts)
- Harmonise SFT, alternative fund, derivatives and threshold reporting
- Mitigate the impact of prudential regulation on securitisation and long-term investing
- Consider market plumbing incl. pricing services, custodians, transfer agents, benchmark providers, and technology. ■

Key-objectives of EU Commission in asset management and shadow banking

Martin Merlin - Director, Financial Market, DG Internal Market and Services, **European Commission**

The Commission's general objective is to set up a stable, transparent and resilient framework for the development of market-based financing channels. The benefits achieved by strengthening the resilience of banks should not be diminished by systemic risks moving to less regulated sectors. Many EU legislative initiatives have already addressed some of the most relevant risks. However, the shadow banking system is constantly changing and adapting to the regulatory context. There will therefore be a need to actively monitor shadow banking activities to ensure that they serve the economy without undermining its stability.

With respect more specifically to asset management, the main objective in the next few months is to conclude negotiations on the Money Market Fund (MMF) proposal, adopted in September 2013. The Italian presidency has started discussions and Parliament will soon appoint a new rapporteur. The aim behind the proposal is to increase the stability and liquidity of MMFs so that these funds can continue to play their crucial role for the financing of the economy. In terms of liquidity, the proposal stresses daily and weekly maturing assets as well as rules on issuer diversification. In terms of stability, the proposal focuses on how MMFs have to value their assets and whether additional measures are needed. The recently adopted SEC rules on MMF should provide further impetus for this work.

Given the size of the investment funds market in general, it is essential that potential systemic risks are identified and addressed. The debate on the liquidity and stability of MMF could inform a wider debate on how to limit systemic risk and prevent investor runs across the fund management industry. Consideration could in particular be given to issues like redemptions in stressed markets and the potential for events at large asset managers to influence asset prices across large sectors of the European economy. ■

Asset protection and collateral management – what needs to be done?

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

The European legislator is faced with an apparent contradiction.

It wants to increase asset protection and ensure that the assets of end investors are protected. It also wants to minimize risk in the financial system, choosing the provision of collateral as an important tool to achieve this.

This contradiction is in fact a twin challenge. There is the challenge of ensuring a sufficient supply of collateral. Add to this, the challenge of ensuring that both the collateral-giver and the collateral-taker are protected.

These challenges require sound operational and legal environments for the provision of collateral.

Without such, the overall supply of collateral will diminish as end investors will choose, or be forced by regulation, not to provide collateral, and collateral as a tool to mitigate risk will be ineffective.

The Proposal from the European Commission for a Regulation on Securities Financing Transactions (SFTR) is welcome.

It takes the right approach, which is to improve legal certainty and transparency in securities holding and in securities collateral chains, thereby making progress towards the twin objectives of asset protection and increased usage of collateral. As an aside, we think the technical criteria within SFTR with respect to reporting obligations could use further refinement.

SFTR is doubly-welcome as we have seen other regulatory initiatives that, often without deliberate intent, place unnecessary obstacles on the provision of collateral. Recent examples include AIFMD and UCITS V.

Understanding how securities account segregation works is essential. As a tool to increase asset protection in securities holding chains, securities account segregation works at the level of the last intermediary in a chain, and it works at each level of the chain when it differentiates client assets from proprietary assets.

Beyond this level of segregation, any additional requirements for segregation have perverse effects. They increase complexity and risk in custody holding chains without – in countries with sound legal regimes – enhancing legal protections.

In the case of tri-party collateral management providers, any requirements for additional securities account segregation are particularly cruel, as they are a major barrier to the use of tri-party services, while the purpose of a tri-party provider is precisely to offer an optimal operational and legal environment for the provision and receipt of collateral. ■

The SIFI debate for asset managers and mutual funds: To designate or not to designate?

Ken Volpert - Head of Investments, **Vanguard,** Europe

In the wake of the global financial crisis, regulatory entities around the world, including the FSB and IOSCO, seek ways to heighten oversight in hopes of preventing a future crisis. The discussion centers on identifying and designating non-bank, non-insurers as systemically important financial institutions (SIFIs). However, there remains a lack of clarity around the SIFI designation as it relates to asset managers.

As a leading global investment manager, Vanguard strongly believes that asset managers and mutual funds are properly and effectively regulated, size is not an appropriate indicator of systemic risk, and investors will ultimately bear the costs and consequences of a SIFI designation.

Foremost, Vanguard, along with other asset managers, operates under a highly effective regulatory structure, with key investor protections established under the Investment Company Act of 1940 and in the EU, under the UCITs Directive. Fund investors are afforded significant protections including transparency of holdings; robust disclosure; limits on leverage and derivatives; and limits on illiquid security holdings.

Secondly, size is a poor indicator of systemic risk. For an asset manager or mutual fund to pose systemic risk, it would have to be significantly interconnected to other institutions through leverage or possess a mismatch between assets and liabilities– neither of these conditions is met by asset managers or mutual funds.

Lastly is the effect a SIFI designation could have on investors. A designation of an asset manager or a mutual fund will not mitigate systemic risk, but instead increase the cost of investing for all investors. By putting designated firms at a competitive disadvantage relative to non-SIFI firms, investor choice and preferences would be negatively impacted.

Vanguard supports appropriate regulation to ensure the resiliency and efficacy of the global financial system. Nevertheless, we strongly believe that existing regulation mitigates risk of investment funds, and to the extent additional requirements are needed, investors and the financial markets would be best served by an activities-based regulatory approach. ■

Structural banking reforms: beware of the consequences on financing mechanisms

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

Several countries, including France and Germany, have already adopted structural banking reforms to limit excessive risk-taking by banks, improve the resilience of credit institutions and enhance financial stability. The project of the European Commission (EC) published on 29 January 2014, which still has to be discussed by the European Parliament, shares similar objectives but proposes a different approach, which raises some issues of concern.

The reform proposed by the EC would impose not only the prohibition of proprietary trading, like the Volcker rule in the United States, but also the potential ring-fencing of other trading activities including market making. This combination of measures might have serious negative consequences on the financing of the economy and on the competitiveness of European banks, to be compared with unproven effects on resolvability and potentially adverse effects on the resilience of the banking sector.

By contrast, the French law passed in July 2013 distinguishes between speculative activities and other trading activities, such as market making, which are useful for the financing of the economy and market liquidity. It aims at preserving the benefits of the European universal banking model, which proved resilient during the financial crisis, and its capacity to lend to the economy. Thus, the French law does not a priori ring-fence market making activities. Moreover, it does not prohibit proprietary trading, but, if a certain threshold is exceeded, requires that such activities be ring-fenced into entities that are legally, economically and organizationally separate. The following threshold shall be applied: a value of financial assets above 7.5% of the total balance sheet. In addition, regardless of this threshold, I want to stress the importance of the supervisory discretion given to the competent authority, which can request the separation of market making activities if they might threaten the solvency of the deposit-taking credit institution or that of its group.

In short, any proposal for further structural banking reforms should be carefully assessed against its negative impact on the financing of the economy, which might outweigh the potential benefits with respect to financial stability. ■

Structural reform of the EU banking sector

Olivier Guersent - Deputy Director General, Financial Services, DG Internal Market and Services, **European Commission**

In the last five years the EU has undertaken a large number of reforms to establish a safer, sounder, more transparent and responsible financial system serving the economy and society as a whole. However, the size and complexity of a small number of very large banks remain an issue of concern. The balance sheet of some of these banks is larger than the GDP of their home countries. The shift towards a transaction-oriented banking model and the corresponding increase in trading has been one of the major reasons of the growing size of bank balance sheets in the years leading up to the financial crisis. Much of the growth was driven by intra-financial-sector borrowing and lending, rather than real economy lending.

While prudential requirements and preventive/resolution powers are essential and necessary instruments to reduce the probability and impact of bank failure, they may in practice not be sufficient to fully address the risks that these banks pose to the financial stability. In particular, the challenge of implementing an orderly resolution of the largest and most complex banks should not underestimated.

Structural bank reforms complement the reforms related to capital requirements by adding another disincentive towards banks excessively expanding their risky trading activities, thus putting a break on the main source of unsustainable bank growth in recent years. This would correct distorted incentives and contribute to a better deployment and allocation of resources towards the real economy. Structural reforms could considerably facilitate the orderly resolution of the above mentioned TBTF banks, thus making the newly granted powers in BRRD more effective.

Universal banks providing a broad range of commercial and investment banking activities are an important feature of the European banking landscape and will continue to serve clients with a broad set of services and financial products, even if the separation of trading activities is imposed by the competent authority. Furthermore, the Commission is also mindful of the important diversity of the EU banking landscape which is not called into question in any way by this proposal.

