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Hellenic Presidency of the Council of the European Union

The Eurofi High Level Seminar 2014

Organised in association with the Greek EU Presidency

31 MARCH - 1 APRIL
ATHENS

SUMMARY OF DISCUSSIONS

Combining resilience and growth

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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.

MAIN TOPICS CURRENTLY ADDRESSED

- **Challenges posed by the deleveraging process and the present monetary context**
- **Current evolutions of the prudential and regulatory framework of banks and insurance companies:** proposals for an EU banking union, fine-tuning of banking and insurance prudential frameworks (liquidity provisions, RWA evaluations, Solvency II), structural reforms of the banking sector, recovery and resolution framework of banks and non-banks, regulation of shadow banking
- **Capital market and investment product regulations:** regulation of securities, derivatives and commodities markets and infrastructures (MiFID II / MiFIR, CSDR, EMIR, recovery and resolution), collateral rules and Securities Law Legislation (SLL), asset management regulations (AIFMD, UCITS, MMFs…), investor protection regulation (PRIPs, MiFID, IMD…)
- **Developing a long term investment perspective and ensuring an appropriate financing of the EU economy:** proposals for enhancing the financing of infrastructure projects and for further diversifying the financing of EU corporates and midcaps, revitalising the market of EU securitised loans in the EU
- **The global consistency of financial regulations** and the implementation of G20 commitments
- **Optimizing the EU financial services internal market:** addressing the increasing fragmentation of EU financial activities prompted by the crisis, conditions for enabling a sustainable SEPA business case, review of the IORP directive, regulation of CRAs…

EUROFI MEMBERS

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

The Eurofi High Level Seminar 2014

ORGANISED IN ASSOCIATION WITH THE GREEK EU PRESIDENCY

ATHENS, 31 MARCH - 1 APRIL 2014

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

Editorial

Eurofi's annual High Level Seminar took place this year in Athens and was organized in association with the Greek EU Presidency.

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

More than 120 distinguished speakers from public institutions and the financial services industry and over 500 delegates participated in the 18 sessions of this international Seminar.

We would like to thank very warmly Minister Stournaras, Minister of Finance of Greece and President of the Ecofin Council, Governor Provopoulos of the Bank of Greece, Mr. Botopoulos, Chairman of the Hellenic Capital Market Commission and their teams for their valuable support in setting up this international event.

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

We express our gratitude to the sponsors for the financial support they provided and their active contribution to the discussions of the Seminar. We also thank all the Eurofi members for their contribution to the preparation of this event and the drafting of the Eurofi papers and for their involvement in the roundtables.

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

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

Jean-Marie **ANDRÈS**
Senior Fellow

Didier **CAHEN**
Secretary General

Marc **TRUCHET**
Senior Fellow

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The summary and background papers were drafted by Eurofi with inputs of its members.
They do not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

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SPEECHES AND EXCHANGES OF VIEWS

Main Priorities of the Greek EU Presidency in the financial area

Yannis Stournaras, The Minister of Finance, Hellenic Republic & President of ECOFIN

Ladies and Gentlemen,

Greece has assumed the Presidency of the Council of the European Union at challenging times for Europe. Despite the ongoing fiscal consolidation which is necessary to return public finances to a sustainable path and the restructuring of the European economies to improve competitiveness, further work is required in these areas.

At a period that growth is gradually picking up, we should make sure that market fragmentation is eliminated, lending to the economy is restored and that new jobs opportunities-especially for young people are created.

The Greek Presidency has put a strong emphasis on the revision of the **regulatory framework for the operation and the supervision of the financial sector**, in order to strengthen confidence and increase liquidity in the European economy.

In the first half of the Presidency, we followed a strategy of clear priorities, aimed at finalising all advanced files in the trilogue stage, building on the work done by the Lithuanian Presidency.

The **Banking Union** constitutes one of the most challenging goals towards the completion of the monetary union since the adoption of the common currency.

Completing the banking union is a prerequisite for restoring liquidity, confidence and reliability in the European economy, and the banking sector, as well as for safeguarding financial stability.

The **Single Resolution Mechanism (SRM)** is a key element of the Banking Union and therefore an overarching priority of the Greek Presidency.

In that respect, we made every effort to reach an agreement acceptable by all parties.

After difficult and lengthy negotiations, we managed to reach an agreement with the representatives of the European Parliament on March 20, 2014.

We are particularly happy that the text received the approval a few days ago by the EU member states

ambassadors. We are now looking forward to the vote by the Plenary of the European Parliament in April and the subsequent final adoption by the Council.
The agreement on the Single Resolution Mechanism entails the central supervision of banks by the ECB. In case of a bank failure, it is no longer in the national governments authority to decide and intervene.

Furthermore, the regulation will enable the establishment of a Single Resolution Board, with broad powers in cases of bank resolution, as well as a Single Resolution Fund amounting to 1% of covered deposits of participating Member States, where the total contributions will stretch in a horizon of eight years.
Overall, we are confident that the SRM will contribute towards increasing the transparency and efficiency in the financial sector.

At the same time member-states should work within the context of the new European regulatory and institutional framework for credit institutions, set out by the Single Supervisory Mechanism as well as the Capital Requirements Directive and accompanying Regulation, in order to promote transparency and accountability, to ensure assets' quality and stronger buffers in the banking system. They should also guarantee a coherent framework of corporate governance and enhanced supervisory duties that meet the needs and challenges of the financial system.

Furthermore, the recent adoption of **Capital Requirements Directive (CRD IV) and Bank Recovery and Resolution Directive (BRRD)** complete the scheme for the improvement of the soundness of the banking sector and its supervision.

In the area of capital markets, the most important file is the revision of **Markets in Financial Instruments Directive (MiFID)** and the corresponding Regulation **(MiFIR)**. The agreement reached in principle with the European Parliament in January is an important step in the direction of establishing a safer, more sound, more transparent and more responsible financial system.

Another important file is the revision of the **UCITS Directive**. Its importance stems from the weaknesses in the provisions governing depositaries and inconsistencies in their national implementation as exposed by the financial crisis and, in particular, the Madoff affair.

A political agreement was reached that enhances investor confidence and protection by introducing additional safeguards as regards depositary functions. It also avoids excessive risk taking, by establishing appropriate remuneration policies and harmonizes administrative sanctions.
Regarding the **Packaged Retail Investment Products (PRIPS Regulation)**, we are fully aware of this important piece of legislation. This strengthens the rules on quality of information provided to consumers across Europe when considering investments. For this reason, we set this difficult and contentious dossier as a priority, and we will strive to reach an agreement with the European Parliament in the current Parliamentary term.

The Greek Presidency is also strongly in favour of a more secure and competitive European payments market, which will allow lower charges, transparency and a wide range of facilities for the benefit of consumers.

In this respect, we have managed to reach a provisional agreement with the European Parliament on the **Payment Accounts Directive (PAD)**. This aims at fee transparency and comparability for payments we make and receive via a banking account.

The objective of this directive is to improve the access to basic payment accounts for all EU citizens. This is critical to achieve the strongest possible participation of all citizens in the economic life of the Union as well as the enhancement of competition among credit institutions, for the benefit of consumers.

In the second half of the Presidency, we will focus on progressing within the Council a series of important files **(Benchmarking, Anti-Money Laundering, Long Term Investment Funds)** or to advance other files at technical level such as the **Payment Services Directive II/Multilateral Interchange Fees Regulation, Insurance Mediation Directive II.**

Last but not least, we can start working on the highly important file put forward by Commissioner Barnier on **structural banking reform**, for the effective completion of the Banking Union.

Ladies and gentlemen,

Europe is still in the process of fiscal consolidation while the first signs of recovery are visible.
However, sustainable growth can only be guaranteed only if liquidity is safeguarded. Up to now credit has been particularly tight in many countries of the European Union.

As a result, investment has contracted substantially, especially in the distressed economies of the European periphery, and this has aggravated the intensity and duration of the crisis.

The restoration of normal credit conditions as a means of financing investment is therefore a necessary condition for the return to sustainable, long-term growth and job creation. For that purpose, the Greek Presidency is determined to advance discussions for the financing of the economy, in particular SME facilitation of access to financing.

Up to this point, financing was based to a large extent on bank intermediation.

Given the process of deleveraging that is currently taking place in the banking sector and the associated limitations in long-term financing, it is vital that alternative sources of financing are sought and alternative financing tools are designed.

In that respect, the agreement reached on the capital increase of the **European Investment Fund** is important, since it will allow the Fund to expand its activities substantially from 2014 onwards. This is expected to benefit the SMEs and mid-cap companies in the European Union.

We consider as very important the **recommendations of a High Level Experts' Group** aimed at boosting bank and capital market financing in Europe for SMEs and infrastructure.

We particularly welcome the **communication by the Commission on long-term financing** which presents a set of actions to mobilise private sources of finance, make better use of public finance, further develop European capital markets, improve SMEs' access to financing, attract private finance to infrastructure and enhance the framework for sustainable finance.

The Greek Presidency strongly supports recommendations and actions fostering the supply of long-term financing and improving and diversifying the system of financial intermediation for long-term investment in Europe.

Thank you!

The SRM, financing the real economy and related European initiatives

George A. Provopoulos, Governor, Bank of Greece

It is a pleasure to welcome you to Athens for this high-level seminar, co-organized by EUROFI, the Greek Presidency, and the Bank of Greece.

My remarks will focus on two issues.

First, I will make a short comment on the agreement reached on the Single Resolution Mechanism (SRM).

Second, I will provide reflections on another important issue – the financing of the real economy and European initiatives related to that financing.

Resolution in the context of a banking union

A prominent feature of the crisis was the existence of negative feedback loops between the fiscal and banking sectors. From that followed the major lesson, that an effective economic and monetary union must include a banking union. A key pillar of the euro-area's banking union will be the Single Resolution Mechanism (SRM). I believe that the outcome of the recent negotiations on the SRM is satisfactory.

First, it ensures the creation of a viable banking system for the euro area through the resolution of failing banks in an orderly fashion that protects financial stability.

Second, the responsibility for deciding the time that resolution of a credit institution is warranted remains primarily a task for supervisors, while the Supervisory Board also retains the right to declare a credit institution "failing or likely-to-fail" in some cases.

Third, resolution mechanisms need efficient decision-making procedures that allow resolutions to take place quickly and efficiently. In Greece, we resolved 12 banks in the last couple of years. All resolutions were carried out unannounced – typically over a single weekend – thus allowing a smooth, uninterrupted transition for depositors of the affected institutions. The resolution process under the agreement satisfies this condition.

Finally, the mechanism needs a credible back-stop. In the Greek case, funds from the Economic Adjustment Programme were earmarked specifically for resolution and recapitalization. As a result, there was never

any doubt about our ability to resolve and recapitalize banks.

In this connection it has been agreed that the Single Resolution Fund is to be composed of contributions from banks over an eight-year period, while the pace of mutualisation envisaged is frontloaded. At the same time an enabling clause has been approved by the Council, so that the Fund can seek public bridge financing. Overall, I welcome the agreement as a step forward toward eliminating the negative feedback loops between banks and sovereigns.

Financing of the real economy

Let me turn to the second issue.

A key characteristic of the euro area economic recovery is the decline in loans to the private sector. This situation applies at both the euro-area and, in many cases, the individual-country levels. Because the euro-area economy is bank-based, bank lending is especially significant for SMEs, which produce the bulk of goods and services. Consequently, a credit contraction raises the question: Can the recovery be sustained in the presence of negative loan growth? A number of actions and initiatives are addressing this issue. I will confine my remarks to two areas.

The first concerns monetary policy. Throughout the crisis, the ECB has put in place both conventional and unconventional policy measures with the objective of increasing confidence and restoring the smooth operation of the monetary transmission mechanism. The volume of credit would have contracted significantly more had it not been for the ample provision of liquidity to European banks by the Eurosystem.

The declining path for real interest rates, suggested by the fact that inflation expectations are anchored close to 2% in combination with the ECB's commitment to keep an accommodative monetary policy stance, will lead to a substantial increase of the demand for credit along the way. There is, however, still work to be done on the supply side of financial markets. This circumstance brings me to the second area that deserves attention, i.e. the need to restore confidence in the banking sector. Confidence has been undermined by the perception that some banks have been holding assets of questionable quality on their balance sheets.

The resulting credit and counterparty risk has contributed to a rise in funding costs, preventing some banks from on-lending to the private sector. Supervisors, at both the European and individual country levels, are using tools – including stress tests, asset quality reviews and transparency exercises – to assess the resilience of banks and to request injections of capital, so that confidence in the quality of bank balance sheets can be restored.

In this context, the establishment of the SSM and the comprehensive assessment taking place will provide a catalyst for the cleaning-up of balance sheets to take place more quickly and more comprehensively than would otherwise have been the case.

The repair of banks' balance sheets is unavoidable and will, of necessity, involve some deleveraging. However, deleveraging does not necessarily lead to credit contraction. The "positive" deleveraging policymakers seek is a procedure in which the growth of equity allows banks to recognize bad loans and refrain from rolling them over, in turn, freeing resources and allowing banks to provide loans to firms that can use them productively.

Again Greece is a prime example of this scenario in action. Following the first recapitalization of our banks in 2012, we began to reform and consolidate the banking system. Banks sharply reduced reliance on central-bank funding while making provisions for bad loans. As a result, they have been able to attract private investors.

Recently, we concluded follow-up stress tests that were exceptionally well received by the markets. Following the release of the results, two core banks have completed much larger than requested capital increases of approximately €3 billion, with significant oversubscription. One of them has issued an additional unsecured bank note for €500 million with a maturity of three years.

These are the first signs of markets' opening up to Greece again. I am therefore confident that the second stage of recapitalization will play an important role in restoring confidence in Greece and a healthy financing of the economy.

As a longer-term strategy, it would be desirable at the European level to develop market standards to allow equity and bond markets to gain ground as a source of funding. Doing so would increase the volume of funds available for long-term investment, contribute to long-term sustainable growth, and increase the resilience of the corporate sector during periods of banking-sector stress.

The development of a deep EU securitization market for corporate loans would provide capital relief to banks, improve risk sharing, and increase banks' lending capacity. To sum up, it has to be accepted that the crisis exposed weaknesses in EMU's original architecture. However, European institutions have responded to the crisis with decisive policies and significant reforms to the original architecture. Those responses will help create a more-effective, crisis-resilient, economic and monetary union in the future.

The benefits of the efforts are already evident at the euro-area level, especially in the sovereign-bond markets, where conditions have normalized to a considerable extent. The benefits are also evident in individual countries such as Greece, where the crisis, deep though it was, gave us the impetus to consolidate and recapitalize the banking sector, while simultaneously undertaking reforms that will allow us to reap substantial benefits in the future.

I thank you for your attention.

Main priorities of the Greek EU Presidency in the financial area

K. Botopoulos, Chairman, Hellenic Capital Market Commission

Ladies and gentlemen, cher Monsieur de Larosière, dear friends, I will focus on the financial market developments based on what the Minister has already said. As you know, there's a big change that is going on in the financial sector under our presidency, and I would like, as I said, to focus on that.

We have been, I think, both lucky and unlucky in our presidency. Unlucky because we have the last presidency term – which is a four month presidency only – a truncated period and at very difficult political and financial times both for Greece and for Europe; and lucky because great progress had already been made before the Greek Presidency in the main financial markets texts, and we have benefited from the work that has been done both by the Lithuanian and the Irish Presidencies – as you will understand when I get into the details.

So, we have tried to base ourselves on the progress that had been made, and arrive, where possible, at what I would call a fair balance; knowing, of course, that there is no perfect text, especially in the financial sector. Based on that we have had a very ambitious agenda – what I call "the five plus three package": five main legislative texts which we have inherited and which have already been finalised, or are in the process of being finalised, and three new important – politically very important, I think – files which we have decided to open up and see how they will proceed from there.

The five files that have been there for us and which have been finalised are, first and foremost, MiFID /MiFIR, which is the main legislative text in the financial markets. The political agreement was reached in February, and I think this is an overall balanced text; very ambitious; very wide. The main features of it being that now all financial instruments – be it shares, of course, which were already there in the old MiFID, but also bonds, structure products, derivatives, most importantly – are now within the regulatory framework.

As you know, the big new step was the creation of the OTFs for non-equities – because now we have both equities and non-equities being regulated – and the establishment of positions for derivatives as well as a

new approach to sanctions. So, MiFID is the main text; I think it's a balanced text; the intention was for it to be more investor-friendly, and we will see if that turns out to be the reality.

The second, and second also in importance, text is MAR/MAD – the Market Abuse Regulation and Directive. This, in all honesty, was already finalised by the Irish Presidency – the text of MAR, of the Regulation – and by the Lithuanian Presidency – the text of MAD, the Directive on the criminal sanctions. What has been done under the Greek Presidency is the vote by the European Parliament. So, this is the first text that is already finalised.

The importance of this is, again, that all the financial instruments are under harmonised sanction regime, which sanction regime is much broader than the older one and, I would say, more criminally based. The new sanction regime is tough enough; we have sanctions going up to €15 million and up to four years of imprisonment.

The third text, and important because this is completely new, is the so-called CSDR on central depositories. This agreement was reached under the Greek Presidency but it had been prepared under the Irish and mostly the Lithuanian Presidency. What the Greek Presidency has done is to finalise the text, and this text has not been an easy one.

We have now harmonised a regulatory framework for the central depositories, which are, of course, essential features of our whole system. The main areas of it is that we have scope and definitions which are harmonised, we have access which is harmonised, we have common rules all over Europe for settlement dispute and settlement discipline and settlement periods; and all those things, I think, render settlement much easier and very important to follow.

UCITS is next; UCITS was also finalised under the Greek Presidency. Again, the political agreement had been reached under the Lithuanian Presidency, but the final political fine-tuning was done under the Greek Presidency as our Minister has said. The main elements of the new UCITS framework are mostly to be found on the remuneration policy, on the role of the custodian, and on sanctions, which, as I will say, is a recurrent item in our framework and we have tried to harmonise it.

Those are the four texts that have already been finalised, and, again, as the Minister has already said, we have a fifth one which we insisted on putting very high on our agenda: it is PRIPs – the Retail Packaged Products.

Today is a big day for the agreement on PRIPs from the Council's viewpoint; the final text of the compromise by the Greek Presidency is on the table of all member states, and the deadline for their assent is expiring today. We hope that there will be an agreement on that, and then it's the turn of the Parliament. We know that the rapporteur, Mrs Bérès, is very dynamic on that issue, but we hope to also find an agreement on that. It's a very important issue because it has this consumer perspective which is very important in our work.

And then, as I have said, we have opened up three new very important files – politically important as well. The first one being ELTIFs – the European long-term investment funds; this new type of collective investment instruments for small and medium enterprises, mostly for non-listed companies which would be, as, again, the Minister has said, a very important tool for growth in our markets. Our aim in that is to arrive at a political agreement, at a common approach under the Greek Presidency.

We have the same aim in the second important political dossier file which we have opened up under my personal chairmanship, which is Benchmarks – Benchmarks is, again, a very sensitive file. This is the first time we have tried to regulate benchmarks. It's obvious that a balance has to be found between comprehensively regulating all benchmarks and respecting the differences between the various kinds of benchmarks -and we are trying to do that. The discussions have already begun and, again, our aim is to arrive at a general position, because the Parliament is not following this file; it is probable that it will be up to our Italian friends to finalise it.

And the third one – also politically important – is the first step in regulating what we call shadow banking – which is neither shadow nor banking, but this is another question. This is the MMF file which will be opened soon by the Greek Presidency.

So, all those changes already there, or in the process of being finalised, I think designate a new landscape in the financial sector at large. I would very briefly sum up the main elements of this financial landscape.

First of all: now all the market infrastructures are being regulated at European level – be it the trading venues, MiFID for equities and non-equities, be it CCPs, NTRs, EMIR, be it now also the central depositories under the CSDR.

Second main element: new areas have opened up and been in regulation for the first time. I talked about the CSDR; we have also shadow banking; benchmarks, which are a new initiative, but as well we have high frequency trading for the first time – albeit timidly, but this is a start – being regulated both in MiFID and in MAR; we have the OTC sector being also, kind of, regulated. So, regulation is moving and covering also those areas.

Third important element: sanctions are being harmonised across all sectors. Of course, the main reference

here, the main text, is MAD, but MiFID is also harmonised according to MAR; UCITS and IFMD are harmonised according to MAR, and we are trying to do that as well for Benchmarks. So sanctions will be harmonised and we will not have this great discrepancy of sanctions that we have as of today.

And the fourth element – and there I'm speaking from a supervisory point of view, this is a kind of "déformation professionnelle" – pertains to the role of ESMA: because ESMA will have two very important tasks after all this regulatory work. The first one, of course, is to draw up the secondary legislation, which is immense. Only for MiFID we have calculated 75 regulatory standards which need to be drawn up, and we may be forgetting some. And the second important area is the bulk of data which needs to be gathered centrally by ESMA. Again, only for MiFID we have 35 different work-streams, as we call them, for gathering such data.

So, you understand the importance of secondary legislation but also the bulk of work, the burden that will be put on the shoulders of ESMA, and we hope to be able to finalise this work on time.

So, many of our friends in the markets are calling this a regulatory tsunami; I know this will be one of the themes of our conference today and tomorrow. Is this a regulatory tsunami? I don't know. What I know for sure is that under the Greek Presidency the financial markets' earth, if I may call it so, has really moved. Thank you very much.

Exchange of views: Perspectives on the financial reforms under way

Jacques de Larosière - President, EUROFI,
Xavier Musca - Deputy Chief Executive Officer, International Retail Banking, Asset Management & Insurance, Crédit Agricole SA

Jacques de Larosière:

Thank you very much for participating in this session. I'm privileged to present to you, Monsieur Xavier Musca who is the Deputy Chief Executive of a very large institution called Le Crédit Agricole. And he has a wide experience, before his participation in that financial institution, he was the head of the French Trésor and I think it's appropriate that I should ask him two questions arising from the debates of this morning.

The first question is, does the present regulation that concerns banks, does it hamper, make it more difficult in terms of the bank's role in the financing of the economy, the lending to the economy? And the second question which is of course derived from the first one is: how would you see an improvement of the regulatory setting that would make the financing of the real economy perhaps easier at this point in time?

Xavier Musca:

Thank you very much for this debate and this interesting question. I'm very much impressed to talk in front of such an audience with people who know a lot of things on these issues, far more than myself, so please take my view as one of the people who tried to organize the G20 at the beginning of the whole story, and who now asks himself whether the decisions we took at that moment was appropriate or not.

And maybe if you will allow me, I will start by making a few remarks on our initial ambition. At the moment of the G20, we said that there was too much leverage in the economy. We said that we needed more capital in the banks, capital of a higher quality. And indeed, that was needed considering the economic situation of the moment. We started from a position in which obviously there was too much leverage, there were not sufficient constraints on the banks.

And all this was intended not only for political purposes, but also because we thought at that time, that having a better capitalized financial system would help recovery. And the decision we took at that moment, can be mainly explained by this ambition. And if you allow me, I just want to say that whatever decisions we took

at that moment have been translated into facts. I have to say that this appears obvious to all the people around this room.

But I think that we should insist on that because a lot of people, journalists, and ordinary people think that nothing has changed in the financial landscape. And I think that one of the messages we should send is basically that, well these decisions, these commitments have been followed. Just to give you some figures, which are to me illustrative. The balance sheets of the banks in the Euro zone, since 2012 have shrunk by more than twelve percent. Deposits have increased by more than twenty-six percent.

Capitals have been raised by thirty-six percent. And the bond issues by the banks shrank by nine percent. What does it mean? It means that, well really, this regulation has had an impact, a material impact, on the functioning of the economy and the financing of the economy. The question we now raise is whether this, in the future will have a negative impact on growth.

Well, I would like first to make two remarks. Undoubtedly at the moment when the G20 engaged in this process, it was with the idea that, as I have said, in the long term, in the medium term, having a better and well capitalized banking system was better for growth, and I still think that's true. And I still think that we have to be proud of what we have done and the progress in which we have engaged is positive in the long run for the economy of all our countries.

Nevertheless, it's also without doubt, at least in my view, that in the recent past, this has had a negative impact on growth for a variety of reasons, I won't expand too much on them. First, we all know that there has been an interaction between market expectation and regulation, which has forced the banks to recapitalize maybe quicker than initially expected. And in the specific case of Europe and the Euro zone, the mere fact that at the moment... at the same moment, we had to suffer a terrible crisis, has increased, magnified the impact of this regulation.

To say this the other way round, we have had, for some countries in the South of Europe, at the same time to deleverage the households, the companies, the states, and the banks. And there was merit in doing all these things separately and it was extremely difficult for them to do that exactly at the same moment. And this leads to me, and that's why I was willing to make this comment as an introduction to the answer to your question, this leads me to the question you raised: and what about now? Are we completely safe?

Well, there are positive signs. First there are signs of recovery in Europe. Second, indeed we have done the job with the banks, we have made a lot of progress. Take my country for instance, before the crisis I think that the capital ratio was around four percent for the banks. I don't know any banks in France which are below ten. So you know, that's a dramatic change in a very short period of time.

And obviously there is one important element of which Mr Nava I think reminded us this morning, the fact that capital flows are going back to Europe and going back to the Euro zone. So maybe, the conjunction of all these factors can make us more confident in the fact that pursuing these reforms, these regulatory reforms, will not hamper growth.

And here I come to your question. Indeed, we have gone through the worst, nevertheless I still have personally some more reasons, some doubts, and I would like to briefly express them. The first one is basically related to one question which is: what about deflation? If you are comfortable that there is no deflationary risk in Europe, well okay, you can carry on because you know, it's not so much of a problem. Other things will take care of that.

On the other hand, if you have doubts about the transmission of the monetary policy decided by the ECB to the real economy, obviously you have to look at the credit multiplier. I think one of my colleagues explained that this morning. And obviously, these regulations are reducing this multiplier. And again, in the long term, no problem, no issue about that. That's a legitimate choice not to have... to leverage the economy since banks already have to face risks.

The question in my view, again, is a question of sequencing. And at the heart of this problem is how do we cope with a situation in which we are have to conduct long term regulatory reforms on the one hand, looking at what is the long term objective. And on the other hand, take care of the current economic situation of specific countries. Let me tell you that in this regard, my own view is that the balance now is struck in a way which is adding to these deflationary forces rather than alleviating them, and I just want to give you two examples.

Well, I'm a bit concerned by the leverage ratio, the importance which is given to this ratio, and I'm also concerned by the way it is calculated. And the way, for example, repos are dealt with in this issue. I say that because even though finally these decisions are taken for the good, at least in my view, I fear that the banking system will adapt beforehand anticipating future regulation by having a more restrictive stance than they would do otherwise.

I have the same concern on the LCR. You know, my sense is that in some countries, notably mine, in which for structural reasons, there is a loan deficit ratio which is clearly above one hundred. If you enter too quickly into LCR, well the only way to deal with that is to deleverage. And obviously let's talk very frankly here, we will not deleverage on our domestic market. But we will

sell activities outside our domestic deleverage on our domestic market. But we will sell activities outside our domestic market and we will deleverage outside our domestic market.

But I'm sure that for the Euro zone as a whole, the impact will be negative. And I think that by defining this in a more generous way, I would say the LCR would be good precisely for the reason I've tried to explain. I personally don't understand why, for example, we are not including ABS in the LCR. I will come back later on this issue because it's related to one debate I heard this morning concerning securitization.

By the same token, I've thought one moment, that there was willingness from supervisors to smooth the path toward a more stringent LCR by putting in place what we call a restricted committed liquidity facility. And you know, for once, the words are right. It's restricted, it's also restrictive. The fact that the interest rate associated with this facility is seventy-five basis points, far above market reference, makes it to be a bit rude, in my view, useless. I mean, I doubt that any bank will try to use this facility fearing for the *stigma* effect as the price is very high.

So my message here, in my view, in the situation of uncertainty about the deflationary pressure, obviously we should let the ECB deal with that through monetary policy, but on the other hand, we should be cautious not to be stringent on regulation at the same moment, with the risk of accentuating this risk, and obviously also, adding to this deflationary pressure, and making the recovery more difficult in those countries (Germany, France) in which these deflationary pressures are less obvious.

My second remark is about uncertainty. We are living in a world of uncertainty obviously, and the fact that for bankers there are a lot of uncertainties surrounding their business, is not the best way to promote growth. I mean, again when you are in our shoes, the way you look at the future is not to put yourself in danger, and above all, after what we have experienced during the past years. It means that when there are uncertainties, you're favoring the world's development for your own activity in the future, and that's not very favorable for investment and for growth.

And obviously there are still uncertainties surrounding a business, uncertainties I mentioned about the definition of some ratios, I won't elaborate too much on that, but there are fundamental uncertainties. Nowadays in Europe, there is in particular the question of the Financial Transaction. We don't know what will happen really, and in some cases it could be extremely painful and even destroy businesses completely. We have also discussed the repo market and you can say that the proposal for reforms presented by Mr. Barnier concerning banking activities in Europe also adds to these uncertainties.

As I have been on the other side, I understand the political dynamics behind that and I won't criticize too much, but indeed the sooner we can clarify all of that, the better for the business. And that's maybe part of your second question, what can be done? I would say: alleviate the uncertainties. And by the same token, I would say the same with the banking union. Obviously the banking union is a very good thing and we support it. And we think that it will reinforce the credibility of the system and therefore encourage investors to go back to European banks, and indeed we are starting to see that, notably in southern countries.

On the other hand, we are in the situation in which the ECB, the next single supervisor, the national supervisor are not able to talk about the future and the question which we are asked very frequently by investors, rating agencies, etc, etc, is what will be the policy followed by the ECB next year? Well that's unavoidable, that's not too dramatic, but my view, my wish, if you allow me to answer your question by a wish, would be that the sooner the better, the ECB will clarify the way they will handle all these problems, the interpretation of the regulation, etc, etc, because clarifying the way we will operate in the future, that's obviously key.

My third message about whether regulation is an impediment to growth. I would like to make a remark on the burden we are putting nowadays on banks. Obviously there is an obvious burden in the fact that there are a lot of regulations, more and more cost incurred to cope with these regulations. I am struck by the fact that at the same moment, "we don't want too big banks", in fact we have raised the level of cost, of fixed cost, which you incur when running banking activities, which means that in the future, competition will be reduced to a certain extent, and we are favouring implicitly big banks and we are encouraging them to expand rather than anything else.

But my point is just to say that these costs are quite high. Just to mention the resolution mechanism we are putting in place right now, with fifty-five billion Euros to gather within the next eight years, all this money will be less for maybe our shareholders, but above all, for the real economy. And I don't understand why we are putting so much pressure on the buildup of this resolution Fund.

At the same moment, we are increasing the cost for the banks to leverage money through, in particular, the bail-in mechanism which makes the cost of raising money slightly more costly than it was in the past, and maybe significantly more costly through time. So I want to underline we are adding to a bail-in mechanism which is quite powerful, a fund which is pre-funded, which does not exist in other constituencies outside the Euro zone. That's also, in my view, is clearly a barrier on growth because these resources will be withdrawn from financing the real economy.

Finally, my answer to your last question will be to discuss about the securitization issue you discussed, I understood this morning. I saw there were interesting debates around that. And obviously I have personally not very strong convictions about what should be done in detail. What I am convinced about is the following. Before the crisis, we had a continental economy which was basically financed by more than eighty percent by banks.

And the choice that collectively we have made, paradoxically after the 2008 crisis which demonstrated, as we were reminded this morning that markets can be dangerous, we have moved to a system which gives more weight to direct financing through the market. Personally, to say frankly what I think, I prefer the old system, but maybe because I come from the French Treasury because I am French, and now I am in a classical universal bank.

But you know, that's a collective choice. And I respect that, and there are some merits in one option and some in another. My personal observation is that being now in a bank, I see that transition between the old state of play and the new rules will take time and will be painful. And my fear is about this transition period. And I think that we should try to smooth it as much as possible. Because again, you know, there will be more and more companies tapping the markets directly, there will be more and more securitization. And to what extent securitization should be favoured or not, I don't know, but the movement will take place.

And the question is, how do we move from one state to another? So my message is simple, and it comes back to my initial reaction... my initial remark. If we fearing that recovery could be hampered in a certain way by the current difficulties, well indeed we have to be, maybe, more lenient on the banks in the short term, and we should also think about favouring, to a certain extent, the access to SMEs, to markets, to money, to bank loans.

Because the real problem of the SMEs, when you look at the figures in Europe, you see that there is no problem for some, basically at least in France, no problem for the big corporations. The question is the medium sized and small companies, whether it is necessary or not to subsidize these, for example, with the securitization process. Well, I don't know precisely but I think that a simple measure, the one I mentioned, if you say that ABS are eligible for LCR, you will encourage the development of the market.

And I understand that some people in the EBA can say legitimately so, this market is not liquid. And that's true, we have to recognize that. It's not liquid today, but the question is, do we want it to develop or not? If we don't push for that, well it will never become a liquid market. In my view we should, in this regard, adopt a proactive view by favouring the development of this market because maybe it is not one hundred percent of the solution, but if it is ten, twenty, thirty percent of the solution, it's better than nothing.

I'm sorry for having been so long in my intervention, maybe too long. And it was my way to prevent other questions, Mr. Governor.

Jacques de Larosière:

Thank you very much. Thank you very much Xavier. You have been indeed a bit long in terms of our procedure, but you have been direct. You have been thoughtful. And I think what you have said actually is of major importance. So this will hopefully enlighten the debates of the following sessions. Thank you very much for participating.

Exchanges of views: Challenges regarding the comprehensive assessment and stress testing of EU banks

Jacques de Larosière, President, Eurofi ,
Danièle Nouy, Chair of the Supervisory Board, European Central Bank
Andréa Enria, Chair, European Banking Authority

Jacques de Larosière:

I would like to greet our two eminent participants now. I'm not going to introduce them with details, because you know them all. Madame Nouy is THE person responsible for single supervision. That is a major task on which she has embarked. I know her well, because she happened to be in the organisation that I chaired as Governor of the Banque de France, when she was at the *Commission bancaire*.

I just wanted to say, I don't want to make her blush, but I have known her for decades, and I don't think it would have been possible to make a better choice. So that's one thing.

Mr Enria, who is on my left side, is responsible for the European Banking Authority. He is the one who is the *Statue du Commandeur*, if I could say so, because he's the one who is in charge of maintaining a single market on banking affairs, and his role, I think, is not at all jeopardised by the single supervisory mechanism of the ECB. I think, in a way, it is enhanced by that role. So I'm going to give the floor to these two eminent personalities, first to Madame Nouy, I will ask her about how she looks at the challenges she has taken on; more precisely, what does she think in terms of the asset quality review – is this taking place? How do you envisage this exercise, which is fundamental? Everybody is waiting for the results of the asset quality review. Then I'll turn to Andrea Enria, but let us start with the questions of Madame Nouy.

Danièle Nouy:

Well, I have two big challenges at the same time. For the current period of time, to get the comprehensive assessment done in a very adequate fashion, and delivering on time its outcome to be joined to the stress test by the European Banking Authority (EBA). And at the same time, to get prepared for taking over supervision of banks in eighteen countries, as of 4th November, so that's very, very challenging. If I start with the first challenge -the comprehensive assessment- this is an exercise of incredible magnitude I can give you a few data.

We have, as you know, 128 banking groups involved. I insist on banking groups, because the subsidiaries, whether they are domestic or in the SSM, or in the European Union, or outside, are taken on board. 760 banking book portfolios will be reviewed, plus some trading book portfolios. We will review approximately 135,000 credit files. We have, right now, 1,000 auditors on independent appraisals for collateral in particular, engaged to complement the national supervisors' teams, and the risk-weighted assets that are involved in this exercise are 3.7 billion euros, so you see that's very big. It's also very big, because we have to establish the proper governance at the centre, "the central project management office"; we have to duplicate it in eighteen countries, and both levels have to work very efficiently together.

Among the challenges as well, are the home-host relationships, because we are reviewing the situation of subsidiaries in many different countries, and on this you are very right, Monsieur de Larosiere, "La Statue du Commandeur", Andrea, is very present. I started in the ECB on 2nd January, and a few days later, I received a letter from Andrea, saying that, regarding the home host relationship, we could do better, *"peut mieux faire"* as we say in French. Indeed, we could do better. I read the different complaints, and I thought they were absolutely legitimate, so, it was a matter of minutes before I phoned to Andrea, to indicate him what actions would be undertaken to improve the situation; and better address home-host relationships. p I made it a personal commitment.

Among other challenges is that of quality insurance, we have three lines of defence for that. First, we have the national teams in the different banks. They are supported by external auditors, and by external appraisers. Secondly, we have the "ECB country teams" that are reviewing the work being done at the national level, and supporting -hopefully not only controlling, but supporting as well- the national supervisory teams, for example by responding to the many questions that are put by the banks, by the auditors; and they are better placed, because they were trained to respond to such questions. And thirdly, we have the quality control achieved at the center.

We have also the challenge of external communication at the right moment; but we must make sure that there are no leaks which would create credibility and reputational risk. At the same time, if we discover something during the asset quality review which is related to accounting, to the accounts, there may be obligations to disclose, in particular in the Market Abuse Directive. If the accounts of a bank are not what they should be, there is an obligation, which is put on the bank, to inform the market. The situation is different in the asset quality review, f the discoveries are not based on accounting but on prudential judgement. This is even more true regarding the stress tests, which are a prudential exercise.

I could go on with my list of challenges: One of the main challenges is to convince the bankers that they have an interest in giving us a lot of information. I fully recognise that it is a lot but this is a one shot exercise, and this is for the purpose of providing the market with transparency on the balance sheets of the European banks. I think the markets do not appreciate yet enough what European banks have done already to repair their balance sheets, so we have to make sure that this is a transparent exercise. Of course, there will be cases where a repair of the balance sheet will be needed, and we will make sure that it is carried out.

Another challenge, after October, will be to be able to enforce the outcome of the asset quality review and stress test. We will have to have a brand new Pillar 2, ECB Pillar 2, instead of eighteen different Pillar 2s in the different countries, we are working on. At the end of the day, what is at stake, and I very much share a number of remarks which have been made already, is that this transparency, this repair of the balance sheet, ends up with the market providing the equity and the funding, that is needed by European banks, to be able to finance the economy.

Jacques de Larosière:

Thank you very much, Madame Nouy, for all this. I understand the work is unfolding. It's, of course, a huge exercise, and it entails inevitably a lot of complications and an extremely high amount of information required from the banks, and I really hope that it can be done by November.

Danièle Nouy:

It will be done by November.

Jacques de Larosière:

Okay. I wanted also to ask Andrea Enria about the articulation of this asset quality review, which you are following very closely because you have published recommendations on it, as was recalled a moment ago. The articulation between that exercise, and the stress test, could you comment on this?

Andrea Enria:

Yes, sure; thank you. Well, basically one of the main weaknesses of the 2011 stress test was that there was no prior asset quality review. We have made an internal and interesting comparison between our exercise in 2011, and the US SCAP in 2009, which has been recognised as a very successful exercise. And in a number of areas, we have been as successful and tough as our US colleagues.

But the lack of an asset quality review has been an element of weakness of the EU exercise. If you look at the

EBA exercise, we generated a change in provisions of the same magnitude as in the US SCAP exercise, but the starting points were not as reliable. In fact, the US exercise involved a major recourse to on-site examinations, with in depth reviews of the bank books, while the EBA did not have even the legal basis to discuss the results directly with the banks. Immediately after the exercise, we realised that this was the key point, and it's very, very good that now we are fixing this aspect, and that the ECB in particular, but all the authorities throughout the European Union, are conducting a serious review of asset quality. This is the first and most important point.

Now, the stress test should provide additional safety by building upon the AQR and making sure that banks are on track towards the full implementation of Basel III requirements, even if we were to face new adverse developments in Europe and globally; and so we are now designing the adverse scenario, closely co-operating with the ECB and the ESRB. It is also an interesting test, in a sense, for us as well, for the new arrangements. I must confess candidly that there have been moments in which I was seriously considering whether the EBA should continue being involved in the stress test. In fact, the stress test is typically a supervisory exercise, and in the experience of the 2011 exercise is that it is very difficult to do it properly, if you cannot go on site, challenge the banks, discuss with the banks, ask for additional information; all activities that are prevented to the EBA under the current legislation.

So I was wondering whether, with the establishment of the SSM, actually wouldn't it have been more appropriate to take a step back in this area – also because as an organization you run a huge reputational risk, without really having the legal tools to perform the task.