The Commission's proposal aims to ensure that universal banks do not grow beyond a size and risk profile that threatens financial stability. It provides a framework ensuring a uniform set of structural measures at EU level. ■

Structural banking reforms – finding the right balance

Axel A. Weber - Chairman of the Board of Directors, **UBS AG**

In recent years, many jurisdictions have come up with new requirements regarding how banks should organize their legal structures and have tightened restrictions on business activities and services that can be provided from a particular entity. The underlying rationale is to isolate some critical banking services (in particular deposit-taking) from supposedly more risky activities. Whether structural separation increases financial stability is debatable, since no particular business model fared particularly well or poorly in the financial crisis. The following should also be considered:

- Structural measures which break up universal banks with diversified portfolios and income streams ultimately result in a less diversified financial services sector, with potentially negative consequences for its resilience against potential shocks.
- Proposals which result in the withdrawal of some firms from certain capital market activities could lead to a situation where such activities are pushed into less regulated areas.
- Client relationships may be disrupted, reducing the range of offerings and the capacity to manage clients' risks. The resulting increase in costs may not be visible for some time, given that reforms are still underway and interest rates are exceptionally low.
- This effect would be amplified by a likely banking sector consolidation. Structural requirements, which work with thresholds, contribute to this effect. For banks that slightly exceed the thresholds, the requirements pose a heavy burden and could impact profitability. Thus, banks will either remain well below the thresholds or try to exceed them substantially, leading to further concentration.
- Finally, a particular concern is the increasing push for self-sufficiency linked to structural requirements, which limits the ability of banks to allocate capital and liquidity in the most efficient way.

Potential unintended consequences are constraints in lending capacity.

Thus significant caution is warranted in the design of new requirements to avoid adverse effects. Marginal benefits of reforms may not justify their likely sizeable negative impact on the economy. ■

We need to give banks room to drive Europe's real economy

Federico Ghizzoni - Chief Executive Officer, **UniCredit**

Universal banks are vital to Europe's real economy. Their role extends well beyond what is typical in the United Kingdom or United States, where banks provide 50 percent or less of corporate financing. In Europe, more than 80 percent of the market is supplied by banks. Enterprises and consumers on the continent will continue to rely heavily on banks for funding of all kinds.

Today, European banks are among the most stable and resilient in the world, having overcome crisis and successfully increased their collective capitalization by €700 billion since 2011. They have met the rigorous Basel III requirements ahead of schedule.

And they are particularly well equipped to serve changing needs in corporate finance. As banking regulation becomes more stringent, Europe's universal banks are already transforming some part of credit exposure into capital market financing. European corporations are increasingly turning to the capital markets for financing, and universal banks are in the best position to match borrowers with the funds they need in a timely manner. This shift will serve the needs of the largest corporate clients while freeing up conventional funding resources for smaller borrowers.

Moreover, the universal banking model is enabling greater business diversification, better capital allocation and improved cost synergies, all of which can lead to enhanced and more resilient profitability.

Yet the EU Commission's new proposal on structural reforms, which appears to be far stricter than the rules now in place in the United States, risks disadvantaging our banks worldwide. There are more effective measures that could be taken to ensure that banks support the real economy while preserving their stability, beginning with the harmonization and simplification of metrics and rules. These should be implemented in the context of a more clear-cut definition of the banking model that regulators ultimately aspire to implement.

Finally, whatever decisions are made, banks can only do well by doing good. We must remain committed to our core values and continue to support the real economy to the best of our abilities with the tools available to us. ■

Asset management and shadow banking regulation

Robust depositaries are key to a stable and safe asset management industry

Eric Derobert - Manager, Group Head of Communications and Public Affairs, **CACEIS**

The asset management industry is expected to fill most of the gap created by the diminishing supply of traditional sources of financing coupled with a growing demand from many sectors of the economy (especially SMEs) as well as demand for investment into infrastructure.

Efforts to maintain this positive trend should obviously not trigger excessive risks or leave aspects of major financial risk unmonitored.

More than 25 years ago, when creating the UCITS directive, and recently when addressing issues concerning the regulatory landscape for alternative funds and traditional funds in UCITS V, the European Union clearly established the duties of the fund depository. Subject to strict eligibility criteria and equipped with the necessary resources, the fund depository is a key player in Europe's heavily-regulated Asset Management industry, given the substantial fiduciary responsibilities attached to its functions. Independent by nature, and carrying out on-going oversight functions, the fund depositary - which should under no circumstances be viewed as a substitute for asset managers achieving full compliance with regulations - has proven itself to be a committed and reliable risk-mitigating player, and as such, has been a solid contributor to the success of the European fund industry.

At a time when so much is expected from the fund industry, close attention should be paid to ensuring the robust nature of the asset servicing sector, which is key to a stable asset management industry. In order for this to be achieved, there needs to be a balanced distribution of risks and rewards along the entire value chain, with the duties assigned to each player defined in a fair and transparent manner. Investor protection and financial stability are legitimate objectives pursued by the regulatory authorities, and fund depositaries are fully committed to playing their part in ensuring the European fund industry is both safe and stable. ■

Loss absorption and recapitalisation capacity for G-SIBs in resolution

Luis M. Linde - Governor, **Banco de España**

An orderly resolution of a G-SIB requires adequate capacity to absorb losses and to recapitalise the institution so it may maintain its critical business operations while minimising the risk of recourse to public funds. To this end, at the time of this article being drafted, the Minimum Requirement of Eligible Liabilities (MREL) concept in the EU Bank Recovery and Resolution Directive (BRRD) is well-defined and established, whereas the new Gone Concern Loss Absorbing Capacity (GLAC) concept is still being debated by the Financial Stability Board. In this latter forum, discussions have focussed on the advisability of Total Loss Absorbing Capacity (TLAC) compared to GLAC.

The GLAC concept envisages a recapitalisation capacity that is entirely separate from the capital levels a G-SIB holds. Owing to that separation, it does not contribute to a commonly shared objective of the supervisory community, namely the strengthening of the capital base of institutions. With regard to GLAC-eligible instruments, it is being disputed whether excess capital over minimum regulatory levels could be envisaged. Were that the case, then GLAC may be entangled with the capital framework and may require changes to the newly implemented Basel III regime, which might not be desirable from the standpoint of regulatory certainty for institutions. Also, the separation principle embedded in GLAC differentiates the supervisors' intervention framework from that of the resolution authorities, as the breaches in capital requirements and, ultimately, in the GLAC requirement would not coincide and would be sequential.

Under the TLAC concept, capital instruments and qualified financial instruments count towards the requirement. In that regard, an institution is allowed to accumulate capital instruments to cover the TLAC requirement. In this framework, when an institution begins to incur significant losses, these would impact both capital levels and TLAC levels. Supervision and resolution authorities could simultaneously activate their respective intervention measures in a coordinated manner to redress the situation; and this is expected to be more effective than a sequential intervention. However, the TLAC concept is also sensitive to the need for adequate recapitalisation capacity when capital is fully – or almost fully – depleted and resolution has to be triggered. To that end, the TLAC concept should include a certain percentage of the requirement that has to be met with qualified financial instruments that are not capital instruments. This portion of the TLAC requirement meets the objectives of a separate GLAC requirement without forgoing the aforementioned advantages and without the inconveniences of the GLAC concept.

In many senses, the TLAC concept is similar to that of MREL as it includes own funds and qualified eligible liabilities; and especially so if, in the BRRD context, authorities use the discretion available in Article 45.13&14 to require that a certain proportion of MREL be covered with qualified financial instruments, namely including a bail-in clause. ■

Global solutions for bank crisis management: Reconciling the GLAC with EU Rules

Jérôme Brunel - Head Group Public Affairs, **Credit Agricole S.A.**

The 2008 financial crisis has led regulators and policy-makers across the world to profoundly review the resolution regimes and bankruptcy laws applicable to the banking sector. The underlying philosophy of these new resolution rules is globally the same everywhere: no taxpayer should continue to bear the heavy cost of rescuing the banking sector and no financial institution should be considered too big to fail. In Europe, the banking resolution toolbox rests on two main pillars: the Banking Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM). The bail-in instrument constitutes a distinctive feature of this new resolution regime and it is complemented by an obligation for banks to hold a Minimum Requirement for Eligible Liabilities (MREL) for the purpose of bail-in. In addition, European policy-makers have signed-off the creation of a 55 bn EUR Single Resolution Fund - which will be entirely contributed by banks - to backstop the eurozone's banking sector in case of deep financial stress. Combined with the Basel3/CRD4 prudential framework and the Single Supervisory Mechanism (SSM), the new European bank resolution regime is expected to offer an unparalleled level of financial security to EU citizen and investors.

Notwithstanding these developments, international regulators are pursuing their work towards the development of global standards for crisis management. In particular, the FSB is reflecting on the introduction of a new prudential standard, namely the Gone-Concern Loss Absorbing Capacity (GLAC). Through this new rule, the FSB hopes to increase the "credibility" of the banking resolution regime by raising requirements for additional loss absorbing capacity beyond minimum regulatory capital requirements. At Crédit Agricole, we support the FSB's efforts aiming at developing global solutions for crisis resolution. However, it is critical in our view that the new GLAC standard does not end up unduly penalizing EU banks which are already subject to the stringent rules of the BRRD, including the MREL for bail-in purposes.

... continued on page 29

MREL and GLAC, a milestone towards ending "Too Big To Fail"

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

At the end of 2013, the FSB identified adequate gone-concern loss absorbing capacity (GLAC) as one of the tools aiming at ending "Too Big to Fail" (TBTF). GLAC objectives are to avoid use of public funds for loss absorption and to allow resolution strategies to effectively be implemented while ensuring the continuity of the critical functions of the failings banks. For this purpose, authorities will need to ensure that G-SIBs hold sufficient resources at all times. In that sense, the European MREL (i.e. the Minimum Requirement and resolution for own funds and eligible liabilities which the EU's draft recovery and resolution Directive refers to) and the GLAC concepts are identical in their objectives.

Whereas discussions on GLAC are still ongoing, MREL has already been approved by all European Member States and is precisely defined in the BRRD as a « Pillar 2 without Pillar 1 » requirement not limited to G-SIBs. This capacity to customize the level of MREL following the purposes of the resolution authorities and the situation of each bank is one of the most positive features of the MREL concept. In addition, the broad range of eligible liabilities and the possibility to meet MREL requirements on a consolidated basis will limit the risk that institutions would face market capacity shortages or be obliged to further increase the size of their balance sheet to issue specific instruments. The latter would be contradictory with the aim of ending TBTF. Finally, MREL does not measure the full range of loss absorbing capacities of an institution, as some elements excluded from the ratio are indeed bail-inable under BRRD (for example, some liabilities with a remaining maturity of less than 1 year).
MREL and GLAC – if not fully similar by the end of the international discussions – will in any case share one important characteristic: they are not sufficient to ensure an orderly resolution worldwide, due to the divergent crisis management frameworks. Beyond the intense cooperation

required by crisis times, we need to develop ex-ante mechanisms for statutory mutual recognition of the resolution tools and powers. This demanding challenge should be high on the FSB agenda. We need in particular to avoid an excessive fragmentation of loss absorbing capacities, which may weaken the capacity of a group to overcome even medium-sized shocks. Moreover, it would make the resolution process more complex. ■

Gone-concern loss absorbing capacity of global systemically important banks

Neil Esho - Deputy Secretary General, **Basel Committee on Banking Supervision (BCBS)**

Basel III's main focus is on increasing the likelihood that banks can survive a period of stress and thereby remain a going-concern. It requires banks to increase their minimum levels of common equity tier 1 (CET1), which is the highest quality form of capital, and to improve their capital buffers, which can be drawn down during periods of stress. Basel III requirements are significant but not sufficient to address the negative externalities posed by Global Systemically Important Banks (GSIBs) or to protect the system from the wider spillover risks of GSIBs.

To address the cross-border negative externalities they create, GSIBs are also subject to additional loss absorbency requirements that will enhance their going-concern loss absorbency and reduce the probability of their failure.

In January 2011, the Basel Committee took further steps to ensure that all classes of capital instruments fully absorb losses at the point of non-viability (PON), before taxpayers are exposed to loss. In essence the PON requirements ensure that all non-CET1 capital and Tier 2 capital will be written-off or converted into common equity upon the occurrence of a trigger event (such as a decision to make a public sector injection of capital to rescue a failed bank).

Gone-concern loss absorbing capacity (GLAC) extends the PON concept (or bail-in) to other forms of bank funding, and seeks to address the problem that, when a bank fails, losses could exceed existing levels of regulatory capital. Work is ongoing to define this funding, what would constitute minimum requirements and how the location of the funding may depend on the resolution strategies of the banking groups. In developing these details there is consensus that GLAC must fit neatly with the existing Basel III framework.

The objectives of GLAC and the minimum requirements for eligible liabilities (MREL) established by the EU are broadly the same. Both seek to ensure that bank liability holders – not taxpayers – bear the cost of bank failures, and that critical financial services are

maintained while a GSIB is restructured or wound-down in resolution. While work is continuing on the GLAC details, it is too early to say how GLAC and MREL may differ. Nevertheless, a key feature of MREL is that it is tailored to each bank. GLAC, on the other hand is only applicable to GSIBs and may include, at least in part, a common minimum standard. ■

Setting the MREL within the new resolution regime

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

During the crisis bank creditors have almost all escaped unscathed, protected by taxpayers. This is not only unjust and burdensome for public finances, but also inefficient: bank creditors must have incentives to monitor and discipline banks, to prevent short-termism and risk shifting by bank shareholders and managers. At the same time, some bank liabilities play a special role in facilitating economic transactions, which requires them to be "informationally insensitive". These liabilities are therefore accompanied by deposit insurance and preference, and safeguards for collateral in resolution regimes. To preserve market discipline, large banks cannot fund themselves entirely through the latter category of liabilities. This is the goal of the FSB's forthcoming gone concern loss absorbing capacity (GLAC) proposals, and the minimum requirement for own funds and eligible liabilities (MREL) set out in the Bank Recovery and Resolution Directive (BRRD).

How will MREL work? Resolution authorities will set it for each bank on a case-by-case basis, and shall use common criteria spelled out by the BRRD with the aim to ensure that similar banks have similar MREL, independently of their location within the Single Market. EBA technical standards (TS) will further flesh out these criteria, building a framework of "constrained discretion" which should ensure a level playing field and allow resolution colleges to discuss and agree joint decisions on the MREL for cross-border groups. Moreover, as the TS will define criteria for setting the MREL for banks with different business models, we expect them to be consistent with the FSB requirements for G-SIFIs.

What about the quality of MREL? The BRRD sets out some specific criteria: liabilities must have a residual maturity of more than one year, and both own funds and other liabilities will be included, so as not to disincentivise higher levels of equity. Senior unsecured liabilities may count, but the BRRD does not ignore the problems which may arise from bailing-in them; rather it allows flexibility on how to deal with them.

Indeed, the MREL may include a requirement for subordinated, contractually bail-inable debt, and more generally the MREL should be set within the larger context of resolution planning. In this regard, the EBA's draft TS on resolvability assessment aim to build a framework of constrained discretion to get to joint decisions, by requiring home and host resolution authorities to identify whether there are obstacles to the feasibility of bailing-in certain liabilities - for example due to set-off rights, the valuation of derivatives, or the risk of treating creditors worse than in insolvency; or to the credibility of doing so, e.g. in light of the importance of corporate transaction deposits to the economy. ■

Cross-border resolution can be made to work! Banks will need restructuring

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

Some people doubt whether home and host jurisdictions can credibly commit to co-operate in the resolution of a globally active bank or dealer without a binding international treaty. A treaty would be useful, but it is not going to happen in this cycle of international financial reform. So is that it, game over? No.

Most people are becoming familiar with resolution jargon: single point of entry (SPE) when a group is resolved top down, as one; multiple point of entry (MPE) when it is resolved in distinct pieces, each of which themselves may be subject to SPE resolution. An SPE resolution of a complex group/ subgroup has two stages. In the first stage, losses in a subsidiary exceeding equity would be transferred to its holding company (holdco) by way of writing down/converting into equity a super-subordinated debt instrument held by the holdco. The trigger would be something like: if the conditions for the host authorities to put the subsidiary into local liquidation or resolution were met, they could instead trigger the intra-group debt conversion/loss transfer. The second step is typically for holdco bondholders to be bailed in, thereby restoring the solvency of the group so that it restructured in an orderly way.

For this strategy to work, obviously the intra-group debt instrument needs to exist. And thus the holdco and the group's home authorities need overtly to have agreed in advance to its existing. The host authorities need to agree too. Even with the local subsidiary's financial problem having been transferred to the holdco, the host authorities remain exposed to disorder in their jurisdiction if the home authorities are not capable of conducting a SPE resolution of the holdco and yet their local subsidiary is not operationally viable without the rest of the group.

The effect is to force home and host authorities to hard wire up front how they will coordinate the resolution of a global group. That means that they find out ex ante whether or not they can co-operate on that hard-wiring, rather than, as in the recent crisis, finding out ex post whether they can cooperate in a more ad hoc resolution.

For example, if a group's home authorities will not make a holding company issue a minimum level of bailinable bonds or if they (or the group board) will not agree to a trigger, in the hands of host authorities, that allows excess losses to be transferred up to the group holdco, then host authorities know that the home is either unable or unwilling to effect a whole-group resolution. However awkward, that is much preferable to discovering ex post, as a crisis breaks, that they can't rely on each other. This can give a harder edge to discussions amongst home and host authorities in supervisory and crisis-management colleges, which otherwise are, I suspect, inclined to flabbiness

This model synthesizes the effects of a treaty. As will be clear, it needs to be accompanied by corporate restructuring. Banking groups (or, for MPE banks, subgroups) need to be headed by pure holding companies. The group's subsidiaries need to issue to that holdco deeply subordinated debt, with the requisite triggers under the control of the authorities. And the holdco needs to issue a minimum value of bonds to the market (so-called gone-concern loss-absorbing capacity), providing the means for recapitalizing a bankrupt holding company.