The conclusion to which we came, discussing collegially also with Danièle and the board, is that there might be a role for the EBA in the stress test, in terms of especially fostering transparency and comparability of information across the whole Single Market. This is a brand that we have developed in these first years of our activity, allowing investors market analysts, any interested party to compare banks, let's say, inside the SSM, under the responsibility of Danièle, and banks in other member states, in the UK, in Sweden, in eastern Europe, on the same footing. So we are very much focusing now on setting up the methodology, the scenario, the templates for disclosure, giving high *granularity* to the disclosure. We disclosed 3,200 data points in 2011, and 7,000 in December this year, and we plan to maintain a very high standard going forward. So this, I think, should be, at least in this test we are having of our arrangements, our main focus. Then, on this common basis, of course it will be the responsibility of the supervisors, including the SSM, to design their own supervisory reaction function, so as to tell banks what they need to do on the basis of these results, and to impose corrective action where it is needed.

So that's how we are planning to define our respective roles going forward. The co-operation is very close, and the fact that Danièle is chairing the Supervisory Board of the SSM is very helpful for all the work we have done together, and for her participation, very active participation, in the EBA board before, so I think that we are starting definitely with the right foot there.

Jacques de Larosière:

Okay, well that seems very encouraging. Would you like to add anything now, at this point?

Danièle Nouy:

I think the fact that we co-operate together is very important. I said that several times to the Parliament, and I do believe it. We do not have to choose between the Single market and the SSM. We can have both; we should have both. I think the SSM can be a plus for the single market, because we will be less divided. We will have more people to think about the important issues.

So I want the SSM to be a real asset for the single market; and co-operation with EBA is key in this respect. I must say that personally I have much respect for Andrea and what he does at EBA; so I'm sure, as for the delivery of the comprehensive assessment in October, I'm absolutely certain that we will manage to get that.

Jacques de Larosière:

Well, this is a very important statement, in my view. I'm a little bit responsible for the existence of EBA, since that was a part of the report which I chaired in 2009, and I think the development of the supervisory, the single supervisory mechanism within the ECB ambit, is not only compatible with the existence of the EBA, but it's actually an absolutely necessary, I would say, co-operation that is engaged. If indeed you were not there, what would happen? You would have a big ECB placed, which would be in charge of supervision, but it would be necessarily, because *"la nature a horreur du vide"*, it would be in charge of regulation, and then you would have London, which is a very large financial centre, which would be doing the regulation... inevitably, of its part. In fact, you would have two Europes, which would be inevitably conflicting, to some degree. The fact that you have an arbitrator, that you have an institution that covers the entire European Union, which is the European Banking Authority, and which is in charge, let's not forget it, because of the decisions taken by the Council and the Parliament, which is in charge of writing the rules and standards in a common way, you have a single market, and I think it is that single market which has been so fragmented and hindered over the past years because of the crisis; it is that market that eventually will revive.

So thank you very much, both of you, for having accepted to exchange your views in such a frank and direct way. I think we've all taken a lot of benefit from that conversation. Thank you again.

Exchange of views: Economic trends in an evolving Economic and Monetary Union

Objectives of the session

This plenary session which concluded the first day of the Eurofi Athens seminar was devoted to discussing the possible role of the financial sector in overcoming growth challenges in the present economic and fiscal context.

The exchange of views focused on short-term priorities for the EU financial sector to answer the financing needs of the E.U. economy in order to foster recovery.

Deleveraging together

"Growth is around zero and fiscal deficits, debt and unemployment remain high in the European Union and in the Euro zone. So this is a good moment to think about economic recovery in Europe" a minister said. The Latvian experience is interesting in that respect. This country has indeed overcome an enormous crisis (its GDP plunged by almost 18% in 2009) and has reestablished a very conservative fiscal position: the budget deficit was only 1% in 2013 and the public debt level has gone down from 45% of GDP in 2010 to 38% in 2013 and will drop to 30% in 2017 which is enviable for many EU countries. Less than 30% of Latvian households have credits and Non Performing Loans which used to be 21% in 2010 have decreased to 9% bearing in mind that GDP in Latvia rose by 4 to 5% over the last three years.

Deleveraging is also taking place in Latvia and it is partly due to the fact that banks are reluctant to lend. According to this minister, there is here an interesting contradiction between a strong growth of GDP and the very low support from banks to resume growth. This can be explained by the change of behaviors of banks 'customers and in particular by the fact that more and more companies are trying to rely on their own resources. However bank lending to SME is a major problem for Latvia and for Europe in general. "Depreciation of collateral has indeed put considerable pressure on the banks during the crisis but strong requirements for collateral to potential borrowers are a major factor that prevents businesses from borrowing from the banks, especially SMEs in this after crisis period", the minister stated. It is unfortunate that SMEs are out of the game. This is why we are looking to other channels or formulas coming from Europe to solve this problem.

Banks deleveraging is needed in order to manage systemic risks in Europe but banks also have to look at business opportunities and take some more risks. This moral dimension is important. Speaking of deleveraging in general, this minister believed that to be effective and successful several pre conditions are required: "a clear exit strategy should be in place, the deleveraging of households should be accompanied by precisely targeted measures aiming the social dimension and a good communication programme from the Government needs to be in place to reach the targeted groups."

Structural reforms also need to be in place or pursued for those countries that started them in earlier years. If member states are serious in that respect, banks, companies and households should feel safer.

Taken from another perspective, "a deleveraged society could be considered as common public good, and from this standpoint Europe has to do more in helping the deleveraging process in its member states by offering SMEs even more development programmes aiming to increase their competitiveness" the minister concluded.

New Finance for overcoming the financial fragmentation in Europe

The acceleration of investments is a crucial condition for bringing about growth. A central bank governor reminded the audience that investment clearly depends on a number of conditions: expected demand, the supply of credit, the cost of capital and the level of confidence. The comprehensive assessment of the leading euro-area banks' balance sheets should contribute to reducing uncertainty about the future, restoring confidence and stimulating renewed lending.

In 2011 and 2012 we suffered a risk of credit crunch: bank lending was drastically falling because fears for the euro survival were high. This is the reason why the ECB took unprecedented steps during this sovereign debt crisis (new refinancing operations with a long maturity and full allotment, OMT programme…) to lower the cost of bank refinancing and providing unlimited 3 year liquidity.

This crisis has created a deep fragmentation across the Eurozone financial markets and this fragmentation remains (continues). The low ratings of countries of the periphery associated with high public yields are transmitted to the private sector borrowing, the governor continued. Enterprises in those countries have still to pay their bank lending 50 or 60 basis points higher than in the core EU countries even if this gap has narrowed. Several additional factors are at work in the credit supply, according to him. Banks are deleveraging and this process is fostered by the Asset Quality Review. In addition non-performing loans are still high in some countries, and this produces two effects: it uses, for banks, more capital through provisioning and thus deteriorates their profitability and it deters banks from lending.

Large and medium size enterprises have access to capital markets and have anticipated this evolution by diversifying their financing resources. But this is not the case of SMEs, which are very reliant on bank financing and they are suffering the most from the crisis. Of course SMEs have to improve their profitability and their financial soundness in many EU countries in order to have access to credit but there is a large number of competitive firms which are facing credit rationing. In such a context, the governor stressed that some are asking for the revitalization of a securitization market. In this perspective he called for simple, transparent products which could be exchanged on platforms rather than over the counter.

Nowadays, the ABS market in Europe is very limited. "So we could, we should engineer a deep, profound and transparent market for securitized loans. But it could be difficult to create rapidly a large market. This is the reason why securitizing mortgage loans would also indirectly improve bank lending capacities for small and medium sized enterprises. At the same time other instruments like mini bonds could help to better finance SMEs" the governor underlined.

The biggest question about the banking sector is the profitability question

The fundamental problem first: the biggest risk is a non-implementation of structural reforms. "Before addressing financing conditions as constraints, we should first look at countries with very low financing conditions but very poor economic results like France. Finance is only part of the solution" another central banker stated. At national level progress towards restoring fiscal soundness and driving forward structural reforms is key to the solution for resuming growth. The crisis has clearly shown that a strategy of postponing reforms is self-defeating as it contributed to the accumulation of imbalances and vulnerabilities in good times and increased the cost of adjustment in bad times.

Concerning financial constraints this speaker stressed that we should make a clear difference between capital market conditions and bank credit conditions. There is a big contrast here. There is indeed a big rally on the capital markets and on bond markets in particular (sovereign debt, corporate bonds and high yield bonds), which is very positive compared to credit which is still weak in the euro area. Reducing uncertainty is key to revive bank lending. The AQR and the standard monetary policy carried out by the ECB should contribute to this objective.

In some EU countries such as Spain, there are still constraints in the supply of bank lending. Nonetheless SME firms often exporting can find access to credit, but it is true that the conditions for banks to make these loans given capital and profitability constraints are harsher. That is obvious. But we should be careful not to conclude that there is a general problem of SMEs, this central banker said.

If we are looking at the credit to non-financial corporations, the figures published by the ECB in January and February are not good, he continued. We had again a contraction of credit. But this could not be the prelude to a further decrease of credit supply. There is indeed always a gap between the credit supply and the recovery. First the recovery starts based on the cash flows of non-financial corporations. So firms start to hoard cash flow in place if relying on credit lines of banks. When we are looking at the components of M1, we can observe an increase of deposits from non-financial corporations. The good news is that firms are preparing for spending if conditions improve. The bad news probably is the lagging indicators: firms and households have been especially cautious about their willingness to lend. But the situation could improve.

"The biggest question about the banking sector and that is a broader question is the profitability question. The banking sector is not profitable and that is a major issue", the central banker concluded.

Financing gaps in Europe

A leader of the industry started his intervention by making some observations with regard to the current economic assessment for Europe and the rest of the world. An economic recovery is underway in Europe. Macroeconomic indicators are stabilizing in Europe. The rest of the world is doing better but there are uncertainties about the strength of the US recovery, or concerns about Chinese growth, or geopolitical concerns. "It is difficult to imagine what more could have been done by central banks and authorities to stabilize the system and protect the world from extreme calamities" he stated.

In an ideal scenario, the available low real yields and ample liquidity should be used as soon as possible to generate above trend growth and jobs so that when the times comes to more normal conditions, the economies are prepared and cushioned for that adjustment.

In practice, according to him, you have in Europe on one side extremely loose monetary conditions and a demand from investors for yield or opportunities to commit capital but there is no current mechanism to bring the parties together; in other words long term investors do not yet have a vehicle to find access to long term investments. More needs to be done to meet demand and support growth in Europe and capital markets can play a major role to meet the growing demand for financing from all market players.

Many measures have been agreed on at the EU level to improve the economic governance of the European Union and to stabilize and make more secure and transparent the financial system. "While all these pieces of regulations or new rules are going to be implemented, more can be done to see how they interact with each other both within the euro area and globally. We also need to be mindful of a number of proposals that are having a dampening effected on liquidity. We need to observe how the financial system will evolve following the implementation of these new regulatory constraints" this speaker added.

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Impressions of the day 31 March

Jacques de Larosière, President, Eurofi

I'm going to give you a few impressions of the day and not a summing up although I've taken a lot of notes.

A. I was struck today by two sorts of, not contradictory, but two different lines of thought.

On the one hand, there was quite a lot of praise and satisfaction stemming from the recent negotiation on the banking union. I'd like to say a word on that. There has been indeed an enormous work done over the last months to reach an accord on this matter.

The Banking Union is indeed an important project because it is supposed to improve the confidence in the banking system in Europe and contribute to breaking the perverse link between the Sovereigns and the banks.
So it's a great task, and it really supposes at least two things.

The first one is that there is a common method for supervising banks. Indeed one of the defects of the situation we had and which led to the enormous tensions that the eurozone was affected by in 2011 and 2012, was the notion that some national supervisors were trying to protect their banks, their champions against bad news and therefore the stress tests that were done in the early part of 2011 were in fact not based on real... valid information. And indeed, the European Banking Authority that launched the first test in 2011 was not really able to double check and verify the reality, the correctness of the information they were getting from the national regulators. So it makes a lot of sense to concentrate into one organization, the ECB, the task of supervising the whole banking sector. And you see already that manifestation of future confidence in the fact that the announcement of the asset quality review is already pushing a number of banks into recapitalizing or writing off loans and assets that are not really worthy. In a way, this confidence factor is already measured by the reality of these adjustments, and I think it's a good thing.

The second pillar of that building up of confidence is to be found in the resolution legislation. Here, I want to pay tribute to people like Mme Ferreira, Sylvie Goulard,

and many others who in Parliament have significantly improved on what the Council had initially pre-negotiated. I think you have managed through a lot of work and a lot of convincing arguments to make the resolution mechanism more workable and therefore more credible. I don't think it's perfect, it has been noted today that there are still quite a lot of complications. The decision making process during the famous weekend is not completely, I would say, adequate but it's certainly an improvement in terms of what the Council agreed last December. The mutualisation of resolution funds has been accelerated which is important but still not perfect because it will take eight years to be achieved and you have noted yourselves that the absence of a clear, simple, direct backstop is not going to give full credibility to the system.

So, I share the views of those who think that this is a big progress. Indeed a few years ago we could not even have imagined that such a degree of federalism or mutualisation would have been possible. But there's still a mile to go and I hope very much that eventually it's going to be improved upon.

When you say that, of course you have not eliminated the problem of the fragmentation of the Union, you've improved the problem but you haven't resolved it. Why is that?

Because banks in a country are always capped by the rating of sovereigns. If we want to break the perverse link between the banks and the sovereigns, the sovereign has to improve its own rating so that it can in a way elevate the quality of the ratings of banks themselves. Therefore, it is of the essence that the countries and the sovereigns continue - or start implementing - structural and macroeconomic reforms, but mostly structural reforms, that will indeed improve the competitiveness, the flexibility and the quality of their economies. That would also help to restore corporate profitability and thus reduce the bad loans problems that are plaguing many banks in the European periphery. That would be in a way, "the third pillar" of the Banking Union. I very much hope that this process of reforms will continue. So much for the Banking Union.

B. On the ability to lend, we've heard different views and that conversation we had a few minutes ago was interesting in this regard because it reflected the diversity of views.

The most classical and official view is that the improvements in the quality and the magnitude of the own funds of the banking system in Europe is a prerequisite for the revival of the ability of banks to lend and therefore the Basel exercise has been laying the foundation for a future more active role of banks in providing loans and activating the money creation which eventually is always linked to the lending activity of banks.

But there is another strand that has been perhaps a little more vocal than in the past sessions which is that the addition of many capital constraints, liquidity constraints, leverage constraints which has taken place in a couple of years only has weighed on the banking system and has contributed very significantly to the phenomenon of deleveraging that we are seeing in the Eurozone and which Peter Praet was stressing a minute ago.

Personally - it shouldn't be my job to say this because I'm supposed to be the chairman- I am more of the second view than of the first one. I think that perhaps in the long run, a very well capitalized banking system may be more apt to lend in a suitable fashion to an economy. But we live in the short run. And what strikes me today is that the recovery of the European region is still very thin and very fragile. At that point of the recovery, after so many quarters of negative growth we have experienced in 2011, 2012, 2013, we are now emerging from that depressed climate. I think that at this point if we don't see some revival of credit to the private sector we might not see the revival of the European economy at all.

So, I'm worried about that. It's not only the asset quality review that is of course shaking a little bit the system because institutions are waiting to see what are the results for themselves, and therefore you have a natural holding back behaviour before you get the results of the diagnosis. It's not only that. I think it's the accumulation of different types of constraints in a classically high leveraged European banking system. High leverage is the way the European economy is financed. And when you finance three quarters of an economy through banks you are bound to have more leverage than when the banks are rather less active or not that crucial in the financing of the economy.

And therefore, I understand from what you have said that many of you feel that the accumulation of these regulatory measures has constrained banks in their ability to lend. One has to understand something which came up today perhaps not as much as I would have thought it would. When you impose in a very short span of time a lot of capital requirements on a bank, by definition you do two things that are more than the consequences of regulation. They are, in a way, the secret purpose of the regulation: ie reducing the size of the banking system.

First you impose less profitability. By definition, if a bank has to put aside more own funds, it is going to have, all things being equal, less remunerative activity: in other words the bank is mechanically going to be less profitable.
Second, when you are less profitable, a few things happen: you are getting more selective on what you're willing to lend because if you have to put a lot more capital against loans, these loans should better be as profitable as possible. Therefore banks are going to exercise

their imagination in a world of very low yields to look for higher yields.

Therefore the imposition - all this is a question of magnitude- of rapidly increasing capital requirements can push banks into more risky concerns or riskier activities because it's very difficult to be profitable with usual, classical types of loans. That's one thing. The other thing is that you can't do it all by raising fresh capital. I'm often told by my American friends "idiot, increase the numerator and you'll see everything will be fine!" Now it is not easy – or even in some cases not possible - to increase the numerator (i.e. capital) if the profitability of the activity goes down.

We have to understand that in Europe the profitability of the banking industry, the return on equity is one of the lowest. If you look at chemicals, metals, communications..., you will see much higher returns. It is the fact that the banking industry is one of the less profitable industries we have in Europe, after years of very profitable returns. I certainly don't want to see those excessive returns to come back again. But the present very poor level of profitability creates a vicious circle, because it's more difficult to raise capital when you don't have enough returns, and it is more difficult to divert earnings into reserves.

So what do you do when you are obliged to abide by the own funds capital and liquidity requirements? The LCR is one of the most de-structuring elements of regulation, because banks are obliged to hold in their balance sheets a lot of very liquid assets usually "zero risk weighted" sovereign assets and to keep them because they are, suitable for their liquidity ratio. But they are not going to move a lot the economy. And as far as the long term liquidity ratio (NSFR), it's a ratio that is going to inevitably reduce the length of the maturities of banking. It cannot be otherwise. The amount of term borrowing that banks would be obliged to raise in order to reach a perfect match between their funding and their assets would be so big that in fact, the only way banks can achieve it is by reducing the length of their assets.

I don't want to paint a picture that is too sombre, but I'm just saying that the accumulation of all these rules in a very short time frame has obliged banks to reduce the size of their balance sheets. That is a fact of observation, it's a reduction of more than 10% in a couple of years, which is something that I have never seen in my long career. Now if that happens, and this is the point that Professor Hanke made this afternoon with a lot of strength, if that happens, exactly at the moment where the recession is still around and when the deflation's harbingers are visible as we have seen today in the last set of figures, then we've got a big problem. Other views nonetheless were less pessimistic.

So that is the second line of reasoning I heard today and this is why I think it would be wise to sit back for a time and see how this is unfolding in terms of its effects on the economy and perhaps not add new layers of regulation like an increase in the leverage ratio or whatever at this point in time. I think it's pragmatic to look at what's happening and to find alternative ways to reduce some of the obvious hurdles that have been if not created at least encouraged.

C. One of these methods is something that I will explain tomorrow, it's not a panacea, it's not a big thing but it's a way of pushing small and medium sized enterprises into financial markets. I'll just say a word on this.

Big companies are ok in terms of financing, they find the money on the market, they find equity and they find debt. Households find some credit for their houses and their consumption. But the only economic agents that don't find money now in an incremental way are small and medium sized enterprises. Now small and medium sized enterprises are the biggest generators of jobs, and I thought that unemployment was the problem of Europe, the socially, politically, ethically, humanly unacceptable problem.

And if I'm told that all these good measures on the banking system, indeed, lead to a lessening of lending to the SME sector that is the big creator of jobs, I feel uneasy. And I say to myself even something modest that can bring financing to the SMEs through securitisation is perhaps a good idea. You have to do it simply; you have to detect the good loans within the SME sector. Mr Visco was right to say that many of the SMEs should not be even borrowing at all and I agree with him on that, but I think that there are a number of SMEs that are demanding credit, that are on the upside, starting to re-export and those companies have difficulties. I'm looking at the figures every month on the ability of small and medium sized enterprises to access credit and I see that in Spain or Italy you have only 52% of companies that declare that they can find easily credit which means 48% cannot find it easily. And when I look at the historic backgrounds I know that there must be something wrong and that it's not only the bad quality of the companies that is in question. If you look at it in a granular fashion, you know that there are SMEs of good quality that cannot find credit because of the general environment that I was explaining for banks.

So I think it would be a good idea to extract from the credits provided by banks even in the past to SMEs, to extract the best ones, ones that have super ratings, prime ratings from the central banks themselves. We do remember that in 2004 the central banks of Europe were eligible to rate SMEs, and I think it would be a good idea if those central banks who know how to rate SMEs, were to rate those that are first quality (by first quality I mean those who would have a probability of loss let's say of 0, 40 %) which is really high quality. And then we would have to find a market.

Of course, you need to get the investors, and to get the investors you need to have safety, confidence in the quality of ratings as well as sufficient return. My understanding of the market is that we are not that far from that equilibrium point provided that a) there could be a form of public guarantee, very limited on the first thin layer of losses and that guarantee could be provided by organizations like the European Investment Bank or national institutions whose job is precisely to do that.
And b) the second prerequisite would be to reassure the market that in case of liquidity tensions, the European Central Bank would be there to buy, not to accept as collateral but to buy some quantums of these first class assets. I think this would give confidence to the market. And then we would have to assure ourselves that these high quality instruments will be treated by the regulators, in particular the regulators of the buyers as insurance companies to be treated as prime quality. I'm not asking for any SME privilege but just equality and not penalization.

So it is an idea that we will work through at Eurofi it with my friends and discuss with a number of officials as well as with the private sector. It's not the solution to the problem that we have stressed a moment ago but it's at least a little light in a very dark tunnel.

So thank you very much for your attention and have a very nice dinner tonight.

Keynote speeches and Exchange of views

Christian Noyer, Governor, Banque de France
Rimantas Šadžius, The Minister of Finance of the Republic of Lithuania

J. de Larosière:

We have two eminent speakers with us this morning – Mr Christian Noyer to my left, who is the Governor of the Banque de France, and Mr Rimantas Šadžius, who is Minister of Finance of the Republic of Lithuania. I will give the floor first to the Minister, who, as you know, has played a significant role in the former Presidency, and I would much appreciate his views on the financial subjects that we have been discussing yesterday.

So, you have the floor.

R. Sadzius:

Thank you Jacques. Please forgive me if I'm not so precise in economic or financial terms since I'm a lawyer from my second background and a PhD in Chemistry from the first – but I think, really, Lithuania has many things to communicate to its counterparts in the European Union about what has happened during the last decade or so, and of course it is very important for us also to have feedback from many people around us in Europe such as concerns about "what are we to do next, how should we manage to get out of the situation that we encountered quite recently?"

Today the frequently used term of deleveraging - including both the private sector and also the public sector – makes us to rethink our economic and monetary policy strategies.

Deleveraging is necessary for further productive economic development of our countries. This economic development is actually based on the proper functioning of the private sector, which is the primary source of all the goods that can then be redistributed to the population.

But what goes on now actually raises many questions about the seeming contradiction between fiscal discipline and growth stimulation; where fiscal discipline should answer the questions of deleveraging for the sovereign, and whether growth stimulation actually contradicts the deleveraging of the private sector.

So, the processes that we have before us are quite contradictory, and the trick is to find the proper combination of all them. I would say the most important issue is not to mix good and evil; we must somehow strike a balance between the different processes that are taking place, the fiscal discipline and growth stimulation from the public sector point of view are two issues that, to my mind, can come together and can enhance each other.

Is it possible to recover – for an enterprise or for the state, at the times of deleveraging – that means with decrease of crediting? I was quite surprised to learn that for some particular enterprises, according to our recent research in the private sector, credit is not the main problem that they encounter. Perhaps, and this is specifically seen in Lithuania, a much more important problem is a lack of qualified human resources. It's also quite an interesting effect, because in Lithuania we still have quite high unemployment–(estimated around 10 percent in March 2014).

Of course, there is a need for credit, both for the private sector and for the public sector to finance some investment that will bear fruit some time later in the future, but the lack of human resources, I think, is also starting to become a problem for our public sector.

The solution: of course, it's investment again. Investment where? In technology, in education; and I think this is the issue that still is ahead for Lithuania and the whole European Union. So, credit-less recovery is possible provided you really have and properly manage human resources.

Ensuring the adequate level of credit resources for businesses and for the state, is still a question. A too high crediting level, too high indebtedness; we all, perhaps, agree, this is bad. Too low is still considered abnormal. But how should you strike a balance between these two extreme points?

One of the areas where, really, the public sector could play its role, is mobilising credit resources for filling the gap of crediting small and medium businesses.

So, that is why I think we should fill, with public resources, the gaps where private resources are not available because of the deleveraging these projects could seem too risky. Here, I think, I can subscribe to the idea of the securitisation of credits to small and medium enterprises – that was quite, I think, extensively discussed yesterday, – but I think that this idea needs public support, not only ideological not just legislative support, but also financial support.

I think one of the best solutions could be mobilising and then paying out the public resources provided, say, by the European Investment Bank and other institutions in Europe. In Lithuania we do have several institutions that, to my view, could be reoriented to serve this purpose, and what we do need, of course, is thinking music to generate particular schemes that then could be put into legal acts, that could be safeguarded from all sides to minimise risks. I say minimise, I don't say to remove the risk because there will be risks, and it is my strong belief there is some level of risk that we should go for, in subsidising small and medium enterprises

So, to summarise my introductory speech – I think then we will have some kind of discussion after Christian has made his intervention. To summarise, I think that basic building blocks of economic growth could be: savings, investment, and especially investment in education and technological progress.

For the first part, savings and financial investment, we should have proper financial instruments – novel but transparent financial instruments – but we also should care about investing in education and technological progress, which still, I would say, lack proper attention from politicians. I think this is where we should do much more.

So, thank you for your attention and, Jacques, I pass the floor to you.

J. de Larosière:

Thank you very much, Rimantas, for this overview and this suggestion. I'll call now on Mr Christian Noyer.

C. Noyer:

Thank you, thank you very much. I will try to follow up on what Mr Šadžius just said, concentrating on one particular aspect of deleveraging, that is the deleveraging from banks; and I fully acknowledge it's certainly not the only one, and perhaps not even the most important, but also the need for measured and sound financing – in particular for SMEs, as was just mentioned – and I will especially talk about securitisation.

Why is it important to develop securitisation now in Europe? Of course bank intermediation remains the dominant channel of financing the economy in Europe, which is different from the situation in the US economy which relies mostly on market-based financing. However, there is a deleveraging at work, which is probably required to strengthen bank balance sheets and to comply with new regulations, and I believe that market-based financing mechanisms can significantly complement bank funding in Europe, and there is scope to develop that.

Of course in part it can be done through easy market operations – issuing bonds or short-term securities – but that's benefiting, essentially, the larger firms with easy direct-market access. If we want market financing not to benefit exclusively those large firms we

need financial techniques like securitisation to breach bank-based and market-based funding, in particular for SMEs.

I also believe that securitisation can make both funding sources mutually reinforcing if securitisation uses existing bank loans and therefore the capacity of the banks to judge the quality of credit, and then free up banks' balance sheets to allow for the provision of new loans to other firms.

A paradox is that the securitisation market, in the EU area in particular, has still to recover from the sudden loss of trust in ABS that took place in the wake of the unravelling of structures that were too opaque, too complex; and that is contrary to what happened in the United States where the problem started and resulted in much, much higher default rates than for ABS in the euro area; but paradoxically in the EU area securitisation is still stigmatised and it continues to be perceived too often as obscure and risky.

Therefore, I think one of our priorities should be to remove this stigma, and to that end, of course, restoring investors' confidence is key, and that requires, in my view, the supply of a simple, safe, transparent securitisation scheme. I see it rather encouraging to see that a number of market initiatives are taking place that currently aim at increasing transparency, harmonisation and safety for structured products.

Indeed public authorities – and certainly that includes central banks – have an important role to play in fostering these developments, and they have already contributed significantly by reducing the risk associated with these products for investors. For instance, through an increased standardisation, an improved transparency of underlying assets, there is an important initiative that we took in the Eurosystem which is called the ABS Loan-level Initiative – actively supported by the ECB – which aims at providing transparency on the underlying assets of an ABS. There is another aspect, which is more in the hands of governments, which have tightened the regulation of credit-rating agencies and increased the transparency of their methodology – which I believe is important to increase trust in the ratings delivered.

We, at the Banque de France, are at the forefront in this field, and I would like to give you a quick overview of a recent French market initiative that we are fully supporting. The objective is to facilitate the securitisation of credit claims – mainly SMEs' loans – which are individually eligible as collateral to the Eurosystem. They are eligible collateral, among other conditions, because their rating – the rating of the loans – is based on our internal assessment model – the Banque de France internal assessment model, which has proven to be quite robust since we have in-depth knowledge of these SMEs through our local branch network. One of the advantages of using that tool is that it reduces the reliance of market participants on credit-rating agencies. Such claims on SMEs will then be pooled in a simple and efficient vehicle, in which all major French banks and some others, by the way, will participate, and that will allow for market refinancing.

We are strong supporters of this initiative because we believe it will become a powerful instrument for a more efficient financing of the economy, and for a central bank it's also important because it will allow a better transmission of our monetary policy. The first issuances should be launched very soon; we are looking forward to it. We hope, of course, that vehicle securities will soon be deemed eligible as collateral by the Eurosystem, therefore reinforcing its attractiveness, and I'm really convinced that such concrete initiatives are key steps toward a renewed securitisation market in Europe.

There are two other aspects that maybe will deserve further attention in the future: one is the harmonisation of prudential treatment across jurisdictions and sectors in order to avoid the misperception of risks by investors; and another aspect that could warrant more attention, maybe, is the need to increase investor protection and the prevention of systemic risk through a more stringent regulation of asset management activities.

I'll stop at that, Chair, and I'm ready for the debate.

J. de Larosière:

Thank you very much for this statement which contains a clear proposal and a clear backing of the idea of securitisation for the purpose of increasing the space – if I could put it – of the banking sector, in terms of financing small and medium-sized enterprises through a clear, transparent and simple methodology for securitisation. I think this is very important. It dovetails very well with what we've been discussing yesterday, and I think, to a certain degree, could answer the concerns we all have about excessive deleveraging which is being observed in some parts of the Union.

So, thank you very much. We've got two minutes left, so if there is a question to one of our two speakers I'm sure they would be happy to take them…No? Well, in that case it leaves me just with the… nice… idea of thanking you both for having come this morning, participating in this seminar.

I just would add a personal view on the securitisation matter. I think what you said, Mr Governor, is very important, very topical, and we should be working on it. You have mentioned an initiative that is supported by the Banque de France, and we're very interested in it. I think, more generally, we should be making some very concrete proposals rather quickly. So, I wanted to tell

you that EUROFI will, as soon as this meeting is over, take an initiative that will encompass the main axis of all these banks – who are the originators of these credits - central banks who are an important lynchpin in the protection of the quality of these assets, because we also believe that we have to limit this to the best prime categories. We'll need, of course, to have the buy-side – insurance companies, pension funds – represented, because those are the ones who will animate the market and buy those assets, and we'll also need investment bankers to see how we can arrange these vehicles. We'll also rely on some possible guarantees, as Mr Šadžius said, which could involve the European Investment Bank and some national public institutions that usually do this. And, of course, the ECB as a backer of last resort is an important feature in the whole system.

So, thank you very much, and now we have to work on it, and quickly.

Achieving an effective economic and monetary union

Yannis Stournaras, The Minister of Finance, Hellenic Republic & President of ECOFIN

Ladies and gentlemen,

Recent economic data in the EU indicate that the recovery has shown signs of acceleration and the prospects for this year are brighter. The exit from the financial crisis is evident. Fiscal adjustment eases, confidence is gradually being restored, while GDP growth resumes in the European economy. Despite the progress, persistently high unemployment, especially among young people, and social insecurity remain a major concern.

The recent crisis was the result of the substantial accumulation of public dept in certain Member States, as well as major imbalance in the banking system. It was reflected in the large external deficits of the Member-States of the euro area and in the refinancing difficulties affecting individual countries of the eurozone.

The prolonged crisis that provoked the longest and most severe recession in Europe, taught us that we should focus more towards better monitoring of economic and financial policies in member-states as well as deepening the Economic and Monetary Union (EMU).

The EMU in its current form will not be able to fulfill its purpose because it is a full monetary union but an imperfect economic union.

Only a much deeper European integration can sustain the common currency without an endless series of bailouts that may affect the solidarity of the European populations and create frictions between the lenders and the borrowers. In this context, we first need to strengthen the coordination of financial, economic and social policies of the member states, and correct structural imbalances within the common currency area.

Economic policies should promote a strong, sustainable and inclusive economic growth, ensure fiscal discipline, improve competitiveness and boosting employment, especially youth employment, in order to preserve the European economic and social model.

Without any doubt, we have already made a series of important decisions and have taken a step towards deepening of EMU.

To be more precise, we have adopted:

- The Treaty on Stability, Coordination and Governance (the so-called "fiscal compact") which came into effect on January 1st, 2014, that provides for coordinated fiscal discipline.
- The Compact for Growth and Jobs, which aims at making the European economy more competitive by fostering growth, investment and employment.
- A six pack and a two pack of legislative proposals to strengthen economic governance. The aim is to increase the coordination of budgetary processes for all euro area Member States and in particular for those countries facing excessive deficits and serious financial imbalances. Member-States with excessive surpluses should also adopt economic policies contributing to the rebalancing of the European economy.

Furthermore, the European Semester, the annual cycle for coordination of economic policy launched in 2011, integrates the multilateral fiscal and macroeconomic surveillance with the implementation of policies that foster smart, sustainable and inclusive growth in the EU. The coordination that takes place in the context of the European Semester is an important step towards EU integration and the deepening of the EMU.
The Economic and Monetary Union is unthinkable without a complete banking union.
In the European Union, the banking sector should be less fragmented along national lines and be strengthened through central mechanisms and institutions.

Following the adoption of the Single Supervisory Mechanism (SSM), we are now a step closer to the completion of the banking union with the latest positive outcome of the negotiations between the Council and the Parliament on the Single Resolution Mechanism.
The Banking Union is perhaps the most challenging reform towards the completion of the monetary union since the adoption of the common currency. The agreement that has been reached on the Single Resolution Mechanism (SRM) on 20th March 2014 entails the central supervision of banks by the ECB. Furthermore, in case of a bank failure, it will not be possible for the national governments to intervene.

A Single Resolution Fund will be established accordingly with €55billion, where the contributions will stretch in 8 years.

SRM will contribute towards more efficiency and transparency in the financial sector.
We are fully confident that this package of banking system reforms, the most comprehensive to date, will also give impetus to economic growth, since it will make it easier to grant loans to SMEs, that form the backbone of the real economy throughout Europe.

Given the process of deleveraging that is currently taking place in the banking sector in several countries, it is vital that discussions promote the financing of investment, particularly of the SMEs. This involves long-term alternative sources of funding, and the design of new financing tools. The Greek Presidency underlines the importance of the enhanced implementation of the Compact for Growth and Jobs, as well as improved SME's access to finance and the recommendations of the High Level Expert Group for the financing of investment in infrastructure and SMEs.

At the December 2012 European Council, Heads of State and Government agreed on a road map for the completion of the Economic and Monetary Union (EMU), which would be based on deeper integration and enhanced solidarity. Since then, the steps needed to be taken to strengthen the EMU governance are an ongoing debate.

Discussions have focused on the following topics:

1) Coordination of national reforms, in particular the ex ante coordination of major economic reforms that has spill-over effects to other Member States. This would ensure both convergence within the EMU and higher levels of sustainable growth.

2) Social dimension of the EMU that puts emphasis on employment and social developments and the use of indicators. Key employment and social indicators now form part of the 2014 European Semester process, allowing for broader understanding of social developments.

3) Partnerships for growth, jobs and competitiveness. These partnerships will be based on a system of mutually agreed contractual arrangements that will facilitate and support Member States' reforms in areas that are crucial for growth and competitiveness.

4) Associated Solidarity mechanisms that would enhance the efforts of Member States that engage in these arrangements. The aim would be to facilitate and support sound policies before countries face economic difficulties.

Obviously, the deepening of the EMU should take into account the integrity of the EU as a whole and should be accompanied by stronger institutions and policies as well as democratically legitimate decision-making structures.

I believe that a stable and globally competitive EU is essential for the deepening of the Economic and Monetary Union. To this end, reforms to promote competitiveness, growth and employment must be pursued. The need to present balanced budgets should be accompanied by the appropriate combination of measures, both on the expenditure and revenue side, that include specific goals for growth, investment and social cohesion. Taking into account the deeper interaction among the member-states of the euro area, those

have already agreed to enhance budget coordination to achieve financial stability. It is essential to stress here that fiscal consolidation without appropriate growth, employment and social cohesion policies becomes austerity, creates euro-pessimism and gives rise to extreme political formations led by Europhobia. The eurozone must ensure financial stability, prosperity and social cohesion and ultimately support the postwar European social model.

Last but not least, instead of establishing unilateral rules, Europe should work together with other governments and international institutions to determine a stricter regulatory framework and increase transparency in financial markets in order to enhance the efficiency and the stability of the world economy.

Thank you!

Turning a corner in financial services

Michel BARNIER, Member of the European Commission, responsible for Internal Market and Services

Ladies and gentlemen,

My thanks to Jacques de Larosière and to Didier Cahen for inviting me to close this year's EUROFI High Level Seminar.

As usual, it has acted as a platform to exchange ideas; brought together many respected speakers from both industry and public authorities; and given us plenty of food for thought.

Before we start, I would like to pay tribute to Jurgen HOLMQUIST whom many of you knew and respected. He was my first Director General in 2010 and I admired him greatly. He died suddenly on Friday and our thoughts are with his family.

1. The global agenda

Allow me to add a few words to the discussion you have just had on derivatives.

Derivatives markets are global markets. They were at the root of the financial crisis.

The G20 agreed that global markets needed strict regulation to make our financial system safer.

Many countries are now moving from designing rules on derivatives to implementing them, for instance in Europe, the USA, Asia and Canada.

We face three challenges. First, differences in substance between our rules. Second, differences in timing between them. And, third, how these rules interact. We need global solutions to meet these challenges. And we are making progress to avoid friction and duplication.

On the issue of difference in substance:

Last year's 'Path Forward' with the US CFTC is a good example. At our last EUROFI meeting in Vilnius we discussed possible problems with the US SEF rules.

February's update of the 'Path Forward' solved this problem. It shows that regulators are not blind to each other's needs or to industry's expectations.

Second, on the issue of timing differences:

The Commission and the CFTC have agreed on ways to bridge the timing differences between when rules come into force in the EU and the US, and found solutions so that our industries do not suffer.

We will be vigilant in making sure that we both deliver what we agreed. But the way in which we came to these solutions was not ideal. They involved last-minute discussions in ad-hoc settings, creating uncertainty in the markets. This is why regulatory cooperation needs to be part of the TTIP mechanism.

And third, on how our rules interact:

In Europe we have moved into implementing mode. The Commission is working hard on its equivalence decisions for foreign CCPs, trade repositories and trading rules.

We are adopting an 'outcomes-based' approach when we look at the rules in other countries. We are not seeking to export the EU's detailed rules. But we do need to make sure that other countries' rules meet our objectives.

Because when we grant equivalence to a third country we will defer to that country's laws and enforcement. Financial firms from that country will have complete access to our financial market. They can compete with our firms. But they can also introduce risk into our financial system.

So we take our equivalence assessment seriously and need to understand how the other countries meet our common objectives in law and in practice. International derivatives regulators have a close and constructive working relationship. There is a growing awareness that going it alone is not a recipe for success.

I am confident that we will be able to resolve the difficult cross-border problems.

2. Wider regulatory reform, including banking union

Derivatives are only one piece of the puzzle. If I look back on the last four years, I am proud of what has been achieved to regulate the financial sector better; return public finances to health; and improve the governance of the euro area.

We created an entirely new set of rules governing the financial sector. We implemented the G20 agenda so that every market, every player and every activity is well regulated and effectively supervised.

We demanded that banks hold more and better capital, that they strengthen their risk governance and curtail the excesses of the past.

We created new supervisory authorities to make sure banks, markets and insurance companies are supervised adequately and in a similar way across the EU. And we are well on the way to creating a banking union which is probably our biggest project since the euro itself.

It will help us to better predict problems and manage them more smoothly. And, vitally, it will mean that taxpayers will no longer be in the front line to pay for failing banks.

Creating the banking union will ensure the integrity of the euro area and the stability of its banking system while securing the interests of the wider EU single market.

I appreciate in particular that non-eurozone members fully supported the negotiations.

3. Long-term financing

Ladies and gentlemen,

The financial reforms I just mentioned were essential. They were the prerequisite to stability and thus growth. But alone, they are not enough.