The EU has a good resolution law with a good set of powers. It is behind the US on getting its banks to restructure so that those powers can be used effectively. The EU needs to get on with it, starting with supporting a strong global 'GLAC' policy on bond issuance at the coming Brisbane summit and getting the obvious banks to restructure. Liikanen, Vickers and Volcker are sub-plots in comparison. ■

Making cross-border resolution work in practice

Flavio Valeri - Chief Country Officer Italy, **Deutsche Bank**

Debates on resolution often get lost in acronyms: G-SIFI, TBTF, BRRD, OLA, SRM. The latest we are getting to grips with is GLAC, or 'gone-concern loss-absorbing capacity'. Jargon which obscures a very simple aim - to make sure even the biggest global banks can fail.

Ending "too big to fail" requires authorities to have both the tools and confidence to shut down failing banks. There is now legislation in place in major jurisdictions - US, EU, Japan and Switzerland – which provides the tools. In particular, the EU power to "bail-in" private creditors will ensure costs of failure are not borne by taxpayers. However, authorities also need the confidence that there is enough bail-in available to absorb losses.

If there is doubt about this, then authorities are incentivised to ring-fence local operations, rather than co-operate, on cross-border banks. This is in nobody's interest, as trapped capital and liquidity raises customer costs and fragments the global system, making it less resilient in future crises.

This is why global agreement on minimum GLAC is so important. It will give authorities confidence that resources will be available in resolution. However, to be effective, this needs to work across different resolution regimes and business models.

It is therefore important that GLAC is not limited to subordinated instruments – not only would this favour specific national banking structures, but it would be bad for financial stability. It would make the system more fragile by increasing reliance on wholesale funding and funding costs. In a crisis, it risks contagion as it concentrates losses and creates false expectations in senior bondholders they will not be bailed-in. EU banks would be particularly affected; given the competitive distortions a narrow GLAC requirement would create relative to the broad EU bail-in regime.

GLAC is necessary to end too big to fail and it is critical that we take the time to get it right. A comprehensive approach - as under the EU regime - will avoid disruptions to funding markets, business models and, ultimately, financial stability. ■

Making resolution possible – open issues and next steps

Axel A. Weber - Chairman of the Board of Directors, **UBS AG**

While I am encouraged by the progress made by both the industry and the official sector in responding to the "too big to fail" challenge, some issues still need to be addressed to make resolution possible, especially for large global financial institutions:

- Banks need their local authorities to commit to setting reasonable self-sufficiency requirements. I am concerned about the ambiguity created by calls for credible global resolution plans on the one hand and increasing self-sufficiency requirements in several jurisdictions on the other. The trend towards self-sufficiency challenges the merits of global resolution strategies, especially if leading financial centers begin to take a predominantly local perspective. It also leads to the creation of more subsidiaries within the global banking system and threatens the success of the "Single Point of Entry"-resolution strategy, which we see as the most efficient approach for global resolution.
- In light of the challenges authorities face in committing to binding international agreements for global resolution, the definition of global standards for "Gone Concern Loss Absorbing Capacity" (GLAC) is crucial, including amount, location and eligible instruments. The amount should be based on a percentage of risk-weighted assets and be sufficient to allow a bank, should it reach the point of non-viability, to replenish its required equity capital to a level considered credible by the market.
- Recovery and resolution planning and putting in place the necessary adjustments to banks' legal structures entail a significant commitment of resources and potentially irreversible adjustments of G-SIFIs. These plans are extensive and complex, and they need to address all of the resulting business implications and operational changes. That's why firms depend on clear and reliable guidance from the authorities.

On balance, while significant progress towards resolution has already been made, there is still a lot of work to do. The industry stands ready to work with the authorities to find solutions that further strengthen confidence in the financial system. ■

Bank loss absorbency rules need to reflect diversity in markets and business models

Douglas Flint - Group Chairman, **HSBC Holdings plc**

Since 2009, important steps have been to address Too Big Too Fail, notably through the Basel III reforms, implemented in Europe through CRD IV.

More recently, in May 2014, following a rigorous negotiation in the European Parliament and Council, the EU adopted the Bank Recovery and Resolution Directive (BRRD), which places an obligation on banks to hold a Minimum Requirement for Eligible Liabilities (MREL) for bail-in purposes. The Financial Stability Board will shortly establish rules on Gone-concern Loss Absorbing Capacity (GLAC) to facilitate cross border resolvability of Global Systemically Important Banks (G-SIBs) through private means.

As European policymakers have already accepted in the BRRD, banks should be able to meet their GLAC requirement through a range of credibly and safely bail-in-able instruments which are appropriate to their funding market, regulatory regime and business model. In my view, this should include capital instruments held in excess of regulatory requirements and, where the local authorities agree, the loss absorbing capacity of deposit insurance schemes.

Moreover, the assessment of any 'gone concern' scenario used to define and calibrate GLAC requirements must take into account a banking group's organisational structure and resolution strategy, as agreed with its Crisis Management Group. A single measure of GLAC may be appropriate for those G-SIBs that will be resolved cross border on a 'Single Point of Entry' basis, but banking groups that are 'Multiple Point of Entry' have limited cross border issues and resolution is locally driven. A toolbox of GLAC components, to be used by national authorities to resolve such groups and which can be calibrated according to the intensity of supervision and available level of central bank liquidity support, is likely to be more appropriate.

Finally, it is important to recognise that loss absorbing capacity is not free and the benefits to stability need to be balanced against the economic consequences of raising the cost of credit. Europe's economy relies on bank credit, which depends on efficient capital allocation. Trapped capital and liquidity, either at individual or consolidated level, cannot by definition support growth. ■

The road to Brisbane – what hope for GLAC?

Giles Williams - Partner, EMA Regulatory Centre of Excellence, **KPMG**

We now have a greater appreciation for the number of moving parts involved in solving the "too big to fail" issue. While progress continues to be made across a number of fronts, none has yet landed e.g. key attributes have still to be incorporated into statutory frameworks, resolution planning remains incomplete and the legal, financial and operating structures of global banks are not yet aligned to a preferred resolution strategy. Therefore, more work is needed for meaningful resolvability assessments and institution specific cooperation agreements to be on the table by the G20 summit in Brisbane.

However, one challenge that will be discussed in Brisbane is how to create sufficient gone concern loss absorbing capacity (GLAC) to enable a global bank to be restructured while keeping its critical economic activities going. The concept of bailing in certain classes of creditor has already gained traction, making it easier for the FSB to establish high-level policy priorities to drive the quantity, quality, location and ownership requirements for GLAC. However, big questions still need to be answered e.g. how can you set GLAC without a transparent resolution strategy and ex-post restructuring plan? Is it possible to raise eligible GLAC within certain jurisdictions? Is GLAC as currently articulated the optimal solution for state owned or retail funded banking groups?

A GLAC mechanism will also have to overcome the common challenges associated with operating across differing regional and local financial markets, national legal systems and divergent regulatory and crisis management frameworks. However, in the absence of an alternative solution that enables global banks in resolution to bear losses through a stabilisation and restructuring phase, there is an understandable momentum behind trying to make GLAC work. Let's hope the desire to find a solution quickly does not overlook the need to construct GLAC in a way that allows global investors to assess and price their risk at a level that works for the diverse bank business models across Europe, but more importantly allows them to support economic growth. ■

Laying the foundations for co-operation on cross-border bank resolution

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

One of the lessons from the global financial crisis was that banks which had been "international in life" were "national in death". It is perhaps unsurprising that, in recent years, authorities have taken steps towards strengthening local prudential requirements. National authorities are accountable to national publics and need confidence that financial stability and depositors in their jurisdictions would be protected should an international bank fail.

But excessive fragmentation of groups along national lines would be harmful to banks and their customers and could make the financial system more fragile and less resilient to shocks.

Instead we must make cross-border resolution work. Following FSB Key Attributes, resolution regimes need to be better aligned. This includes host countries having a statutory power to recognise resolution actions of home countries, as has been done in the EU BRRD.

... continued on page 29

Beyond Solvency II: Challenges for insurance supervision

Edouard Fernandez-Bollo - Secretary General, **Autorité de Contrôle Prudentiel et de Résolution (ACPR)**

While the implementation of Solvency II, a major work in progress, is definitely on the good track, insurance supervisors have to face simultaneously other important challenges.

We are creating common international prudential standards. The IAIS has decided to tackle the issue in two steps: first, in 2010, it initiated the design of a comprehensive framework for the supervision of Internationally Active Insurance Groups (IAIGs). Then in 2013, it started the development of a global insurance capital standard (ICS) that should be published in 2016. Regarding the systemic institutions, a first standardized capital requirement (Basic Capital Requirement) will be publicized by the end of 2014. It will be the basis for a Higher Loss Absobency Capacity to be applied starting in 2019.

These developments will be a landmark for insurance supervision enhancing convergence and setting a level playing field that we very much welcome. Of course, as a European supervisor, consistency with Solvency II principles is an issue of paramount relevance. Another extremely important issue raised by the FSB is to have a well-adapted framework for systemic risk that really captures the specificities of this industry. To that purpose, we think that the support of further research is useful and a careful analysis of the activities of each relevant group needed. ACPR is actively contributing to this analysis through its supervisory work on the main groups present in France. It has also launched a network of research on insurance supervision and systemic risk gathering supervisors, academics and representatives from the industry.

At the level of the European Union, we must reap the full benefits of the further integration of the EU market. The harmonization of the prudential regimes, the building of common approaches to detect risk and vulnerabilities should contribute to avoid any risk of fragmentation. We think furthermore that building up an efficient European-wide consumer protection, will also be an important contribution to the financial integration. ACPR, for which consumer protection is a key mission, will be actively involved in the elaboration of the different ongoing European legal drafts. Our aim is to ensure that a cross-sectorial approach is adopted to clarify the information disclosed to consumers and that it is adapted to the different financial industries and channels of distribution. ■

Solvency II delegated acts: More weight on parliament's scrutiny power

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

The preparation towards Solvency II is in full progress. It is understood that, for a successful preparation, the insurance undertakings and supervisory authorities need better clarity and predictability on the details of the rules. The delegated acts and implementing technical standards play a key role in this regard. Both, European Parliament and Council, have the right of objection to the draft delegated acts. With the tight timeline until 2016 in mind, the Commission shall proceed as quickly as possible with the consultation of the Parliament and the Member States in order to ensure a smooth finalization of the process. As Parliamentarians we count on the Commission that the guiding principles and basic parameters set out in the directive will be fully respected.

The Parliament continuously advocates the principle of proportionality that shall be binding for the Commission, the European and national competent authorities and the Member States. It is important that all the different layers of the new regulatory and supervisory framework allow for a size-proportionate and risk-proportionate implementation. Particular scrutiny is given to the delegated acts that specify the Long Term Guarantee Measures.

The technical calibrations have to be risk-appropriate and shall ensure the insurers' abilities to invest long-term and to provide sustainable long-term products. On the decisions on temporary equivalence for third countries the Parliament will be equally involved with objection rights. Granting equivalence or temporary equivalence is also an important tool with regard to the current international regulatory developments. It shall be our major interest to safeguard the global competitiveness of European insurance and reinsurance groups.

In recent financial services legislation the Parliament expressed its increasing reservations towards the delegation of power to the Commission. This general concern has to be addressed. I consider it necessary that an early exchange of views is established between the Parliament and the Commission, similar to the procedure that is foreseen for Member States by expert group meetings. A participation of the relevant EU supervisory authorities shall also be assessed. ■

How insurers differ from banks

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

Four differences and two similarities can be identified between insurers and banks as regards their interaction with the financial system and hence as regards possible systemic risk.

The differences are the following: banks are institutionally connected with each other through the interbank market, whereas insurers are stand-alone operators; banks engage in maturity transformation, whereas insurers aim to match the duration of assets and liabilities; banks are inherently liquidity-short, whereas insurers are inherently liquidity-rich; and banks create money, credit and handle the payment system, which insurers do not.

The two similarities are that both insurers and banks are financial intermediaries, contributing to the intermediation between savings and investment; and both are large-scale investors in financial markets, with insurers being focused particularly on the long-term.

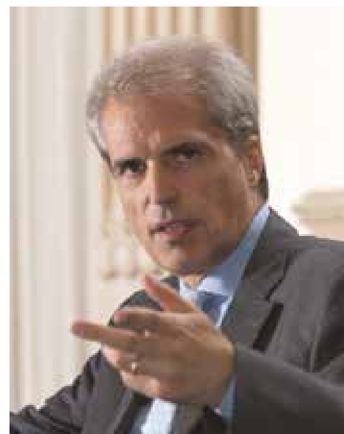
The differences underscore the fact that banks have a fundamentally different role within the financial system and with regard to systemic risk. Banks operate, and can only operate, within a banking system. Liquidity is allocated on a daily basis and shifted in substantial amounts between banks and the central banks; the system also serves as a protection against a possible liquidity risk that comes from handling money and holding short-term deposits. The banking system constitutes a kind of "inner core" of the financial system, where contagion and liquidity risks are prevalent.

Insurers operate only in an "outer circle" of the financial system, connected to other financial institutions essentially through their financial market investments. They act and react as other investors do, with the specific quality that leverage is quasi-absent in insurance and hence insurers do not act as other leveraged investors in financial cycles.

These fundamental differences need to be accounted for in systemic financial regulation so as to foster diversity in the system. Otherwise, if all financial institutions are broadly treated in the same fashion, they will all react in similar ways, which will augment procyclicality that is damaging the economy. The issue is not more regulation or less regulation. The issue is about regulation that is appropriate, coherent and takes societies' interests in long-term sustainability explicitly into account. ■

The latest insurance regulatory developments require deep analysis and a coordinated approach

Sergio Balbinot- Group Chief Insurance Officer, **Generali**



Preserving the fundamental role of insurers as long-term investors should be our common goal. And our priority is the need for balanced, clear and consistent regulation.

Overlaps and contradictions among regulatory requirements would lead to greater costs, higher administrative workload, legal uncertainty, compliance concerns and reputational issues.

The insurance sector is facing several challenging developments. Among others, the BCR, the new capital standard for the Global Systemically Important Insurers. The fundamental lesson we learnt from SII is that if we want capital standards to be not only "numbers" but actual, effective protection mechanisms, we need analysis, proposals and long discussions with the parties involved. And this means time, but time is precisely what is amazingly missing from the ambitious deadline set by the IAIS and the FSB. So the coming weeks and months are critical and there will be limited possibility for the industry to provide input and try to define a balanced, simple and comparable global capital standard.

I personally called on European policymakers to bring greater political accountability and transparency to the discussions at international level. We welcome steps taken by the Commission and I hope this constructive dialogue will continue and bring useful results, reminding us that the ultimate end–users of a sound regulatory regime are our customers.

It is equally important that the outcome of the work on international capital standards is compatible with Solvency II.

The Omnibus II agreement of November 2013 was a great achievement as it updated the Solvency II Directive in important ways.

If implemented correctly, the Omnibus II measures can reflect the way the insurance industry manages its long-term business avoiding unintended consequences. These measures can help to avoid overstating the risks to which our balance sheets are exposed and reduce the problems of exaggerating the real volatility identified in the quantitative impact studies and impact assessments.

One of the most important measures, in this sense, is the Volatility Adjustment. Anyway, the formulas and parameters adopted for the its calculation need transparency and clarity. Otherwise, the VA will not be replicable and predictable.

Despite the above challenges, I am sure that the insurance industry will maintain an open and constructive engagement with policymakers, legislators and supervisors and will contribute to global and European frameworks that allow our distinctive and innovative sector to grow, continuing to protect and serve the needs of its customers. ■

Appropriate use of internal models will be critical for the success of Solvency II

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

Authorising the use of internal models to determine the SCR is one of the first, main challenges for supervisors in Solvency II.

SCR measures the amount of capital that would be necessary to stand unexpected losses under a predetermined worst case scenario. It is clear that the best calibration of this amount can be achieved by modelling the actual risk profile of the specific company. In this sense, the use of the standard formula could be seen as a "simpler" way to determine a proxy of the economic capital, based on average market data and assumptions. Use of internal models is also intended to promote good risk management, as it is a tool to better understand the impact of risk factors' changes.

As experienced in other financial sectors, however, internal models could also be misleading and lead to serious undesired consequences if their results are poorly understood or mismanaged. They could also fail to quantify robust capital requirements, because of excessive uncertainty and subjective judgment in the calculation.

While insurance regimes around the globe are still seeking consensus on how to balance, on one side, risk sensitiveness and incentives and, on the other, prudence and objectiveness in determining capital requirements, many European insurance companies have already applied to get supervisory approval in time for Solvency II first application.

EU supervisors are now asked to strike that balance in practice, in the context of complex prudential valuation processes. It is crucial that the expected level of prudence is achieved and, at the same time, a level playing field at national and international level is ensured.

Besides appropriate level of resources within national Authorities and EIOPA, this requires diligence and commitment from companies, which should refrain from using internal models simply as a way to save capital. Sustaining quality in data gathering and in statistical methodology, ensuring actual and effective use of the models, setting the appropriate governance and reporting for their use are all key criteria to meet, if we want that internal models deliver the expected advantages and the new European regime succeed. ■

The risk-based approach should become global

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

In the last 15 years, several countries across all continents have enacted risk-based regulation and supervision, with different nuances, but with lots of commonalities. In the EU, a major step towards risk-based supervision is represented by the development of Solvency II.

But the world keeps changing. Globalisation and increasing integration of financial markets have shown us the need to go further and to develop global regulation. This idea has been evolving from a fairy tale to reality.

We already have a methodology allowing us to assess and ultimately identify global systemically important insurers (G-SIIs). The next objective is to develop standards to be applied to G-SIIs and Internationally Active Insurance Groups (IAIGs).