To consolidate the growth that is slowly returning, the single market is vital; it must work efficiently. And access to finance is essential for all those who have projects and need financing to see them happen.

Here in Greece, less than one-third of Greek SMEs got all the credit they applied for last year.

Finance is also essential to meet Europe's massive long-term investment needs. In the EU, some one trillion euros will be needed by 2020 for transport, energy and telecoms infrastructure alone.

We need to bridge these funding gaps to support sustainable economic growth. That's why the European Commission put forward last week a series of ideas to stimulate new and different ways of providing long-term financing.

This financing will have to come from a variety of sources in addition to the bank funding on which Europe relies so heavily:

- private funding
- public financing
- and the capital markets.

One of the suggestions we have put forward is to revive sustainable securitisation markets. Because we want to make it easier for small businesses to access capital markets and larger pools of investment.

I fully understand that the word securitisation makes some people nervous. And brings back memories of US mortgage sub primes when securitisation was a byword for shady practices and excessive risk-taking.

I can assure you we have no intention of letting that happen again. We want securitisation products to be part of the toolbox that will unlock additional sources of funding to the real economy.

But only in ways that raise no financial stability concerns. The first step is to define criteria by which we can identify safe, high-quality securitisation structures and products.

Therefore differentiating between good and bad securitisation, in line with what EIOPA advocates. The Commission and the international standard setters have already started to work on this. We have also made a proposal to improve the governance and transparency of pension funds, one of the biggest sources of private funding.

All of this will improve financial stability; promote cross-border activity and help long-term investment.

Conclusion

Ladies and gentlemen, over the last day and a half; and indeed over the last four years; you have heard a lot about new rules; new structures.

The pace of reform has been relentless.

We are nearing the end of the rule-making phase and entering a period of implementing and enforcing those rules.

What matters now is
- how those rules are put into practice including how they work on a global level;
- what effects they have on the behaviour of market players;
- and what the outcomes are for individuals and businesses.

That will entail a whole new era of partnership. Between the EU and other jurisdictions. Between European and national authorities. Between public and private operators. And between all of us and the people we aim to serve.

It promises to be an exciting time.

Thank you for your attention.

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The Eurofi High Level Seminar 2014

Organised in association with the Greek EU Presidency

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SUMMARY OF DISCUSSIONS

Expected evolution of bank and market intermediated financing and of the competitiveness of the EU financial system following on-going reforms

Objectives of the session

At a moment when the current Commission is finishing an impressive series of reforms triggered by an unprecedented financial crisis, this first session of the Eurofi seminar was dedicated to stepping back and considering likely long-term impacts of these regulations on the structure of the European financial sector.

This session also covered the market-based financing mechanisms needed to complete or support bank financing within the E.U. (e.g. securitisation) and the actions needed to develop such mechanisms in a significant way. A reference was made to the organisation of the US financing mechanisms in order to provide an understanding of possible alternative financing structures.

Summary of the session

1. What Europe has already achieved for repairing the financial sector

A representative of the public sector stressed the fact that in the E.U. a subdued mood is inappropriate. Europe, he said, has achieved a phenomenal job managing at the same time to significantly repair the financial system - bank capitalisation has improved massively, half a trillion, which puts the European banking system in a much better place to face the next few years – and at the same time Europe has succeeded also in preserving a forward looking attitude to imagine the necessary deepening and complementation of the financial system. Beside this the E.U. has succeeded in consistently driving budget deficits down and rebuilding consumer and industrial confidence. Finally he concluded by reminding the audience that this progress has been made on the basis of the creation of the Banking Union and a dramatic improvement of the coordination of the macro economic policies of the different Member States. These achievements are given credence by the fact that though Europe is not the fastest growing area in the world, it remains the most trusted area in the world hence if something happens somewhere in the world then liquidity flows to Europe, he said.

Another participant on the panel expressed the opinion that the absence of credit has been the result of what may be a once in a century event. Hence credit will return once the problems, which caused its absence, have gone away e.g. inappropriate bank structure, bank regulation, the governmental structure of the Euro area and more generally market regulation including rating agencies. Indeed he said, there was sufficient provision of credit pre-crisis, both from the banking sector and from the securitisation sector, but that credit was unsustainable. Consequently what has been done over the past years in terms of regulation has been to try and generate banking structures, securitisation structures, other forms of structure, which can generate credit sustainability.

Furthermore, a representative of the public sector stressed that in his opinion Europe has not a great deal to learn from the United States about how to construct an economic and monetary union and about regulation. He concluded by saying that the Euro area and Europe as a whole have made progress: the Euro area is recovering, the Banking Union is progressing, etc. though in the US and in Asia this is not properly understood. Finally the AQR, he said, is by far the most important thing happening in the world economy this year. Europe will get through the AQR but it will be difficult to do it well.

Another panellist stressed in particular that the recent paper of the Commission on long term financing should be considered as a critical additional step within a legislative continuum, as regulation is not something which is discreet. This paper, he said, has worked out various pieces on various areas about long term financing, among which the definition of the long-term concept represents a true generational move.

2. The impact of financial regulation on the economy

However many panellists expressed the opinion that a pertinent issue to examine is the effect - intended and unintended - of financial regulation on the pace of growth and economic development, in particular in a context where In the US, the recession seems to be disappearing, whereas in Europe the quantum of consistency of recovery is tepid at best.

One of the panellists in particular stressed that European growth is likely to lag behind the US recovery for the foreseeable future, due to the intended or unintended consequences of differing regulatory approaches to the broader financial service sector and to capital markets in particular. In Europe, he said, the preferred buy-to-hold model has caused just at a time when they are needed most, bank balance sheets to be still suffering and deleveraging. This is not only due to the potential distribution of risk but also to the appetite of potential buyers of that risk, he concluded.

An other one stated that given the enormous amount of financial regulation that has been put in place, the really key part of the new financial regulation in Europe will come in the implementation phase where an effective dialogue between the industry and the regulators will be critical to ensure that there are no unintended consequences to the definitions and drafting of the different regulation pieces. One panellist said that in particular one objective of the comprehensive assessment should be to observe the effects of financial service regulation on the industry as a whole and specially to highlight any inconsistencies between different types of financial service regulations and jurisdictions.

A representative of the industry reminded the panellists that though banks have increased their capital, at the same time they contracted their assets in order to comply with the Basel III regulation – he illustrated the point quoting that the aggregated balance sheet of the Euro area banking system decreased from the high point of 34.8 trillion in May 2012, down to 30.4 trillion in December 2013. He concluded by stressing that those 4.4 trillion less are the beginning of the problem that the E.U. is faced with though such de-leverage was intended. Indeed, he said, the contribution of loans to Euro area residents to such a contraction is increasing - in 2012, they represented only 6% of the deleveraging but 20% in 2013: the contraction of loans outstanding amounted

to 587 billion during this period, half for corporates, half for individuals. Consequently, he predicted that once the banks have been capitalised enough and the quality of assets has been reviewed, the banking system will not resume lending because regulation - the Basel III constraints - is going to stay despite the huge injection of liquidity into the banking system, he concluded.

This executive of the private sector illustrated the constraints imposed by the new banking regulations by the expected impact of the liquidity ratio (LCR), which, he said, will lower the money multiplier by 28% from around 11.6 to 8.3. This means that assuming that the liquidity injected by the ECB remains unchanged, bank lending outstanding may decrease by 28%, and should monetary policy normalise and its balance sheet return to its historic average, bank loans outstanding should decrease by approximately 2.8 trillion, which means 2.2 trillion on top of the decrease that has already been seen.

The case of Germany already illustrates the expected effects of the regulations. Though the economy has very strong fundamentals, growth is still hamper by the context of a slowdown in bank lending to the private sector - mainly the lending to corporates, he said.

Yet a progressive upturn in lending to corporates would be desirable during the course of 2014 to back economic growth and even boost it. Indeed credit-less recoveries are characterised by a relatively low GDP growth rate. Finally he reminded the audience that Basel III will also require American banks to adjust but they will not impact the US economy to the same extent, as non-financial corporations rely more heavily on capital markets and more importantly, the GSEs, which are not subject to Basel III, and federal guarantees in general play a central role in the real estate lending market.

This panellist concluded by saying that developing securitisation and capital markets is necessary. But stopping preventing banks from lending is also mandatory. This supposes not adding further restrictive regulations to Basel III.

Another representative of the private sector quoted the working paper 485 of the Bank of England entitled "Identifying Channels of Credit", and stated that in a context where bank capital requirements are varied, markets may not substitute for bank lending, and finally in any case for an economy to expand, the money has to expand. Indeed, he said, the question is where that actual money comes from. Quoting again a paper of the Bank of England - the first Quarterly Bulletin – he stressed in that respect that broad money is a measure of the total amount of money held by households and companies in the economy - 97% - which is mostly created by commercial banks themselves.

Another panellist also stressed that part of deleveraging is not just getting equity into banks; it is getting equity into companies, and he illustrated the necessary initiatives in this area by alluding to the Business Growth Fund that is actually focusing on SMEs in the UK.

In that respect a representative from the public sector stated that though due to the structure of the EU which makes it difficult to follow the course that the United States followed, nevertheless it is suggested that it is wise to force banks to deleverage by raising equity rather than shrinking the balance sheet and this improves the speed of recovery.

3. An emerging issue: the insufficient profitability of bank lending in the EU

One panellist stressed that beside regulation issues, in so far as commercial banks are in the liquidity insurance business through deposits and through committed credit lines, one critical issue is that committed lines of credit to medium sized and large companies do not make any money at all.

He explained that they ought to make money because these committed lines are only going to be used when the world is in a bas state either because the borrower is in idiosyncratic difficulty or the system as a whole is in difficulty or actually because the provider of the liquidity insurance is in difficulty. Consequently, he said, charging them at a reasonable economic price in necessary in order to have a healthy financial system. This should worry policy makers, he said.

Yet banks do not charge these lines sufficiently because they want to have various types of businesses that can make money and that can be run by somebody else e.g. MNA business or some other deal, whereas no one else can insure liquidity.

Consequently this representative of the public sector stated that the re-regulation of the banking sector is partly designed to drive up the cost of banking finance, which was too low. Though another panellist stressed that banks need to be able to propose many more products outside the balance sheet to have additional sources of profitability, and they are required to encourage bank lending, this representative of the public sector insisted on the fact that banks should be able to make decent returns from their core business instead of in particular levering up and running a trading business with a public sector subsidy.

Another panellist also stressed that an often-overlooked aspect is that corporate lending has become much less profitable for banks as on the bond market ten years ago banks could fund themselves with a 50 to 100 basis point advantage while today, an average bank funds itself between 50 and 20 basis points less competitively than what an average corporate can provide. Increased funding for banks is basically pushed over to SMEs and therefore not necessarily enhancing the

long-term growth capacity of SMEs in Europe. Finally banks really start to pay for the cost of capital on corporate loans when they are highly rated and the corporates are lowly rated.

More over a participant on the panel stressed that favouring cross subsidisation between lending and non-lending banking activities, which favour the financing of SMEs can only happen if the debates on bank structure reform remain controlled.

4. The comparison of Europe to the US

A panellists stated that it is not a coincidence that the US has seen such a fast recovery, as the US is home to the deepest and most liquid capital markets in the world, which is a critical element of the direct funding of the corporate sector, but also of the securitisation process through which the US banks originate and distribute risk, rather than buying and holding as is mainly the case here in Europe.

However this participant stressed that one needs to think quite carefully before assuming that since banks are not lending, the US model is some kind of panacea.

The comparison of Europe to the US is a little bit futile insisted another speaker. In particular he expressed the opinion that one specificity of the US, is that it is a very rich country in financial asset terms - 75 trillion. There, he said, wealth is distributed across the economy from many different agents and transmission channels in a way, which is radically different to that of the Euro area. In particular, the average US household is three times wealthier in financial asset terms and, on a gross basis, four times on that asset basis. Finally Americans allocate less than a fifth of their wealth to bank deposits.

Conversely, he said, in the Euro area, you find 20 trillion of financial assets and almost half of them are in deposit form. The pension industry is tiny by comparison, half of what it is in the US. Consequently the challenge is very different. Moreover, the bank balance sheets - 17 of the 33 trillion on the ECB database, is lending into the public sector, the corporate sector and households. And of corporate loans - 7 trillion of the 33 trillion - 1 trillion goes through the bond markets today. Another speaker clarified the fact that 4.6 trillion of intermediation through the banking system exist in Europe with less than a trillion of it actually happening in the markets, and that it is essentially the reverse of the US model.

The panellists were finally of the opinion that the issue is to understand what causes that and is acting as a hand brake on recovery in Europe.

In addition the participants on the panel were of the opinion that one cannot recreate a US bond market overnight. It grew up over many decades and encompasses 2,500 rated companies among which 1,500 are investment grade, whereas in Europe we have 700. In addition a participant said that importing capital into the ecosystem from abroad is critical. It is similar to mobilising savings to deleverage banks, he concluded.

A representative of the public sector also reminded the audience of the fact that differences in the structure of financial product demand in the United States have also an effect. Credit cards are becoming the most important part of the payment system in the US, though still a fairly small product in Europe. And credit card receivables are heavily securitised. Similarly auto purchases are more likely to be financed with debt in the United States than in Europe and that is also a very heavily securitised product.

Another panellist also stressed that SME securitisation is not a major part of the provision of capital to SMEs in the United States. Though non-bank financial institutions deal with important aspects of the business, e.g. consumer finance channels finance the smallest SMEs - credit card loans and personal loans, he said that SME financing in the US is mostly a bank business. Consequently he expressed the opinion that because policy makers forced bank recapitalisation by raising equity, and not because of the existence of securitisation markets, SME finance was not too damaged in the United States during this crisis.

Finally many panellists stressed the fact that the US began approaching the structure of financial mechanisms in the 30s. Consequently the ratio of 70 / 30 has been around for a long time. In particular the mortgage market in the United States is a securitised market while in Europe, the mortgage market is actually used as a funding mechanism through the covered bond market. The US securitisation market is very longstanding and the European is relatively newer.

Furthermore a representative of the public sector stressed that the structure of the financial system depends to a large extent on public policies that have emerged over a long period. He reminded the audience that in the US, capital market based systems developed because cross-state banking in branch form was prohibited. In addition in the US the subsidisation of housing is deep, and consequently the entire residential mortgage market is underwritten by the public sector. Conversely, he said, in Europe residential mortgage markets have greatly developed without the involvement of the public sector. Lastly social security policies matter a great deal as well and in particular pension systems funded privately need to build up assets over time. This influences greatly the structure of demand for assets and of course generates a different intermediation.

Finally one panellist summarised the argument by stating that the apparent market based ratio is high in the United States because of the government policy of favouring certain securitisation entities, particularly Fannie and Freddie, who even before the crisis, had a distinct advantage in terms of cost of funding and capital as a result of government support.

A panellist also expressed the opinion that the likelihood that EU financing mechanisms will shift to an American style is very low, partly because EU economies are so much more centred on small and medium enterprises than in the US. In Europe 80 million people are employed in SMEs compared to less than 30 in the US. Bank balance sheets will therefore continue to play an important role.

Finally a participant on the panel stressed that one important lesson of the US experience is that non-bank financial institutions and market-based finance are not more resilient than bank-based finance. Actually, he said, the recent crisis was first a crisis of market-based finance: in 2008, auto lending shut down because the securitisation market for auto lending shut down and you had to work hard to find a bank willing to loan someone money to buy a car because they knew they would not be able to securitise. You can find other examples over the last 20 or 25 years when securitisation markets shut down and there was disruption in the sectors that they served. It is more difficult for policy makers to address such a situations because securitisation activity is more diffuse whereas in a bank-based financial system the headquarters of which are well identified you can more quickly figure out what to do.

One representative of the private sector first stressed that shadow banking has been demonised and now it is being rehabilitated as market-based finance. We might even do that with banks at some point he suggested wondering if the decline of the long-term US GDP growth over time is somehow in correlation with the rise of market-based finance.

5. What do we need to change to allow European capital markets to play a more active role?

However most panellists were of the opinion that Europe deserves a better balance between banking and capital markets, without being dogmatic about the issue of how big it should be.

In that respect a welcome was given to the efforts by ESMA to increase transparency and disclosure for securitisation instruments, and the increasing focus at the

G20 level on the dialogue about cooperation between regulations and the industry.

We have to acknowledge that regulation does actually cast a shadow, stressed a panellist. Some of the rules that are being introduced are quite onerous: there is something like twice the capital levels required for bank investors - the credit recovery ratio, risk retention rules, enhanced disclosures and reporting and finally the stigma of securitisation being apart of the shadow banking system.

A participant quoted a recent investor survey at J.P. Morgan - 100 buy-side investors, third banks, third asset managers and third insurance companies – This survey shows that the investor side of the market is extremely upbeat about the securitisation market, with 76% of the surveyed institutions saying that there is a great deal of appetite for investment and the market is quite robust and willing to entertain more securitisation.

However 77% of the surveyed investors stress that the headwinds come from regulation, while only 22% of investors are saying that there is some concern about sovereign risk, and 18% allude to relating to the overhang of "repoed" ABSs. By far, the biggest regulatory concern with the investor community was Solvency II, which could actually reduce the return on capital for this investor segment to single digits.

A representative from the public sector said that Solvency II is misguided to the extent that households need to think of and correctly believe that insurance companies which are providing their liabilities, are very low risk. Therefore insurance companies are not going to be the great provider of risk capital to the extent that that has been the case. Mutual funds will be tremendously important over the next 25 years.

Finally, the participants acknowledged that securitisation has a role to play, and that it is one of the key routes to the return of healthy growth in Europe. The challenge is in particular to un-encumber the banks through securitisation, to allow for much more intermediation that the banks can carry to benefit the SME. This requires a supportive regulatory framework, the participants concluded. In this regard the communication from the Commission on long term financing is very exciting as it states that there have to be some "in-flight" adjustments and some recalibration of the rules.

6. Conditions for reviving securitisation

In the whole securitisation market, in Europe in 2006, just before the crisis, the ABS market consisted of about 550 billion in Europe, which was comparatively small vis-à-vis the United States but it was nevertheless, relatively vibrant and did its job. That continued to grow but it was transformed completely in 2008 as a result of the crisis and became a repo market used to secure funding for the banking system. In 2010, 2011, this began to trail off again, so in 2013 the amount that was placed with end investors was only 54 billion.

Indeed in Europe, we still face a certain stigma concerning securitisation, said a panellist. In the US, there is a clear demarcation around the securitisation sectors that underperformed during the crisis and those that did not e.g. recovery in the auto loan securitisation market has been blossoming, whereas the subprime mortgage and home equity loan securitisation market remains moribund. The difference in performance of these asset classes is only just emerging in Europe. A representative from the public sector asserted in that respect that the stigma should not be considered as an exogenous fact and we need to work on it as it can be modified by clarifying the difference between what is good securitisation and what is bad securitisation.

A participant said in that respect that the issue raised is to sort out the difference between the necessity to design a fundamentally new credit structure or simply the need for changes which could be needed to allow the existing structure to revive. Then he observed that the discussion has rightly been more about putting in place the conditions that are needed to enable existing structures to return to playing their roles. Indeed said another participant, securitisation – i.e. the distribution of asset backed securities - points to the nature of banks who invent the new credit that is needed for expansion, while markets distribute and manage the risk.

Finally most panellists agreed on the fact that securitisation is the way to go, provided that it is safe and sound. However one panellist pointed out that to help SMEs, it is not just an issue of securitising SME loans; it is an issue of making balance sheet space available for the banking system. In this perspective the securitisation of mortgages and consumer lending receivables are also valuable options.

Furthermore another participant wondered why you would want to package those SME loans into a physical securitisation and sell them to a third party as SMEs are the best priced loans that a bank can make at a moment when Basel III tells the banks to do less trading and more lending and when revolving credit facilities to large corporates loses money. Consequently he suggested that as SME lending is just one product in a spectrum of products that a bank will sell to a corporate, the securitisation playing the role there would be synthetic securitisation, which is not universally accepted across the Euro area. He stressed in that respect that the capital introduced into the system is appropriate as long as it is not being done on an artificial basis and is done with greater structural and risk integrity. Finally he illustrated the potential of such synthetic securitisation informing the audience of the fact that that market has been doubling year on year in Germany, Switzerland, the UK, even most recently in

Portugal. 10 billion of synthetic mezzanines are more than 100 billion of SME lending. In a 7 trillion market, that is resource constraint. A broader range of countries should consider that.

A representative of the public sector stressed that there is a problem with SME finance: securitisation can be a useful thing he said, but it faces formidable problems and not a single report from the official or the private sector on securitisation that is good at all.
He pointed first to the ratings of asset-backed securities. No reason, he said, to think that rating agencies or anybody should be any good at rating aggregate risk. An AAA tranche is something that people will invest in, thinking that it is safe, yet, because it does not have a claim on future generations, it is unlikely to be completely safe in all states of the world and when countries arise in which the AAA tranches get downgraded, you get a rupture in market behaviour. He declared he had never seen any intelligent comment on what the solution might be. This is quite unlike rating idiosyncratic risk in the corporate sector and rating sovereign securities. By definition, the construction of a state and a corporate enables them to call upon future wealth. That cannot be done in any securitisation and anyone who buys securitisation is engaging in a very bad form of cognitive dissonance, he concluded.
Finally he stated that actually to make this work there need to be some kind of public guarantee and consequently a well-constructed transfer union. To achieve the Euro area recovery and the revival of securitisation the Euro area will be faced with the necessity to overcome this great challenge. “You complete the monetary union by adding an economic union and an economic union will not be constructed without it being, in some significant degree, a transfer union” said Jean-Claude Trichet. However the Member States within the European Union only provide a public guarantee for essential services that are provided for their own citizens.

Many panellists finally agreed on the fact that the biggest challenge that Europe faces in putting together a securitisation market is that Europe has not much to learn from America: Fannie and Freddie must not be considered as models and the American debate about reforming Fannie and Freddie shows how difficult it is to get past state-sponsored capitalism which they have in the US in the housing market.

Calibration of banking prudential requirements and expected impacts on lending

Objectives of the session

The objective of this session was to discuss the issues related to the calibration and the implementation of the new regulatory framework in the E.U. banking system.

Background of the session prepared by Eurofi

Basel III is a comprehensive set of regulatory measures defined between 2011 (levels of capital) and 2013 (liquidity coverage ratio), which is aimed at strengthening the banking sector at global level in order to rebuild the confidence on the banking sector and reinforce its soundness so as to avoid the economic cost of banking crisis and in particular systemic ones. The rationale behind these improved regulations is that only well-capitalised and liquid banks can sufficiently finance the economy. These measures encompass notably:
New capital ratios including capital surcharges for global (and domestic) systemically important banks (G-SIBs; D-SIBs), i.e. in particular

- A new definition of the common equity Tier 1 (CET1) and increased levels of capital;
- New risk-weightings for securitisation, the trading book and counterparty credit risk;
- A capital conservation buffer;
- A non-risk based back-stop leverage ratio;
- Two liquidity standards – the liquidity coverage ratio (LCR) and the Net Stable Funding Ratio (NSFR) -.

Additional revisions are underway regarding the trading book, large exposures, OTC derivatives margins, banking book interest rate risk management, etc.

Implementing the new banking regulations: are E.U. banks still a long way ahead?

As of the most recent EBA monitoring exercise (30 June 2013 figures) based on a sample of 174 E.U. banks, the capital shortfalls related to the minimum ratioand the total capital ratio, amount respectively to €103.3 billion (Tier 1 of 8,5%) and to €164.8 billion (total capital of 10.5%).

In fact if the situation of larger (Group 1) banks has improved (in June 2011 their CET1 shortfall was €225 Billion and is now €30 billion and total capital shortfall now at €150 billion coming from more than €450 billion), no progress has been achieved in average by smaller (Group 2) banks (around €25 billion shortfall of the CET 1 in 2011 and in 2013, and total capital shortfall coming from near €45 billion to near €40 billion).

However, despite the unprecedented effort to reinforce banks capital, the shortfall resulting from the leverage ratio(LR) for the banks of the sample is EUR 127.8 billion. And currently only 69.5% of the Group 1 banks and 76% of Group 2 banks comply with the 3% LR.

Regarding short-term liquidity constraints (LCR), 58.5% of Group 1 banks already meet the 100% LCR requirement, while only one bank is still below 60% (minimum LCR as of 2015). Among Group 2 banks 69.3% already reach an LCR of at least 100%, while 18.1% need to improve their liquidity positions to reach the minimum requirement set for 2015. The total LCR shortfall is EUR 262 billion (€217 billion correspond to Group 1 and €45 billion to Group 2), which represents 0.8% of total assets (EUR 31.7 trillion).

In this context, considering the efforts already achieved but also that E.U. banks are still a long way ahead of the level of resources they are expected to reach, it is wise to spend time describing the path taken by E.U. banks to improve their regulatory position e.g. deleveraging, reduction of certain activities or risks, right issues, concentration etc., as well as the possible impacts on the economy.

Another topic to be discussed is the timetable of the implementation of the reforms. Indeed some observers consider that these reforms constitute an endless addition of regulations, which impacts negatively notably equity holders and investors in general. Indeed they evolve in a lasting situation of regulatory uncertainty, which expose them to possible dilutions and unexpected reductions of earnings.

More generally the monitoring figures elaborated by the EBA, raise the issue of whether E.U. banks will succeed in due time, to comply with all the new requirements. In particular some question the feasibility of certain features of the new banking regulations. Regarding the NSFR in particular it is worth noting that in the Eurozone, financial institutions supply €19,550 billions of long-term financing on the basis of only €8,400 billion of long-term resources. In this context the additional long-term resources imposed by the projected NSFR have been estimated to €1,300 billion which are not absorbable by financial markets.

Domestic bank-landscapes and the wealth of the economies impact the outcomes of the new regulation in the E.U.

In addition it is worth analysing in different E.U. countries, the impact of the economic and banking context on the capacity of banks to shift toward the new regulatory constraints and achieve a sufficient focus on the

financing of the economy. Some of these contexts are for example

- The necessity for certain banks to simultaneously reinforce their regulatory capital and the quality of their assets badly impacted by the economic recession,
- In highly competitive domestic markets the increase of the regulatory capital negatively impacts the profitability of the banks; consequently the banks face difficulties to sufficiently attract equity holders and may be incentivised to favour activities with higher risk/ return ratios to the detriment of plain lending to the E.U. economy,

Eventually the combinations of those factors may be detrimental to the economic recovery, which requires increasing lending on the short term. According to recent data issued by the ECB, in the eurozone credit to non financial institutions is down by 3% on an annual basis but by 11,4% in Spain, by 5,6% in Italy etc. In addition the banking sector might miss the risk profile targeted by the regulators when shaping the new bank regulatory framework (e.g. reduction of market activities).

What is still remaining from a risk-based regulatory framework?

Calibrating a non-risk based leverage ratio as a backstop is challenging. Indeed, the appropriate level of a backstop for a leveraged bank holding high quality loans to the economy is undoubtedly significantly different than the level relevant for a bank with larger proportions of risky assets stemming from financial market activities. In particular defining a universal level for such a backstop may prove attempting the impossible as far as contrary to American banks E.U. ones do not off load their best loans out of their balance sheets.

The EBA monitoring document is instructive in that respect. It highlights that assuming that the banks already comply with the new capital requirements the shortfall of tier 1 capital corresponding to the non-risk based LR would amount to EUR 109.7 billion (minimum T1) and EUR 64.2 billion (minimum T1 plus CCB).

These figures mean that - though according to the EBA the ratios are expected to improve as a result of the changes to the LR recently proposed by the BCBS – currently the LR would become in many cases the binding constraint in terms of Core Tier 1 capital and the Total Regulatory Capital despite the LR – solely intended as regulatory backstop - was expected not to detract the positive incentives specific to risk-based approaches.

Some may argue that the solution might be a recalibration factoring in the risk profile of most of Group 1 banks, which are actually not risky though leveraged. In the context where risk weighting processes and outcomes continue to attract scepticism among certain supervisors, financial analysts or investors, the solution might prove out of reach. Indeed so is the scepticism that many advocate that the priority for setting bank regulatory constraints should be given not only to defining minima to risk weighs but to favour simpler and non-risk based approaches.

Finally these figures raise the question of a possible drift from the initial regulatory objectives. Actually the balance between risk-based and non risk-based constraints, is falling over in favour of non-risk based ones. It is the so-called Basel IV.

Summary of the session

1. The role of bank money in growth

To introduce the debates one participant on the panel reminded the audience that we are still in the throes of the Great Recession. In the US the nominal aggregate demand since 1987 has been 5% per year. We are currently at 2 and 3/4% per year. This is the same level as we had in the mild recession of 1990, 1991. He explained that in this context money dominates vis-à-vis fiscal policy for interpreting correctly the situation. This is illustrated by Japan where they had a massive Keynesian fiscal stimulus and a very tight monetary policy, and essentially no growth for a generation. Symmetrically Bill Clinton had a massive fiscal squeeze - government expenditure came way down as a proportion of GDP by 3.1 percentage points during his eight-year term - however the U.S. pursued very accommodative monetary policies and experienced one of the biggest economic booms that we have had in recent times.

However he stressed that one had to look at money in the broadest sense and that broad money is divided into two categories. One is state money produced by the central bank on which most people focus when they think in terms of monetary policy. Now it turns out that state money is just peanuts. Conversely the second one created by commercial banks, is called bank money, which "is the elephant in the room". Today, roughly 10% of the money supply in the E.U. is state money - in the United States and in the U.K. it is about 20% - and 90% is bank money (80% bank money in the U.K. and the U.S.).

The participant concluded by stressing that regarding growth the current exclusive focus of monetary policy on central banks money is misguided and one should be paying the most careful attention on bank supervision and regulation, which are the determinants of the evolution of bank money. He reminded the audience in that respect that since Lehman went down broad money growth in both the EU and the United States collapsed. In the EU the rate of growth and broad money was almost 9% per year from 2002 to 2008, and is now less than 1%. In the US it has been about 7%, and now post-Lehman it's just a little over a half a percent.

He concluded by saying that one reason for the insufficient attention paid to bank money is that bank supervision and bank regulation usually does not change very fast and the bank money regime is constant, while the only thing that changes very much is state money.

2. Likely sources of the excesses witnessed in the run up of the crisis to be addressed

Various representatives of the public sector stated in this context that the interpretation of the current recession, which explains why we have to regulate and recapitalise banks, is money expansion in particular bank money expansion, which was unsustainable and required major structural repair. Indeed banks were over leveraged and engaging in a lot of risk before the crisis they said. They stressed in that respect that this is all the more important as financial crises are debilitating. They reminded the audience that the IMF in 2009 in that respect had an initial estimate for the impact of the crisis of $12 trillion dollars. The Fed and the Congressional Budget Office in 2012 estimated the impact at $13 trillion. And the U.S. Government Accountability Office estimated it at $22 trillion dollars measured in lost economic output and loss of wealth.

However a participant on the panel disagreed stating that the excesses before the crisis were not caused by bank money but by state money and the policy of the Federal Reserve in particular. He said that Ben Bernanke, who was the Governor of the Federal Reserve in November of 2002 before he became chairman, explained that "Deflation was the main enemy in the United States and the Fed had to start fighting deflation". Consequently by June of 2003 the federal funds rate went down to a record low of 1%. This created enormous excesses of state money that had a knock-on effect on bank money through investment banking where the problems concentrated as it generated yield chasing and leverage in investment and shadow banks.

He also explained that no money and no capital were lost in commercial banks in the United States. "Actually if you look at deposit-taking banks, "normal" banks" he said, "at least in the United States they didn't have excessive leverage."At the time of the crisis they had less leverage than perhaps they've had any time in the last 20 years. In addition at the highest point of bank losses, deposit-taking banks' losses were absolutely tiny: losses were amounting to only 1% of equity at the time and 99% of the equity and capital was completely untouched." Yet another participant challenged this opinion pointing out the difficulties faced by Citibank.

3. Combining deleveraging and resuming growth is needed

Many representatives of the banking industry in this context of a great recession were of the opinion that credit demand has been very weak for some time and has been the main driver of the collapse in lending in certain member states.

However they concluded that now as lending demand is coming back, banking regulations may start to actually act as a constraint. One of them quoted the example of Spain where over the last few years a lot of financial reforms have taken place beyond the general reforms

- Basel 3 – by demanding more provisions in to saving banks in particular and the cleaning-up of banks' balance sheet. And he concluded by saying that in Spain we are witnessing an increase on the previous year of 10% of outstanding lending (7% for SMEs), which is good news, but he stressed that additional lending would contribute to a further recovery of the economy, which is still very lacklustre.

Finally they were of the opinion that the issue to address is to find out how to combine the need to resume growth and the necessary deleverage of certain economies - in Spain bank lending to the economy amounted to170% of GDP at the peak of 2008; it has now gone down to 130 but is still too high to be sustainable and the average of the European Union is slightly less than 100.

4. Specific impacts of tightening banking regulation on bank money

According to various representatives of the industry, many reports (Bank of England, IMF, BIS, etc.) suggest that though over time things will even out, from the moment you put more capital requirements or regulations on banks, it will slow down (banking activity). They insisted on the fact that actually the regulators have been putting the brakes on for five years i.e. bank capitalisation has more or less doubled since 2007 in Europe as well.
Indeed they explained that to address the tightening of the regulation the banks mainly reduced Risk Weighted Assets (RWA) rather than supplying capital.

They explained that actually, beside the retention of earning, the reduction of the RWA represents more than 70% of the contribution. Then they insisted on the fact that this provokes concern because in Europe there is a great reliance on bank financing -72% in the UK, 94% in the periphery, that compares with about 30, 35% in the US - With the European economy turning the corner it is essential that companies continue to be able to access funding in order to help encourage European growth.
Many representatives of the industry were convinced that there is a real recessionary effect and expect the LCR to further accentuate such a trend. One of them stated that in the institution he represents in 2013 loans to SMEs grew by 3% because of a strong growth in deposits - more than 5% - but there was also a real restriction on the credit to public authorities and on CIB activities to focus liquidity on SMEs and individuals.

Regulators for their part were of the opinion that according to the BIS working paper 443 as far as Global Systemically Important Banks are concerned higher capital ratios since the crisis have been adjusted mainly by retaining earnings and not through sharp adjustments to lending and asset growth. Furthermore the research concluded that banks in aggregate do not appear to have cut sharply the assets or lending growth due to higher capital standards. It also concluded that banks that had high capital ratios at the start of the process or strong profitability in the post-crisis years, grew significantly more than others: this points to the importance of solid bank balance sheets to support lending, the regulators said.

5. Specific impacts of the different regulation

The regulators noted that the interbank market, which contracted sharply at the height of the crisis and has not returned to pre-crisis levels, is now comprised largely of secured transactions (i.e. repos). They do not think that this is one of the developments caused by extended regulation.

Conversely the representatives of the industry consider that most of this reduction stems from the post-Lehman bank regulation which forces banks to massively invest in government bonds the cash they struggle to attract, which does not benefit commercial and industrial loans or mortgages. One representative of the industry illustrated the trend asserting that in 2015 the roll out of the **Liquidity Coverage Ratio** (LCR), the first global liquidity standard for large internationally active banks, will impede financial institutions in maintaining the financing of the economy as with the new ratio you can grant only 80 credits out of 100 deposits as 20 are dedicated to the liquidity buffer.

In addition a representative of the banking sector warned them on the fact that though Europe favours retail based banking-systems, the regulatory treatment of insured deposits is punitive (i.e. an inappropriately excessive run rate of these deposits in the LCR) and departs from the Basel framework. Similarly covered bonds though they worked particularly well during the crisis are considered in the LCR as a second-best liquid asset.

In addition the representatives of the industry considered that the recently agreed **leverage ratio** which is likely to become the decisive regulation for a certain number of banks, is consequently expected to have a negative impact in particular on the repo market at the expense of corporate debt market liquidity, potentially increasing borrowing costs for corporates.

The **Net Stable Funding Ratio** (NSFR) on which a consultation is on going is expected to have similar effects. But it would not just impact bank liquidity but also the financing and more generally the monetary policy transmission.

A participant from the public sector however asserted that there is sufficient empirical evidence, which shows that in a crisis situation banks who were sufficiently capitalised maintained a better ability to lend, by accessing funding at a cheaper price and by being able to take on

risk in the SME sector, the residential market sector and elsewhere in the real economy. Consequently the overall strengthening of the capital positions of banks was a necessary - but not sufficient - condition to repair the situation and the crisis and this context requires also an aggressive monetary expansion to compensate for the risk of shrinking the monetary base down to a level, which would cause serious pro-cyclical negative effects.
This is why since the onset of the crisis, monetary expansion has been mostly counter cyclical whereas some of the banking measures are pro-cyclical by nature and in addition supervisors who tend to be rather relaxed when everything is fine, become very "aggressive" after a crisis.

6. Timing of the repair of the banking system is critical

One panellist stressed that the choices regarding the calibration of regulatory frameworks have worldwide consequences on the business models of banks, banking products and the availability of financing to citizens and businesses. He said however that at the same time these standards are essential for re establishing the confidence of the market and among investors on the financial area.
Finally most of the participants in the panel were of the opinion that there is no problem with very high capital requirements, tough leverage ratios, etc. The critical point is the repair process, which should not start in the middle of an economic slump because this is pro-cyclical.

A participant on the panel said in that respect that the misguided nature of this monetary policy stems from its timing which is pro cyclical. In particular the abruptness of the introduction of new bank regulatory regimes caused an upheaval in bank corporate planning and strategy, a great deal of uncertainty in banks and consequently constrained the growth in bank money. He concluded by saying that one can see absolutely no policy rationale for actually confiscating the equity held by shareholders of banks, something that has been happening on a massive scale.

The regulators explained that Basel III capital and liquidity requirements take the long-term view and are meant to be in place in so-called normal times. In that respect there is not an easy solution to what is happening in Europe, which is in the same crisis right now as the US were a couple of years ago just in a different part of the cycle.

7. Progress toward adopting the new standards

Globally the regulators were also of the opinion that Europe is on track regarding the repair process. The definition of capital has been improved and new capital requirements increasing the quantity of capital in the banking system have been set up.

Various representatives of the public sector issued encouraging data regarding the trend of the implementation of new bank regulations. The shortfall capital of **Common Equity Tier 1** (CET1) which was €58 billion as of the middle of 2013, shows a significant decrease from the period six months earlier, year-end 2012 when that figure was €115 billion. EBA's figures for the shortfall of the big banks in the sample was €36 billion down from €70 billion. Those banks have after-tax profits before distribution of €456 billion. The story is similar for Group 2 banks. The CET1 shortfall decreased by more than 50% between June 2011 and June 2013.

Moreover the EBA considers that when it urged banks to recapitalise by increasing their capital rather than deleveraging they did that (until mid-2012), as there was a market to provide capital for strengthening banks rather than forcing banks to deleverage.

Regarding the **LCR** Europe is very close to implementing the global agreements regulators said. The EBA has produced two reports to the commission on the definition of liquid assets and on the expected impacts. The empirical evidence shows that on average the introduction of the LCR would not have any systemic impact in Europe though it would hit certain business models of certain institutions and we have therefore to be very careful with the calibration.

They also reminded the audience that though the **leverage ratio** has been agreed, maybe not the calibration, nor the fact that it is meant to become a Pillar 1 standard in 2018. In that respect Central Bank Governors and Heads of Supervision concluded in January 2014 that the Basel Committee should conduct further analyses on whether or not 3% is the right number. The work is expected to be finished by 2017.

In addition they reminded the audience that the Basel agreement being reached allows for rising up the issue caused by the differences between U.S. GAP and IFRS accounting standards. They also stated that the leverage ratio should not be viewed as the single binding constraint on bank lending activity, but as a backstop to other regulations and in particular risk-sensitive capital ratios. In this context as the most convincing arguments for those who proposed a higher leverage ratio is the lack of confidence in the **risk-based ratios**, so beside the review of the 3%, the BCBS has also to look at things like better disclosure, the use of floors and benchmarks for risk weightings, the fundamental review of the trading book, etc.

Finally they said that the definitions regarding the NSFR are being finalised and Europe is moving ahead in line with the global agreements. However a consultation process is being initiated for the purpose of settling possible interpretation issues.

8. Level playing field and harmonisation

The panellists agreed on the fact that despite the huge and commendable effort to coordinate G20 reform efforts now we can see **national regulatory focus**. This goes against the need for harmonisation, which is specially required in the case of global banks, e.g. many different definitions of liquidity standards, leverage, and structural rules separating retail business from investment banking. This means fragmenting markets that were not divided before and will be imposed at the expense of the access to finance for global business in particular.