With the Basic Capital Requirement (BCR), we aim to create a first level of comparability at global level. The Insurance Capital Standard (ICS) should be risk-based and contain fundamental principles such as a total balance sheet approach; clear and transparent target calibration criteria for capital requirements; explicit recognition of risk diversification; and consideration in capital requirements of all the material risks to which the IAIG is exposed. The details of these building blocks should be developed further until the end of 2016 and subsequently, a testing phase should drive us towards setting up a global capital regime.

Global capital standards should not replicate Solvency II; in fact, I do not think that they should be as granular as Solvency II. Going forward, European regulators should be open to make adjustments to our system if that is needed. Companies should be subject to only one capital regime. ■

Getting international insurance rules right

Susan Greenwell - Vice President, Head, International Government Relations, **MetLife**

An important consideration as we look at next steps in the regulation of the insurance sector in the context of global standard setting is the current G-20 focus on economic growth.

The insurance industry's contribution to economic growth is well documented. However, the future of the industry depends on regulation, and in particular capital requirements, that reflect the unique insurance risk profile and business model, and ensure a level playing field for all insurers. Additional considerations are difficulties arising from a lack of a common valuation and accounting standards.

While the current IAIS capital standard setting agenda appears to be moving in the right direction, and aims to develop a common balance sheet, key elements that would permit fair assessment of the structure and application of capital requirements are absent.

For this reason, there is continuing concern that capital charges may be inappropriately levied on a few companies with the resulting unintended consequences on competition, markets and policyholders.

There is no doubt that agreement on a common international capital standard would be highly desirable. I would like to highlight just some of the elements which are essential for making it a success:

- The relationship between the Basic Capital Requirement (BCR) and Higher Loss Absorbency (HLA) for so-called systemically important insurers and the International Capital Standard (ICS) for all globally active insurance groups needs to be clarified;
- The final calibration of the rules needs to be tested against economic data;
- Many fundamental specifications of the BCR have not yet been defined even though the IAIS is to reach agreement on this part of the capital framework before the end of this year;
- The timetables for developing the capital framework seem overly ambitious;
- The potential imposition of any new capital charges need to be proportionate to the specific risk profile of insurers. ■

A Global Capital Standard needs to be sufficiently credible, to overcome regulatory fragmentation and unlock its potential benefits

Stephan Unterberger - Head of Economic Capital Management, **Zurich Insurance Company**

Over the past few decades, insurance has undergone a fundamental transformation from a largely domestic business to a truly global industry. This process was mainly driven by changing customer needs: the increasing economic integration, the rising importance of multinational companies in production and trade, and the growing mobility of consumers in the globalized economy required insurers to expand their business models. At the same time, the risks themselves have become global. Yet, the regulatory and supervisory frameworks underpinning a safe and sustainable insurance industry have remained in large part domestically or regionally focused. This gap increasingly limits the ability of insurers to meet the needs of their global client base or respond to global risk challenges, while rendering the effective supervision of insurance groups a highly complex endeavor.

The transition towards a global insurance regulatory framework is not a smooth process, however. Indeed, Zurich observes a growing willingness of national supervisors and policymakers to focus on local regulatory frameworks and to embrace protective measures. Such measures are seen by many national supervisors and regulators as a way to keep capital close. However, the resulting regulatory fragmentation limits the ability of insurers to manage their capital effectively and realizing global diversification effects, which are ultimately at the heart of the business model of every insurance company and which are the main reason for the positive contributions insurers can make to societal and individual welfare. In addition, a well-designed and executed global standard can also contribute to the greater stability of the financial system through the benefits of a common methodology and Group supervision. Such a global standard needs to be sufficiently credible though in order to allow for convergence of the wide set of national and regional standards towards one common and comparable metric across the globe.

For any global standard to achieve these benefits, it must

i) fully reflect the economics of the insurance business by applying an economic and market-consistent valuation framework
ii) be risk-based, i.e. the level of capital that must be held depends on the risks that an insurance group assumes
iii) consider diversification benefits, i.e. diversification benefits within an insurer's portfolio must be reflected in the determination of the capital to be held
iv) apply on a consolidated basis to the total balance sheet of an insurance group to ensure all activities within the group are covered appropriately

Otherwise we risk that a global standard will exist in addition to the current set of national and regional requirements, clearly an un-desirable outcome for policyholders, policy makers and the insurance industry. ■

Considerations on HLA and systemic risk mitigation

Dr. Martina Baumgärtel - Head of Group Regulatory Affairs, **Allianz SE**

After completing the Basic Capital Requirement (BCR) later this year, the focus will shift to develop a Higher Loss Absorbency (HLA) capital add-on for GSIIs. Unfortunately, substantial uncertainty remains regarding key elements of the new requirements. As such, we are still waiting for the final calibration of the BCR as a basis for the HLA and relevant BCR details like the treatment of Margins Over Current Estimates. In addition, the definition of the scope of the HLA in terms of Non-Traditional Non-Insurance business is still under discussion. Notwithstanding this, a few key considerations are essential for the HLA development:

GSII focus for HLA is short-sighted - If systemically risky activities are only regulated for GSIIs, it can be expected that those activities will either move to non-GSIIs or are reinsured, which could even increase systemic risk as they would fall short of supervisors' focus.

HLA needs to be incentive-compatible - If supervisors want to restrain systemic risk effectively, the regulation needs to incentivize the reduction of activities triggering systemic risk and must therefore be applied to those activities only.

Systemic relevance versus riskiness - Activities with systemic relevance (spillover effects from other market participants which affect the insurer) must - irrespective of the GSII status – be subject to normal prudential regulation and - if not already done - be tackled uniformly for all market players. In contrast, systemically risky activities, in which the insurer could through their own activities "infect" other institutions, might warrant additional regulation.

Finally, we wonder whether additional capital is the best answer to mitigate systemic risk. Looking at examples like the AIG failure, we believe that other

measures like the establishment of effective Group supervision (no unregulated activity) and globally consistent capital standards and prudential rules for insurers would be more effective. As such, the new capital measures must not automatically lead to additional capital requirements but should depend on the risk profile and soundness of the existing capital regime of the insurer. ■

Bank crisis management at the global level

Global solutions for bank crisis management: Reconciling the GLAC with EU Rules

Jérôme Brunel - Head Group Public Affairs, **Credit Agricole S.A.**

continuation of page 26

Whilst recognizing that the scope of application of MREL and GLAC might differ, we would urge the FSB to come forward with a proposal that is consistent with the BRRD approach on the MREL. In this context, it is key that the FSB takes a flexible approach towards the composition of GLAC liabilities so that banks can meet the GLAC requirement through a broad range of bailin-able instruments, as currently permitted under the BRRD. Such an approach would help banks to best accommodate the GLAC requirement to their specific business models, regulatory environments, organizational structures and, last but not least, their funding model. It would also help resolution authorities to spread losses over a broad investor base if necessary and limit the risk of moral hazard at the level of unsecured senior debt holders. Equally important, the location of the GLAC should be consistent with the group's organizational structure and its high-level resolution strategy (SPE or MPE) as agreed in its Crisis Management Group (CMG), as already foreseen by EU legislation.

Ultimately, any decision on new global resolution standards such as the GLAC (including calibration, timeframe, etc.), should be informed by a proper feasibility study and impact analysis, based on a structured dialogue with industry stakeholders. The duplication of tools and regulations across jurisdictions should be avoided at all costs. Instead the FSB should aim at promoting better coordination between supervisors at global level. ■

Laying the foundations for co-operation on cross-border bank resolution

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

continuation of page 27

Authorities have been co-operating in "Crisis Management Groups" to develop group strategies for G-SIBs. This involves working towards cross-border co-operation agreements setting out how home and host authorities would coordinate actions in a resolution.

But for such arrangements to work at the point of crisis, they need concrete underpinning that barriers to coordination are addressed and firms are set-up safe to fail. One example is adequacy of loss-absorbing capacity (LAC) and how it is distributed within groups.

Groups need sufficient LAC, e.g. capital or unsecured long term debt, which could readily be written down or converted to equity in resolution. Prepositioning of LAC to relevant subsidiaries within a group would provide authorities, creditors and customers of the subsidiary with confidence that necessary resources would be available in resolution, avoiding the need to "ring-fence" nationally. And, even in a domestic context (or within Banking Union),

and in particular if combined with requirements to disclose the creditor hierarchy on a legal entity basis, it would ensure enhanced clarity that losses would fall to shareholders and private creditors over taxpayers. ■

G20 Transparency: more work to do

Michael Bodson - President & Chief Executive Officer, **The Depository Trust & Clearing Corporation (DTCC)**

As we approach the fifth anniversary of the G20 Finance Ministers meeting in Pittsburg, the mandate requiring the reporting of all over-the-counter (OTC) derivatives transactions to trade repositories is among the most advanced in implementation. The measure, which is designed to improve the transparency of derivatives markets by providing a window into exposures across the global system, has been enacted in some form in 15 of the G20 jurisdictions, according to the Financial Stability Board's most recent progress report. However, the reality is that significant obstacles continue to deny regulators and the investing public the level of transparency envisioned in Pittsburg.

Despite near unanimous agreement among policymakers on the benefits of the trade reporting requirement, a regional approach to the rulemaking process has resulted in reporting mandates looking very different across major derivatives jurisdictions. The lack of harmonized rules and implementation timelines across markets have produced challenges for participants and infrastructures seeking to fulfill their global reporting obligations. Moreover, the absence of data-sharing agreements among jurisdictions and the ongoing divergence over protocols for supervising derivatives markets across borders continue to prevent regulators from having a single global view of activity to effectively monitor and mitigate risk.

This lack of harmonization is forcing market infrastructures to build regional solutions instead of global ones, which only serve to increase the cost of compliance and operational complexity, create legal uncertainty and negatively impact market efficiency. If trade reporting remains regionally fragmented, regulators will never achieve the level of transparency that is needed to protect the stability and integrity of the financial system. The result could be an increase in systemic risk.

As we look to the future, we urge policymakers to work collaboratively with one another and with the industry to build trust and to resolve differences in policy and approach. They must also look beyond national interests to establish globally-consistent policies. While a great deal of progress has been made over the past 5 years, there is still more work to do to deliver on the promises of the Pittsburg meeting. ■

Meeting the challenges of cross-border regulation

Greg Medcraft - Chairman, **Australian Securities and Investments Commission** and Chairman, **International Organization of Securities Commissions (IOSCO)**

The post-crisis decline in cross-border activity in the markets we regulate, and its impact on global economic growth, are well documented.

The jury is out on why this has been the case. Macroeconomic conditions and forces have no doubt played a role. Differences in the way in which key jurisdictions have implemented regulation in response to the Crisis and guidance developed by international standard setters may also have played a part.

Whatever the reasons, I believe we in the Official Sector must reflect on the actions we should take to address regulatory impediments to cross-border activity - be they duplicative or inconsistent national or regional regulation. Addressing these impediments will, I believe, support global economic growth.

We at IOSCO are taking action within a framework with 3 elements.

The first element of our approach is continuing to **design** global standards – or a global rule book – which sets out expectations about how activity in global markets should be regulated at the national and regional level. This rule book provides a foundation for consistent national and regional approaches to regulation.

IOSCO has a strong track record in this space, having developed guidance in relation to credit ratings agencies, financial benchmarks, financial markets infrastructure, commodity derivatives and OTC derivatives. Our challenge is to develop appropriately granular and timely standards which are amenable to being implemented in a consistent and co-ordinated way.

The **second** element of our approach is about encouraging consistent and harmonized implementation of these standards.

This area poses particular challenges. We recognize that the implementation of standards at national and regional level will always reflect domestic political, legal and regulatory philosophy considerations. Even though we may be on the same page about the outcomes we want to achieve, there will inevitably be differences of detail and different thinking about whether and how regulation might apply to foreign activities and firms.

The Task Force on Cross-Border regulation we established last year is progressing IOSCO's thinking in this area.

The Task Force will issue a Consultation Paper early in the final quarter of this year setting out a tool kit of measures which might be used by national and regional regulators to regulate foreign firms and their activities.

The tool kit will include measures (including substituted compliance, equivalence, mutual recognition and passporting) which are being used by national authorities as the basis for deciding whether to trust and defer to regulation in the home jurisdiction as the basis for allowing a foreign firm to engage in activities in the host jurisdiction. Our thinking is the tool kit will at the very least help develop a common language as a basis for common approaches to reducing unnecessary regulatory duplication and regulatory costs associated with cross-border activity.

We encourage industry to respond to the Consultation Paper.

The **third** element of our approach is our work on cross-border regulatory co-operation in supervision and enforcement.

Without co-operation, we cannot be confident the standards and regulation we implement at national and regional level are – in effect – operating in a consistent way. Effective co-operation will feed into national authorities' thinking about whether to trust and defer to the regulatory framework of other jurisdictions.

IOSCO has provided a successful framework for this in relation to cross-border **enforcement** activity through its *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information* (MMoU). Regulators from over 100 jurisdictions have signed up to what is now seen as the global benchmark for cross-border regulatory co-operation. Over 2,500 requests for co-operation under the MMoU were made last year.

IOSCO's next challenge will be to develop a similar MMoU covering co-operation in supervision of cross-border activity building on its work in 2010 in designing Principles of Supervisory Co-operation. ■

Consistent implementation of OTC derivatives rules

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

The OTC derivatives reform is one of the few areas where we early on in the process agreed global reforms with detailed calendars. Unfortunately, when we transposed these high level commitments in our laws the inconsistencies started to raise and the timing slipped. So what was conceived as a global reform for a global market risks turning into market fragmentation and reduction of cross-border business, as recently reported by some market studies.

The regulatory community has a duty to respond to these detrimental market developments following the implementation of what was envisaged to be a globally coordinated market reform. Although there are a number of fora to develop international standards and global solutions, when it turns to local implementation the rules always differ slightly in view of local specificities. These differences now impede in too many cases the reliance on, or deference to, foreign regimes.

So far the regulators of the major OTC derivatives markets agreed one basic principle applicable to cross-border transactions, i.e. the strictest rule. This means that for pure cross-border transactions when for example one regime applies the clearing obligation to a particular product or a particular entity and another regime does not, the regime applying the clearing obligation should prevail. Unfortunately, this basic principle does not work in all cases. In particular, when the clearing obligation applies in both jurisdictions but the rules are incompatible, market participants will be unable to fulfil the two sets of rules simultaneously and will therefore be exposed to legal uncertainty, as none of the two is stricter. Similar cases apply to the treatment of branches and affiliates which are potentially exposed to multiple sets of rules.

To avoid the market fragmentation that we are already experiencing there is only one solution: reliance on equivalent regimes. We all agree that this is a solution; unfortunately not all the relevant regulators are ready to implement this principle widely.

With the forthcoming standards on bilateral margins we have the opportunity to implement them in our local rules in a globally compatible manner. We have developed detailed international standards and we are now moving to the transposition of these standards in our own regimes. ESMA together with EBA and EIOPA has already consulted on the proposed rules and is in constant dialogue with foreign regulators on their implementation. Given the granularity of the international standards, we should be able to achieve compatible and equivalent rules. This will allow to rely on each other and avoid the complex exercise of determining which set of rules is the strictest. ■

Challenges of implementing consistent cross-border market regulations

Ashley Alder - Chief Executive Officer, **Securities and Futures Commission (SFC),** Hong Kong

Six years after the onset of the financial crisis, the initial enthusiasm for a set of global, top-down regulations has dimmed. National regulators have been hard at work putting in place rules designed primarily to protect their own domestic interests, many of which fall short of the G20 ambition for more harmonized implementation of standards and synchronized global solutions.

Rather than exporting standards to other jurisdictions extraterritorially, agreeing upon on a set of common tools and processes for implementing rules that aims to achieve equivalent outcomes remains a worthy goal.

There is a growing realization, however, that the reality on the ground is far more complex. For one, harmonized financial regulation operating at an international level is only truly effective if grounded in legal treaties. Absent this, global agencies will find it difficult to implement consensus-driven solutions, based only on peer pressure and applying broad principles of soft law.

Moreover, if national regulators are to be given a clear remit to act collaboratively beyond borders, national legislation must be amended to reflect this. In both cases, governments are best placed to drive this process and enable this to happen.

That said, much has been done on the national level to increase the safety and soundness in the financial system, all based on enforceable national laws which are bound to differ as they are products of different political processes. Jurisdictions in Asia, for instance, have specific circumstances and needs, and have largely rejected a "one-size-fits-all" approach exported from other parts of the world. Where these laws collide, regulators are dealing on a practical level, using measures such as deferring to a foreign law or regulatory regime when it is judged to be sufficiently "equivalent", or to apply "substituted compliance" instead of exporting their own.

This is where the IOSCO Task Force on Cross Border Regulation comes in. Acknowledging the complex reality of cross-border securities regulations, the Task Force is developing a toolkit which describes issues and experiences with the use of different techniques to regulate cross-border activities. It will update the G20 at the Brisbane Summit in November, and aims to issue a consultation paper by the end of 2014. ■

Making it work - Global Market Regulation

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

Global market regulation is certainly not a new concept. It has been on the agenda for years in the Americas, in Europe and in Asia. Everyone agrees that global rules are a precondition for well-functioning global financial markets and clear and consistent market regulation allows all market participants to function properly within a global framework and respond appropriately to customers' needs.

We need to acknowledge that much has been achieved in this regard already. The BCBS and IOSCO work on margin requirements for non-centrally cleared derivatives is a good example of a top down cross-border regulation approach. However, now we need to safeguard this work and not allow it to be undermined by localized initiatives leaving unworkable and inconsistent final rules in the different jurisdictions.