Though one person on the panel stressed that one has to be very careful about harmonisation which may sound great, but may eliminate competition and experimentation, which are usually positive dynamics, most participants agreed on the fact that a real level playing field and harmonisation are very much pro competition. However a representative of the industry declared that one should strive to harmonise things only where it makes sense: if something is globally competitive it is sensible to do it globally. Where it is sensible to do it only within a jurisdiction or within a region, then regulate it only there.
However, considering E.U. specificities of financing arrangements, the participants raised the question of whether European rules can be calibrated specifically. The regulators stressed in that respect that the Basel prudential framework, capital, liquidity and leverage ratio have now been agreed; and we would not as a general principle encourage different calibrations across regions but on the contrary support consistent implementation i.e. no lowering of standards and no gold plating of the standards which have been agreed globally as Basel standards are a minimum and countries are permitted to adopt tougher standards if necessary given their local circumstances.

Another participant from the industry warned that the differentiation of leverage levels is very dangerous (e.g. lending to the public sector, to very specialized businesses in the mortgage industry, differentiating the leverage level according to the size of banks, etc.) would be a mistake. We do not want a system that is built on the basis of excessive leverage and harmonisation and standardisation is key in that respect.

Finally a representative of the industry warned that regarding capital and liquidity the level of national discretion was too high and he questioned whether this was in line with the principle of a single rulebook. In particular he cited the counter cyclical buffer and systemic risk buffers as he was of the opinion that they should be based on explicit risks affecting financial stability. He proposed in particular that the principles underpinning these requirements should be available, yet the regulators are allowed to impose stricter buffer requirements simply because they are more risk averse than others. It is important that the European Systemic Risk Board should use its authority and mandate given by the CRD IV to define such principles and achieve further harmonisation, he concluded.

A regulator suggested using the opportunities through the ECB and the new supervisory process in Europe to have more harmonisation and practice

9. Priorities of the co legislators for implementing the new global banking framework

A representative of the public sector described the current legislative context saying that now the commission is operating on bank regulation through **Delegated Acts**, which means in democratic terms that the co legislators have entrusted the commission on their behalf to make a Delegated Act on the basis of their framed mandate.

That being said, when it comes to LCR, Europe is, with respect to the timing for adopting the standard, “super equivalent” to Basel because the co-legislators have decided that the LCR should enjoy a shorter phasing-in period than the Basel guidelines had provided for: this underlines the attention and importance that the co-legislators attach to it.

On the NSFR and leverage regulations though the Commission first of all will comply with the deadlines and deliver by the 30th of June, but it has decided to use these first few months of 2014 to consult as widely as possible and to organise a stakeholders’ group.

The speaker also insisted on the fact that the **long-term financing** of the E.U. economy is an issue, which is quite important for calibrating banks’ parameters so as to put together resilience and growth.
The Commission has issued a document regarding this field. There are various ways to improve long-term financing: the non-bank ways but also finding out the new role here for banks.
The legislators have, when they came to transpose Basel III, decided to exploit the full democratic possibilities of having some positive action for **SMEs**, giving them a clear advantage over that which already existed with Basel. The question we asked there was: “should we continue in that direction?” The same concerns **infrastructure**, there is a Commission’s proposal for structural regulation, which is on the table and which will be discussed under the next E.U. parliament; but when you transpose it you need to respect fully what has been negotiated, while making sure that you bring it down to the impact on the economy and most especially making sure that it works.

A representative of the industry however stressed that one should not underestimate how critical technical standards are and what damage can be done by not getting the details right. He quoted two examples in that respect. The practical calculation of the leverage, regarding FX forwards or FX swaps could represent a trillion Euros of balance sheet difference. This will first and foremost affect the derivatives business but it has side effects on lending because there is only one source of capital in the bank money. The industry representative asserted that, consequently, when you consider the necessary amount of mending regarding SMEs, banks couldn't afford that magnitude of uncertainty. The impacts stemming from the differences between accounting standards for derivatives in the E.U. and the U.S. (IFRS Vs. US GAAP) for the larger European banks amount to about 100 plus billion euro. Similarly, provided that according to the EBA, European banks are broadly aligned with that 3% leverage ratio, envisaging a new calibration up to 4% just represents for a number of EU banks an additional need of capital of 33%.

This representative of the industry stressed that an appropriate calibration would require clarifying the benefits expected in particular for the economy, of doing certain businesses or not. For example in Europe the intention of the commission is to tighten the regulation on repo transactions. However, in the US about 30% of the Treasury is being funded through repo markets. In Germany it is about 80%.

However a representative of the public sector disagreed on such projected consequences and reminded the audience that the proposed regulation on the leverage of banks was developed so that there are no IFRS – US GAAP differences.

10. Re launching a securitisation market in the E.U. is necessary to finance the economy

A representative of the industry exposed a possible solution for alleviating the consequences of regulation on the financing of the economy. He reminded the audience that a better working securitization segment based on plain vanilla securitisation would restore the confidence of investors and this is needed because this would mean less capital consumption, more opportunities for banks to lend, and also a better distribution of good risk.

However he concluded that although in the E.U. we want lending to SMEs to be revived and that interesting initiatives can help to favour good securitisation (PCS), bank capital requirements for securitisation, which are in the process of being finalised and were found to be woefully too low during the crisis, are still very demanding as well as Solvency II, which is important for the final buyers of ABS.

11. RWA

A participant on the panel from the buy side stressed that an excessive reliance on particular ratios is not the right way to manage risk in financial institutions. He provided the example of rating agencies who do not rely on standardised risk weights and who realise that in some cases they overestimate or underestimate risk, as it is not standardised around the world.

He was of the opinion however that adding minimum risk levels for the ratios is a very important complement to the risk-weighted approach. It is useful to define complementary layers he said, similarly transparency is incredibly important and the financial statements should allow the users and the investors to make judgments and compare entities across the world.

He stressed in particular the necessity to adjust the risk for the macroeconomic specificity of the regions in which the assets are held, and that judgment and not simply ratios is critical to identify if something may be misaligned and react accordingly. He concluded that moreover, risk and liquidity figures should primarily be used as tools for comparison. However he recognised the difficulty of achieving an appropriate calibration. In particular the differences between banking systems distance us from a strict harmonisation. In particular in the US Fannie Mae and Freddy Mac absorb much of the housing risk and impose necessary differences in regulatory levels.

However hard work to align these situations as closely as possible, needs to be done.
In addition you need to dig deeper and region-by-region, into covered bonds markets and understand the risks that exist. Similarly the collateralisation of repos, the government funding of banks in southern Europe are challenging when it comes to building the ratios appropriately.

Finally a representative of the industry stressed that it is critical when standardising risk rates to introduce more comparability, requires first to ensure that those standards will provide different numbers when risks are different. For example how can we envisage similar risk rates in the U.S. and in the E.U. as in the U.S. the loan book requires six times the provisions required in Europe he said.

Implementing the Banking Union, the SRM and the BRRD

Objectives of the session

This session was devoted to discussing the main pending issues regarding the Single Resolution Mechanism (SRM) following the EU agreement reached at the trilogue level on 20 March 2014.

The pending issues related to the delegated acts that the Commission has to adopt following the adoption of the Bank Recovery and Resolution Directive by the EU institutions in December 2013 (timing to decide the resolution, rules to calculate the contribution of banks to national resolution funds etc.) were also addressed.

The impact of resolution and bail in on the cost of funding of banks were discussed as well as the backstops needed if capital short falls are identified in the coming months.

Background of the session prepared by Eurofi

The Creation of a banking union is essential to contributing to the re-integration of financial and banking markets and breaking the link between sovereigns and banks.

The crisis has made clear that the vulnerability of the financial and banking system is a key weakness of the European Union: capital circulates freely and rapidly from one country to another, which can amplify the potential fallout from "banking panics". Moreover, in a monetary union, the negative feedback loop between banks and sovereigns can in the extreme, undermine the viability of the monetary union. This is why effective supranational mechanisms in place for supervision, resolution and the guarantee of deposits are essential.

The banking union will ensure in particular that banks in the euro area are considered as « euro area banks » and not as « Irish », « German » or « Italian banks ». The goal is to ensure that credit conditions in the euro area will not depend on where you are but on who you are.

To achieve this, we need to have three things in place:

i. Federal bank supervision, to guarantee that all institutions are subject to the same rules and same methods of control. A supra-national supervisor is in fact better placed to assess the risks of cross-border activities and therefore to protect and encourage such activities; it is not subject to national biases that can lead to the temptation of economic introversion. It is therefore more credible and strengthens stability and confidence in the area;

ii. A unified mechanism for the resolution of banking crises, which should be backed by a credible and European public backstop, so that individual countries no longer have to shoulder the burden of major upheavals on their own;

iii. A unified deposit-guarantee mechanism to avoid banking panics.

Over the past year, these ideas have been translated into concrete action.

The move towards a Single Supervisory Mechanism is firmly on track.

By November 2014, the main banks in the euro area will be supervised by a federalized system headed in Frankfurt according to the same high standards. Moreover the entire European banking system will be supervised on the basis of a single set of principles – the Single Rule Book – which is in the process of being compiled by the European Banking Authority.

Ahead of taking on its new responsibilities, the ECB has undertaken a Comprehensive assessment of the euro area banking system focusing on 128 banks in 18 member states that constitute around 85 percent of euro bank assets. This Comprehensive Assessment aims to enhance the transparency of their balance sheets, and in doing so, to trigger balance sheet repair where necessary, as well as to strengthen confidence.

The agreement on a framework for Bank Recovery and Resolution, achieved on 20 December 2013, organizes the resolution in the EU.

This directive aimed at harmonising at the EU level national rules on bank recovery and resolution. The goal of bank resolution is to wind up the bank in an orderly way, keeping the essential functions intact and running.

The legislative framework establishes a range of instruments to tackle potential bank crises at three stages: preparatory and preventative, early intervention, and resolution. Member states will be required, as a general rule, to set up ex-ante resolution funds to ensure that additional financing are available if bail-in reaches its limits. Banks will have to draw up recovery plans, and update them annually, setting out the measures they would take to restore their financial position in the event of significant deterioration. Resolution authorities will have to prepare resolution plans for each bank, laying out the actions they might take if it were to meet the conditions for resolution.

<u>Bail-in instead of bail out becomes the rule</u>

Bail-in provisions will enable resolution authorities to write down or convert into equity the claims of the shareholders and creditors of banks that are failing or likely to fail. Certain types of liabilities will be permanently excluded from bail-in. A minimum level of losses equal to 8% of total liabilities including own funds will have to be imposed on an institution's shareholders and creditors before access can be granted to the resolution fund. Eligible deposits beyond €100.000 from natural persons and micro, small and medium-sized enterprises will have preference over the claims of ordinary unsecured, non-preferred creditors and depositors

from large corporations. The deposit guarantee scheme, which will always step in for covered deposits (i.e. deposits below €100,000) will have a higher ranking than eligible deposits.

State aid becomes a remote possibility since it must be preceded by at least a contribution of private bail-in (8%) and resolution funds (up to 5% of total liabilities).

In extraordinary circumstances, where other resolution tools (including bail-in) are deemed to be insufficient to preserve financial stability, government support may be provided through injections of new capital or taking a bank into temporary ownership.

The specificities of the Single Resolution Mechanism Process

The Single Resolution Mechanism (SRM) is another pillar of the banking union, alongside the SSM. Ideally, the SRM should consist of a single system with two main elements: a single authority and a single fund backed by a European public backstop.

In December 2012, the European Council recognized that in the Banking Union, bank supervision and resolution needed to be exercised by the same level of authority. On 10 July 2013, the Commission proposed a Single Resolution Mechanism (SRM) for the Banking Union. On 20 March 2014, the Parliament and the Council reached a provisional agreement on the Single Resolution mechanism.

The key questions relating to the SRM which have proved difficult to resolve include:

- how the decision-making process for resolving a failing bank would work: the ECB in particular has argued that decisions would need to be made quickly (eg over a weekend); in addition the role of the Council raises the issue of a possible "politicization" of the resolution process;
- whether resources should be pooled to create a single euro-area backstop so that it could be used to provide additional public support to banks anywhere in the euro area, or whether national resolution funds should first be used to bail out national banks (the solidarity would remain "national" in that case), and the use of the pooled euro-area backstop should be subject to conditions which provide strict national budgetary safeguards: the Commission and the ECB have argued that, without a euro-area SRM, the euro-area SSM would be much less likely to be effective;
- whether a Single Resolution Fund of €55 billion would be large enough; if not, whether there would need to be a public further federal backstop, and if so who would provide it and how it would be funded: in particular, whether it would be temporarily funded by the European Stability Mechanism, which is funded by taxpayers and includes €60 billion potentially available directly to recapitalise banks, but has so far been used only to bail out governments.
- whether too much emphasis is being put on the recovery of ailing banks. Contrary to the US system which is more consistent with the "no more bail out" principle, the BRRD still allows, under exceptional circumstances and subject to state aid rules, preemptive bailing outs and exempts countries from the bailing in rules.

Further assessment is needed to clarify whether the agreement reached in trialogue on 20 March 2014 answers theses questions.

Summary of the session

The Single Resolution Mechanism (SRM): a major step forward to the banking union.

All the speakers agreed that the EU has made crucial progress with the adoption of a harmonised bank resolution regime (the Bank Recovery and Resolution Directive) and the decision to create a Single Resolution Mechanism. The new rules are designed to ensure and will indeed ensure that – notwithstanding stronger supervision – if a bank subject to the Single Supervisory Mechanism (SSM) faces serious difficulties, its resolution can be managed efficiently and with minimal costs to taxpayers and the real economy.

This session took place just one week after the agreement between the EU Parliament and the EU Council regarding the SRM (24 March 2014). The SRM is responsible for the resolution of banks in member States participating in the banking union. Resolution decisions will be prepared and monitored by a Single Resolution Board (SRB) to ensure a coherent and uniform approach of resolution rules. In addition, the SRM regulation establishes the Single Resolution Fund (SRF), which has a target level of €55 billion.

In order to protect taxpayers from bail-outs of failing banks, the Resolution Fund consists of contributions from the banking sector and can only be used once 8% of bondholder bail-in[1] has been provided. National and EU public funds will only be used as a last resort.

The speakers were notably delighted that the co-legislators (the EU Parliament and the Council) have delivered on the SRM as it is a crucial complement to the Single Supervisory Mechanism. A central banker stressed that "the agreement reached between the Parliament and the Council is a major step toward the completion of the Banking Union and the breaking of the link between sovereign and bank risk. It would have been extremely useful if all these mechanisms had been in place when we were undergoing all this stress". "Without the SRM the Banking Union would not be complete" a regulator added. All the representatives of the financial industry also welcomed the achievement of this agreement on the SRM. A leader of the industry in particular pointed out that "the SRM is a critical building block, which is intended to protect tax money. This is no doubt positive for financial stability. It seeks to minimize the likelihood of systemic crisis and also provides a predictable legislation defining how a bank which is likely to fail or which is failing will be resolved, which is very positive".

An EU decision maker noted that the Banking Union was created in under two years. Since the conception of the Commission (June 2013), it took only nine months and 16 hours to deliver the SRM. "It is very rare to agree on EU progress so fast", he said.

The main features of the agreement between the EU Parliament and the Council on the SRM

The moderator introduced the session by remind the audience of the main achievements of this agreement.

The EU Parliament has secured major improvements to core areas of the mechanism regarding what the EU Council agreed on in December 2013.In terms of the decision process, the procedure was streamlined and speeded up:

The ECB – acting in its supervisory capacity- will trigger the resolution process, responsible for deciding whether a bank is failing or likely to fail. The Board may be engaged in this respect asking the ECB to act in order to avoid the risk of forbearance[2].

As a rule, individual resolution decisions will now be taken by the Resolution Board in its executive session. For this session, the Board will consist of the Chairman, the Vice Chair, the four permanent members and the relevant national authorities where the troubled bank is established. The plenary session will only be competent to decide in individual resolution cases if the support of the Resolution Fund exceeds €5 billion, thus making the process less prone to political interference. Moreover, any resolution scheme involving the use of the Single Resolution Fund can be adopted by the Board only after the Commission has approved the use of the Fund under State aid rules.

The Commission has a role in adopting or objecting to the draft resolution schemes. All this is supposed to happen within tight deadlines, in total 31 hours, in order to allow the resolving of an ailing bank over the week – end. . The Council will be involved only at the Commission's express request.

The Parliament also accelerated the mutualization process of the Resolution Fund: 40% in the first year, 20% in the second year, the rest equally over a further 6 years.

Strengths and weaknesses of this agreement on the SRM

A good basis for the funding, the decision making, and the allocation of responsibilities within the SRM

A public decision maker described the main strengths of this agreement:

- First, a resolution mechanism is only credible if it is properly funded. This speaker therefore welcomed the mutualization of the Single Resolution Fund since it will reach its target capacity more quickly than originally envisaged. However, "we still do not have

a solution if the Single Resolution Fund becomes depleted. The current compromise makes reference to a borrowing capacity of the fund. I trust that this commitment will soon be followed by concrete steps" the speaker said.

- Second, to preserve financial stability the resolution scheme needs to streamline efficient decision making processes, which the original compromise did not achieve, in his view. "The compromise text has been significantly improved allowing for cross border resolutions to be adopted over a weekend. I believe it is really possible" this speaker added.
- Third, an effective Banking Union requires a clear allocation of responsibilities between supervisory and resolution authorities. The agreement clarified the fact that, as a supervisor, the ECB will have the primary role in deciding whether a bank is failing or likely to fail, then it will be up to the Single Resolution Board to decide whether a failing bank should enter into resolution or should follow the normal bankruptcy proceedings.

In the same vein, a central banker also made a comment on the strengths of this mechanism. "The creation of the centralized decision making mechanism will ensure that failed banks will be resolved quickly, efficiently and based on transparent and commonly agreed rules, as adopted in the BRRD. The second strength is the establishment of the Single Resolution Fund which will support the funding of resolution costs if not covered by the use of the bail-in instrument, of course" this central banker emphasized.

According to another public EU decision maker the SRM is a major step forward for building cross border resolutions across the whole of Europe, not only in the Eurozone. "The reason is that the Single Resolution Board will replace 18 resolution authorities; national resolution authorities will remain. However, the Single Resolution Board will be the coordinating actor for cross border resolution also beyond the borders of the Eurozone".

However a central banker recalled that the SRM has two drawbacks: the first one is related to the transitional period. The transitional period is the first eight years. Although the compromise with the European Parliament foresees 60% of mutualization in the first two years, given the fact that the fund's capital will grow gradually, that means that this might prove a burden on the national compartments which will be wiped out first. The second drawback is the absence of a common backstop in the transitional period.

A leader of the industry maintained that "we can see exceptions in the EU legislative framework on banking resolution and the possibility of bail out rules in exceptional circumstances. So the predictability of the resolution process is less than 100%. This why rating agencies need more time before making decisions regarding the impact of these new rules on the rating of EU banks."

The lack of a credible backstop

A senior banker also worried about the lack of a credible public backstop. He stressed that on the one hand the comprehensive assessment is set up to foster transparency on banks' balance sheets and foster confidence in the banks among all stakeholders in order to contribute to the revival of credit to the euro area economy; but on the other hand member states do not express their trust in this approach because they do not provide at this stage any backstop. "Such a solid and well-defined backstop should be put in place, not to be used but just to reinforce trust in the euro banking system" he said.

The Single Resolution Fund will be able to borrow from the markets but "the organization of the credit line has not been defined" an EU public decision maker added.

Another international public decision maker insisted on the need to set up a credible backstop: "I think that it's all good and well to have all these bail-in rules but at the end of the day I think this is not really the point of a backstop. The point of a backstop is to provide a credibility thing in advance, which means the big bazooka sense. So I think we would still think that it's important to have some kind of additional mechanism, certainly now as we are going through the Asset Quality Review (AQR)" he explained. He continued by asking "what happens if the resolution fund has to raise money very quickly and how do you do that? In some cases it's easy if you can just put government debt in a bank you don't actually have to raise the money, but if you actually need the cash that's a different story".

The European Stability Mechanism (ESM): an efficient backstop?

A representative of the EU institutions emphasized that the ESM in the current construction is a second or third line of defence but represents "an efficient firewall, a large scale backstop". The ESM can provide Euro Member States with financial assistance, with based on the existing instrument of indirect bank recapitalization, already implemented for Spain. However state support under the new state aid rule implies first the bailing-in of equity and junior debt. An EU official explained that the direct bank recapitalization tool of the ESM (€60 billion), should be available to recapitalize banks when all the other means (bail-in, resolution fund) have been exhausted; the requesting ESM member would also have to be unable to provide the beneficiary bank with financial assistance without serious effects on its fiscal situation.

The calibration of the Single Resolution Fund (SRF) and specific issues

A banker raised technical issues about the calibration of the Single Resolution Fund and more precisely about the banks' contributions to the SRF: first, the build up period has been reduced from ten to eight years and, this represents for large banks an annual cost of

hundreds of millions of euros. He stressed that "this is a huge level of non productive funds diverted away from the economic financing when, at the same time, the bail-in tool is supposed to provide a significant loss absorption capacity in the case of a failing bank and a crisis".

Secondly the banker underlined competitive distortions between the SSM banks and the non SSM banks. Non SSM banks still enjoy a period of ten years in which to build up their national resolution fund and some of the countries even have the possibility to allocate the systemic tax to the fund. In addition, the calculation of individual bank's contribution to the Single Resolution Fund is a matter of concern[3]. Some domestic banking sectors will be penalized by the current formula which does not take into account risk weighted assets, despite the fact that risk weighted assets are supposed to reflect the risk profile of the bank. Consequently, this speaker mentioned that "for instance, the French banking sector is likely to contribute 3 4 billion euros more in the case of the Single Resolution Fund than in the National Domestic Fund. In a national domestic fund it should finance 10 billion and very likely we are going for 14 billion".

In such a context, he proposed that whatever the final contribution formula is, no individual banks should be required to pay more to the Single Resolution Fund than what they would have contributed to the National Fund. Lastly, he added that the treatment of intra group transactions and derivatives should be exempted from the calculation of contributions in order to avoid the issue of double accounting.

An EU decision maker answered that the greatest result of the agreement of the last days is – an intellectual or philosophical change of paradigm. We have moved from a situation where the burden of a bank was borne by the tax payer, to a situation where the burden will be assumed first by the private sector (shareholders and creditors) and the Fund which represents "a mutualized private insurance protection". The benefit is clear - it is first of all, "a much healthier financial system. Healthier in the purest possible microeconomic sense; in the sense that the risk pricing is more correct because people pay the price of the risk they take. And second, a much stronger banking system because the regulators have not only reinforced the capital (Liability) side of banks but the Asset Quality Review (AQR) is an unprecedented exercise that will examine in depth the asset quality of the banks. So here there may be some private costs but there are no social costs and I think this is the main issue to keep in mind", this speaker pointed out.

The move towards a Single Supervisory Mechanism is firmly on track

In 2012 Europe was committed to building a genuine Banking Union. Not even two years later it had delivered on this ambitious programme. An EU supervisor noted that "we now have to dedicate all our efforts to making it work properly and enforcing the outcome of the Comprehensive Assessment. With this recent political agreement, the two core pillars of the Banking Union will be in place very soon" She commented on each of them in turn.

SSM preparations are making good progress. The Comprehensive Assessment is advancing at full steam. She stressed that this Comprehensive Assessment will be rigorous. The AQR threshold is 8% Common Equity Tier 1 (CET1). For the stress test, in the baseline scenario the capital threshold is also 8% CET1, whilst in the adverse scenario the capital threshold is 5,5%CET1. These thresholds are higher than in the previous exercises and require a higher quality of capital than in the past thanks to the CRD IV.

"Supervision and resolution are closely linked" she said. "We do not know yet how many capital shortfall cases will result from the comprehensive assessment. The coverage of such shortfalls will have to "be done first and foremost via market based solutions, however, given the scale of the exercise which could lead to a market failure or a crowding out of the private capital markets, public backstops are needed. In the presence of such a market failure we think that it might be in the public interest, and maybe the cheapest solution as well for taxpayers, to temporarily recapitalize viable banks which under normal market conditions would have been able to attract private capital. But this public recapitalization will in all cases have to respect the state aid rules".

A leader of the industry stated that the SSM is no doubt credit positive and it is credit positive for many reasons: "it is about restoring confidence in the short term, it is about repairing balance sheet in the short term as well, but in the longer term it is about making sure that supervision will be undertaken in the same way across the region with no regulatory capture or less, and based on the same set of rules which has not been the case until today".

Remaining issues concerning the implementation of the SSM

A banker stressed that data secrecy laws apply in many EU countries, which makes it very difficult to manage the risk of a group across borders and might make it even more difficult to implement the Single Supervisory Mechanism. In addition he underlined that there are still local regulation embedding large exposure limits which may prevent the single supervisor from considering a cross border bank as a group.

"The implementation of the SSM should preserve the diversity of the business models of EU banks" was what another representative of the industry worried about. This banker explained that he represented a mortgage bank which provides 60% of credit in a Nordic EU country and benefits from more than 15% of CET1 (Core Equity Tiers 1). With regard to the Liquidity Coverage Ratio (LCR) since its mortgage business is entirely funded by the issuance of covered bonds (the bank has no deposits), it is of paramount importance that the EU regulator should include covered bonds in the definition of High Quality Liquidity Assets (HQLA). These mortgage bonds are more liquid than most government bonds and the bank has gone through the crisis without any problem. So the biggest threat for the bank is the harmonization of regulatory standards. The definition and the implementation of the single rule book should take into account the diversity of the EU banking

landscape provided that the business model has proved its robustness, this banker said.

Another banker evoked an issue concerning the Asset Quality Review. "We are noticing that more and more regulations or policy makers are really taking this stance even on the banking portfolios about these risk weighted assets. So we trust and we hope that the Asset Quality Review and the stressed exercises will help dispel fears about the robustness of risk weighted assets. We have worked a lot to build up, under the control of supervisors, really the way of assessing risk through the Basel process, which has by the way resisted through the crisis, so we would like and we hope that the AQR will restore confidence in the Basel II approach without imposing flaws everywhere" he said.

Not all risk weights are fully rational, an EU supervisor answered. "We learnt from the crisis that there is no risk free asset; nevertheless there is still some 0% risk weights in the regulations, so there is something to fix there. In addition, when the risk weighted assets are calculated from models we need to make sure that the models are robust and they are validated and assessed in a consistent fashion. So the review of models validation is very high on our list of priorities after November 2014. This being said supervisors have nothing against the models. I think, personally, that we need both the risk weighted assets and the leverage ratio. We need both metrics" this speaker added.

Lastly an international public decision maker reminded the audience that we really have to deal with the legacy of the crisis. The AQR is a unique opportunity in this respect. "I know legacy is a bad word but there are probably still assets out there that are not performing well. We need to clean that up very quickly and get them out of the system because otherwise, you know, funding will be uncertain, the cost of funding will indeed be high. It will get higher not just because of what we're doing but it will be higher because of continuing uncertainty about who's holding what" he said. An EU supervisor approved this statement and added that"we don't need zombie banks that are not making loans because they are overloaded with legacy assets. It is time to turn the page and to start something new, especially with the SSM and the new rules for supervision".

The BRRD organizes resolution in the EU

This legislative framework establishes a range of instruments to tackle potential bank crises at three stages: preparatory and preventive, early intervention and resolution. Banks and resolution authorities are required to draw up recovery and resolution plans on how to deal with situations which might lead to financial stress or the failure of a bank. Three speakers from the public authorities pointed out that with the BRRD and the SRM a resolution scheme can be adopted and implemented in a week end but to do so "good preparation is key". This is why it is so important that banks should draw up recovery plans and resolution authorities will have to prepare resolution plans for each bank.

Resolution authorities have to adopt joint decisions in advance on resolution strategies

Another representative of the public authorities stressed that the crisis showed that credible arrangements for cross border resolution are fundamental to repair the current fragmentation of the EU banking market. The BRRD legislation introduces tools to achieve progress in that respect. The joint decision in particular has an added value because it is binding. To promote trust and common understanding, resolution authorities must front load their discussion on what they would do in the event of a bank resolution, through resolution colleges and the resolution planning process and then act in advance to remove obstacles. He said: "the issue is how we ensure that joint decisions are achieved. Because they are not mandatory in the BRRD. The EBA as mediator is ready to assist with this. Moreover, the BRRD assigns to the EBA the task of delivering 40 technical standard guidelines within the next 12 months. It must establish in particular a legal framework of constrained discretion for resolution authorities to create the common baseline on which those joint decisions can be built".

The cost of funding should increase and banks could be incentivized to take more risks

The cost of building bail –inable should not be underestimated according to several speakers from the industry. A higher cost of funding is likely to be passed on through the price of credit. A banker explained that this subject looks like the discussion concerning the introduction of capital requirements which took place around three years ago. "What we've seen is that the cost of equity has gone up in European banking at a moment when precisely we have seen the return on equity going down. And that's why it has become hard to get funds for equity, and this is one of the reasons why the banking system in Europe has deleveraged and is still deleveraging to a large degree.

With the new bail-in regime we are doing it again in a pro-cyclical fashion: we are introducing a requirement for more instruments that may suffer losses. In doing so, we remove an implicit subsidy of that debt. By removing the subsidy we may increase the cost of debt, but as a counterpart there will be less leverage and less taking of risk. And some people go even to the extreme of saying that the additional cost of debt will be compensated by less risky, and therefore the cost will not go up that much.

Now, what I'm afraid of is that all this line of reasoning assumes something which is very important - it assumes that the banks will indeed not take more risk,

assumes that our regulators will be able to verify all the risk being taken by the banks. I'm afraid that in the last crisis we learned that that was not the case; that the regulators were not able to assess, to verify all the risk being taken by the banks. And I'm afraid that banks will have strong incentives to take "non verifiable" risk because, after all, the markets, the capital markets request a high return on equities, and the cost of equity is the benchmark for the banks.

And more importantly maybe, a cheap way for banks to generate capital is to take more risk. That's why I think that the basic construction of this underestimates the effect on the cost of debt and, therefore again, the European Union is undertaking some regulation on a steady state, if you wish, but precisely at the moment when it will hurt the cost of the funding of banks, and therefore the cost of credit, and therefore the recovery of the economy".

But the new bail-in regime should modify banks' incentives in risk taking

An EU regulator confirmed that supervisors and regulators in the crisis have been unable to detect risky behaviour and avoid it. "Dealing with the banking crisis in Europe required 1,600 billion euros of state aid. That means 1600 billion of public resources. We've largely solved it outside resolution", he affirmed. This is the world we're trying to change today through the new bail-in framework.

From now on (henceforth), if a bank still gets into trouble despite all the prudential improvements and needs to have recourse to public funds, the normal rule is resolution and the resolution tools are available. Indeed the BRRD is due to apply them across the EU from the beginning of 2015, with the bail-in system starting from the beginning of 2016. In such a context, "this year the only thing that forces a contribution from private shareholders are the state aid rules, which imply that all junior debt will have to contribute, and capital of course, whether a bank needs to be recapitalized outside or within resolution", the EU official indicated.

From 2015, the BRRD requires that capital instruments are written down or converted for any bank which is at the point of non-viability. If State support is needed on top of that, State aid rules need to be complied with, including conversion of all junior creditors. So already in 2015 the authorities have a range of tools – some of them obligatory – which allows them to access private layers of capital in case of need.

From 2016, bail-in provisions will enable resolution authorities to write down or convert into equity the claims of the shareholders and creditors of banks that are failing or likely to fail. A minimum level of losses equal to 8% of total liabilities including own funds will have to be imposed on an institution's shareholders and creditors before access can be granted to the resolution fund. So this EU regulator concluded by mentioning that "the public backstop is important but the first port of call already today is going to be formed by contributions from the private sector". These contributions are substantial and lower the need for and the amount of any eventual public support

Communication challenges for the ECB and outside Europe

A leader of the industry pointed out two communication challenges. Concerning the AQR, there are different banking business models and a number of divergences among Member States in accounting treatments and between accounting treatment and prudential treatment in particular."This is why an early intervention on some of that stuff without getting into specifics should be a good plan" he thought. Moreover people outside Europe seem not to understand Europe's achievements concerning the banking union. More communication outside Europe would be appropriate.

"Accounting is beyond supervisors' territory; we have to rely on the auditors firms to make sure that there is one IFRS implementation, in Europe and notably for the SSM countries. On the prudential components of the provisions or on the assessment of the value of the assets and collateral, we have these common definitions provided by the EBA which are a useful step forward. But there are still national options that we will have to address during the coming months. Those national options are at the top of the SSM's agenda after November; we have no choice but to increase significantly consistency in Europe" an EU supervisors added.

An international regulator also stressed that Europe is making a phenomenal progress with the agreement on the SSM, the SRM and the BRRD. But it is a complex undertaking to explain to people what exactly the decision making process is in Europe. "Who is actually holding the ball at the end of the day (ECB, SRB, SRF, ESM...)?" he asked.

This why he agreed with the representative of the industry on the need to step up communication with the private sector outside Europe to make them understand exactly what is going on in Europe. "I think it is fairly simple, there is this shift of a system where there is an implicit subsidy that was provided by the public sector towards a system that is now standing on its own more than before. That's the fundamental change" he added.

1. The BRRD enshrines in binding rules the principle of bail – in in all EU member states so that shareholders and creditors pay for banks' mistakes, not taxpayers. Any additional funds required will come from the banking sector itself in the shape of specially set up resolution funds
2. The Board retains the power to make this determination if at the request of the Board the ECB does not make it. The Board may request any information from the ECB to be able to make such a determination.
3. Banks would contribute to this fund according to their share of the country's banks total liabilities less own funds and covered deposits

Providing appropriate financing tools for EU SMEs and midcaps

Objectives of the session

The objective of this session was to discuss the short and medium term priorities for improving the financing of small SMEs (turnover < 50 Mio €) and larger mid-sized companies or midcaps (turnover comprised between 50 Mio € and around 1 Bio €) in the EU: i.e. financing tools and related policy measures and public actions.

Background of the session prepared by Eurofi

Banks are by far the main source of external financing for non- financial companies in the EU, covering 50 to 90% of their needs, depending on their size.

The share of bank financing tends to be higher for SMEs (EU enterprises with a turnover ≤ € 50 million) and smaller midcaps for which publicly available information and visibility about their projects and management capabilities is limited. In the absence of a legal definition at EU level, midcaps are referred to in this paper as a proxy for the "middle market" which comprises enterprises with a turnover ranging from € 50 million to around € 1 billion.

In the US, commercial banks and savings institutions are also the leading source of credit for small businesses (defined mostly as companies with no more than 500 employees). Direct market-intermediated financing plays a larger role than in the EU but is only a limited part of the overall US small business financing. The difference however with the EU is that market mechanisms supporting bank financing are generally much more developed in the US. The Government Sponsored Enterprises (GSEs) indeed purchase a significant proportion of credits originated by retail banks (mortgages, consumer credit, auto loans...), thus freeing up capital to support lending by banks both to their retail and small business clients.

The cost of bank credit is expected to increase and the availability of long term loans reduce with the implementation of Basel III capital and liquidity rules.

Such evolutions could impact significantly the financing of EU SMEs and midcaps given their strong reliance on bank financing.

Statistics published by the ECB in its survey on the access to finance of SMEs in the euro area indicate signs of credit rationing for SMEs in some EU countries. This issue which first emerged in periphery countries could touch other EU states to a certain extent. The proportion of bank loans facing obstacles reported by the ECB survey (rejections, partial coverage or loans refused by the borrower because of a high price) was for example respectively 29% and 48% in France and Italy during the second semester of 2013. Such figures can be explained by a combina- tion of demand and supply factors, but some observers believe that this could be a prelude to a decrease of credit supply in certain EU countries.

Enterprises based in countries with poor sovereign ratings are moreover penalised by the negative impact of such ratings on their financing conditions. Initiatives such as the ECB sovereign bond purchase programme (OMT facility) and the Banking Union should help to reduce the fragmentation of financing conditions across EU member states. Moreover the EIB is working on the development of a common methodology for the credit scoring of SMEs and midcaps in order to foster the provision of more objective information on their intrinsic risks.

Many measures have been taken and proposed by the EU public institutions since the beginning of the crisis to facilitate the financing of EU SMEs and midcaps.

The EIB has stepped up its financial support in favour of SMEs (funding and guarantees). The EU Commission (EC) has developed regulatory frameworks for venture capital funds and European Long Term Investment Funds (ELTIF) and a specific label for growth SME markets in MiFID II, as well as consulted on the prospects of crowdfunding. Private placement regimes are also being extended on a domestic basis. Furthermore, capital requirements more favourable to SME loans have been introduced in CRD IV and the Eurosystem has reduced haircuts on SME ABSs posted as collateral for its regular monetary policy operations, taking into account the introduction by the ECB of a loan level data transparency initiative.

Additional proposals have been made by a high level expert group chaired by A. Giovannini and J. Moran regarding notably the access to appropriate corporate and credit data on SMEs, the cross-border investment of funds in SME loans and the setting up of an EU platform for mini-bonds.

Moreover a self-initiative report of the EU Parliament drafted by W. Klinz stresses the role national and multilateral (EIB) development banks can play in supporting SME financing, as well as the possible contribution of vehicles such as ELTIF and transparent securitisation mechanisms. The EC is also called upon to propose an EU framework for channelling the short-term liquidity of private households into long term investments, which could provide additional retirement solutions.

The priorities to be pursued in the short and medium term, respectively for SMEs and midcaps, however still need to be completely established.

Priorities should take into account the potential impacts and the implementation timing of the different actions proposed, as well as possible emergencies to be addressed in certain countries or industrial sectors. There should also be an overall perspective on the financing needs of SME / midcap issuers and investors in order to achieve a consistent approach of the regulation of the different instruments available.

Suggestions have been made in this regard by the industry. Concerning SMEs, the expansion of the support provided by public banks, the revitalisation of SME securitisation and developing an improved access to reliable information in order to facilitate credit provision by alternative providers are the main actions favoured. As for midcaps, which have less difficulty in accessing market-intermediated funding, the development of a European private placement regime, the expansion of EU high yield bond markets and efforts to improve the consistency of EU bond legislations are put forward, as well as actions to encourage equity financing and promote IPOs (e.g. rebuilding an appropriate ecosystem, better balancing incentives for bond and equity financing, adapting rules for SME and midcap issuers).

An idea that has gained traction in the past months for SMEs is revitalising loan securitisation in order to refinance SME loans and alleviate SME financing constraints for banks. The ECB notably has called for the development of high quality plain vanilla products capable of being rated and priced in a simple way. Several actions have been initiated by the private and public sectors but these have only had a limited impact so far (the PCS Prime Collateralized Securities initiative and proposals made by the EIB and the EC to set up instruments involving the use of EIB and structural funds).

Relaunching EU securitisation markets on a sound basis seems feasible but requires overcoming several obstacles in the short term, such as the sharp increases in capital requirements for securitisation exposures mandated in Basel III and Solvency II, the current low interest rates and margins of bank loans and the absence of standardised and easily accessible information on SME loans.

Given the urgent need to step up lending in the EU, solutions involving the intervention of public institutions such as the ECB and / or national central banks (in order to impose appropriate quality standards based on the current criteria used for accepting SME loans as eligible collateral in central bank refinancing, support the emergence of securitisation conduits and purchase eligible loans temporarily, if needed, to foster the launching of the market) and the EIB (in order to offer some guarantees for the securities issued) are proposed to help revitalise the EU securitisation market in a relatively short timeframe.

Summary of the session

The importance of SMEs[1] for the European economy was stressed. Several speakers emphasized that SMEs are the backbone of the economy. They employ more people than large companies and also generate more employment (around 60 to 80% of job creations in the EU). It is therefore essential that SMEs have access to sufficient financial resources in order to continue growing and creating jobs.

SMEs are mainly financed by banks at present in Europe, but bank credit is expected to diminish with the implementation of the new Basel III rules an industry speaker believed. The reduction of lending is not the choice of banks, since banks need to lend to make money, but banks need to control and diversify their risks because it is the money of their customers that they are lending.

Main challenges regarding the financing of EU SMEs

Both supply and demand factors affect SME financing.

Fragmentation of rules and financing conditions across the EU

A public representative stressed that the factors that determine the business environment of SMEs still differ hugely between member states. There are major differences between interest rates but also in the proportion of credit refusals to SMEs and in accounting, transparency and insolvency rules. There are also differences in the way SMEs are categorized and defined.

The fragmentation of financing conditions is a major issue an industry spokesman stated as it hinders the appropriate allocation of credit throughout the euro zone and the transmission of the monetary policy.

A public decision-maker explained that the rules that determine how companies work and are financed have tended to stay local in the EU notably because of the extremely important role played by banks in the financing of non-financial companies. Another public speaker thought that the local nature of rules could be explained by the local or regional dimension of most SME businesses. This issue which has been under-estimated so far the speaker believed, has significant impact when trying to launch cross-border activity. The fragmentation of financing conditions is not only a sovereign issue [i.e. related to sovereign interest rates] it also relates to differences in the rules pertaining to the business environment. Governments should not just wait for the Commission to bring about further standardization and for a major European initiative in this area, the speaker stated, they should start identifying best practices and ways to make rules converge (e.g. bankruptcy rules considering the speed at which any debts can be enforced in the local court systems or the way the protection of creditors is dealt with). This is very important for encouraging more cross-border direct lending or investment in securitized products, since foreign investors, who have less familiarity and possibly less "levers to pull" than the local banks, need to be reassured about the business environment and their rights. Until this is achieved there will be a variation of pricing since there is usually a correlation between higher interest rates and weaker sets of business environments.

High levels of public debt reduce investment opportunities for the private sector

An industry spokesman believed that a second issue that needs to be addressed is the high level of public debt which "evicts" the private sector from financing opportunities as public debt carries a risk weight of zero with regard to prudential requirements and provides attractive yields in some countries. Public deficits – which are not really public since they are paid by the private sector - should be reduced the speaker argued.

SMEs have too much debt and too little equity capital

A third issue, some speakers added, is that SMEs have too much debt and too little capital. SMEs need more equity.

The problem, a public speaker believed, is not only that banks are not lending enough it is that there are many SMEs that banks should not be lending to. SMEs need to be allowed to die with the appropriate bankruptcy rules and to be rebuilt in order to create a more active and entrepreneurial society.

Different approaches and tools proposed to support the financing of SMEs

A public representative stressed the importance of identifying priorities "that can be moved on" among the multitude of ideas floating around at present and of "debunking some myths". More diversification is needed in the financing of EU SMEs but it is difficult to set a target. The appropriate proportion of banking vs non-banking financing needs to be worked out over time.

Tools need to be adapted to the specificities of different categories of SMEs

Three broad categories of SMEs need to be considered a public decision-maker suggested: the small ones which will be financed by their banks and for which crowdfunding might also play a role, the mid-sized ones for which bank financing will also remain important and the larger ones which can seek direct financing in the markets and for which private placement and high yield

bond markets need to be further developed at EU level. Ways to alleviate the pressure of regulatory requirements on banks' balance sheets also need to be looked at for the two first categories.

An industry expert explained that the real problem is the financing of mid-sized companies [i.e. companies which have a turnover comprised between 50 million and around 1 billion euros or midcaps]. The challenge is to help them to grow without them being bought up by competitors before they achieve a significant size. There are appropriate financing resources in place in Europe usually for start-ups (e.g. in France where resources are provided locally by business angels and local venture capital firms and could be completed in the future by crowdfunding platforms) and for larger midcaps (which can list bonds or equity on the public market or engage in private placement) but this is not the case for mid-sized companies in between these two categories. The problem is that often these companies do not have an appropriate financial structure with the right combination of debt and equity. Equity financing is available thanks to the role played by the EIB in particular, which is very active in this area but financing debt may be a problem if the action of banks is restricted. For such companies the intermediation of banks is needed because they have the local presence and the knowledge of the history of the company which are necessary, as well as the capacity to analyse credit risks, which is not the case of insurance companies for example. Mid-sized companies cannot easily get direct financing on the market because they have no official rating.

An industry representative added that the financing needs of SMEs differ quite significantly depending on their size, their stage of development and their activity. Moreover, beyond financing constraints, SMEs are subject to many other administrative rules which need to be taken into account (this is the case in France for example particularly for companies that count more than 50 employees).

Implementing "supporting factors" for SMEs in EU banking regulation

A regulator emphasized the role already played by banking regulation in supporting SME lending. There is a "supporting factor" in place at present in the CRD IV whereby the capital charge that has to be allocated to cover SME risk is reduced by 25% which is quite significant. The way this works is that banks first have to calculate the normal risk coverage that is required for financing a given SME, then the 25% discount factor is applied on top of that. The task of the EBA will be to monitor the implementation of this measure over time in order to verify that appropriate risk management is in place within banks and to ensure that it is implemented in a harmonized way across the EU. So far supervisors and regulators have relied on very limited data using the size of loans as the only – very basic – criterion for identifying SME loans (previously 1 million euro, increased to 1.5 million), the regulator stated. Around 25% of loans granted across Europe to the corporate sector fall in this category. More specific criteria need to be developed in the future in order to identify SME loans, in the speaker's view, based on a categorization of SMEs and midcaps. There is a European Commission recommendation with a consistent SME definition[2], however market participants may use other definitions. There is no common definition of midcaps across Europe or at least if it exists it has been determined for a different purpose. Secondly, benchmarks are needed in order to categorize the risks of loans and to clarify the way risks are assessed within banks. This process has been initiated, assessing "low default portfolios", but benchmarks now need to be produced for the SME sector.

An industry representative stressed that a proper calibration of the remaining banking prudential standards (regarding liquidity and leverage) is essential in order to avoid a reduction of lending to SMEs. These standards which are "inspired by the other side of the Atlantic" the speaker stated should be calibrated according to

the characteristics of the European economy. An appropriate calibration of Solvency II requirements is also needed for insurance companies.

Providing appropriate incentives and guarantees for SME financing

Incentives are also important an industry player believed. Tax incentives have recently been put in place in France to encourage equity investment in SMEs (with the PEA[3] PME – a fiscal wrapper targeting investments in SME shares). There are also national and regional public back-up tools and guarantees as well as efforts to create new tools such as crowdfunding instruments with the appropriate standards. Banks and notably cooperative ones are developing local initiatives whereby they support local placements of midcap securities with a guarantee of the bank. This allows them to manage some placements below the standard average floor of 150 million euros. Banks are also participating in regional funds and regional venture capital companies backed by regional councils.

Securitisation of SME loans

Several speakers agreed that given that banks are due to continue to play a leading role on the debt side for SMEs, securitization could play a major role in supporting SME financing notably for improving the liquidity and capital requirements of banks, but several conditions and obstacles need to be overcome.

An industry player however pointed out that SME loans are the most difficult category of loans to securitise. They are a bit like "the North face for mountain climbers". Reviving the securitization market solely with SME loans is a difficult challenge the speaker believed. The process should start with easier categories such as mortgages. The US for example has chosen to revive all categories of securitization and not only Collateralized Loan Obligations (CLOs)[4]. Another industry speaker stressed that although securitization is an attractive tool there are still many technical complexities to be solved and issues regarding the cost of transfer of credit which is high for such small credits.

Several issues were put forward by the speakers on the panel regarding SME loan securitization.

1) Securitisation needs to be "simple, safe and transparent" as stated earlier on during the seminar by Christian Noyer with a harmonization of rules, as well as "high quality standards" in the underwriting process. There also needs to be "skin in the game" for the originator.

   The Prime Collateral Securities (PCS) criteria were suggested by an industry speaker as an appropriate way to provide the level of quality needed for securitization. A public speaker stressed that the European Investment Bank (EIB) and the European Investment Fund (EIF) have an important role to play in this context and the SME initiative jointly conducted by the EIB and the EU Commission[5] was underestimated in this regard. One of the key recommendations of this initiative is that the EIB and the EIF should be playing a role in defining the new European standards for securitization in order to move towards common rules across the EU. An industry speaker however stressed that although the involvement of the EIB to help launching the market seems a good idea this needs to be done "wisely" as the EIB is not going to "close all the gaps".

   There has been an attempt made by EIOPA in Solvency II to define what is good and bad securitization[6] an industry player pointed out but the criteria proposed do not seem appropriate. They are fairly complex and some of them are contrary to certain national laws. For example in the current legislation all SME loans are considered as good securitization. This is in line with the political objective to foster

SME lending but it means that midcap loans will be considered as bad securitization. In the same way mezzanine tranches are rated as bad securitization in Solvency II. It is doubtful that insurance companies will buy them if these criteria are maintained given the very high capital charges that will be required but on the other hand someone has to buy these tranches and all cannot be bought by the EIB.

Risk transfers [provided e.g. by securitization] work if there is a reduction of the uncertainty created by differing rules a public speaker believed. Risk and uncertainty should not be mixed up. Risk can be compensated for by higher yields for investors - when thinking of passing on loans to investors one has to admit that there will be failures further down the road - but uncertainty cannot be distributed to investors. Uncertainty should be reduced by regulation i.e. by a regulation of the operational environment [in which investors and issuers operate]. This includes streamlining the differences in rules that prevail in different member states and that may hinder the development of companies in Europe. Regulation indeed creates incentives and one has to make sure that the proper incentives are provided in order to channel money into long term investments, which is key for the future of Europe.

Bank regulators may contribute to the development of appropriate securitization, a public speaker emphasized. Two different initiatives seem interesting in this regard. The first one is the simple and transparent refinancing vehicle set up in France with several banks issuing bonds guaranteed by credit claims on SMEs involving central bank refinancing. The second one set up in Denmark involves market refinancing. In both cases data is needed in order to secure the roll-over from the banks' balance sheets onto the securitization market and to ensure simplicity and transparency. For that a register is needed. The French initiative relies on the Central Bank register, whereas the Danish one would rely more on an internal bank assessment register or benchmark.

Another suggestion that was made for encouraging SME loan securitization was that such securitisations should be treated by regulators as liquid securities that could help to cover the liquidity ratio in particular (LCR).

2) The difficulty of accessing appropriate information on the underlying loans was pointed out by several speakers.

Information on SMEs is mainly held by banks at present which consider this as a competitive advantage for them a public speaker believed. At the same time assessments show that different banks operating in the same region can have quite different opinions of the same company. There is therefore also an issue regarding the standardization of information and of credit assessments and this is the main obstacle to creating a market for SME financing in Europe. The Banking Union could be an opportunity for supervisors to ask banks to share the information they hold on SMEs, maybe not at the company level but at least at a "cluster" level so that this information can be made available to investors and investors can become more confident with the risks that they may take.

A public speaker stressed that a common methodology for credit scoring is necessary in order to make data more comparable. Standard information on loans is needed as well as risk assessment on a statistical basis. Such proposals should however be presented in a way that may not be perceived as an additional "layer of bureaucracy" by SMEs.

An industry expert emphasized that since many potential investors in securitized products such as insurance companies do not have the appropriate capacity to analyze credit risks, sufficient transparency is needed. An alternative could be to further develop partnerships between banks and insurers. The issue is that mid-sized companies, and particularly the innovative ones, are reticent to disclosing widely information on their activities and projects.

This means that risks need to be evaluated on a statistical basis which raises the question of the size of the database available. Another difficulty to be taken into account is that insurers usually want to invest in liquid assets. Some kind of public guarantee possibly limited to certain tranches of the vehicle could help to solve many of these issues, the expert believed.

An industry representative added that when it comes to financing SMEs providing investors with access to accurate and transparent information is essential. Some best practices were cited including the Banque de France model, which uses detailed loan level data and additional information on SME performance to develop ratings on which investors can rely, and the European Datawarehouse ABS repository[7] which designed to support the loan level data transparency initiative of the ECB.

3) A public speaker suggested that the securitization process should be started in "A league" countries such as Germany or France so that markets become comfortable with a European securitisation label before moving to other countries for which there might be more reluctance such as Italy, Spain or Ireland.

   A second step could be for "A league" country banks that have structured securitization transactions in their home country to securitise loans originated in other countries. This approach would help to build progressively liquidity and scale in the European market which is necessary for attracting investors and could be an alternative to the usual proposal of providing many public guarantees for such products in order to move them into the market.

4) The need to have sufficient diversification of investors was also pointed out by a public speaker.

   Ultimately and both for debt and equity the question is how risks should be managed and transferred across different investors in the economy. Investors need to be sufficiently diversified. They cannot only be from the public or the banking sector. International diversification is also necessary to move towards a wider European scope. There must also be diversification of the investors in each type of securitization tranche i.e. not only senior tranches but also mezzanine and more junior tranches. Appropriate information is also key for achieving this.

Direct financing of SMEs in the capital markets with equity and bond instruments

A regulator believed that there are many other different forms of finance than securitization to be considered including direct financing by the market and investors through bonds or crowdfunding for example. Such tools can support the financing of SMEs and midcaps but also involve some "downsides" that need to be taken into account. First developing such tools means encouraging shadow banking type initiatives which requires an appropriate risk management approach. Another issue is that there are some risks and constraints for the SMEs engaging in such tools. Most SMEs are fairly small and will therefore generate relatively limited issues when going directly to the capital markets. This means that they will have relatively less negotiating power than larger companies and higher costs. Secondly there are placement risks and in some countries such as Germany the gap between issuance and placement has widened. There are also potential risks for investors that need to be considered, the regulator emphasized. SMEs in general tend to have a higher risk profile compared with larger companies with a more diversified business profile. In the past many SME bonds were issued by companies that found it hard to gain credit from their principal bank or other "traditional lenders". There are also re-financing risks (since bond issues have to be refinanced after some time) which may prove to be less flexible than bank financing. The financing of SMEs therefore also affects the topic of investor protection. The question is whether investors have sufficient and reliable information about such bond issues and about the business model and management of the issuer in order to evaluate potential risks and returns which are usually correlated. In this area there is still room for improvement when it comes to transparency and comprehensibility of investment offerings.

A public representative stressed that the access of SMEs to capital markets should be facilitated and that the proportion of financing by the capital markets compared to banks should increase. A mixture of bond and equity tools probably needs to be used but there should be a stronger incentive to finance with equity rather than continuously financing with debt as is the case at present. This would help to improve the equity situation of the SME sector within a few years. Indeed SMEs generally have low equity not because they do not make money the speaker thought, but because it is not attractive to invest money that way. One of the first issues to be tackled is to eliminate the differences in the fiscal treatment of debt and equity since costs can be deducted in the first case whereas this is not possible for equity. Continuing the involvement of the so-called development banks such as the EIB and the KfW is also necessary. They are doing a very good job in mobilizing funds that can be invested in SMEs, possibly matched by funds provided by the government, as is the case in Greece where a 100 billion euro fund has been launched. Moreover the need for public guarantees should be evaluated but this should not be systematic otherwise the taxpayer will be brought in once again.

An industry representative believed that equity markets have a "fantastic potential for growth and job creation" in which exchanges can play a major role. There would be potential for stronger growth if companies were more financed by equity. In addition equity financing

brings more stability in companies which may also have positive systemic impacts. Research conducted in the US and in Scandinavia shows that raising capital on the stock market can be a "tremendous source of growth" for companies. US figures indicate that 92% of the growth of a company usually happens after an Initial Public Offering (IPO). Statistics in Sweden reveal that SMEs listed on the growth market in Stockholm create on average 36% jobs on an annual basis. Hence, a company of 50 employees may grow to almost 240 employees after five years if it goes public.

More however needs to be done the speaker emphasized to provide support for SMEs wishing to raise capital. Two key issues need to be addressed in this regard: liquidity which has moved more to the large companies over the last years and the eco-system surrounding capital markets including research coverage which has consequently deteriorated and diminished reducing the visibility of these companies. Another very important element in this context is the trend on the institutional side towards more investment in the index rather than active investment. This trend may affect the potential of mid-sized companies to raise capital on the stock market because many of them do not reach the indexes and are therefore precluded from institutional capital. There should therefore be incentives to encourage institutional investors and pension funds to engage more in active investment. Active investment can, as research shows, generate good yields over time and yields in some cases higher than index investment.

Some banks have launched "quasi-equity" funds an industry speaker explained, that can help to improve the capacity of leverage of the SME sector, but what is critical is having access to appropriate information about SMEs (e.g. the tax filing of the SME) in order to facilitate credit assessments. Such information should be shared across European countries. Indeed banks cannot afford to make mistakes when lending with an average return on assets of around 1%. If transparency is insufficient banks prefer not to lend in order to avoid the risk.

Corporate bonds are an additional way of providing financing to companies an industry speaker suggested. Bonds are a good way, for mid-sized companies which are not ready to access capital markets on the equity side, to have access to the capital pool that exchanges and capital markets can provide. Listing bonds can give a strong foothold for a company to raise capital for its future growth. The regulatory environment may also be less stringent for listing bonds rather than equity. A well-functioning secondary market for bonds is however needed.

A public speaker stressed that despite recurring calls for developing an equity and debt SME market in Europe there is no such market at present. The SME equity market is limited to venture capital which is still quite marginal in the EU. The challenge in moving from some venture capital investment to more broadly developed listing is the absence of information. Without information investors are unable to evaluate the risks.

An industry player described the role of capital markets in Greece. Studies have evaluated that the need for equity injection for Greek SMEs amounts to 10 to 12 billion euros, 4 to 5 of which are fresh money and the rest a capitalization of existing debt. The most important issue in capital markets, the speaker believed, is offering price mechanisms along with transparency and liquidity. Among the companies listed on the Athens Large Cap Index six are private companies and the remainder are banks or formerly state-owned companies that have been privatized. This figure may seem small but these are companies which grew over the last 20 years from being SMEs into large internationally visible companies, illustrating the role capital markets can play in supporting the growth of such companies. These companies have specific characteristics. First their owners see the benefit of raising capital in the market and are not afraid of a reduction of their shareholding percentage. Secondly they are able to communicate in the professional and standardized way that is expected by the international investment community. The other issue is transparency. With technological evolution giving information to the public is no longer that costly. The problem is the "reputation" or reliability of the information. One action that could easily be taken in this regard is to exclude managers that are also shareholders from voting for external auditors for example. Another issue is to improve the accessibility of Greek firms, which are often small even if they are positioned on attractive segments for foreign investors such as tourism. The creation of a sector of listed funds willing to invest in SMEs and sufficiently visible for foreign investors is a solution to this. A prototype of such funds which could be potentially duplicated, should be created in order to achieve the goals fixed in Greece for equity financing.

A public speaker pointed out that SMEs engaging in the capital markets will however have to accept to act no longer with their gut-feeling but with a structured strategic approach. They will also have to disclose information in a more professional way and be able to convince financiers that they are serious about managing their risks and the uncertainty of their business.

Private equity should also be a good way to complement bank financing, the speaker suggested, with venture capital companies taking a minority stake in companies and following their growth path for a certain number of years.

1. The term 'SMEs" in the remainder of this document covers both small companies with a turnover < 50 million euros and mid-sized companies i.e. midcaps which may have a turnover up to 1 billion euros.
2. Commission Recommendation 2003/361 of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.
3. PEA: Plan d'Epargne en Actions.
4. CLOs are securities backed by a pool of debt, often relatively low rated mid-sized and larger coporate loans.
5. The EC and the EIB made proposals to the Council in June 2013 to set up a joint securitisation instrument for new and possibly existing SME loans potentially combined with a joint guarantee instrument, both involving the use of EIB and structural funds. So far three EU member states (Spain, Portugal and Malta) have committed significant resources including from ESIF to this initiative. Some additional member states are currently considering joining at a later stage.
6. EIOPA was asked by the EU Commission to consider whether the capital requirements for certain long-term investments under Solvency II could be adjusted or reduced without threatening the prudential nature of the regime. Instead of the current 7% capital charge for all AAA-rated securitizations, EIOPA has proposed that the charges for less risky issues (qualified as "Type A" assets) be reduced to 4.3% and charges for more risky issues ("Type B" assets) would start at 12.5% in order to identify less risky securitizations. EIOPA has developed criteria based on the structure of the securitizations, the quality of underlying assets, the underwriting processes and the transparency available for investors. Type A assets are generally consumer-related – such as residential mortgage and auto loans / leases – but also include SME loans. Everything else including CMBS, CDOs/CLOs etc… is in the Type B category. Some observers stress that the criteria should be reviewed as they attach more importance to the volatility of spreads than to the quality (e.g. default rate) of the assets.
7. The European Datawarehouse launched in 2011 provides the means to collect and distribute standardized loan-level ABS performance data.ABS and credit claims are accepted as collateral for Eurosystem credit operations. In June 2012 the ECB extended the pool of eligible collateral to include SME-loan backed ABS with a second best credit rating of at least BBB-. The ABS loan-level initiative establishes specific loan-by-loan information requirements for asset-backed securities (ABSs) accepted as collateral in Eurosystem credit operations. Loan-by-loan information requirements for residential mortgage-backed securities (RMBSs) and ABSs backed by SME loans began on 3 January 2013.

Supporting the financing of long term projects

Objectives of the session

Various initiatives are underway at the E.U. level to propose solutions for completing and diversifying the financing of long-term projects and developing direct capital market financing (ELTIF, evolution of national procurement processes, measures to facilitate the access of investors to information on infrastructure projects…). The possible means to better channel savings toward the right users are also on the political agenda.

The objective of this session was to help to clarify the possible outcomes of these initiatives as well as the priorities that should be pursued taking into account their feasibility and possible impact and possible national specificities.

The issues raised by the current unprecedented deleveraging trend witnessed in the E.U., which negatively impacts the financing of long-term projects were also discussed.

Background of the session prepared by Eurofi

Various political initiatives underway to address the financing challenges face by long-term projects in the E.U.

Enhancing E.U competitiveness in the global context requires that governments and businesses of various sizes access long-term financing. In the context of the financial crisis and the subsequent adjustment of banks' regulations, which affects the ability of the banking sector in Europe, the challenge for E.U. Commission is to find out whether Europe's historical dependence on bank intermediation will give way to a more diversified system with higher shares of capital market financing. An additional challenge is to better channel the savings to the projects. In addition policy makers must ensure that recovering E.U. economies will not be heading credit crunch and will find the necessary financings when needed. This has triggered various political initiatives.

The E.U. Commission's Green Paper on the long-term financing of the European economy, stated that improving the financing of infrastructure projects raises a wide range of issues: the role of public development banks and institutional investors, the impact of bank and insurance regulations and accounting standards, the extent to which European bonds markets could provide funding to infrastructure projects, the requisites for enabling long term savings and the conditions to match both savers and projects sponsors expectations, etc.

In June 2013, the Commission proposed the creation of new investment funds (European Long-Term Investment Funds – ELTIF) for varied investors who want to put money into companies and projects for the long-term.

In May 2013 the Economic and Financial Committee (EFC) set up a High Level Expert Group (HLEG) to further analyse the issues raised. It published a report on December 2013 putting together short and medium term suggestions to develop complementary market tools:

- Certain areas for progress are related to **national procurement processes** in the E.U. e.g. the openness to non bank financing, generalised "value for money analysis" to better compare delivery options, facilitate Public Private Partnership (PPP) and diversify the forms of financings, the definition of a standardised documentation for the PPPs across the E.U., improved project planning, etc. The Expert group insisted also on the necessity to stabilise national regulations to reduce the regulatory risk, which frightens investors.
- Other suggestions concern **harmonising and improving bankruptcy regimes** in diverse areas e.g. out of court settlement arrangements; transparency of national regimes, tenor of the procedures, the consistency across the E.U. of the ranking of claims and claw back periods.
- Various possible initiatives are listed to **improve access for investors to information on infrastructure projects** e.g. E.U minimum data requirements on the previous 10 to 15 years, a pan European data-warehouse tracking the performance of infrastructure projects and providing real-time information on projects planning and procurement phases. A definition of risk assessment standards for infrastructure projects and the improvement of the transparency of risk rating approaches are also suggested.
- The HLEG suggested also passporting infrastructure assets by lifting up regulatory, tax and legislative barriers to cross border investment.
- National and EU authorities are also invited to reform development banks to enable cross border cooperating.

It is time to clarify the targeted financing architecture for the E.U.

Yet the challenge is still to identify at the E.U. level which elements are key to facilitate the involvement of investors through market finance solutions.

In the E.U. it is essential to fight against those national specificities, which trigger unaffordable operational costs, increase the perceived riskiness of infrastructure assets and constitute a dramatic drawback for investors to looking at the E.U. as a single market.

In addition, E.U. policy makers must spot out the **catalysts for an effective take off of both bond and securitisation markets for infrastructure projects**, which are affectively attractive for E.U. and international investors e.g. the existence of liquid secondary markets, the possible liquidity back-stops, the availability of foreign exchange risk hedging-tools, the minimum rating required to make those securities compelling to E.U. and international investors, etc.

In each case public E.U. authorities must clarify the **need for and the form of a public intervention**. In the U.S. the development of the securitisation market has been supported by the GSEs, which are instrumental to ensure the liquidity of the secondary market (Cf. Session 1 of the Athens Eurofi Seminar, and the Eurofi paper "Reviving securitisation in the EU to support SME financing"). Europe must explicitly define its own financial market architecture, clarifying the role of banks and markets, positioning the public entities if required, and anticipating the related costs of the financing.

The **success factors related to the ELTIF** should also be better understood. In that respect E.U. authorities should clarify the relevant behaviours of E.U. households (limited risk appetite, high liquidity expectations, etc. which have been reinforced by the shape of existing financial products) and the possible solutions (Infrastructure bonds and securities benefiting from liquid markets, etc.), which are likely favour the development of the ELTIF.

The Basel Committee for Banking Supervisors as well as the EIOPA, have started a certain **recalibration of some capital charges**, which are critical to better financing infrastructure assets. The fact that the prudential evolutions underway fit to infrastructure projects risk specificities must be carefully checked. According to the insurance industry the capital charges recently adjusted by the EIOPA remain essentially dissuasive. Similarly, the IASB standards expected to take into account business models specificities and avoid short-term bias, are overdue.

Demonstrating that an E.U. infrastructure financial market is likely and that the objectives are ambitious

Lastly the political initiative dedicated to long-term financing must avoid leaving the impression that it is piecemeal. In that respect the **communication of convincing objectives and working streams** is essential e.g. the targeted size of bond and securitisation market, the mechanisms to off load banks' balance sheets in order to possibly preserve their role in certain financings (e.g. green field financing), liquidity arrangements for those markets, the targeted role of public authorities, national and EU initiatives for collecting data, procurement practices, legal frameworks, etc.

In addition E.U. public authorities need to choose which initiatives are critical in order to focus its political impetus.

Such political communication should help to **demonstrate that an E.U. infrastructure financial market is likely, that the objectives are ambitious and proportionate to E.U. needs and that the process is closely monitored**. A specific action plan of the E.U. council is probably required in this perspective.

Last but not least E.U. policy makers have to address the current and unprecedented deleveraging trend witnessed in the E.U., which is also threatening the financings for infrastructure projects which expected to improve E.U. competitiveness in a context where market finance solution will take time to be effective.

Summary of the session

1. Long term financing issues

Matching existing savings with investment needs is the critical issue

The participants on the panel agreed that improving long-term financing in the E.U. is a topic that will stay very **high on the agenda** of the next legislature and will be one of the key priorities of the new Commission.

In that respect many of the panellists stressed that it supposes focusing on two areas, financing SME's and financing the infrastructure related to the need to create **new infrastructures** in line with our Europe 2020 ambitious objectives which are far behind the goals set in 2010 - but also it is crucial to maintain an appropriate **level of maintenance** of existing infrastructures, which is often forgotten. Clearly, they said, policy makers in the E.U. have to focus on **establishing favourable and supportive business environments** - energy, transportation, digital, telecommunication, etc. – These are required to make sure that Europe becomes again an appealing investment destination. Even in many countries that are considered to be successful, including Germany, there exists a tremendous investment-gap.

The panellists also insisted that faced with these investment needs, pension funds and insurance companies and more generally retail investors exist in Europe, that are eager to invest. The issue is therefore that the money that is available does not find its way toward the investments ensuring long-term growth although this is very necessary after a few years' stagnation or even recession in some cases.
Finally infrastructure is in great demand; the average annual global expenditure on infrastructure is circa 3.8% of GDP, i.e. USD 2.4 trillion p.a. and in 2013 the expressed investment needs globally over the next 20 years represent between USD 50 and 70 trillion, while pension funds have only 0.9% of their assets invested in infrastructures and European insurance companies 1%. So there is an enormous potential. To narrow the gap, the panellist generally agreed on the need of having investment vehicles in place. To this end, standardisation such that infrastructure becomes an asset class was viewed as being key.

In addition one panellist reminded the audience that only investing in the long-term would address these financial needs linked to an **ageing population** when it comes to pensions. Indeed infrastructure financing is an asset class made in heaven because it gives you long-term **inflation protected returns, he said**. Another panellist reminded the audience that in the current low interest rate environment, institutional investors and retail investors who save for old age would be grateful for any opportunity to find a reasonable return.

Further investing to enhance European competitiveness in a context of fiscal consolidation

One panellist reminded the audience of the economic context of the debate. He said that the global financial crisis and the sovereign debt crisis in the EU have slowed down economic growth across Europe and hampered the financial intermediation process.

In such a context the panellists agreed on the fact that while **fiscal policies** will serve as an underlying foundation for improving the competitiveness of the E.U., **long-term investment** is required to enter the path toward a sustainable growth, which enhances E.U. competitiveness and triggers job creation.

Yet the panellists said, the E.U. Member States faced with limited public finances, have significantly reduced their investment i.e. education, technology, research and development, transport facilities, as well as telecommunication infrastructure.

One participant on the panel reminded the audience that in many sectors e.g. energy, broadband, telecom, etc. normally **the user of the facilities is he who pays.** But conversely sometimes for motorways, roads or sporting facilities public authorities heavily subsidise the project. A participant stressed in addition that though very scarce, public money is often essential to make projects sustainable. Finally he concluded by stating that positioned at the heart of the current political momentum toward further private financing, the public sector should not deceive itself regarding expected benefits or the real involvement of public money. In particular, they **should state clearly** if their target is to increase the fiscal room for manoeuvre of governments or if it is to introduce a new financing technology. In any case avoiding disappointing situations in that respect requires clarifying the expected value of each project and testing its economic affordability as well as the ability to deliver it, he concluded.

The repair of E.U. banking systems is still limiting the ability to finance economies

One panellist illustrated the impact of financial regulation on the economy, quoting the example of Greece. In Greece, in a context of a six-year recession with a cumulative amount of almost 26-28%, despite an in-depth repair process, the difficulties faced by banks required the intervention of the central bank as a lender of last resort, to face up to the **dramatic reduction** of the amount **of liquidity** available in the banking system. And currently provided that confidence in both the banking system and the economy is improving only progressively, Greece is still in need of the E.U. and international institutions to enhance the financing available to

the economy and especially to the SMEs, though so far their need is mainly - more than 75% - for **working capital. The panellist in particular highlighted the fact that in certain economies the challenge is also that** small and medium enterprises are frequently not bankable.

In a context where the European financial system is basically a bank-based system, under pressure from Basel III to reinforce the balance sheets, the introduction of the banking union, etc. we have seen, said a participant, the European banking system moving ahead to finance again the economy more quickly than probably we could think. This is good news.
But finally a public decision maker stated that the banking system in the E.U. appears less robust than expected despite all the **regulatory measures** that the banking industry has already implemented. And he expressed in particular the fear that the forthcoming **Asset Quality Review** (AQR) may influence further the behaviour of banks that are becoming excessively "prudent" at the expense of long-term economic development.

Hence, he said, the E.U. needs to complement the traditional intermediation process by banks, by alternative financing mechanisms. Indeed, he insisted, when it comes to long-term investments, the European Union is largely dependent on bank financing. However another speaker said that a market-based financial system as in the US is a destination that the European financial system is not going to reach or that will take a long time, and non-bank financing is gaining momentum but has to go hand in hand with the banking sector.

2. The European political answer

To develop long-term financing, the EU institutions have launched numerous initiatives in the course of a year:

- March 2013, the Commission Green Paper, which traces the path to follow for the financing of long-term projects.
- June 2013, the Commission proposes the European Long Term Investment Fund (ELTIF).
- September 2013, the G20 Study Group on Financing for Investment.
- December 2013, the Economic and Financial Committee (EFC) launches the High Level Expert Group.
- March 2014, the Commission's communication drafts the way forward on these long-term projects.

A refocus of E.U. budget priorities

An E.U. policy maker reminded the audience of the fact that the first effort provided by the **Commission** was to further orientate the budget at the EU level toward growth areas. The Commission also published the Green Paper in the spring of 2013, he added, and it has worked during the debates initiated by the High Level Group and is working very closely with the Australian Presidency of the G20.

Repairing the banking system at the national level

The Greek example reminded also the audience that National authorities have been faced with **the issue of closing banks** possibly, as well as with the issues linked to the **recapitalization** by public funds in the case of **systemically** important institutions in order to up grade the banking system that has changed.

E.U. and national development banks are providing counter cyclical support for the economy and the financial system

One participant from the public sector indicated that **public financial institutions** have played a very important counter cyclical role to support investment and long term financing in the E.U. He added however, that though they should not envisage intervening on a permanent basis it is appropriate for them to develop a set of instruments that facilitate their support – in particular those that can help institutional investors to come to these new markets and invest in long-term projects. He concluded by stating that a combination of both public and private interventions is key at a time when there is less public money but still a need for instruments to mitigate risk.

A necessary review of the financial regulatory frameworks

Many participants stressed that the paper of the Commission on long term financing is extremely timely and the six pillars that it encompasses can shape an ambitious agenda for action in particular in the short term, without pre judging what the new political E.U. leaders will come up with. Indeed the communication proposes a range of **regulatory and economic measures**, for the first half of 2014, which give a sign of action already now and open the door to possible evolutions within financial regulations (regarding calibration in particular) and supervision.

A participant from the public sector declared in particular that the Commission is going to take some action in the **banking regulations** provided that banks are fundamental to the European economy and will continue to be core for providing credit. In that respect the **delegated act on the Liquidity Coverage Ratio (LCR) and on the Net Stable Funding** Ratio (NSFR) will focus attention on the possible effects of **calibrations on long term financing**. He stressed however that there the challenge is to find the appropriate balance between the safety of the banking system and sufficient credit provision for the economy.

A specific focus on market finance

At the same time a speaker explained that policy makers at the E.U. level had made it clear that **capital**

market financing has to increase its role in the European economy.

In that respect the Commission will propose within the delegated act for Solvency II a series of incentives to **improve the ability of insurers** to engage in long term financing. However the challenge is not only about the level of capital requirements; it is also about the possibility to access to new and varied areas of asset classes. Consequently certain Member States have changed their regulation on insurance companies to **anticipate Solvency II** and for example allow them to invest in debt funds supporting non-listed companies.

More generally said a representative of the public sector, many things have been already done regarding market finance in the E.U. and we have now to see how it works for long term financing. He explained in particular that MIFiD for example is a big achievement but we have now to pay attention to how this will play out for long term financing. He also stressed that the design of the SME growth market label needs to combine on the one hand simplified rules and the reduced burden to make it attractive to SME's, and on the other hand more information to investors to make this instrument attractive to institutional investors. More work has to be done at the level of implementation to facilitate long term financing he concluded.

Some participants added that the communication of the E.C. also rightly emphasizes other sources of financing for instance crowd funding and private placement and certain Member States have taken certain operational initiatives in that respect (such as tge private placement charter in France).

3. Current concrete achievements and areas for progress

A participant from the public sector addressed one critical question, which is how can we move from an ecosystem that relied very massively on banks to a more diverse financing architecture? He tried to answer on the basis of EIB data and in particular the European PPP Expertise Centre – which show that institutional investors' money is coming into infrastructure: in the European Union, nearly 20% of debt last year was funded by institutional investors - insurance, mutual funds, and pensions – and it is a lot more than it was before. In addition, he said, banks that had withdrawn before are coming back. However he pointed to one thing that is distinctive with institutional investors, which is that they do provide long term and very long term money – Banks are providing money for 20 years and Institutional investors for 30 years (up to 45 years)

Finally he said that what is observed is that the engagement of institutional investors is based on four different models: direct lending - usually big ticket operation; partnering with a bank, sometimes it is the EIB; intermediated through a debt fund; finally a system of credit enhancement, there the EIB EC project bond is clearly the reference.

However he concluded, though an other participant from the public sector explained that in France, in Marseille, a relatively small project - less than two hundred million € – has been financed very successfully with a project bond, by saying that one can observe the presence of only large investors having money to invest in the necessary skills and make informed decisions. So there is a minority of players and finally the money goes essentially to mainly large projects. Finally he suggested that policy makers in the E.U. have not yet stabilised the appropriate financing model and that they have to look at whether there are any additional financing practices emerging. In particular he stressed that in the E.U. we do not know enough to judge whether credit enhancement is essential or not, or if partnering with banks or developping debt funds is better.

4. Involving retail, small and medium investors: the role for European Long-term Investment Funds

One priority acknowledged by all the participants on the panel is to create investment vehicles to pull financing from multiple sources and channel it toward long-term investments in a sound and sustainable manner, bearing in mind that there are two types of investors, institutional investors and retail investors, the needs of whom differ. Indeed involving smaller players is a very important issue to address as among investors exist many second tier players holding altogether a very significant share of the money.

Moreover, they stressed, this money in addition has to be channelled toward smaller projects provided that in particular projects requiring investing more than five hundred million of Euros are not that many in any given year and small and medium public works represent about 70% of total investments.

In that respect many speakers agreed on the fact that appropriately managed ELTIFs - good due diligence, good risk management, etc. - are very important provided that not too many insurance companies in Europe will have the capability to analyze individually these big infrastructure projects. These funds should enable medium sized companies and small companies to invest in this kind of long-term asset. The participants however suggested that European decision makers when defining the ELTIF should also come up with something that is appealing to retail investors and not only to institutional investors.

In addition as we cannot afford any accidents with this new type of investing especially if we make them available to the citizens, a panellist suggested that we should in the E.U. allow the public to have access to those assets only indirectly through professionally managed institutional investors. One participant stressed that indeed in infrastructure projects there is construction risk, legal risk, political risk, etc., which need to be taken into account. Consequently all the participants agreed on the fact that those funds to be convincing and catch on must be of a high quality and reliable, with very reduced loss rates. Policy makers must at any price avoid disappointing investors, since losses after a relatively short period of time would be a catastrophe.

Another speaker highlighted the fact that in particular the potential for mis-selling should be explored and understood by policy makers, and that the information that we are going to give to the different possible investors is very critical. They should in addition make an effort to clearly inform retail investors that a long-term investment - yet not quite as long as for institutional investors - is much longer than parking money in a bank. After a few years' experience we can try to make them available to the public because in particular we have to recognize that we have a major liquidity mismatch issue here.

Finally the solution should not be a one size fits all.

A participant on the panel added that policy makers should also look at the possibility of increasing the attractiveness of those products by offering special tax conditions as the U.S. do when you invest in a bond

that is financing an infrastructure investment, bridges, roads, etc you get tax shields.

5. Creating an asset class

A panellist of the public sector indicated that the E.U. Commission and the G20 are committed to making infrastructure an asset class. He clarified that this has a number of regulatory implications, many horizontal issues among which is the accounting issue, and at the same time this requires transparency regarding the pipeline of projects and the credit issued. However in the short term, the primary need is related to the pipeline itself, as we have not enough projects in the pipeline.

Many participants on the panel expressed their satisfaction and optimism as they expect a huge impact of the new regulations provided that the objective is to take infrastructure as an asset class, because it is really adequate to have a specific treatment, as default rates of infrastructure projects are different from those of SMEs and so forth, one said.

But there are many impediments, another participant warned, and building a specific asset for those assets implies many things. He explained that concretely if an investor looks at an investment in infrastructures he currently needs about 2 weeks and 10 to 15 people for just a fifty million investment. This is absolutely inefficient he said as he can invest the same amount of money in two minutes in any listed corporate bonds.

The need for specific changes in the regulatory framework in the E.U regarding in particular loan transfers among the various European financial institutions, and the discount of these securities at the ECB, were also mentioned. In that respect many areas of progress were proposed e.g. standardizing European procurement processes on the basis of a common template so that common risk transfers standards can be established, eliminating discrepancies between insolvency laws of Member States, changing the current regulatory capital for new ones that reflect the different risk profiles during the project life cycle – e.g. Greenfield vs. Brownfield, the promotion of attractive capital charges for insurers acknowledging the role of these investors in the long term area, insuring the liquidity of those assets…

Finally a participant pointed to the risk of regionalization of the framework: certain E.U. Member States he said, are trying to pre-position themselves in the field of Long-Term Investment Funds, though it is only if we build the framework in a pan European perspective like a UCIT that this market will take off and attract savings from other parts of the world. He concluded by there saying that we should really put standardization and a pan European framework ahead of national interests and that we need to look at those issues taking a global perspective.