As a global market participant, we have witnessed the emergence of major inconsistencies between national jurisdictions, caused by the much discussed "bottom-up approach" towards regulation, one example being derivative clearing requirements. From an EU perspective, the process of non-EU Central Counterparty Clearing House (CCP) recognition under EMIR has taken longer than expected and communication with the market could be improved. On this we would urge the European Commission to consider that any form of mutual recognition needs to be practical and workable for both US and Asian market participants. Commissioner Barnier's announcement before the summer on the equivalence determinations for CCPs in Japan, Singapore, Australia, Hong Kong and India was a very welcome step in the right direction. We do, however, remain concerned about US-EU CCP mutual recognition. In the US, the CFTC Derivatives Clearing Organization (DCO) rules which require non-US CCPs that meet the CFTC'S DCO definition to register may be construed as a hindrance as it places the non-US CCP directly under CFTC supervision. Needless to say this would not be welcomed by the non US home regulators of the CCP in question.

These bottom up approaches see market participants, including financial institutions, investors and commercial end-users confronted with duplicative, inconsistent and conflicting requirements often aggravated further by divergent implementation timeframes. As a result, cross-border trading and investment is challenged and meeting client needs is impacted. At the same time, regulators are faced with increased supervisory and oversight burdens. All of which could be alleviated through enhanced international dialogue and collaboration between policy makers, regulators and international market participants. We welcome the work of the IOSCO Task Force on Cross-Border Regulation and have actively engaged via the Cross-Border Regulation Forum (CBRF) in the bid to make market regulation work for all participants. To this end, the development of cooperation and consultation mechanisms will be paramount to ensuring the early identification of potential conflicts and bringing together the relevant stakeholders. ■

Reconciling global financial markets with national regulatory systems

Michel Barnier - Vice-President of the European Commission, responsible for Internal Market and Services

We have come a long way in post-crisis financial reform since 2007/08. G20 and FSB co-ordination has ensured that rules for the financial sector have similar characteristics, regardless of where they apply. Globally agreed frameworks pursue similar aims, whilst still taking account national specificities. Yet, despite these shared objectives, we all know that financial markets differ between countries. So do legal and regulatory traditions. This means that some differences in the details of applicable rules and the way supervision functions on the ground are unavoidable.

The challenge we face is to reconcile the needs of global financial markets and cross-border businesses with the diverse legal, regulatory and supervisory reality in different countries. Requiring companies to comply with all the rules of all countries in which they do business cannot be the answer. This is costly, unnecessary and often impossible in practice since even rules pursuing similar outcomes can be contradictory. Global financial markets do not require one single set of rules. What they do need is internationally co-ordinated financial regulation and co-operation between supervisors, based on a system of reliance and deference. In EU financial regulation, this is referred to as the equivalence concept. Based on an assessment of the outcome achieved by a foreign regulatory and supervisory system, the European Commission may recognise that system as being equivalent to the EU standards. This approach allows foreign firms to operate in the EU subject to the rules and supervision of their home country and EU operators to treat foreign counterparties as if they were EU entities. The equivalence concept is not new to EU financial legislation but its importance has increased considerably in the wake of the crisis.

Where countries have committed to the G20 agreed reforms, as further developed through fora like the FSB, Basel, IOSCO or IAIS, their regulatory and supervisory systems should have sufficient similarity to justify a system of deference and recognition. I am not advocating that there should be a single system of recognition to be applied by all countries. Reliance should not be automatic or subject to a uniform process. However, given the common, global regulatory agenda, I do believe that many countries could have a favourable predisposition to recognition and deference to a foreign regulator. It would be helpful for global financial operators but would also improve the safety and resilience of the whole financial system enabling more effective global supervision. Our common efforts to this end must continue. ■

Financial Regulation - Global but also consistent?

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

A key objective of the G20 regulatory reform agenda was to achieve global consistency and a harmonised approach in responding to the financial crisis. Half way through the agenda, it is a good moment to assess to what extent this objective has been achieved with derivatives regulation being a goodtest case.

Compared to the pre-crisis period, good progress has been made. The G20 agreements have resulted in common areas of objectives, regulations and coordination in implementation. At the same time, more can and must be done. Often, the devil is in the detail and national or regional implementation differs in small but very important areas. Relevant examples here are the definition of FX financial instruments and the extent to which they are in scope or the types of assets that will be eligible collateral. Things often become even more complex as implementation timetables vary significantly, e.g. for mandatory central clearing and trade execution venues.

These differences make outcome-based equivalence and substituted compliance assessments even more important to avoid the disruption of the functioning of global financial markets. Recent experience has shown, however, that these assessments need to be undertaken with increased speed and transparency to avoid creating uncertainty in the markets.

But there are also positive examples such as the requirements for uncleared derivatives where consistent implementation seems likely. This is due in part to the important work that IOSCO has done by drafting global principles. In general, IOSCO is playing an important role in promoting global consistency in cross-border market regulation, a role that should be further strengthened and supported by national regulators.

In light of further regulation in the area of financial markets and market structure, as well as newly emerging questions such as the suspension or early termination of derivative contracts in the context of a bank's recovery or resolution, international consistency and close cooperation among national regulators and facilitated by bodies such as IOSCO will be key. ■

The Pittsburgh G20 commitments: Avoidance of regulatory arbitrage

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

In July 2013 the European Commission and the CFTC agreed to solve remaining differences in EU and US derivatives clearing rules. This has been achieved in regards to OTC derivatives or 'swaps', but not in Exchange Traded Derivatives (ETDs) where the reforms have created regulatory arbitrage in margin standards. Long established practices and procedures embedded in other jurisdictions' legislation and supervisory rules are now inconsistent with EU arrangements. At the time of writing the EU and US dialogue was ongoing with no resolution on the horizon.

This unfortunate experience provides important lessons for the creation of future legislation and supervisory rules. It is essential to co-ordinate at a global level while laws are at a formative stage avoiding the risk of marketplace fragmentation through regulatory arbitrage. Without global standards, markets will simply migrate to the least prescriptive jurisdiction and any benefit of higher standards may be lost or lead to global market dislocation. The development and implementation of EMIR has achieved significant progress in ensuring financial markets are safer and will serve the interests of society; this is to be applauded. However, fixing the remaining cross jurisdiction differences is essential.

At the end of June Vice President of the Commission M. Barnier updated the market on the international dialogue. His statement gave grounds for optimism in his determination to ensure alignment of "key aspects of margin requirements to avoid arbitrage opportunities".

These are positive signs, but the need to "fix" problems can be avoided through engaged international regulatory and industry agreement on the substance of detailed Laws and supervisory rules in the formative stages. The challenge is to avoid a repetition of the difficulties we have seen in

EMIR. The finalisation of MIFID II/MIFIR will prove whether lessons have been learned and whether the international financial market's regulatory leaders can develop harmonious reform. ■

International efforts to enhance cross-border regulation

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

The interconnectedness of financial markets has made cross-border regulation a core focus of financial market policy. Which makes it all the more surprising that national lawmakers and international policy-makers do not always pay transnational aspects the attention they deserve. Trade reporting and the regulation of over-the-counter derivatives appear to be particular problem areas. It is in the nature of things that approaches to supervision will differ as long as conditions in individual countries differ, either for political and legal reasons or for structural reasons. Global regulatory harmonisation is therefore almost too much to expect and – as long as these differences exist – not desirable either.

But things that are the same should be regulated in the same fashion world-wide, which is clearly hard enough already.

The International Organization of Securities Commissions (IOSCO) has taken on this Herculean task. It has charged a Task Force on Cross-Border Regulation with putting together a "toolbox" that it aims to use to help it remove impediments to cross-border regulation. The Task Force has asked market participants for their experiences and invited IOSCO members from all parts of the world to explain their national regulatory provisions. This survey has shown that what (among other things) makes shaping cross-border regulation so difficult is – to put it blunt – to some extend a lack of trust. Most jurisdictions are reluctant to allow themselves to be represented in supervisory matters by foreign authorities and even claim extraterritorial powers – sometimes even when the substance of the legislation is identical. If it is not, many jurisdictions demand that the foreign regime is at least equivalent. The countries involved can only agree if they succeed in agreeing on a common regulatory objective. A lack of such common understanding may result in inconsistencies, an unnecessary regulatory burden for supervised entities and ultimately higher costs for the consumer. IOSCO´s initiative is intended to support jurisdictions by making it easier for national supervisory authorities to come to an understanding early on, to build confidence and to find practical solutions – not only, but also with the aid of the toolbox, which contains a number of tried and tested approaches. ■

Credit photo : Schafgans DGPh

SAVE THE DATES

Next Eurofi event organised in association with the forthcoming Latvian EU Presidency

The Eurofi High Level Seminar 2015

22, 23 & 24 April 2015
Riga, Latvia

• Seminar by invitation only on the eve of the informal Ecofin meeting
• Invitations will be extended to representatives of the public authorities and members and partners of Eurofi
• Main focus of the discussions: Measures required to foster an appropriate financing of the EU economy and priorities for the new EU Commission and Parliament in the different sectors of financial regulation

---

Following Eurofi event

The Eurofi Financial Forum 2015

9, 10 & 11 September 2015
Luxembourg

Forum organised with the contribution of the Eurofi members

EUROFI MEMBERS