6. Differences between financing infrastructures and SMEs

The panel also discussed the different financial instrument required. On the infrastructure side the European Commission has set up some efficient instrument i.e. the project bond initiative. This is the first phase, which is working well as large life insurance and pension funds are entirely capable of buying those products.

Symmetrically one panellist quoted the example of Italy who is trying to create mini bonds to finance small enterprises and launched consequently 20 debt funds worth about 200 billion Euros. However he was of the opinion that these initiatives will not solve the problem of each of the 30,000 SMEs that need financing. In that regard many panellists agreed on the fact that regarding SMEs financing, even in the US through 20,000 community banks, banks traditionally finance SMEs.

In addition one panellist clarified the fact that in the E.U., financing mechanisms for SMEs are quite national in terms of guarantee schemes, and this works pretty well. So he questioned the necessity to transfer these schemes at the European level, unless we are thinking about the securitisation of SME loans in order to generate ECB collateral.

7. Securitization

It is in this context that the E.U. Commission is committed to promote high quality securitization of SME financing. It is expected to allow for better funding not only for smaller and medium sized companies but also for larger companies and other areas of investment. This is undertaken, one panellist from the public sector said, with broad support at the G20 and the Commission is working together with the European Central Bank and international supervisors, to define better how this will succeed.

A panellist from the private sector stressed in that respect that the key issue regarding the development of securitisation, is that banks will play a different role, which is advising investors on credit risk. This requires, he said, working on the differentiation of high quality securitisation products and developing common global standards such as risk retention rules, transparency demands, etc. Furthermore, he said, we have to carry out analyses at both macro and micro levels, to find out the possible impacts of the behaviours of certain participants on other participants on the value chain.

8. Procurement process

The European Union and the Member States should work to standardise procurement procedures said a representative of a development bank. Indeed, he said, the development of alternative sources of financings for infrastructure projects is happening only in a limited

number of countries - UK, France and the Netherlands - and for the rest there is hardly anything.
He explained there that to spread that good practice to more countries, a mental revolution in the public is needed as the procurement process has been built and developed on the basis of a bank relationship. He stated in that respect that institutional investors commit money differently from banks and their pace is different. He concluded by stating that both investors and procurement authorities have to adapt to each other and that is, according to practitioners, a tremendous difficulty to overcome.

9. Leveraging Solvency II

Insurance companies and pension funds have a role to play in long-term investment and growth. Consequently a representative of the public sector stated that Solvency II helps to encourage insurance companies to long term investment, however the current proposal for calibrating the capital charge for such assets is not the optimal and there is clearly not enough granularity given.

However many participants agreed on the fact that Solvency II definitely brings the E.U. to a much better situation regarding the role of insurance and pension funds on long-term investment and growth, than the one we have now with Solvency I, which encompasses in the different countries around Europe a number of **limits** to the investments among which are included infrastructure financings. Indeed Solvency II removes all these limitations and in addition penalises mismatching i.e. demands for more capital whenever the companies do not appropriately match their assets and their liabilities. This brings a huge incentive to match long-term liabilities with long-term assets like infrastructure financings and certain securitizations.

One speaker underlined the fact that regulators are much more comfortable with insurance companies the assets of which are further diversified, going for some part on infrastructure and securitisation and not just concentrating on sovereigns and banks. This diversification makes sense in terms of risk and can help the economy also.
Finally one of the most important elements is that insurance companies and pension funds should make a good assessment of the projects - it is about risk management – and understand that there is some risk in there. With Solvency II the companies will do these analyses.

However, representatives of the private sector stressed, the regulator is rather sticking insurers to corporate bonds the risk of which according to the capital charge looks much more attractive. Securitization is a good example of the state of the art in regulation: there the regulatory capital demanded by Solvency II from the insurance industry is four times the demand of Basel III to banks for the same type of investment, though the two industries are extremely complementary with respect to infrastructure financing.
Of course there is the issue of the calibration of the regulatory framework. For the supervisor the calibration **needs to be done with evidence** so as to align it the best we can to the risks.
A regulator acknowledged that for sure, in certain areas calibration can be improved and be a little bit more granular. However, he said, every time we run away from the principle of alining calibration with risk, we create price distortions and bubbles and eventually a financial crisis; we make a mess out of the markets and someone will have to pay. However regulators cannot provide inappropriate incentives and have to align as much as possible with risk.

Finally he stressed that regarding calibration there are number of misunderstandings, which stem from the fact that in Solvency II, the definition of risk is spread volatility, not the probability of defaults or recovery rates. Consequently regulators cannot improve further the calibration of infrastructure financings, as they do not have sufficient data. He concluded by saying that we should make a common effort, to have a basic database on infrastructure projects out there. He stressed in particular that though everybody has some data, no one has sufficient data in order to achieve good calibrations. This was expressed as a plea for more standardization, transparency, and data on infrastructure projects. The regulator said that someone needs to choose this issue and have a database that would show the cash flow that applies to investors, the different elements of the different projects: having a market, which is much more liquid imposes increasing its transparency.
However another representative of the public sector proposed imagining mechanisms for adapting insurance regulations building on emerging evidence and data on an on-going basis, so as to progressively improve the regulatory framework as we move on. It is indeed important to monitor correctly what would be the impact of the new regime and then fine-tune it building review clauses, which are not too far away.

A panellist reminded the audience that pension funds also have an important contribution to the long term financing as far as it is a level playing field regarding prudential constraints with the insurance sector.

10. The conditions for taking the long-term perspective

More generally certain panellists insisted on the need to help investors to take a long-term perspective regarding their investment.

In that respect they first stressed the issue related to accounting standards – currently the IFRS, which has a very deep negative impact on how long-term projects are assessed and can be financed. One of the panellists reminded the audience that depending on the

accounting standard you apply - IFRS or for example French GAP - the balance sheet of the investor reacts very differently and this impacts the capacity of the financial institution to invest on the long-term perspective and be on a patient strategy.
The panellist expressed the need to better take into account the reality of investor strategy in accounting standards but complained that this is extremely difficult because of the governance structure of the IASB.

Certain panellists said in addition that to encourage other types of savings one may build on the evolution of life insurance in France. There in existing contracts the money is guaranteed yearly but they are trying to develop a system in which redemption value will be guaranteed only after a minimum of eight years. Finally they propose three possible investments: one guaranteeing the money at all times (yearly), another with 100% of risk, a third one guaranteeing the money only after a certain period of time which could allow for less stringent prudential requirements and for a little bit more risk and financial reward, by investing more in new asset classes, shares and so forth and in particular on a longer term perspective.

Other panellists also stressed that mobilising private financial resources on long-term projects and building the appropriate infrastructures, require an effective predictability for those projects. This supposes they said, rightly analysing and monitoring the expected socio-economic value collectively – i.e. the different types of externalities – and guaranteeing accordingly sufficient tax and regulatory predictability. There is room for improvement given for example the challenges witnessed in the international negotiations and the trading market in Europe for carbon prices.

Addressing systemic risks in the asset management sector

Objectives of the session

The objective of this session was to discuss the approach for addressing possible systemic risk issues associated with asset management and whether additional rules may be needed in the EU to mitigate such risks (in addition to UCITS and AIFMD requirements and on-going MMF proposals), in the context of the assessments under way regarding the shadow banking sector and the identification of Non-Bank Non-Insurer (NBNI) SIFIs. The expected impacts for the asset management sector of the recent proposals made by the EU Commission to improve the transparency of securities financing transactions were also discussed.

Background of the session prepared by Eurofi

Retail investment funds are regulated in the EU at the product level (UCITS directive) and funds sold to professional investors at the management company level (AIFMD). These regulations cover many potential risks (such as leverage, liquidity and operational risks). Assessments of the risks posed by the "shadow banking" sector, however, showed that existing fund regulations do not directly address some systemic risks which may be amplified by factors such as the interconnectedness of funds within the financial system and their exposure to run risks. The risks identified concern in particular Money Market Funds (MMF) and securities financing transactions (SFT) such as securities lending and repos used notably by funds. These risks are currently being addressed by regulatory proposals made by the EU Commission (EC). Constant NAV MMFs (CNAV) are the main focus of the MMF proposals, while the SFT proposal aims to improve the reporting and transparency of such transactions.

Broader assessments of the systemic nature of asset management activities and entities have been conducted in the context of the work on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) by international (FSB and IOSCO) and US regulators (Office of Financial Research (OFR) of the US Treasury).

These reports attempt to identify the channels whereby investment funds may transmit risks across the financial system. Connections within the financial system created for example by counterparty or credit exposures and the disruptions to financial markets potentially caused by large liquidations of assets by a fund are the main channels pointed out.

In terms of scope, the FSB consultation clarifies the fact that systemic implications should primarily be assessed at the fund level, where exposures to the financial system are created, but asks whether the focus should be extended to families of funds with similar strategies or to asset managers together with the funds they manage. The OFR focuses more on asset management activities as the starting point for assessing vulnerabilities.

The factors that could potentially make investment funds risky have also been analyzed. Size is considered as a factor of risk in the US OFR report, which questions in particular the potential impact the failure of a major asset management entity may have on the financial system. The FSB proposes to use size as an initial filter (the threshold for investment funds would be set at $ 100 billion in net assets under management) to identify the funds on which to focus further analysis. Further potential risk indicators or filters put forward by these reports include interconnectedness, leverage and complexity, a potential lack of substitutability of certain funds, the cross-border dimension and redemption risks which may lead to first mover advantages. The OFR suggests that "reaching for yield" and herding behaviours are additional risk factors that need to be considered. Another issue the OFR report stresses concerns the gaps in the data on asset management activities (regarding e.g. "separate accounts" managed on behalf of large institutional investors or securities lending and repo transactions) that may impede effective macro-prudential analysis and the oversight of asset management firms and activities.

The EU Parliament Econ Committee recently acknowledged in a report on the recovery and resolution of non-bank institutions that the size and business model of asset managers "do not typically present systemic risk" and that significant safeguards already exist in the EU notably with asset custody rules. The Committee's report states that more work needs to be done on an international basis in this area based upon improved data collection and analysis and calls on the EU Commission to further assess the systemic risks associated with asset managers. Additional assessments are justified, the report stresses, by the growth of "much larger" asset management firms, many of whom are "exploring new business opportunities that could fundamentally change their business models and over time increase their systemic importance". An effective securities law regime is also pointed out as a way by which many of the issues involved in case of failure of a large cross-border asset manager could be mitigated.

A significant number of commentators, including think tanks, academics and policy makers, as well as industry participants have raised points of contention with the analysis of the possible link between asset management and systemic risk put forward in these regulatory initiatives and assessments, that will need to be taken into account in their future steps.

These commentators and asset managers firstly refute that systemic risk resides at the management company

level, arguing that asset managers primarily act as agents. Unlike banks they are not direct participants in the financial markets, they do not act as lenders or counterparties and do not invest on their own account. Market and counterparty risks are borne by the investors in the fund and investment decisions are made at fund level meaning that where potential systemic risks may materialize is at that level.

In addition, they emphasize that risks are not correlated with the size of the assets under management, since larger asset managers tend to manage a more diverse range of funds and to have a more developed risk management function.

Secondly, industry players stress that many of the risks mentioned particularly in the OFR report, are already addressed in the EU by existing fund and derivative frameworks: UCITS and the AIFMD which together cover all funds distributed in the EU and EMIR covering derivatives exposures, due to be completed by legislative proposals regarding MMFs and SFT.

Moreover, some additional issues identified during the financial crisis are being addressed by EU regulators. This is the case for example of Exchange Traded Funds (ETFs) for which specific guidelines were proposed by ESMA in 2012. ETFs are usually structured as UCITS in the EU, but may raise interconnectedness issues with the banking sector which are not directly covered by UCITS rules. The difficulty of tracking asset ownership in the case of re-use and the interconnectedness such practices create are another concern of regulators for which the reporting and transparency rules recently proposed for SFT could be an answer.

Suggestions have also been made that the consistency of regulatory reportings across jurisdictions could be improved in the EU.

Finally, these commentators and industry players generally believe that specific plans for recovery and resolution are unnecessary in the case of asset managers. As assets are held in trust by a custodian (depositary) and segregated (unlike a bank where the depositor has a contractual claim against the bank), investors are assured to get their assets back in case of failure of the asset manager. These rules will be further tightened in the EU with the implementation of the UCITS V and AIFM directives. If an asset manager goes bankrupt the management of the fund where assets are invested can be moved to another management company demonstrating substitutability at the entity level, industry players claim.

Summary of the session

1. Objectives and conditions of the assessment of systemic risk issues associated with asset management

1.1. Context

Investment funds are regulated in the EU at the product level for funds sold to retail investors (UCITS directive) and at the management company level for funds sold to professional investors (AIFMD). These regulations cover many potential risks (such as leverage, liquidity and operational risks). Assessments related to the "shadow banking" initiatives of the FSB and the EU Commission showed that existing fund regulations do not directly address some systemic risks which may be amplified by factors such as the interconnectedness of funds within the financial system and their exposure to run risks[1].

Broader assessments of the possible vulnerabilities that asset management activities might create in the financial system have been conducted by international (FSB and IOSCO) and US regulators (Office of Financial Research (OFR) of the US Treasury) in the context of the work on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs)[2].

1.2. Objectives and conditions of the assessment

Speakers generally agreed that assessing systemic risk issues associated with asset management activities is a "legitimate" objective but several industry speakers stressed that there should be no preconceived ideas in doing so and questioned how designating specific asset management entities as Systemically Important Financial Institutions (SIFIs) or G-SIFIs (Global SIFIs) would help to achieve public policy objectives in terms of reducing systemic risk.

As bank intermediation is expected to shrink with the "re-regulation" of the banking sector, the debate is now moving towards assessing whether the regulation of the shadow banking and asset management sectors needs reviewing in such a context, a speaker emphasized. The market can be thought of as a "two by two matrix". One dimension is shadow banking and the other asset management activities and the second dimension is good and bad (i.e.good=not threatening financial stability and bad=threatening it). Two cells of this matrix are clearly identifiable: there can be some bad shadow banking and there is good asset management. Asset management is indeed the key instrument for allocating savings (which banking is not). What is still unclear is whether there is some "good" shadow banking and whether there is any "bad" asset management.

Several industry speakers expressed their concern with the process underway regarding assessment methodologies for the identification of non-bank non-insurer (NBNI) G-SIFIs[3].

An industry speaker explained that there is some anxiety within the asset management industry about the implications of being designated a G-SIFI. The IOSCO / FSB consultative document starts with identifying a threshold at which it is "almost expected" that a fund will be designated (100 billion $ of assets under management) the speaker thought and there is no idea at present about what that would entail. Seeking to better understand the investment management business and the risk inherent in it is quite legitimate but that is not the question that is being put on the table. The question that is being asked is whether some investment management businesses should be designated as G-SIFIs the speaker stated. Given the level of leverage of the banking industry, which is on average ten times higher than the asset management sector, there are many banks that should be brought into that category before funds or fund managers are "caught".

Another industry participant agreed that a clarification of the implications of being designated a G-SIFI would be a necessary preliminary step to having a "good" discussion. There is a widespread concern that such a designation might lead to imposing a resolution framework or mandating capital requirements that would not be adapted to the asset management sector. Another possible consequence could be additional reporting and supervision but the amount of reporting produced is already very extensive.

A policy maker explained that there are no preconceived ideas in the assessments underway and that risks have to be assessed properly, which means asking "the right questions". Policy-makers "deserve an honest and complete set of answers".

A regulator confirmed that systemic risk issues in the non-bank non-insurer area are being approached in an open way because this is "unchartered territory". There is "no room for dogma or ideology" in such assessments either on the regulatory or on the industry side. The consultation led by IOSCO and the FSB regarding the methodology for the identification of non-bank non-insurer SIFIs is being conducted in the context of the implementation of the G20 commitments. Although there is similar work underway regarding banking and insurance entities the approach for NBNI will be different in order to take into account the specificities of the sector and the current limited availability of data (even if efforts are being made to improve such data). Unlike banks an element of national supervisory judgement is proposed with international consistency ensured through an international oversight group.

What needs to be done an industry speaker stressed is to identify the precise systemic risks that have to

be addressed and analyze solutions across the whole financial ecosystem, before determining if these problems are better solved with a designation or without. Designating specific entities (i.e. funds, firms, etc…) rather than looking at a financial ecosystem as a whole is likely to be ineffective in addressing systemic risk as the end investors and the asset owners will simply move from fund to fund and firm to firm.

A public representative advised regulators to "get to grips" with this issue of systemic risks before the legislative process starts in the EU Parliament because dogma and ideology are sometimes present in the Parliament debates.

An official stressed that there is a misunderstanding of the intentions of the process going on in the United States aiming at identifying stability issues in the asset management sector. The primary objective of this process is not to designate certain firms or funds but to assess where risks might lie in the financial system and then to identify whether or not there is "any reason to think that any particular entity might be the source of threats", either transmitting or amplifying risks (which is not necessarily the case). The misunderstanding probably stems from the status of the Financial Stability Oversight Council (FSOC) which has only one binding authority which is designation. The FSOC has many other tools at its disposal but these are non-binding.

Financial stability is about looking at the entire financial system and not about looking at any particular entity, the speaker stated. That is why it is the activities that are being assessed to understand where risks might lie (such as securities financing transactions including securities lending, the reinvestment of cash collateral…). Regulatory arbitrage is a concern underpinning this evaluation. With the large programme of regulation of the banking sector underway there is a risk that some financial activity could migrate towards less regulated parts of the financial system. That may be appropriate but macro-prudential regulators need to look across the financial system in order to identify where risks might lie, whoever is engaged in those activities, and where financial activity might migrate with financial innovation.

The concern with designation is nevertheless understandable another speaker added, because of the way Dodd Frank and also the IOSCO / FSB documents are framed but Dodd Frank in the speaker's view will probably get "tweaked" eventually with all the active lobbying going on in the US.

2. Main vulnerabilities identified

2.1. Possible areas of focus of financial stability analyses regarding mutual funds and alternative investment funds

The first area of focus mentioned by several regulators is liquidity risks which are present in some asset management activities[4]. Liquidity risks in case of forced liquidation are an issue worth considering, particularly if the fund is highly leveraged a policy maker stressed. The "dynamics" of redemptions also need to be taken into account. Investing in a pool of less liquid assets and promising liquidity and redemption involves liquidity transformation which is more costly and difficult to provide under stress and volatility. Due to their "first-come first-served" redemption policies, even mutual funds which are not levered could be subject to runs, a market expert emphasized. Liquidity risks are present in other activities such as the reinvestment of cash collateral resulting from agency securities lending transactions, a regulator pointed out. This activity is similar to funding a pool of assets using short term repo funding with similar liquidity risks.

Leverage and maturity transformation which are the usual focus of financial stability assessments were pointed out as other points of attention.

For MMFs for example the risk is at the level of the maturity transformation activity, a regulator mentioned.

What is also known, a market expert emphasized, is that some asset management activities are levered but without much maturity mismatch - this is the case of hedge funds -, that there are a few truly big hedge funds and that hedge funds "come in herds". What still needs researching is whether the levered part of the asset management industry can create systemic risks. Some have said that hedge fund failures were completely orderly during the crisis which demonstrated that hedge funds do not create specific difficulties. Others were extremely anxious about the possible failure of some hedge funds during the crisis. Another issue which is well documented is that even without leverage and maturity transformation asset managers may have a herding behaviour. This is not intentional but results from the incentives created by relative performance measurements. As a result, funds tend to invest gradually in the market but may come out "very abruptly", the speaker stated.

An industry speaker explained that regarding the risk of mass redemptions (or "runs") or the consequences of herding behaviour, pricing mechanisms are the right answer. In case of a run, prices might fall substantially before reaching eventually a point of equilibrium. One problem with such price controlling mechanisms is if the price fall is an uncontrolled free fall. There are, in the view of this speaker, however mechanisms to control this such as the ability for stock exchanges to suspend trading or for the board of a fund to bring down a gate if the other mechanisms that exist in the market were to fail. One issue that deserves more attention is unregulated high frequency trading, the speaker believed, because a crisis might be triggered by a highly computer based trading activity happening during the night and out of control. Such a scenario might be worthwhile investigating.

Another industry speaker stated that herding and run risks are very largely the result of the end-client's asset allocation decisions, rather than asset manager investment discretion. They are the consequence of client subscriptions and redemptions. Looking at the fund construct will address run risk concerns and enhance investor protection. Three elements need to be considered: the pricing mechanism and methodology for subscriptions and redemptions, the redemption features of the fund including board powers in the event of an emergency and lastly the underlying portfolio construction rules and the limits put on leverage and liquidity.

Some other "areas of concern" were mentioned by a public speaker. The first area is the risks involved in the credit transfers managed by funds. Funds are now considered to be the biggest source of infrastructure financing in Europe for example and this certainly involves some credit risk. The implications of this type of disintermediation and the related risks need to be better understood. Many politicians do not perceive such mechanisms positively because there is the suspicion that they are designed to try to avoid regulation. A second question when talking about the recovery and resolution of CCPs and clearing members being "part of the CCP" is whether or not asset managers will become general clearing members of CCPs and what that might entail. Securities lending and what happens

if a counterparty goes bankrupt overnight is another major issue: i.e. how can the assets be located and who is responsible for getting them back to their owner. This is a major issue when it happens on a cross-border basis because there are important potential problems of conflicts of insolvency law which have not yet been solved. Therefore saying that client assets are safe and secure in the context of a global securities lending programme is probably "naïve at best". Some solutions are available but will involve much more disclosure in order to make people comfortable going forward with such mechanisms. Segregating all client accounts is a possibility but whether securities can be lent in such a case needs to be clarified as well as what segregation actually means.

Another issue that needs to be examined is whether a fund failure can "ripple through" the financial system in any way through counterparty risk, bank or broker connections or through direct trading links.

2.2. Separate accounts

Separate accounts[5] are a particular area of concern for US regulators in particular. Unlike US 40-Act funds[6] (offered to the general public), in which regulation limits leverage and the share of the portfolio that may be lent, separate accounts have no such limits in the US. There are investment management agreements governing these accounts and potentially limiting risk-taking but if there was a widespread use of leverage and securities lending with reinvested cash collateral in such accounts this might increase system-wide vulnerabilities. Moreover the lack of comprehensive data on the activities of these accounts obscures the understanding of any weaknesses by supervisors.

Regarding separate accounts some demystification seems necessary an industry figure believed. These are "fairly benign" accounts as the end clients tend to be very conservative, typically pension funds and insurance companies, which are themselves subject to comprehensive regulation. 98% of the separate accounts managed by the company the speaker belongs to are long only which means that they invest in cash securities (i.e. bonds and equities) and are not levered. Where there are some issues on which the industry is currently working is with regard to the information that is disclosed to the public on such activities, as it has not been a regulatory requirement so far.

2.3. Data insufficiencies

In addition to separate accounts there is more broadly a lack of adequate data on securities lending and repo transactions regarding both the borrowing and lending sides of the equation a regulator pointed out. The data must also be of sufficient quality using appropriate standards for identifying both entities and instruments. This issue is currently being addressed in the EU with the proposal recently made by the EU Commission regarding Securities Financing Transactions (SFT).

Moreover several speakers underlined the general lack of consistent data beyond separate accounts and SFT transactions.

3. Specificities of the asset management business model

3.1. The agency business model

The specificities of the agency business model used by the asset management industry were stressed.

An industry participant emphasized that asset managers are not the owners of the assets nor are they counterparties to any of the trades including derivative trades. Asset managers do not act as principal. They invest assets as fiduciaries on behalf of their clients following client-specified guidelines and subsequent gains and losses belong to the clients of the fund. It is unlikely that an asset manager will fail in the same way as a bank might. If an asset manager were to fail the resolution process would be much more straightforward because the assets are owned by the clients and kept in custody by a depository.

Another industry participant added that the agency business model makes the investment management business "fundamentally" different from the banking model because 100% of the assets of the underlying investors may be used as a buffer. If losses arise in a fund 100% of the assets of the fund can indeed be used to absorb them unlike the banking model where the money at risk belongs to depositors.

Several regulators speaking on the panel agreed that the sector needs a different analytical framework from activities where participants act as principal and that risks should not be addressed in the same way as for banks in particular. They however doubted whether the agency business model could rule out all vulnerabilities and risks.

3.2. Client-driven nature of asset management activities

The client-driven nature of the asset management business was also emphasized by an industry participant. Asset managers manage products and bring them to the market but the actual flows are driven by clients' decisions in many cases based on the suggestions of their advisors. In the vast majority of cases the clients and / or their consultants decide first what asset class they want to allocate assets to and then look for a manager.

4. Approach for assessing systemic risks

4.1. Level at which systemic risks should be assessed

Assessing financial stability risks requires "looking across the system" and not just at each entity an official stated.

Activities in which asset managers engage (such as securities financing transactions, the reinvestment of cash collateral…) is the appropriate starting point when considering how asset management might generate, transmit or amplify systemic risks. Such a focus will help to understand vulnerabilities in three ways, regardless of where the activities occur and who engages in them: first, to understand the basic economics of the diverse business models among those firms and thus the vulnerabilities that they may present; second, to analyze all the parties to financial transactions for example securities borrowers and lenders and the relationships connecting them, rather than just one part of the system; and finally, to recognize that financial innovation and regulatory arbitrage may cause activity to migrate away from traditional venues towards other potentially less transparent, more vulnerable and possibly more problematic areas. A focus on the chains of transactions and activities therefore enables regulators to assess vulnerabilities that result from the collective behaviour of many market participants even if any single entity involved in the risky activity or any link in the chain might not alone appear to be materially important.

An activities based approach furthermore helps to track the flows of risk across the financial system and does not tilt the scales towards any particular remedy nor does it dictate how and at which level risk should be mitigated. Activities can be aggregated into firms or separated out depending on what makes most sense. In addition an analytical focus on activities helps to better appraise hidden risks to the financial system (such as reinvestment of cash collateral in securities lending and reaching for yield in less liquid asset classes), the official explained, and to target specifically how gaps in the data needed to analyze risks should be filled even in areas like separate accounts.

Several speakers emphasized that risks should be evaluated at the fund level because that is where economic exposures are created and where data is produced. This may be done at the individual fund level or at the aggregate level of several funds.

This does not rule out other options which need to be further assessed, some believed i.e. considering families of funds or a combination of asset managers and the funds they manage.

The level at which decisions regarding funds are made and should be made in the best interests of clients also needs to be analyzed, a regulator stressed. The appropriate level possibly goes beyond families of funds [which is a possible level of assessment suggested in the IOSCO consultation paper] because there could be funds with very different profiles for which the decisions to invest in certain asset classes are made in a pooled way with the assets being allocated later on. This issue could potentially be addressed with an approach of clustering funds and implementing enhanced regulatory approaches for certain types of funds.

The situation where an asset manager belongs to a banking group also needs to be analyzed as the failure of a fund might in such a case have a negative impact on the reputation of the holding company brand.
An industry speaker believed that the management company was generally not an appropriate level for assessing risks. There could be a reputational risk to be considered in case of a fund failure that might provoke further redemptions for other funds managed by the same management company but experience has shown that is not the way it works. Another argument for evaluating risks at the management company level could be that some companies have a consolidated view of risks with a centralised risk management system that may give instructions to sell positions for all the funds managed by the company when a certain limit is passed. In such a case assessing risks at the aggregate level of the different funds concerned might be useful.

4.2. Indicators for assessing possible systemic risk issues associated with asset management

Several indicators for assessing systemic risks were mentioned such as leverage, interconnectedness, substitutability, size, complexity and cross-jurisdictional presence.

Leverage together with inter-connectedness are probably the most important indicators for the asset management sector

Several speakers suggested that leverage is the most important indicator for evaluating systemic risks in the asset management sector, possibly together with interconnectedness. The latter also takes into account counterparty exposure risks as well as intra-financial system liabilities a regulator explained.

There are two types of leverage: borrowing money to increase assets and the leverage implicit in derivative exposures.

Excessive derivative exposures leading to forced liquidations is what happened to the hedge fund managed by LTCM (Long Term Capital Management) which collapsed in 1998 and had to be bailed out. It had a relatively low level of assets under management but was extremely highly leveraged with more than 1 trillion dollars in gross notional exposure (corresponding to 25 times the clients' assets).

However, these exposures were unsecured which is inconceivable in today's markets an industry speaker pointed out. In addition leverage is closely controlled by EU asset management regulation. Leverage through the use of derivatives is strictly limited and monitored for UCITS funds[7] and AIFMD rules already impose regular reporting to regulators on the extent of leverage and rules for each manager to set "reasonable" leverage limits in respect to the AIF it manages with the

possibility for home regulators to impose their own limits. EU regulators therefore have the appropriate tools to monitor the leverage of investment funds and intervene if needed. Depositories may also play a role in supporting this monitoring. In addition the investor prospectus includes information on the investment and risk policies of the fund and on the level of leverage and its method of calculation. Investors indeed have to be aware of the risks that they face. Lenders should also understand the extent of their exposure but this is a more a banking regulation matter than an investment fund issue a speaker thought.

The relevance of size as a key indicator of risk is disputed

The FSB proposes to use size as an initial filter (with a threshold set at $ 100 billion in net assets under management)[8] to identify the funds on which to focus further analysis regarding systemic risks.

An industry participant stated that there is no correlation between risk and size for investment funds. Large asset managers tend to have very diversified businesses and not to be concentrated in any particular asset class which actually helps to reduce risks. What does create risks is leverage. Some smaller very levered funds can be very risky whereas this is not the case for much larger index funds. A parallel was made with OTC derivatives. If the choice had been made to regulate the two or three main players differently from the rest of the marketplace – which is not the case either in Europe or in the US - there might have been two possible outcomes. Either these players would have been perceived as stronger, more desirable and would have ended up concentrating most of the business in the market or on the contrary these players could have been considered weaker and would have lost much of their business which then would have moved to the three or four smaller players further down the list. The same is true for Money Market Funds (MMFs). The solutions that are being worked out in Europe and the US should apply to all MMFs and not only to the largest ones because that would lead to concentration risk or to the elimination of that business.

Although it is difficult to say that the biggest funds are necessarily the riskiest ones, size should be taken into account in the assessment, a regulator however believed.

A policy-maker nevertheless suggested that the size threshold of $ 100 billion of assets under management proposed by the FSB does not seem appropriate. There might not be one single European fund concerned in such a case (and at present only 14 funds in the world are above this threshold according to another speaker). In recent years the largest systemic shock was caused in 2008 by the Reserve Primary fund that only had $ 60 billion of assets under management. Looking at leverage and derivative exposures seems much more sensible. The alternative threshold proposed by the FSB set at a value between $ 400 – 600 billion in gross notional exposure for hedge funds seems to make sense the speaker believed. This would cover five to ten funds in the EU and would have covered LTCM. Interconnection is also a valid criterion when looking at derivative exposures. The redemption policy, the type of fund (i.e. open or closed) and the liquidity of the assets the fund invests in also need to be considered.

An industry participant mentioned that the size of the fund probably plays a role in liquidity risks but this is not the primary factor to be considered. A combination of the two criteria of leverage and size of a fund could possibly be a good idea for evaluating risks.

Substitutability usually considered to be possible for investment funds may need to be further assessed in some specific situations

Substitutability is usually "very high" in the investment management sector, an industry participant stated, compared to other activities such as custody, for which transferring activities to another custodian in case of failure would be much more complex and lengthy given the need to replicate all the systems and controls. Statistics collected by ICI Global (Investment Company Institute), a trade association, show that during the last decade up to 2012, 4500 funds merged or ceased operating and that nearly 500 managers withdrew from the market with no significant impact on the market and no call on taxpayer money.

The resolution of an asset manager is "a fairly straightforward exercise" another industry representative argued. A major element that needs to be taken into account is that asset managers are not subject to short-term funding. When financial institutions have got into trouble in the past it has mostly been because of exposures to short term funding and the inability to roll-over paper, forcing asset sales. But asset managers do not operate in such a way. No assets are put in inventory on asset managers' balance sheets and creditors of the management company have no claim on the separate account or mutual fund assets that are managed by the company. Separate account clients can also take their assets away very quickly and already do so on a regular basis because they own the assets and have their own custody capacity. Such funds have an independent board which has the ability to change the management company.

A regulator agreed that substitutability is usually considered to be possible in the asset management sector, but further assessment might be needed in certain specific cases e.g. depending on the market share of the fund in terms of the turnover of certain assets or when particular investment strategies are used.

A policy maker added that given the high level of concentration of the sector, substitution might not always

be possible without market disruption and run risks. In addition big asset managers often explain that their expertise is irreplaceable, according to the policy maker. This could mean that it might not always be possible for another asset manager to easily step in and take over the complex operations involved in the management of the fund if the manager fails.

A regulator added that substitution works in normal market conditions but is not guaranteed to work in stressed conditions or if a run has started. During the crisis issues with MMFs were addressed partly with the imposition of mechanisms such as gates and pockets.

Other indicators may also be considered

The complexity and cross-jurisdictional nature of the activity are other factors that need to be taken into account when assessing risks.

Complexity involves looking for example at the re-hypothecation of collateral, high-frequency trading, liquidity risks and unencumbered cash holdings to meet collateral calls a regulator explained. In addition the evolutions that are due to take place in the OTC derivatives area also need to be considered as they may have an impact on securities lending and repo in particular.
Cross-jurisdictional presence means evaluating the investments made, the marketing activities conducted as well as the presence of counterparties in different jurisdictions.

5. Scope covered by existing EU regulations and areas that may require further regulations or rules

5.1. Existing EU asset management regulations already cover a large range of risks

A regulator stressed that much has already been done in the EU to mitigate risks in the asset management sector with the UCITS directive, which has been recently reviewed (UCITS V) and the Alternative Investment Fund Manager Directive (AIFMD) covering the asset management companies managing non-UCITS funds. European fund rules are already very detailed covering all types of funds managed in the EU and the risks that may materialise both at the fund and management company levels. These regulations cover many potential risks (such as leverage, liquidity and operational risks). They will be completed by ESMA's role in assessing and monitoring systemic risks and vulnerabilities (e.g. with regard to the leverage of funds following the implementation of the AIFMD) which is expected to develop.

The UCITS rules applying to depositories that are in charge of overseeing funds and asset managers' decisions and safekeeping fund assets have also been reviewed in a detailed and coherent way in the context of UCITS V and the liability regime has been completed in particular with asset restitution rules[9]. The role of depositories has also been extended to alternative funds with the AIFMD.

An industry participant stated that the completion of the rules pertaining to depositories is a "very big step forward" in protecting investors. Depositories indeed play a role in risk prevention through their oversight function, as they are in charge of controlling the way asset managers operate. If the depository considers that the asset manager is not in a position to effect its role this has to be reported back to the regulator and in some cases this might require transferring the management of the fund or liquidating it. Many depositories are also regulated as Global SIFIs which adds to the protection provided. Depositories as securities services providers also put in place recovery and resolution plans (RRP) which are updated on a yearly basis. The objective of such RRP is notably to be able to transfer the business of the depository to another institution if necessary. This type of transfer however takes much more time than transferring pure fund management business.

5.2. Proposals made in the EU to complete the regulation of SFTs and MMFs

Proposals to regulate the transparency and reporting of Securities Financing Transactions (SFT)

Measures to increase the transparency of securities lending and repo transactions and to impose some conditions on the re-use of collateral have recently been proposed by the EU Commission.

Industry participants on the panel were generally supportive of these proposals.

An industry participant explained that SFT are a critical tool for the financial industry and the real economy. Having a deep and liquid repo market is essential for supporting a primary issuance market and for providing price transparency. SFT are equally important for investment and liquidity management and as a transmission mechanism of monetary policy. Moreover, collateral [which is increasingly used in the financial system in particular for securing OTC derivatives and bank funding transactions] is becoming "the new cash" the speaker stressed. There have been concerns about whether the supply of collateral would be sufficient in the future to cover the increasing demand for collateral. Increasing the availability of collateral e.g. with loan securitisation and broadening the eligibility of high quality assets is being considered, but such increases in supply could possibly be offset by Quantitative Easing (QE) actions for example. The speaker however believed that the discussion on the aggregate supply and demand for collateral was "somewhat misplaced" and that there should be a greater focus on collateral fluidity which is essential for connecting the aggregate supply and demand. Having the proper plumbing is also very important. This requires having the right market infrastructure with triparty interoperability in T2S and a uniform settlement framework across the EU.

Transparency and the proper reporting of SFT transactions are crucial in order to instil investor confidence as well as the confidence of regulators. Better information and reporting is also needed regarding collateral, maturity and liquidity transformation. The cost of this added transparency compared to the benefits gained however needs to be evaluated the industry speaker emphasized. The information that is needed and the reasons for collecting it should also be specified as well as the way to create a scalable, cost effective, cross-border and centrally managed and supervised framework for delivering greater transparency. The data that needs to be collected and reported to trade repositories also still needs to be agreed upon.

The measures suggested by the EU Commission in its recent SFT proposal "all seem very sensible" and should promote greater confidence in the market and should support collateral fluidity the industry speaker believed.

One issue that may need more attention is better defining asset re-use and rehypothecation, which are terms often used interchangeably but that actually have quite different legal underpinnings. Rehypothecation relates to the discretionary right that a pledgeor can give to a pledgee to re-use the collateral[10]. Whereas re-use actually provides legal title of transfer from seller to buyer[11]. Aligning the legal underpinnings of the contract with a disclosure and a better marketing of those risks to the end-investors and regulators is essential.

Another industry speaker emphasized the importance of collateral being transferred under transfer of ownership because that is the only way to ensure the safety of the ownership of the assets and then to allow that these assets may be re-used or rehypothecated.

Proposals regarding the regulation of MMFs are under review

One of the next steps from a regulatory perspective is to move forward with the proposal made by the EU Commission to complete the regulation of MMFs, a regulator mentioned, in order to address the risks that such funds may pose to financial stability. MMFs indeed face run risks and also provide some investors with a first mover advantage. One of the solutions being considered both in the EU and in the US is the possible move from a Constant NAV (CNAV) to a Variable NAV (VNAV) system for MMFs. This is however quite a sensitive topic since MMFs are important instruments for the short term cycle of the economy.

5.3. Areas that may require further regulation or rules

Several areas where risks that may affect funds and their clients remain to be addressed were pinpointed by the speakers on the panel.

Improving and harmonising data collection and reporting

Improving and harmonising data requirements and data collection is a key objective, an official stressed. This needs to be done both at an EU and at a global level.

Regarding reporting requirements an industry speaker stressed that gathering data is not sufficient, data requirements need to be defined consistently across regions in such a way that data can be transformed into information that can be compared, aggregated and analyzed globally so that it is more useful for regulators and that appropriate decisions can be made going forward. There are four areas that could benefit from improvement: (i) private funds for which there are several different and overlapping reportings at the international level; (ii) swap data for which there should be some regulation to force consistent reporting of data to the different swap data repositories; (iii) threshold reporting which is reported in many different ways to many different entities; (iv) and securities lending which is a new area for which common standards could be set from the start.

Separate accounts are another issue but the problem is that regulators do not have enough information about these funds. Knowing at all times where the assets are is extremely important also for such funds. In this perspective having data standards that may enable one to understand the flows of assets not only through the plumbing but also through the whole chain from ultimate lender to ultimate user would be very useful a regulator stressed.

An official strongly agreed with the objective of improving data harmonisation and transparency and creating meaningful information rather than data. In this perspective work is being launched in the US for example to clean up the swap repository data.

EU level securities law and insolvency rules

Another area that needs to be examined a public representative stressed is securities law and how to determine and follow-up the ownership of securities on a cross-border basis with the development of SFT in particular. This is a particularly complex area because it involves legal systems and property laws that differ across the EU.

Another important objective is the harmonisation of insolvency rules within the EU, a regulator added, in the context of the implementation of recovery and resolution mechanisms. Progress is however difficult as such laws are deeply connected to corporate law and have a strong cultural dimension.

A conceptual framework for assessing market finance risks

A market observer suggested that what is missing is a specific conceptual model for categorising risks in the capital markets and asset management areas similar to the type of framework that exists in the banking sector (where measures are mapped out as addressing problems of excessive leverage, interconnectedness, opacity, maturity mismatch and too big to fail). Such a mapping does not exist in the market finance area and may be completely different from the banking framework, which means that regulators end up with shopping lists. When a new problem arises then a new measure is added to the list. This is fine in the short-run, politically at least, but is not the right approach for the longer run and for ensuring the welfare of citizens the speaker believed.

A regulator however emphasized the diversity of activities and issues that can be found in securities markets such as credit rating agencies, hedge funds, mutual funds... Capturing such a diversity of issues in a single framework might be very difficult.

Other issues affecting the asset management sector and its regulation

Several topics impacting the asset management sector and for which there might be a need for further assessment and possible regulatory interventions were mentioned by some speakers on the panel.

Exchange Traded Funds (ETFs) are an area that is subject to many myths and that needs to be further assessed a speaker suggested. Proposals have been made by the industry recommending notably improvements in disclosure and standardisation.

Liquidity in fixed income markets and particularly the corporate bond market is another important issue for which proposals to encourage more standardisation have recently been made.

CCPs are also an important area for asset managers. They are in some people's minds too big to fail. The solutions regarding recovery versus resolution need to be further assessed for such infrastructures.

Regarding the safekeeping of assets, correcting some loopholes in AIFMD seems necessary a speaker pointed out. For example one loophole which has actually been corrected in UCITS V and would need to be amended in the same way in the AIFMD, is the fact that when securities are safekept by an investor CSD, UCITS V considers this as a delegation whereas in the AIFMD assets are considered not to be protected. Another area where there are regulatory developments is the IORP proposal which suggests having a depository framework for personal pensions which means that there would be the same level of transparency and monitoring for these kinds of funds.

6. The role of securities market regulators in mitigating systemic risks and ensuring stability

A regulator stressed that stability issues are fairly new to securities market regulators - unlike banking regulators. These issues have been added to their mandates as part of the response to the financial crisis.

Work on financial stability issues in the capital markets sector was initiated in the EU with the UCITS IV package a regulator added. Many safeguards have been built into the UCITS legislation in terms of obligations for risk management structures, stress testing on the liquidity of portfolios, ability of funds to honour their commitments particularly in terms of redemptions. Stability has also been a strong focus of recent market-related legislative processes such as AIFMD, OTC derivatives, short selling and credit rating agencies. Securities regulators are also concerned by the possible loss of confidence in the market that would follow the failure of a large asset manager and the reputational risks that could impact other segments of the industry.

One of the issues that regulators are facing however in securities and derivative markets is the limited data

that is available, but additional regulatory requirements are being proposed to complete the data regulators are provided with.

Another speaker nevertheless believed that securities regulators are not all focused on financial stability issues to the same extent. Although some bodies such as IOSCO and ESMA have been able to lead a change in this perspective, UK and US market regulators seem to be less focused on financial stability issues the speaker thought. This is partly because of the way their mandate is framed which is centred more on market integrity and efficiency. A solution for the US could be to broaden the powers of the FSOC so that it can make binding recommendations to all the micro-regulators on the supervision and regulation of activities and markets that are materially threatening stability. In the UK the financial policy committee of the Bank of England can already make binding recommendations to the FCA on activities and market regulation.

A regulator disagreed about the lack of focus of securities regulators on financial stability issues. What has happened in some countries is that prudential stability questions have moved to another authority as has been the case in the UK where the role in derivatives for example was transferred from the FCA to the Bank of England because of the stability and prudential perspective.

1. The FSB identifies in the policy framework for "strengthening oversight and regulation of shadow banking entities" published in August 2013 several types of collective investment vehicles other than MMFs exposed to shadow banking risk factors (e.g. maturity / liquidity transformation and liquidity) and run risks including credit investment funds, ETFs, credit hedge funds and private equity funds. Different policy toolkits are proposed including tools to manage redemption pressures, tools to manage liquidity risks, limits on leverage, restrictions on the maturity of portfolio assets.
2. The FSB published for consultation in January 2014 assessment methodologies for identifying NBNI G-SIFIs. A process of identification of non-bank SIFIs has also been launched in the US steered by the Financial Stability Oversight Council (FSOC). A report was released for consultation in September 2013 by the US Treasury's Office of Financial Research (OFR) detailing the possible vulnerabilities that the asset management industry could create in the financial system.
3. Consultative document of FSB / IOSCO on "Assessment methodologies for identifying non-bank non-insurer G-SIFIs" – 8 January 2014.
4. Liquidity transformation entails using cash-like liabilities to buy harder-to-sell assets such as loans. Maturity transformation which is a concept close to liquidity transformation involves obtaining short-term funds to invest in longer-term assets.
5. Separate accounts are portfolios of securities directly owned by the investor and managed according to a specific discipline and/or style by a professional investment manager. They are similar to mutual funds in that the investment manager develops a model portfolio specializing in a particular aspect of the market (such as large-cap, growth, small-cap or value) and purchases or sells securities in an effort to generate positive returns. Account owners have the ability to customize their accounts by excluding certain securities or industries, or employing tax-advantaged strategies. Many separate account programmes also offer the feature of including mutual funds within the separately managed account to further customize an investor's portfolio. A key difference between mutual funds and separate accounts is that, in a separate account, the money manager is purchasing the securities in the portfolio on behalf of the investor, not on behalf of the fund.
6. The Investment Company Act Of 1940 is a legislation which defines the responsibilities and limitations placed on open-end mutual funds, unit investment trusts and closed-end funds that offer investment products to the public
7. UCITS funds have set restrictions on leverage. Managers have the ability through the use of derivatives to increase the leverage of a UCITS fund up to a total market exposure of 200% of the UCITS fund's net asset value. Greater risk management obligations apply in such a case.
8. The FSB proposes in its consultation on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) to use size as an initial filter (with a threshold set at $ 100 billion in net assets under management) to identify the funds on which to focus further analysis. In the case of hedge funds an alternative threshold is proposed to be set at a value between $ 400 – 600 billion in gross notional exposure.
9. The depository is liable to the UCITS and its unit holders for the loss of financial instruments held in custody unless the depositary can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequences of which would have been unavoidable despite all reasonable efforts to the contrary. This liability implies an obligation of restitution of the assets held in custody by the depositary and without undue delay in the event of loss.
10. A pledgee who is given a right of rehypothecation can exercise his right and dispose of the collateral by means of sale or repo. In practice rights of rehypothecation are typically given by hedge funds to prime brokers on assets in the fund's segregated custody account, where they will be subject to a pledge in favour of the prime broker.
11. The EBA has stated that 'Re-hypothecation refers to the right of financial intermediaries to sell, pledge, invest or perform transactions with client assets they hold; and it allows prime brokers and other financial intermediaries to obtain funding using their client collateral… Collateral re-use usually covers a broader context, where securities delivered in one transaction are used to collateralise another transaction, including the ability to reuse collateral through change in (temporary) ownership".

Financial market infrastructure reforms

Objectives of the session

The objective of the session was to discuss the latest developments regarding the on-going reforms impacting European securities and derivatives financial market infrastructures (FMIs): Central Counterparties (CCPs), Central Securities Depositories (CSDs) and Trade Repositories (TRs).

The discussion more specifically covered the evolutions expected in the EU post-trading market following the adoption of the CSD Regulation (CSDR) and the implementation of TARGET2-Securities (T2S), the key challenges to be addressed in the definition of the technical standards and delegated acts for the CSDR, the key issues in designing an EU recovery and resolution framework for FMIs, as well as the first results of the mandatory reporting of derivative trades to TRs launched in February 2014.

Background of the session prepared by Eurofi

Significant evolutions are expected in the post-trading market with the implementation of the CSDR and T2S

A political agreement was reached on the Central Securities Depository Regulation (CSDR) at the end of 2013. The text is now scheduled to be considered in the plenary session of the Parliament mid-April 2014. The agreed regulation defines the role of the CSDs operating in the EU and provides harmonised settlement rules. A compromise was found for some contentious elements including the conditions under which banking services ancillary to settlement may be provided by a CSD and settlement discipline measures.

The CSDR level II standards and the delegated acts are due to be defined by the end of 2014 so that the regulation may be implemented in 2015. Challenging issues include the definition of appropriate settlement discipline standards and the timing of the implementation of these standards with respect to the schedule of TARGET2-Securities (T2S).

The adoption of unified settlement rules with the CSDR should facilitate the implementation of T2S programmed between June 2015 and February 2017. For T2S the current challenge is to maximize the volumes on the platform and to expand coverage of instruments / markets. The main issue for market participants in the short term is determining how they will connect to T2S either directly or indirectly, for which markets and at what pace.

The implementation of T2S is expected to transform the environment of CSDs and custodians. Competition is anticipated to increase between custodian banks on a cross-border and regional basis. There has also been discussion about the expansion of competition between CSDs and custodian banks. At this stage, one global custodian has launched a CSD. The main focus of regional / global custodians so far is on enhancing their T2S coverage and offering and on separating settlement services and asset servicing. Some CSDs are pursuing projects to diversify the services they provide in the custody area, in the perspective of the upcoming outsourcing of their settlement services to T2S.

The final outcome of these evolutions is difficult to anticipate. Despite the positive effects greater competition might provide, some observers are concerned that such changes may trigger more fragmentation among service providers in the short term and potentially blur the delineation between Financial Market Infrastructures (FMIs) and intermediaries and the scope of application of regulations. Others stress that the CSDR and T2S might not provide sufficient harmonization of rules. Asset servicing areas will continue to be highly fragmented on a national basis in particular. Several initiatives have however been launched to address the issues related to corporate actions. The need for a common framework for securities (the project of an EU Securities Law Legislation) in order to tackle notably conflicts of law is also often cited in this context, but there are no proposals officially tabled so far.

Defining an appropriate recovery and resolution (R&R) framework for FMIs is the main forthcoming challenge following the implementation of EMIR and the CSDR

CCPs will concentrate a large part of the risks related to derivatives transactions with the implementation of the clearing obligations of EMIR by the end of 2014. This will provide many benefits for the market, but also increase the risk of CCPs. EMIR which already requires many risk mitigation measures is therefore due to be completed by a R&R framework providing additional crisis prevention and management tools in order to address cases where the "ordinary" recovery tools required in EMIR have failed.

Following a consultation paper published in 2012 by the EU Commission (EC) on the R&R of non-banks and proposals made at the global level by CPSS-IOSCO, the EC is expected to publish a proposal for CCPs by the end of 2014. The EU Parliament also adopted a self-initiative report about the R&R of non-banks at the end of 2013.

Several questions remain to be solved regarding CCP R&R: (i) the objective of such a framework and the extent to which the continuity of services should be ensured; (ii) how to allocate losses between defaulting, non defaulting members and potentially their customers ; (iii) how to take into account the interdependence between a CCP and its clearing members many of which are likely to be GSIFIs; (iv) the appropriate toolbox for allocating losses and the way to address different asset classes / market segments within a CCP.

Other issues include: (i) the delineation between R&R procedures and ordinary risk management processes as well as between recovery and resolution phases, (ii) the

organization and the role of the resolution authorities and (iii) the way to handle the R&R of a cross-border CCP.

Although CCPs are considered to be the priority, the EU R&R framework is expected to also cover (I)CSDs, possibly in a second stage, due to their critical role in the functioning of EU financial markets.

Such a framework should complement the CSDR provisions and take into account the specificities of CSDs and ICSDs. CSDs do not have default waterfalls at present, as they are currently not exposed to credit risk. Several R&R tools including cash calls, margin haircuts and loss allocation mechanisms, cited in the context of CCPs are thought not to be applicable to CSDs, as they may create incentives for CSD participants to become indirect. The specificities of (I)CSDs operating with a banking license and exposed to credit risk will also need to be further assessed. Such FMIs however stress that the banking activities they perform are limited in their scope, comprising mainly custody services and fully collateralized intra-day credit operations. Some observers however suggest that distinctions should be made in the R&R framework and possibly capital requirements between core CSD services and ancillary banking services.

The reporting of data on derivatives transactions to Trade Repositories (TRs) launched in February 2014 needs to be closely monitored

The mandatory reporting in the EU of all on and off-exchange derivative trades to a TR by all counterparties in a derivative contract, as well as by the CCP used, started on 12 February 2014. This reporting is meant to enable regulators to identify and analyse potential risks associated with derivative markets. Six TRs have so far been registered in the EU.

Several issues will need to be closely monitored. The fragmentation of TRs and the reconciliation and aggregation complexity this may lead to is the main issue stressed. The FSB is currently evaluating different models for aggregating such data. ESMA is also assessing ways to reconcile the data that will be reported in the EU by both counterparties involved in each trade. The on-going implementation of a system of Legal Entity Identifiers (LEI) should also help to identify the participants in trades. The magnitude of volumes that will be reported and the potential difficulty in keeping track of all the data has also been stressed. Other issues include the fact that rules have not yet been clearly defined for on-exchange products, the alignment of EMIR and MiFIR reportings and the differences between EMIR and Dodd Frank reporting requirements.

Summary of the session

Overview of Financial Market Infrastructure (FMI) reforms in the EU

The importance of "well functioning and well designed" Financial Market Infrastructures (FMIs) for the efficiency of capital allocation across the EU single market and for moving towards more market-intermediated financing was stressed.

A regulator gave an overview of the on-going FMI reforms aiming to achieve this objective.

There is a three-step approach to reduce the fragmentation of the EU post-trade landscape and remove national barriers, completing EMIR clearing and MiFID trading requirements. Firstly with TARGET2-Securities (T2S) the Eurosystem will provide an integrated market infrastructure for the settlement of securities in central bank money and trigger an evolution towards a single set of rules, standards and tariffs for all settlement transactions across the Eurozone and for those non-Euro EU markets that would decide to join T2S. Secondly T2S will drive further harmonization and the establishment of common standards in many other areas of post-trading including corporate actions, account numbering and settlement finality. Thirdly the forthcoming CSD Regulation (CSDR) will implement a common regulatory framework for EU CSDs, helping to foster competition between CSDs by streamlining licensing regimes and supervisory rules across the EU and enhancing the legal and operational conditions for cross-border settlements in the EU. The CSDR will also include harmonization provisions such as measures shortening the standard settlement cycle to T+2 and rules aimed at creating a harmonized settlement discipline regime (to address settlement fails) across the EU.

The "game-changing nature" of T2S was emphasized by the regulator. T2S[1] will lead to a radical evolution of the positioning of the 40 or so CSDs in the EU and of the services they provide. The outsourcing of settlement to T2S will create greater efficiency by suppressing duplicate CSD infrastructures using different rules. This may lead to the merger of some CSDs or the creation of new CSDs. Furthermore T2S, by providing the basic settlement services, will enable participating CSDs to focus on value-added services. In addition to providing notary services CSDs will be able to develop an investor CSD business meaning that in addition to custody and settlement services mainly for domestic securities (the so-called issuer CSD function), CSDs will be able to offer settlement services for securities issued in other CSDs as well as improved collateral management services. T2S will also make it easier normally for CSD participants to move business from one CSD to another depending on their level of cost-efficiency and service. This might however, as a result, blur the delineation between CSDs and custodians, the regulator believed.

Additional actions are being conducted by the Eurosystem to improve the functioning of the repo market and of collateral management. The Eurosystem intends in particular to make assets more easily available when and where they are needed by an auto-collateralisation functionality in T2S and initiatives to establish the interoperability of collateral management services.

An industry player stressed that the different pieces of EU legislation concerning FMIs (MiFID II / MiFIR, EMIR, CSDR, SFT regulation…) have several common themes. They push financial market activity to central infrastructures such as trading venues, stock exchanges, CCPs, CSDs and Trade Repositories (TRs), considering that such infrastructures are safer and create a possibility for greater transparency. These different pieces of legislation also mandate competition between infrastructure providers following the decision by EU legislators not to impose a single monopoly provider. In addition they mandate the use of collateral as the main risk mitigation tool.

These different pieces of legislation put together create several challenges, the industry speaker explained. The first challenge is related to competition and how to ensure fair competition and a level playing field and to avoid prohibitive barriers to entry. In this regard T2S and the related work conducted on the harmonisation of rules are major positive steps forward but much work still remains to be accomplished. A second challenge is recovery and resolution (R&R) of FMIs which is becoming more and more relevant with the move towards increased competition and higher concentration of activity within FMIs. At the same time competition may bring part of the solution by fostering the creation of alternative providers. R&R obligations should however be designed to ensure that they do not function as additional barriers to entry. A third challenge relates to the role of intermediaries which is not well taken into account in the current wave of regulation as they are usually viewed by regulators as less "legitimate" than FMIs, the speaker thought. Various restrictions and obligations are being imposed on them in different regulatory initiatives, such as the revision of the shareholder rights directive which may well impose obligations on intermediaries without creating the preconditions that would allow them to fulfill those obligations and the proposal for an EU Financial Transaction Tax (FTT). Intermediaries should however not be considered as a part of the problem but rather as part of the solution, the industry player emphasized. Intermediaries indeed play a key role in the market which needs to be preserved, providing access to market infrastructures for market participants (both issuers and providers). A fourth challenge pertains to collateral which has become critical to the functioning of financial markets. Regulations concerning market infrastructures and their participants need to facilitate the transfer and use of collateral.

There must also be the right degree of transparency on the use of collateral and Securities Financing Transactions (SFT). The recent proposal of the EU Commission on SFT has many good points but raises the question as to whether the model used by EMIR to gain transparency on OTC derivatives is the right one for SFT.

Another industry player pointed out that the level of competition is already very high within the asset servicing industry. Moreover there was an agreement that intermediaries should not be considered as substitutes for CSDs or other market infrastructures and that regulations should appropriately take into account the role of intermediaries in order to avoid blurring the boundaries between intermediaries and infrastructures.

A public representative stressed that the objectives of the EU Parliament regarding the CSDR were first related to end-investors. The CSDR which will provide a regulatory framework for CSDs is due to improve competition and efficiency which should benefit intermediaries but its first objective is to provide protection and safety for client (end-investor) assets. Increased efficiency and safety should indeed attract more investors into the European market.

An industry player emphasized that the new regulations such as MiFID II / MiFIR and EMIR were "creating a revolution" in the business model of intermediaries which needs to be taken into account. There should be increasing standardization of OTC derivatives products (e.g. of interest rate derivatives) as a result of these rules and less sophisticated and customized products. There will be an increasing role for trading platforms which will be more and more plugged into CCPs, reducing the role of intermediaries and the share of processes such as voice broking for example.

Harmonisation of post-trading rules

Several speakers stressed the importance of harmonizing rules within the EU in the post-trading area.

Despite the progress expected with T2S and the CSDR, harmonisation will remain a major challenge in the coming years an industry player believed. Fragmentation across EU markets continues to be an issue as markets are not using the same rules and processes. It is the lack of harmonization across EU member states which explains why (cross-border) post-trading costs within Europe are higher than in the US (which is one single domestic market) both for issuers and investors. Efficiency within the main EU domestic markets is indeed the same as in the US. T2S and CSDR are major steps in the right direction and the design of these initiatives is appropriate the speaker thought, but their implementation remains challenging.

An industry speaker stated that the issue in the EU is more to harmonize post-trading rules across EU Member States than to improve efficiency within domestic markets. There is indeed already a high degree of efficiency in EU domestic CSDs with a 98% efficiency rate.

The key role that T2S is playing as a catalyst for harmonization was pointed out by another industry speaker. This is true for the market as a whole, but there is also the "internal harmonization" that is going on within intermediaries and asset servicing providers which have to revisit and reorganize their service offering in order to provide access to T2S from different jurisdictions. This reorganization will also foster further harmonization.

Another issue is that although the harmonization directly related to settlement is well engaged (with some fine-tuning still required), some other areas remain challenging an industry spokesman explained. This is the case in particular of corporate actions[2]. There is a collective agreement on standards regarding corporate actions "on flows" but this is only an agreement in principle and standards need to be ready for implementation by the time the testing of T2S starts. Going forward the issue of corporate actions "on stock" will also have to be solved in order to foster sufficient competition. Other areas (such as tax processing or securities law) will have to be addressed by the incoming EU Commission and Parliament.

An industry speaker stressed the importance for end-investors and for the industry of two types of standards: messaging and regulatory standards.

Messaging standards are essential to efficiency, since they provide a common form of communication and understanding, define what is and is not acceptable, enable automation and reduce error rates. It is important to develop commonly agreed, open standards. ISO standards are such an example; created with and for the industry, they are "open", meaning that they can be used on or off the SWIFT network. The value of open messaging standards has been recognized by CPSS / IOSCO which have devoted one of their twenty-four principles to this topic. The importance of using open messaging standards is also mentioned in the recently agreed CSDR text and has been recognized by the ECB in T2S. The ISO 20022 open standard format was chosen for T2S which means that all direct members of T2S can use this standard to communicate with the T2S platform and with FMIs[3]. The speaker however thought that a "regulatory push" for such standards will be necessary before they are to be adopted more widely. If all CSDs in Europe enabled their customers to use ISO 20022 messages e.g. for their domestic markets, this would significantly improve efficiency.

Regulatory standards in the same way give a common frame for reference, but not much has been done so far to achieve their international acceptance. There are still many differences regarding e.g. demands to access data and data privacy laws.

Another industry player agreed with the importance of harmonization but stressed the flipside of the cost of implementation. The right balance has to be found between "what can be gained and what may be lost" when implementing standards. In addition there is not always a sufficient level of detail in the standards proposed in legislations such as EMIR or MiFID.

Some flexibility in the definition of the rules (rather than at the level of their implementation) could be useful, another speaker suggested. A good example of such flexibility exists in the current Belgian settlement discipline regime which states that if settlement efficiency is above a certain level (e.g. 98 or 99%) and therefore is working well there should be no penalty but if efficiency goes below this level then there will be penalties.

Another industry speaker stressed the importance of harmonization at the global level. Europe should endeavour to involve other jurisdictions in America or Asia at an early stage of the definition of its requirements. Another speaker however stressed that one had to be pragmatic and that achieving further harmonization in Europe should be the first priority.

The differences that subsist between the US and the EU in the rules being defined and adopted and the timing of their implementation were stressed by the industry speaker. There are differences between the status of US Swap Exchange Facilities (SEFs) and EU Organised or Multilateral Trading Facilities (OTFs / MTFs). There are also issues regarding pre and post-trade transparency standards for derivatives or fixed income products which are "more or less fixed" in the US and not yet so in Europe. Reporting time standards are not fixed either in the EU. In addition there are issues in Europe with regard to the access policy to platforms for OTC products. These differences will lead to a fragmentation of the derivative market, which used to be global, and to price discrepancies, the speaker believed. There is a risk of regulatory arbitrage in the future depending on the location of platforms. Some clients are asking to relocate platforms anticipating the EU Financial Transaction Tax (FTT) project but also because of clearing rules which impose location requirements. Clearing is indeed the top issue for intermediaries and particularly intermediary brokers.

CSDR Level II technical standards and delegated acts

Several speakers emphasized that the definition of the Level II technical standards and delegated acts for the CSDR is a major challenge ahead and that these standards are extremely important to make a success of the CSDR. ESMA published on the 20 March 2014 a discussion paper regarding these standards. The EU standards will be developed taking into account the existing international CPSS / IOSCO standards.

Level II will have to be proportionate an industry player stressed in order to take into account the singularity of the different CSDs which are very jurisdiction dependent. There are many differences across CSDs (e.g. regarding methodologies), which is not the case for exchanges or CCPs. A good balance will need to be found between providing high level principles of harmonization and some flexibility for each CSD. The existing standards of CSDs which proved to be efficient so far should be a good starting point.

A policy maker explained that Level II standards were still on the learning curve. There has not been that much experience so far with such standards and the

way in which institutions work together in the coming months regarding e.g. MiFID II, the CSDR will be "absolutely critical".

The importance of getting quickly to an agreement on the CSDR (which still remained to be adopted by the Parliament plenary session at the time of the panel) was also stressed by a public speaker. Having T2S in the background and making sure that the CSDR does not hold up its implementation has helped so far in moving the CSDR process along.

From a T2S perspective the standards on the settlement date and on CSD links are particularly relevant a regulator thought. With T2S providing for seamless transactions between CSDs on the T2S platform and the CSDR aligning settlement times, the likelihood of fails due to differing settlement dates and other frictions between CSD settlement processes will diminish. Detailed rules, for which input from the industry will be useful, will however be needed for defining a scheme for buy-ins and penalties in case of settlement fails particularly for less liquid securities (settlement discipline policy). In addition T2S will simplify the complex existing "web of links" between CSDs with the implementation of a single securities settlement system, which means that the way CSD links are dealt with in the CSDR is very important. The establishment and maintenance of CSD links in particular should not be "overburdened with regulation", the regulator stressed.

Several speakers stressed that market discipline rules were the most challenging area to be addressed in the definition of technical standards for the CSDR. That is due to the nature of the issues at stake and the possible impact any measures in that area may have on liquidity, a regulator explained. An industry spokesman warned that there is a risk of disintermediation of EU market infrastructures if CSDR Level II market discipline standards are not properly defined. A public speaker however believed that the CSDR framework was proportionate and should not lead to any disintermediation. Settlement activities will be monitored according to the reporting structure within the CSDR, therefore any "move away" from CSDs to internal processes will be identified. If this nevertheless happens a review of the CSDR would probably be necessary.

Analyzing the actual rates of fails and their underlying reasons based on the information held by CSDs and market participants is necessary an industry speaker suggested. Market discipline measures should also take precisely into account different asset types as well as different situations and types of transactions. Much valuable experience existing in this area can be used a regulator believed. A survey has been conducted by ESMA in order to develop a better understanding of such issues and some settlement field data has also been collected based on national practices. Responses to the ESMA discussion paper should help to give further evidence and data.

Another important area which is new and came into the compromise on the CSDR is colleges of regulators for CSDs, a regulator added. Having seen how such colleges work in the EMIR space, ensuring the consistency of how legislatures implement them and what this means for standards is extremely important in order to go towards further harmonization and common standards.

Recovery and resolution (R&R)

Regarding CCPs, a regulator thought that although much has been done around recovery and loss-allocation rules in EMIR and at CPSS-IOSCO level in conjunction with the industry, this would not be sufficient "in the world of mandatory central clearing". Having a credible approach to the resolution of FMIs is indeed also very important. The first issue is deciding the outcome that is to be achieved and the type of "transaction" that can be put in place. The two "natural" outcomes of a CCP failure are unacceptable the regulator emphasized: i.e. (i) going into an insolvency process which would lead to a massive close-out of contracts cascading through the financial markets with potential large adverse systemic effects or (ii) ending up in a situation where the State would in some way have to step in to bail-out the failing CCP in order to avoid the previous effects mentioned. In the banking sector the tools that are privileged to preserve the activities of a failing bank are the transfer to another provider in the market or possibly to a bridge institution which would temporarily hold the activity until it could be sold into the market. With a CCP such transfers are difficult to achieve in a short period of time. This is equally difficult for the healthy services of a multi-service CCP of which some services are damaged, given the operational financial dependency that exists across services.

For complicated global banks it has been admitted that a bridge transaction would not work and that instead a resolution should mean a bail-in of creditors in order to buy time for an orderly reorganization of the entity and its activities. This is probably the most promising route to go down also for CCP resolution the regulator thought, but this raises a number of questions. One relates to the way liabilities may be shared and the resources that may be available. For CCPs once the default waterfall has been exhausted some variation margin may be left which could be bailed-in. Beyond that, cash calls could be used but they cannot be unlimited since having unlimited liabilities in respect to a failing CCP would be unacceptable for users. There is also initial margin, but it will be needed to ensure the continuation of the systemic services provided by the CCP. Drawing on shareholders is another possibility to the extent that they have not already been wiped out, which is probably unlikely when the point of resolution is reached. Another question is how the ownership of the CCP may be transferred to creditors that have been bailed-in.

The interoperability of CCPs raises additional issues, the regulator added, and whether liabilities that relate

to other CCPs should be bailed-in. This makes sense from a creditor's perspective but due to the risk of contagion it also means that such links will have to be risk-managed in an effective way. Some questions also need to be addressed in the context of resolution planning with regard to the users of such FMIs and to what extent it is possible for the market and for them to migrate elsewhere.

A final question, the regulator believed, was who wields the powers for resolution and who should be the resolution authorities for FMIs. The same question can be asked in other jurisdictions such as the US where there may be three or four different possibilities. This underscores the importance of creating crisis management or resolution groups as a complement to the college arrangements that exist for supervising FMIs. Such groups should involve the broader range of EU authorities that are likely to be involved in a resolution transaction for an FMI as well as third-countries if appropriate. An industry representative emphasized that insolvency law does not make sense for CCPs as it focuses on creditors and that a new legislation is needed. This has been shown by the Lehman case. Recovery and resolution are nevertheless closely interlinked and measures have to be defined for both outcomes jointly [and not only for e.g. resolution]. R&R is about whether market participants are ready or not to support a certain market. If they consider that the losses are too high and that there is no point in continuing certain market segments then this is a resolution situation. At such a stage it is difficult to imagine that the business can be transferred to another entity willing to pick it up.

So far four CCPs have defaulted globally: three in Asia and one in Europe. The most "interesting" default occurred in Hong Kong in 1987 where the government helped the market to continue by granting a two billion dollar loan which was paid back through levies on the market participants spread out over a certain period.

Three main issues were stressed by the industry speaker. The first one is the importance of having the right incentives in place in order to increase the likelihood of recovery, given the impacts that R&R rules and tools may have on the willingness of clearing members and market participants to support default management mechanisms. This needs to be considered when thinking about loss allocation tools and other mechanisms such as cash calls. The second issue is the choice of the authority in charge of the process. There should be a strong authority familiar with the operations that the CCP runs and the market in which it operates endowed with the appropriate decision-making powers to act quickly and with sufficient flexibility. Thirdly the legislation should provide sufficient certainty for CCPs and authorities to act. There should be for example termination rights for clearing houses on certain market segments and the possibility to ring-fence losses of CCPs in order to avoid contagion.

The fact that most if not all of the large members of CCPs are Systemically Important Financial Institutions (SIFIs or Global SIFIs) was also pointed out. This means there are strong potential interferences between the R&R of CCPs and of their clearing members. The public authorities need to assess how that interferes with the objective of the clearing house and the market which is to continue the market to the fullest extent possible.

Regarding CSDs, recovery and resolution requirements are already in the CSDR a public speaker stressed, including requirements for recovery and resolution plans to be put in place. However what is missing in the post-trade space is a securities law legislation which would help to solve on a cross-border basis some important issues such as the consequences of insolvency. This should be a priority for the forthcoming EU Commission and Parliament. Solving such questions will however take a long time given the political issues that may be raised across member states.

Trade Repositories (TRs)

A regulator explained that the results so far of the launching of TRs in the EU are satisfactory ("so far so good"). Getting the project underway and making sure that the six TRS currently operating in the EU were able to take reports as of the 12 February 2014 and to manage the reporting of millions of daily transactions by thousands of financial and non-financial players was quite a challenge.

Many issues however remain to be addressed the regulator stressed. Some are in the process of being solved. This is the case of problems around getting Legal Entity Identifiers (LEI) and pre-LEIs in place and being able to use them and also getting some players, particularly non-financial players, ready for the process.

Two problem areas however remain to be addressed on which ESMA is working hard. The first one is data quality. Data indeed needs to be comparable and has to be aggregatable. Much work is being done on common formats, on defining in greater detail what needs to be reported and how data should be reported. This is not always easy as some market participants might have to make changes in the processes they have already put in place. The problem is that the testing phase was short and evolutions now need to be made retrospectively to make sure that the fields of the reporting can be used by everyone and understood in the same way. The second area is the access to data by regulators: this concerns access by regulators to the six TRs but also making sure that the data can be brought together and analysed properly so that regulators can fulfill their mission.

1. The objective of T2S is to improve the cost effectiveness of cross-border settlement thanks to a centralization of DVP (Delivery-versus-Payment) settlement in central bank money aimed at facilitating the establishment of links between CSDs. The objective is to foster a reduction of cross-border settlement fees and of the liquidity needs (and related capital requirements) of market participants by a pooling of cash and collateral. The platform is due to be launched by the ECB between June 2015 and February 2017 in 4 successive waves of implementation.
2. Corporate actions (CAs) are material changes or events related to a security. The processing of CAs does not fall within the remit of T2S but T2S supports CSDs in their management of such services by offering the necessary functionalities to ensure their effective and efficient processing. Two major business cases have been considered with regard to implementing and harmonizing CAs in T2S: (i) CAs "on stock" which relate to settled balances (ii) CAs "on flows" which concern CAs on pending settlement transactions. There are two main types of CAs "on stock": (i) distributions whereby the issuer of a security delivers particular proceeds (e.g. cash, securities, rights) to the holder of that security without affecting the underlying security and (ii) reorganizations such as stock splits or conversions whereby the underlying security is replaced with one or more proceeds (securities, cash). CAs "on flows" comprise market claims (i.e. the process of reallocating the proceeds of a distribution to the contractually entitled party when this party is not in possession of the underlying securities at close of business of the record date), transformations (i.e. the process by which pending transactions still unsettled by the end of the record date or the market deadline are cancelled and replaced in accordance with the terms of a reorganization) and buyer protection mechanisms (i.e. a process whereby a buyer who has yet to receive the underlying securities of an elective CA instructs the seller in order to receive the proceeds of his/her choice). Source: Corporate actions in T2S – T2S Special Series January 2014.
3. Swift has been awarded a licence to provide connectivity services to T2S. Swift is currently engaged in delivering SWIFT's Value-Added-Network (VAN) solution for T2S allowing for the secure exchange of information in ISO 20022 formats between T2S participants and the T2S platform.

Addressing the risks and mobilisation challenges of expanding collateral use and reuse

Objectives of the session

The objective of this session was to discuss the main challenges raised by the increasing use of collateral in terms of availability and asset encumbrance, the solutions implemented or proposed to favour an efficient use of collateral and the related policy implications in the EU, taking stock of the initiatives under way both in the private and public sectors.

Background of the session prepared by Eurofi

Collateral mobilization is due to become an increasing challenge, but many solutions are being put in place by the private and public sectors.

Increasing demand for collateral combined with constraints on its supply could lead to greater scarcity in Europe.

The use of collateral has strongly risen in the EU since the financial crisis with risk aversion and concerns over counterparty and sovereign risks. The demand for high quality assets (HQA) is expected to increase further in the coming years with the forthcoming implementation of regulatory measures derived from the G20 commitments (Basel III, OTC derivatives requirements) and the on-going LTRO operations of the ECB.

Limitations being put on the re-use of collateral notably in EMIR and UCITS V and stricter asset segregation rules may further reduce its availability. The legislative proposals recently made by the EU Commission (EC) to improve the reporting and transparency of securities financing transactions (SFT) should however help to mitigate some of the risks associated with rehypothecation in particular.

Another issue pointed out by many industry players is the multiplicity of collateral rules in different EU regulations (e.g. EMIR, UCITS V...) which in some cases differ or possibly contradict each other and the insufficient consistency of terminology regarding e.g. rehypothecation and reuse.

The main issue to be addressed is the allocation of collateral across multiple asset pools and providing access to appropriate collateral.

The threat of a collateral crunch previously mentioned as a possible result of these evolutions has been dismissed by global and EU regulators. The situation may however vary across jurisdictions and the fragmentation of collateral across multiple asset pools with collateral often managed in silos remains a significant issue.

Specific concern is also raised by buy-side players who do not always have the ability to raise the cash collateral required or who might be impacted by additional requirements imposed e.g. on repo transactions.

Solutions are being put in place by the private and public sectors to optimize the use of the existing collateral supply.

Actions have been taken within the Eurosystem since 2008 to relax eligibility criteria and to extend eligible collateral in bank refinancing operations. Other measures put in place by the ECB will facilitate the cross-border use of collateral, such as the suppression of repatriation requirements as of May 2014, the integration within the Eurosystem's collateral framework of cross-border triparty collateral management services and the widening of the collateral framework to accept marketable assets denominated in foreign currencies. The implementation of TARGET2-Securities (T2S) by 2015-16 will also facilitate the delivery against payment in central bank money of collateral transactions within the EU on a domestic and cross-border basis. Moreover the Single Supervisory Mechanism (SSM) should further facilitate the cross-border integration of EU securities markets.

Several private sector solutions also contribute to avoiding a shortage in collateral assets. These include services such as tri-party collateral management, entity-level and market-level collateral optimization and collateral transformation. Partnerships are also being developed by EU market infrastructures with providers outside the EU in order to facilitate a more efficient mobilization of collateral at the global level. Concerns have however been raised by some regulators regarding the risks that an excessive use of collateral lending or transformation services may create. The legislative proposals recently made by the EU Commission (EC) to improve the reporting and transparency of securities financing transactions (SFT) including securities lending should help to mitigate such risks by providing supervisors with the information necessary to facilitate the monitoring of SFT and to develop appropriate policy tools if needed.

Additional solutions are envisaged both by the private and the public sectors to increase the stock and liquidity of available collateral.

One of the solutions envisaged in Europe for increasing the supply of collateral is to develop the pool of securitized credit claims. Measures have been taken by the Eurosystem to alleviate the costs of using credit claims as collateral. Initiatives are also being conducted in certain jurisdictions to go towards such an objective for example with the refinancing vehicle set up in France issuing bonds guaranteed by credit claims.

CCP practices are another area where evolutions could be envisaged. Possible actions include cross-margining (i.e. the sharing of pledged collateral across different cleared assets) and expanding the range of eligible collateral. But these changes will probably remain limited given the need to preserve market integrity and investor protection and the current fragmentation of the EU market.

Further standardizing collateral requirements across the EU within given usage classes (e.g. collateral used in the context of CCPs or for a given currency…) has also been proposed in order to promote liquidity within the relevant asset markets. Sufficient diversification of collateral should however be preserved at the overall level.

The increasing use of collateral has important implications for the functioning and structure of the financial system that are currently being assessed.

The BIS and the ESRB have raised concerns about the possible impacts that an increasing recourse to collateral may have on the functioning and stability of the overall financial system and about the current lack of transparency on the extent of collateralization.

Increased collateralization raises asset encumbrance which may have negative effects if it becomes excessive e.g. increasing the risks of unsecured creditors and augmenting liquidity risks for banks.

Higher use of collateral may also favour pro-cyclicality. During economic downturns the effects of the economic cycle on bank leverage and credit supply can be amplified when the share of collateralized financial transactions is greater.

Actions are under way in the EU to improve the data available for monitoring asset encumbrance and collateral positions.

In the context of the implementation of the CRR the EBA is currently developing reporting templates that should be implemented in all banks by the end of 2014. Such data should in particular help creditors to assess the actual risks they face and improve the pricing of funding as well as facilitate institution- level and macro-prudential supervision.

In addition, repositories collecting data on securities lending and repo transactions mandated in the EC proposal regarding SFT should enable supervisors to better evaluate and monitor such exposures.

Putting backstops on asset encumbrance or on covered bond issuance has also been considered. The LCR however already involves a buffer of unencumbered assets to be held as insurance against liquidity shocks.

Summary of the session

Main issues to be addressed regarding collateral management

A regulator stressed that the issue of collateral has become, with the financial crisis and the private and public sectors' answers to it, a very important issue within the whole of Europe and across all financial sectors.

Collateral markets have grown and changed tremendously over the last years: the value of collateral in the global OTC derivatives markets has nearly quadrupled from $ 1 to 3.7 trillion and the EU repo market has also grown significantly over that period. There have been two main phases in this evolution a regulator pointed out. Before the crisis, episodes such as the collapse of the hedge fund managed by LTCM in 1998, which was extremely highly leveraged with huge unsecured derivative positions[1], contributed to stimulate an increased reliance on collateral in the system. Despite this, until the onset of the global financial crisis, the use of collateral was neither mandated nor sought for in many transactions. This reflected both the high level of trust that prevailed between counterparties and, as has been revealed since, overconfidence in the system. The Lehman bankruptcy changed this. In the months following September 2008, a number of defaults resulted in a near-total freeze of the financial system. As a result, most major players required a collateralisation of their exposures and unsecured issuance collapsed. Notwithstanding emergency liquidity provision by central banks to address systemic stress, this encouraged secured lending markets to develop. Compounding this, regulatory initiatives such as EMIR clearing obligations drove even further an increased demand for collateral.

The growing importance of collateral in the financial system gives rise to several issues, the regulator stressed. First, the possibility of a scarcity of collateral in the financial system is a major cause for concern. It is compounded by the difficulty of estimating the supply and demand of collateral at a system level due to the complex factors at play but also of identifying and remedying potential local squeezes. The way to achieve an efficient allocation of high-quality collateral is a second issue. Among the potential solutions discussed the concept of a central collateral repository or pool is worth assessing in greater detail. Collateral re-use is a third topic of focus. Re-use has been brought forward as a means to alleviate possible collateral strains. However, the formation of long and complex collateral chains, the opacity of collateral re-use practices and the untested risk management framework for collateral re-use in periods of stress can also raise financial stability concerns. Going forward there needs to be a better understanding of the impact of re-use practices on interconnectedness and procyclicality in the system. Finally, a better understanding of collateral and its newly enhanced role in the post-crisis era is needed. This will require a thorough analysis, built on high-quality and up-to-date data regarding activities in the industry. To achieve this, the recent proposal by the European Commission on the transparency of securities financing transactions marks one key step towards shedding light on such activities.

A policy maker thought that collateral issues boiled down to three main aspects: Protection, Allocation and Information (PAI) which are of prime importance for the work of the EU Commission in this area.

Regarding Protection, there has been a major evolution in the market over the last five years towards secured debt, before any of the global or EU regulations entered into force. Such secured transactions are meant to protect the banks but also all the participants and counterparties in the financial system. Segregation is a key aspect of protection. It comes at a cost but is necessary. Protection rules are being developed in different jurisdictions across the world so an issue to address is how EU protection requirements (e.g. bankruptcy laws, requirements in banking, clearing, derivatives...) interact and actually work together with the requirements of other jurisdictions such as the US. Another characteristic is that collateral can work "two ways". This will become apparent in the context of the collateral exchanges used to secure uncleared derivative transactions for which collateral will have to be posted by banks to the non-banking sector in addition to the collateral being posted by corporates with banks and the financial system. The details of this still have to be worked out: what type of collateral will have to be posted, can the collateral that is posted "two ways" be netted, can the collateral be used in other ways and functions...

The second key aspect is Allocation of collateral. A recent survey concluded that around 40% of the collateral of the financial and non-financial firms that were interviewed was trapped in local pools of collateral. There is a huge potential for improving efficiency from that perspective the speaker claimed. Market infrastructures in particular have a role to play in collateral optimisation with the use of cross-portfolio margining and the use of collateral "hubs" or "highways". The eligibility of collateral is another issue. If there is a very strict definition of collateral, which is the case for example for CCPs, which only accept cash in order to be able to liquidate positions quickly in stressed markets, this has consequences for some buy-side players such as pension funds that do not have much cash collateral because the available cash is distributed to pensioners at the end of each month. Revisiting eligible collateral criteria for CCPs might be necessary. The acceptability of non-cash collateral is being assessed by the EU Commission in this perspective. Hedging is another problem with some firms concerned that they might not be able

to afford hedging in the future with the new derivative rules being put in place.

Information is a third key issue. The possible shortage of collateral is no longer a point of discussion, the policy-maker believed. Improving transparency on collateral transactions and the reporting to the regulatory community is very important and this is the objective of transparency measures recently proposed by the EU Commission regarding the reporting of Securities Financing Transactions (SFT) to trade repositories. The objective of this proposal is to improve the information on practices such as re-use, rather than banning them. In this context it is worth mentioning that EU derivative rules already mandate the reporting of the collateral posted, which should give regulators a good idea of the impact of such rules. This goes beyond what many other jurisdictions are requesting. The mandatory reporting of repos, asset encumbrance, etc… by banks in the Capital Requirements Regulation (CRR) will help to complete the information on how the market is reacting to the new rules and what the needs may be.

Solutions to optimise the mobilisation and allocation of collateral at the EU and global levels

Solutions being put in place by the Eurosystem

A regulator stressed the importance of collateral for the Eurosystem and outlined the solutions put in place by the Eurosystem to facilitate collateral mobilisation. Collateral is the instrument through which the duties of central banks are performed, since monetary policy instruments are based on collateral according to the Treaty on the functioning of the European Union.

There have never really been threats of a global collateral shortage, but localised shortages of collateral have been observed at times in some domestic markets. There are three main ways of avoiding or managing a possible collateral shortage according to the regulator. The first one, which should be "discarded immediately", would be to accept lower quality collateral. This is not permitted by the Treaty governing the Eurosystem and would not be possible either for the private sector due to the internal risk management systems used. A second more promising option is to make better use of the available collateral. Some important initiatives that have already been decided by the Eurosystem and will come into effect in the course of 2014 fall into this category: the removal of the repatriation requirement and the possibility of using tri-party collateral management services across borders. These new developments [that are detailed further down in this summary] are particularly important for larger intermediaries that work across borders. They will make tri-party services available to all Euro area banks and for all marketable assets allowing participants to opt for a more consolidated approach and an easier use of the existing pool of collateral. TARGET2-Securities (T2S) which has just been released for external testing is another public sector initiative steered by the ECB that can also be mentioned in this context. T2S will enable major banks that work with several CSDs to consolidate their CSD accounts and manage their pool of collateral in a centralised way (instead of having several buffers in different local markets). These evolutions will be completed by services developed by the private sector and CSDs such as collateral optimisation services. A third way of reducing or eliminating collateral shortage, and probably the most ambitious one, is to rebuild trust in the market so that less collateral is needed. The Banking Union may contribute to this objective. The downgrade of sovereign bonds can create difficulties for banks if they are insufficiently diversified because the bonds of their own sovereigns may be rejected or accepted with higher haircuts. Severing the link between banks and their sovereigns, which is underway, could help to deal with such situations.

A regulator further detailed the measures that are being put in place by the Eurosystem to facilitate the mobilisation of collateral within the Eurozone.

An enhancement of the Eurosystem collateral management services in the form of the removal of the repatriation requirement from the Correspondent Central Banking Model (CCBM) is due to go live on the 26 May 2014. CCBM was established by the Eurosystem in 1999 when the euro was introduced in order to allow Eurosystem counterparties to mobilize any eligible asset regardless of the location of the counterparty or the asset. The CCBM model was set up as an interim solution as there were no adequate arrangements at market level at that time to move assets across borders easily. Notwithstanding improvements at market level in the meantime, namely the increased establishement of links between CSDs, the CCBM is today still the most used channel for moving collateral across borders for the purpose of Eurosystem credit operations. With the removal of the repatriation requirement, counterparties using the CCBM will no longer have to bring back or repatriate assets to the issuer CSD in order to mobilize them via the CCBM and get credit from their local central bank. This is an important benefit which has been facilitated by other EU initiatives over the last years such as the Settlement Finality Directive and the Collateral Directive.

Removing the repatriation requirement also allows tri-party collateral management services to be introduced on a cross-border basis via the CCBM. Such services are arrangements whereby collateral givers and takers avail themselves of services offered by a tri-party agent who takes care of all the complex processes related to allocation, substitution and valuation of collateral using sophisticated algorithms to better identify the economic value of collateral. Such services are available today on a domestic level within the Eurosystem

collateral framework, meaning that they can be used by Eurosystem counterparties in the country in which the services are provided in order to mobilise collateral with the local central bank. As of 29 September 2014, triparty collateral management services will also be supported on a cross-border basis via the CCBM. This means that counterparties that operate in countries where there is no local offering of tri-party services will be able to use a service provider based in another country, while counterparties that operate in countries where there is a local offering will have the choice of the local offering as well as the service offered in other countries.

The combination of these two actions will make the mobilisation of collateral more efficient, the regulator stressed, not only for providing collateral to the central bank but also for market operations. Tri-party services in particular allow counterparties to re-use with the central bank the assets that they have received for example in tri-party repo operations with the market. This allows more liquid collateral pools to exist and also supports tri-party settlement interoperability. The Eurosystem also works as a catalyst to foster developments on the market side through the COGESI[2], a contact group it has established with the industry.

The industry players speaking on the panel were supportive of the developments steered by the Eurosystem. The end of the repatriation requirement in combination with the delivery of T2S was considered to be a real "game changer" as it will enable the users of Eurozone CSDs to manage a single pool of collateral and also of cash through Target 2 and therefore to centralise their Eurozone business through a single domestic CSD. The forthcoming cross-border integration of tri-party services was also believed to be a major step forward, allowing the efficiencies of tri-party mechanisms to be used in the management of collateral in order to move assets on a real-time basis across various jurisdictions and increase the fluidity of collateral.

An industry speaker added that although T2S will help to increase the mobility of assets across silos, this will only concern the physical silos in the market. There are also legal silos to be considered. One needs to know who owns the assets and what are the rules pertaining to them. There are huge amounts of assets in CSDs in particular and one needs to know what can be done with them and what needs to be put in place to mitigate credit risks when assets are taken up.

Industry solutions and developments

An industry speaker stressed that the debate on collateral has moved over the last 3 or 4 years. The issue is no longer the amount and eligibility of collateral (i.e. whether there might be collateral scarcity and whether there will be a sufficient amount of good quality collateral in the system, which can probably be sorted out by usual supply, demand and pricing mechanisms) but rather the mobility and velocity of collateral (i.e. how to get collateral in the right place, at the right time and with the right party). How to ensure the greater velocity of collateral movement on the same day as the trade especially for treasury management operations is being discussed with clients and the authorities in the Eurozone.

The issue of collateral movement has also a global dimension. Market infrastructures (such as ICSDs[3] and CSDs) and commercial banks providing collateral management services contribute to increasing collateral mobility and "unlocking" collateral pools globally. Market infrastructures in particular facilitate collateral transformation processes[4] and help clients to source collateral from wherever they hold it in the most optimal way (i.e. CSDs, banks, agents) and to allocate it to where it is needed (i.e. central banks, CCPs or participants in the OTC markets). This is a way of creating a global virtual pool of collateral and limiting the present fragmentation of liquidity pools. Creating a single securities pool at the global level (as is facilitated by T2S in the Eurozone) is not possible. Virtual liquidity pools have to be put in place because of timing differences and differences in securities laws.

Another area of improvement being worked on, in order to be able to mobilize collateral on the same day as the trade, is interoperability between the two ICSDs which involves lengthening opening hours and improving the number of settlement cycles across the so-called "bridge" between the two ICSDs.

One aspect on which there might not be sufficient focus at present, another industry speaker emphasized, is the buy-side. Much has been done for the sell-side but more needs to be done for the buy-side. One of the issues for the buy-side is cash collateral which is predominantly used for example for variation margins with CCPs. The challenge is that variation margins can be requested at a very short notice and huge amounts of cash or liquidity might be needed putting a great strain on buy-side clients. Tri-party mechanisms, which are only used at present by a limited number of large buy-side players, are increasingly being looked at by the buy-side as a way to help reach the cash market. This could however mean obtaining cash loans in the repo market in 24 hours which is usually quite challenging. In addition there needs to be more understanding as to how such services can fit into the organisational structure of buy-side players.

Variation margin requirements can also be quite challenging for sell-side players, for example when managing a very extreme long-dated interest rate derivative portfolio, for which there is a shift in interest rate requiring a large overnight shift in cash margins.

An industry representative stressed that tri-party collateral management services only cover 15% of the repo

market. In addition most of the OTC derivatives market whether cleared or uncleared does not use tri-party providers either. Collateral management therefore also needs to be considered more broadly and holistically than just tri-party services.

A public representative believed that the buy-side has been active in the collateral management and securities financing space "for a long time". Asset managers have been making a "serious amount of revenue" out of these activities for a long time both for the funds they manage and for themselves. The investor protection aspects however have not been a priority in this area so far. The fact that the assets concerned belong to investors should not be forgotten. This issue may be solved by the proposal of the EU Commission to regulate the transparency and reporting of SFT. There have indeed been many separate initiatives but these issues need to be brought together in order to define very clearly the rules of the game and the protections that exist. There needs to be information in particular about who owns what, where and when the assets are used and also some form of agreement on insolvency and which bankruptcy rules might apply at each stage of the process notably when assets are being transferred across different jurisdictions.

A regulator emphasized that the issue in capital markets is making the market work as a system - both in good and stressed times - while ensuring proper protection for the end investor. This is the conundrum that has to be solved. Ultimately achieving legal certainty is very important because one needs to know where assets are lying and who they belong to both to make the process work and for investor protection.

The CCP agenda also needs to be taken into account in the discussion about collateral. By netting a large proportion of the transactions CCPs reduce the overall demand for collateral. But such market infrastructures need to be sufficiently secure and stable which involves certain obligations including making sure that the collateral is ultimately held in an environment where protection is offered through the Settlement Finality Directive.

Impact of market and banking regulations on collateral management

Collateral re-use and rehypothecation need to be better distinguished in EU regulations

An industry speaker stressed that rehypothecation and re-use, which are often used interchangeably in EU regulations, should not be mixed up as they correspond to different legal regimes and different practices. With re-use the legal title of transfer is given to someone else who then has legal ownership over the assets and can use them freely. Reuse of assets is something that the sell side has been using for some time and which is valued because assets can easily be tracked.

Another industry figure suggested that the FSB paper on shadow banking in particular has been very useful in making a clear delineation between reuse and rehypothecation[5]. Rehypothecation involves intermediaries such as prime brokers – and not custodians – using their clients' assets to obtain funding and holding the proceeds on their balance sheets. This distinction made by the FSB should be echoed in other legislations because when reuse and rehypothecation are used indistinctively one does not know what is intended in the regulation. Collateral agency providers can only effectively support their clients in being compliant with different regulations if the rules are clarified.

A multiplicity of regulations impact the collateral and Securities Financing Transactions (SFT) areas at EU and global levels

Industry players speaking on the panel stressed the accumulation of rules impacting collateral and SFT, as well as clarifications required in the rules touching collateral and some conflicts between rules at the EU level and also between EU and US rules.

The situation is challenging for regulators because on the one hand they want to facilitate the movement of collateral in order to meet expected increases in demand but on the other hand they want to avoid excessive leverage being created in the financial system that way. As a result a "huge number" of regulatory proposals are touching the collateral and SFT areas, an industry speaker emphasized, maybe as much as thirty in total when looking at the global, the EU and the US levels. Around one third of these rules are being proposed in the EU (including prudential banking requirements, SFT rules, extra collateral requirements, asset encumbrance rules, etc...). The multiplicity of these rules is a concern for the industry and its customers due to their expected impacts and also because of possible conflicts of rules. Another issue policy makers should be careful about, is not adding friction to collateral mobility with possible measures such as limitations on collateral re-use or segregation rules.

The first impacts will come from banking prudential rules. The Liquidity Capital Ratio (LCR) will boost demand for high quality liquid assets in banks. Two other measures will affect the supply of collateral: the leverage ratio will limit the amount of collateral transformation that may be performed on bank balance sheets and the large exposure regime will make it much more difficult for banks to intermediate as agents the lending of securities from sovereign wealth funds and hedge funds for example to users. The reason for the latter is that banks typically already provide an indemnity against the brokered unit default risk associated with such large exposures, but the standardized capital charge that is embedded in the proposed large exposure rules can be ten to forty times higher than what is used by most banks in their current approach. This

will therefore potentially "throttle" the ability of those assets to move from the holders of the assets to the users of that collateral, an industry player stated.

A second issue is rehypothecation and re-use of collateral. Besides the distinction that needs to be made in regulations between these two practices, there are questions as to which type of arrangement should be allowed. Pledge arrangements are used in the US whereas title of transfer is typically, but not exclusively, used in the EU. Some EU regulations such as the AIFMD favour title of transfer. In EMIR there are some limited situations where assets can be reused. There are also areas where EU rules appear to conflict. For example a UCITS fund having to post collateral cannot rehypothecate or reuse assets at present which means that if they engage in a collateral upgrade or transformation transaction taking some assets and converting them into CCP eligible assets – which is a great way of adding liquidity and mobility to collateral – these assets cannot be used. Maybe a UCITS fund should be allowed to reuse assets but not to rehypothecate them, an industry player suggested. Moreover, there are questions about the amount of rehypothecation that should be allowed with potential conflicts between rules defined at the global level and in some jurisdictions such as the US.

Collateral eligibility is another subject, as central banks and CCPs for example have differing eligibility rules. One of the key issues is the treatment of sovereigns with some very prescriptive draft rules being proposed in the US regarding the use of dollar-denominated or Treasury securities. The custody of collateral also raises questions. Under EU rules custodians cannot hold collateral on behalf of CCPs[6]. Many think this should be changed the speaker stated. Other issues concern the BCBS IOSCO proposals related to margins on uncleared swaps and the way the cash is held: can it be held as a regular bank deposit or does it need to be segregated somehow? This also needs to be sorted out.

Segregation is another area where clarification is needed. It has to be offered under EMIR but does not have to be used. US Dodd Frank and BCBS IOSCO rules are not specific about segregation. Requirements vary in EU regulations. AIFMD has segregation requirements for some client assets but what should happen at sub-custody level is not clear. UCITS has segregation rules but the way they should be applied is not specified. The Capital Requirements Regulation (CRR) gives benefits for segregation. The result of such variations is usually that market participants who are subject to several of these rules will apply the most conservative ones to all their activities. An industry player emphasized that although greater segregation may be necessary for client protection and is the "obvious way forward", segregation is costly. Having to access accounts that are segregated indeed makes effective collateral management and particularly tri-party operations much more complex and rather less efficient.

Two additional areas of contention were mentioned. A first area is the impact of regulatory proposals regarding securities lending. The way the universal margining requirements, which are mentioned by the FSB policy framework for securities lending, may interact with commercially-driven margin requirements that are already in place still needs to be clarified. The MMF rules proposed could also be an issue: if Constant NAV funds (CNAV) are outlawed, that may have an impact on the

way securities lending transactions are conducted and trigger the need to look for alternatives. The Financial Transaction Tax (FTT), at least in the current form of the proposal, is also an issue as it may suppress more than 65% of the EU securities lending market according to some market estimates.

The suggestion was made that such issues potentially affecting collateral management need to be looked at horizontally (rather than regulation by regulation).

Adopting some horizontal standards across these different areas of application would be very useful, an industry speaker suggested. This should start with the terminology used (e.g. with common definitions of reuse and rehypothecation).

A policy maker strongly supported the idea of having a horizontal overview of the regulation applying to collateral in particular. The general intention of the EU Commission is to seek cross-sectoral consistency but when idiosyncratic proposals are negotiated they do not always receive the cross-sectoral consistency attention that may be needed. One way of approaching this is developing a Securities Law Regulation at the EU level but achieving such horizontal consistency requires having the different elements of sectoral legislation in place first which raises an issue of synchronisation.

Having a coordinated approach at the global level regarding SFT reporting was also suggested, building on the proposals recently made in the EU and the fact that the SEC has been mandated in the US by Dodd-Frank to create transparency rules around the SFT.

A public representative emphasized that securities lending and reuse / rehypothecation issues have been discussed on many occasions in the context of regulatory files such as AIFMD, UCITS, short selling EMIR, CSDR, MiFID, etc... but the resulting pieces of legislation do not address these issues properly. There is still much confusion about who can use such transactions, when they can be used and what information needs to be reported. The proposal made in January by the EU Commission for improving the reporting and transparency of SFT needs to be taken up by the new Commission and new Parliament as soon as possible and enacted. This could have been managed in the CSDR or in MiFID II but there was opposition from a large number of Member States. In addition safekeeping is not considered as a core service but as an ancillary one in MiFID.

Challenges raised by increasing asset encumbrance

A regulator explained that with the increase in demand for collateral since the outset of the crisis the encumbrance of assets on the balance sheets of European banks significantly grew from 7 to 27% between 2007 and 2011. This higher level of encumbrance of bank assets is greatly changing the way in which banks are viewed by the markets and especially the unsecured claimants of banks. Banking regulators have therefore been trying to assess whether the present level of encumbrance (close to one third of their assets) is excessive and how the risks associated with such levels can be managed.

Securing transactions was one of the main ways used during the financial crisis for handling the liquidity and short term funding problems of banks when unsecured interbank money markets dried up in a matter of days. It has clearly been a positive factor and has helped to stabilize financial markets but also has downsides linked to the increase in the subordination of unsecured creditors and higher asset encumbrance levels. The liquidity risks of banks indeed increase with higher asset encumbrance because the availability of potentially usable assets decreases and banks find it more and more difficult to identify asset pools that can be quickly encumbered in case of liquidity need. In addition the ability of a bank to manage its liquidity becomes more and more exposed to market valuation in such a case. This is seen by regulators as a major issue because if there is a general market downturn of eligible collateral or an increased call on collateral by the counterparts of banks, this can severely and very quickly impede the ability of banks to manage their liquidity positions. The sum of these different effects may create a very procyclical process and a systemic problem for the entire financial system. If encumbrance moves up, liquidity management will become more and more difficult leading to even higher encumbrance in the event of financial stress. This may increase the subordination of unsecrured creditors even further leading to downgrades and to a continuation of the same vicious circle.

This requires looking at how the efficiency of the use of collateral can be improved the regulator suggested. Regarding the banking sector two major initiatives have been launched by EU regulators to tackle these issues. The first one is the implementation of requirements mandating banks to report their encumbrance positions more systematically to their prudential supervisors. These requirements will be put in place in 2014 as part of the general extension of the reporting framework of banks. A second proposal on which a consultation is being finalised by the EBA is to set up a specific disclosure framework regarding encumbrance through which banks would be asked to disclose publicly their encumbrance positions. This public disclosure of encumbrance would be less detailed than the former regulatory reporting, but raises concerns within the industry, the regulator stressed, because of its potential procyclical effects. This is quite a dilemma because on the one hand public disclosure is necessary in order to provide the markets with better information and increase trust, but on the other hand it may lead to adverse market reactions in situations of stress. The regulator however believed that for correctly pricing credit and especially unsecured claims such information is necessary.

Some differences in the way encumbrance is treated depending on the way the monetary policy is run were emphasized by another regulator. For example in the US monetary policy is run quantitatively using outright purchases of bonds. Since bonds are taken off the balance sheets of banks in doing so there are no encumbrance problems within the balance sheets of US banks. But in Europe such operations are performed mainly by using repos so banks' balance sheets are encumbered. If one accepts the most likely hypothesis which is that central banks will automatically renew their operations then this leads to a run-off rate[7] equal to zero applied to such transactions according to the prudential regulation and to repos with central banks being better treated than those within the market. This means that European banks might have an incentive to go to the central bank rather than to the market because of this difference in regulation.

A participant in the audience added that the Fed currently has a very large balance sheet as a consequence of its quantitative easing policy, a balance sheet in excess of $ 4 trillion. The Fed is currently testing a "full allotment reverse repo facility" which allows it to set a floor under the overnight secured lending rate (repo) by offering to borrow funds from a broad array of market participants – not just banks - at a fixed rate. If the Fed implements this facility, it will significantly change the functioning of and the risk in short-term funding markets, with the Fed becoming the counterparty of last resort.

1. The hedge fund managed by LTCM (Long Term Capital Management) which collapsed in 1998 and had to be bailed out had a relatively low level of assets under management but was extremely highly leveraged with more than 1 trillion dollars in gross notional unsecured exposure (corresponding to 25 times the clients' assets).
2. The COGESI ((Contact group on euro securities infrastructures) addresses issues and developments which are relevant for the euro securities settlement industry and which are of common interest for the Eurosystem, market infrastructures and market participants.
3. Euroclear Bank and Clearstream Banking Luxembourg.
4. Collateral transformation services enable participants to swap non-eligible collateral for eligible collateral.
5. The FSB finds it useful to define "re-use" as any use of securities delivered in one transaction in order to collateralize another transaction and "rehypothecation" more narrowly as re-use of client assets. Source: FSB – Strengthening oversight and regulation of shadow banking – 29 August 2013.
6. Custodian banks are engaged in the collateral market both as tri-party providers and also as holders of collateral on behalf of customers and in the lending of that collateral through SFT.
7. The LCR (Liquidity Capital Ratio) assigns run-off rates to each source of funding designed to simulate a severe stress scenario. A run-off rate reflects the amount of funding maturing in the 30-day window that will not roll over.

Implementing Solvency II

Objectives of the session

The new E.U. solvency regime is entering in its implementation phase according to a tight timetable. In parallel the EIOPA is trying to fine-tune its role and power in order to achieve further consistency in the E.U. among domestic supervisors in a particularly tough economic context.

This session aimed to identify the multiple challenges faced by the different types of E.U. insurance undertakings (large or small, international or domestic, etc.) as well as E.U. and domestic supervisors during this critical period, in defining implementation measures and guidance.

Background of the session prepared by Eurofi

Solvency II: entering on the implementation phase

The framework directive on "the taking-up and pursuit of the business of Insurance and Reinsurance" - Solvency II - was adopted in November 2009. It should be applicable from 1 January 2016. Additional legislative elements (Omnibus II) where required regarding the long-term insurance guarantees to address the challenges unveiled by the QIS 5 achieved in the economic and financial conditions specific to the financial and sovereign crisis.

As a principle based legislation to come into force the new framework now requires

- The definition of the Implementing Measures (Level 2 by the Commission). The E.U. Commission will propose them after Omnibus II directive enters into force (the Commission, the Parliament and the Council reached an agreement in November 2013)
- The definition of Implementing Technical Standards (Level 2.5 proposed by the EIOPA and adopted by the Commission)
- The provision of Guidance to ensure consistent implementation and cooperation between member states (Level 3 - EIOPA)

In addition E.U. co-legislators delegated to the Commission the definition of certain "non-essential elements", which supplement the legislation (so-called delegated acts). Lastly the EIOPA has defined an interim solvency regime, which applies from 1 January 2014 until the 31 December 2015, consisting of specific guidelines targeting the reduction of the difficulties linked to periods of "dual running".

The challenge for this regulatory work, which encompasses a number of practical critical issues, is to remain consistent with level I legislation, given that it is undertaken at a moment when E.U. institutions are being renewed. This raises also certain challenges so as to avoid any delay in an already tight timetable until 2016.

Insurance companies are still cautious regarding the practical implementation of the long-term package

Several features of the trialogue agreement have still to be translated into practical terms. In that respect the insurance industry is worried in particular by the practicalities of the Volatility Adjuster and its consistency with the Level I decision.

In addition, this is a moment when Europe is seeking to switch from a bank intermediated financing of the economy toward an increased involvement of institutional investors among which are insurers; thus insurance companies are awaiting the concrete reweighting of the risk of certain assets (SMEs, Infrastructures, securitisation), which as currently set, are repelling for them.

The concrete implementation of the Pillar I and Pillar II of the new framework is challenging for both the industry and the supervisors

Beyond the debates triggered by the standard formula and long term guarantees, the implementation of the pillar I of Solvency II challenges in particular small and medium size companies. Indeed certain companies using the Solvency II standard formula may consider using Undertaking Specific Parameters (USP) for calculating their risk capital. Actually, the undertakings are allowed to replace market-average parameters of the standard formula by companies-specific ones so as to receive lower SCRs. Similarly a company can use USPs to better reflect re/ insurance programmes in the standard formula. However the use of USPs is submitted to the regulators' approval on the basis of evidence of complete, accurate, and appropriate data.

In the same vein the internal models developed by E.U. insurance groups to assess their regulatory capital will have to be approved as well. In that respect the supervisors in the E.U. will be facing many challenges, among which is to make those internal models consistent at the European level, and another is to make them credible and robust in a context where their modelling reputation has been critically weakened in particular in the banking area to the extent that some investors and regulators are considering increasing the role of non risk-sensitive regulatory back-stops. The process adopted by the regulators at the national and E.U. levels, their affective coordination and the rele- vant resources they will succeed in mobilising will be essential in that respect.

Lastly the new regulatory framework for insurance undertakings also challenges the governance and the risk management (Pillar II) of the companies. Indeed insurance undertakings have to develop their Own Risk and Solvency Assessment (ORSA) at the heart of their risk management system. As a consequence of Solvency

II, insurers are expected to progressively develop new kinds of long-term guarantees, and better price related options and guarantees.

Achieving the equivalence of regional solvency regimes in the global context

The equivalence of national and regional solvency regimes with Solvency II is an important consideration for a number of EU or non-EU groups.

Indeed the equivalence or not of local regimes may affect whether local business will have to restate local capital requirements according to Solvency II rules, and will consequently affect the pricing of certain products in related countries. It is also important for those insurance groups looking to adopt a branch structure notably to ease movement of capital around the group. The consequences of buying reinsurance from non-equivalent jurisdictions and how equivalence may affect business acquisition decisions are also relevant issues.

Bermuda, Switzerland and Japan are seeking permanent equivalence. A group of transitional countries, including Australia, Singapore, Hong Kong and South Africa, is seeking to be regarded as equivalent for a specified period. The US is yet to formally join this group. Its inclusion is clearly crucial to many insurers in the UK, given the size of the US market and its importance to their businesses. Discussions between EU and US regulators are continuing. The challenge is in particular how to secure agreement across all the different state jurisdictions within the US.

Improving the surveillance of insurers' practices in the current financial and economic context

No sovereign risk approach has been formally mentioned in the trialogue agreement.

However according to this agreement the Commission and the EIOPA will be given the power to adopt technical standards encompassing quantitative limits, asset eligibility criteria whenever the calculations techniques proposed by the new regulation to define the Standard Capital Ratio prove inadequate.

In this context in the recent Financial Stability Report the EIOPA has stated in particular some concern regarding undertakings exposed to sovereigns with long-lasting reduced yields, as well as concern regarding excessive concentrations of exposure of insurance undertakings to sovereigns and financials that risk spread reversals. The European Authority also mentioned certain "liquidity swaps" and "value in force monetisation" by which life companies may exchange future cash flows against present cash.

More generally the EIOPA stressed that a weak macroeconomic climate might threaten insurance companies.
Consequently the EIOPA is defining a dedicated analytical framework and may rapidly run a comprehensive stress test. Beside this, in order to perform its supervisory role more efficiently the EIOPA is expressing the need for the extension of its current power in order to conduct an inquiry into a particular type of financial institution, type of product, or type of conduct. This power is not aimed to be confined to situations of potential threat to the stability of the financial system but would be used more generally to support independent assessments of supervisory practices.

Summary of the session

1. Challenges related to the implementation of the new regulatory framework

All the panellists expressed their satisfaction regarding the adoption of Solvency II, which will equip Europe with an economic regulatory framework consistent throughout the E.U.

However many representatives from both the industry and the public sector acknowledged that implementing the new regulatory framework is a difficult issue. In particular many examples were provided regarding the **complexity** of certain measures of the framework, which makes it challenging to harmonise the regulatory package and define the Implementing Technical Standards (ITS) and the Regulatory Technical Standards (RTS) i.e. the so-called level 2.5. Yet at the E.U. level the message is that the Commission's target is to adopt the delegated acts by September 2014 at the latest, and that the related regulatory process is under control.

A regulator from an E.U. Member State said that one example of complexity is that of defining a detailed one-size-fits-all approach to the so-called matching-adjustment, which is intended to allow for firm-specific adjustments. He added that how to calculate **technical provision** also remains a key issue for insurance companies since depending on the assumptions made on the number of variables involved you can end with widely different results. Finally he stressed that one of the most crucial issues is how the discount rate curve will be practically designed by EIOPA.

Beside these technicalities a representative of the public sector underlined the fact that moving from Solvency I to Solvency II requires the supervisors to **change their mindset**. He stressed that indeed the supervisors have now to deal with much more volatile solvency ratios and consequently have to interpret the possible changes to find out whether they stem from a solvency gap of the undertaking or from non-idiosyncratic aspects.

The challenge for the regulators when defining the preparatory guidelines, said a representative of the public sector, is to combine **consistency without** ignoring diversity. **This is perceived as** a precondition for the predictability of the framework and for achieving a level playing field and avoiding regulatory arbitrage. Consistency is also needed throughout Europe and local supervisors have a role to play to make sure that what is done for one company in one country is similar to what is imposed on other companies in other countries.
He said that this supposes building on commonalities and understanding possible differences. He pointed out that this also requires enhancing the convergence of supervisory practices throughout the EU, which is one of the priorities of the EIOPA that will materialise through the definition of a common application package on internal models. Finally he concluded defining a credible, transparent and auditable methodology, a supervisory review process, etc. should enable them to avoid the mistakes made in the banking areas, which created black boxes regarding risk models.

In addition the role of EIOPA consist of making sure that the various levels of the Solvency II regulation are consistent. In that respect a representative of the public sector insisted on the fact that the preparatory guidelines are the biggest success of EIOPA - a three year-old institution – and this results from a permanent link at all levels with the **legal services of the European commission** in order to make sure that level three measures are not going beyond **level one or level two**, though it will not always please either some of the supervisors or some of the industry members.

Another key issue mentioned by many panellists is the **timetable of the implementation of the new framework**. Level 2.5 and level 3 specifications indeed are coming late into the process and just before the real implementation of Solvency II expected at the beginning of 2016. This is questioning whether the industry will have enough time to implement them, especially those who have internal models, as level two measures are not yet finalised and the level three is expected to appear in February next year.

The problem faced by the industry is in particular that to complete the implementation of Solvency II in 2016, it has actually to up date internal models for 1st of April 2015 only leaving a couple of months in which to prepare. Indeed provided that the E.U. colleges of supervisors of insurance groups demand having a sufficient understanding well in advance, insurance groups are looking to freeze internal model developments this summer 2014, and perform test applications in October 2104. Indeed adjusting internal models is not like switching them on or off, said a representative of the industry, and this still requires good will from all sides since the industry still lacks some of the fundamental definitions e.g. the rules for calculating volatility adjustment and credit risk adjustment, etc.

Otherwise we might end up with internal models, which cannot physically be implemented in all companies at the same time and in addition we risk one jurisdiction having an interpretation different from another one. The supervisory mechanism and the colleges of supervisors will have a key role to play and in that respect; however this suggests more stringent rules for the interaction and decision-making of the diverse E.U. supervisors. In particular the approval of internal

models requires unanimous decisions by the whole college although at the moment we see different people in different camps.

Additional issues

Finally the long-term package is just a small part of the framework, which it proves to be difficult to implement. Pillar I as a whole is going to be **quite complex**, emphasised a representative of the public sector. He stressed that in addition the implementation of Pillar II and Pillar III have already started: the cooperation of everyone, i.e. companies, supervisors, and EIOPA, is needed - he said.

Another issue is also how **Solvency II should be applied to groups:** at level one a principle exists, which states that what applies to individual companies should apply to groups; but we still do not know how, or what it means in terms of capital calculation, governance, etc. **Equivalence** with non-EU countries is also a big issue, as it influences the strength of E.U. groups and how they can compete in a level playing field with non-European insurers outside Europe.

Finally alluding to the numerous letters from industry referring to an open list of at least 100 issues to be addressed, a representative of the public sector suggested in the context of multiple and diverse challenges ahead, that the industry and the regulators should focus on the implementation rather than on reopening things. He justified this position by the fact that regulatory uncertainty is bad for everybody and the fact the existing compromise is not a bad one.

2. Consequences of complexity on small and medium insurance companies

To illustrate the impacts of the new regulatory framework on small and medium insurance companies, a representative from the public sector provided the example of Greece. There the market is very small - around €4 billion annual premiums - and fragmented - 75 companies the largest of which had a €650 million annual premiums and the third largest has €350 million and many companies around €50 million with 100 to 50 employees. One can imagine he said the consequences of such an avalanche of regulation for both the companies and the supervisor, who have been for three years in the Central Bank.

This complexity is compounded by the fact that Greece is expecting growth in the insurance industry as the economy is emerging from this crisis, and the crisis has completely changed the role of the state regarding social support - pensions and health. The insurance industry will have now a complementary role to play as it advances.

Finally Pillar I is imposing on many of these companies 3 to 3 ½ times more regulatory capital and one result of the new regulation will be an "abrupt" consolidation of the industry. It is expected that less than half the companies will still continue operating in the market within 18 months.

3. The Long-Term Package and the paper issued by the E.U. commission on long term investment

A representative of the public sector illustrated the challenges to which the Long Term Package is expected to answer reminding the audience of the issues faced in Greece. There he said, insurance companies need prudential rules enabling them to complement the State in long-term guarantees and pensions, and support the Greek economy. In addition an appropriate implementation path is critical since for example in Greece insurers have been harshly impacted by the recent haircuts on Greek bonds: currently insurance companies are still uncertain about the possibilities left to them to deal with the situation.

One panellist summarised the general progress brought about by the Long-Term Guarantee Package saying that the LTG package is a relevant addition that does not undermine the whole initial framework, which was very solid but could not factor in sufficiently the specific issue of long-term investment. In particular, he said that the initial framework was unable to deal with the consequences of the movement of credit spreads that had different impacts on the companies depending on whether the assets and liabilities of the companies were well matched or not. He insisted on the need the mechanism to work and achieve these objectives.

A representative of the public sector insisted on the fact that the paper on long-term financing issued by the Commission complements the LTG Package of Solvency II. Indeed he said, infrastructure financing is an area where the role of insurance companies with long-term liabilities, should probably be larger than the role of banks, due to the shape the co-legislators finally gave to Solvency II, which encourages matching assets and liabilities. Insurance companies are in the perfect position to sustain this type of long-term investment, though they need to be accompanied by all sorts of other tools.

This paper in addition has the merit of posing some key principles on what is long-term investment, which must be investment, patient investment and must be engaged– he said. The paper also proposes two positive initiatives, one toward infrastructure financing the other one on securitisation. Finally this representative of the public sector said that the EIOPA has made a critical - though very minimum - opening on securitisation, which has been the driver for the last few months because it is trying to call high quality what is high quality securitisation, bearing in mind that securitization took a blow in the crisis. He stressed that this opening was made in the context of international willingness to make sure all should have high-quality securitisation.

This speaker concluded by reminding the audience that the long-term financing for the benefit of the European economy will be the intellectual piece of work for the next few years and that in this perspective the huge amounts of financial securities that will be issued, should be produced according to the highest standards because there is no room for gambling.

However many representatives of the industry warned that as it exists currently, the long-term package will not at all encourage insurers to finance certain long-term financial tools useful for the economy. A representative of the industry reminded the audience that depending on the outcome of the delegated acts it might rather hamper the economic role the European insurance industry should play in particular as long-term financiers.

The representatives of the industry clarified the fact that infrastructure and SME financings and securitisation are still penalised. To correct the situation they asked the regulators to charge the risk just as it is. Yet currently infrastructure bonds are charged 49% at the moment because we currently do not factor in the regulation that the recovery rate of infrastructure bonds, for instance, is between 65 and 80% compared to traditional corporate bonds where the recovery rate is 48%. Similarly the treatment of securitization is still raising issues. Though all the participants on the panel said that the EIOPA is definitely right in proposing a clear distinction between high quality and low quality securitisation and that they also appreciated the reduction up to 21% charge when previously it used to be at a 42% rate, they stressed that this level is penalising and inadequate when you consider that the risk of a default of high rated securitisation between 2007 and 2013 – not very good years – only amounted to 0.14%...

One panellist said that beside these calibration issues, the volatility of the regulatory capital of insurance companies is still an issue and we need to come to a conclusion on volatility adjustment, credit risk adjustment and matching adjustment.

In this context, a representative of the public sector explained that materialising the long term package, because it results from a political compromise, raises challenges in terms of calibration and requires huge volumes of data, which are not always available, and the use of spread indexes which can be problematic.

In addition a regulator from a Member State said that tuning the volatility adjustment to each company will be challenging for supervisors because while the E.U. framework sets the adjustment at 65% at the level one, they have to adjust it depending on the level of matching of the company and the predictability of technical revisions. He concluded by warning on the fact that there are still other issues that could influence the ability of the volatility adjustment to achieve such objectives as the definition of the reference portfolio and the design of fundamental spreads. However EIOPA and national regulators underlined the fact that they are greatly committed to deliver on that. Finally, they said that it is crucial to be as transparent as possible, by explaining which methodology and assumptions were involved. Indeed a few basis points on the curve could have strong impacts on solvency.

However the opinion of certain regulators is that what we have is good and makes sense, and we should try it: it is important also for the credibility of the risk-based supervision, they insisted.

4. The risk of regulatory inflation

A great deal of effort is expected from all companies in order to comply with 100% of Solvency II from the 1st January 2016. Yet another discussion about a global standard has started stressed representatives of the industry. In addition some of them wondered if there is a political control of Europe on this additional global exercise, if there is a single European approach and if it will be compatible with Solvency II.

Indeed, they said, if we want Europe to be able to defend Solvency II and IFRS, versus for instance the current American RBC and the current US GAP, we need to have a common front in that global discussion, and we do not have it today. The industry has also its homework to do to be more united, added one of them.

Adding a single supervisory mechanism and BCRs at the global level is expected to make even more complex the regulatory context as it involves the very same people and resources which are scarce within the industry as well as the supervisors.
Finally, as many dynamics exist at the moment on a global scale coming also from the IAIS, if we were in addition to add something like a SSM in Europe for insurers the outcome would certainly not eventually support policyholder protection and solid supervision, one panellist concluded.

However, representatives of the industry acknowledged that E.U. insurers definitely need an approach to basically reconcile the US framework and the European one, which today are extremely different. One representative of the industry explained in that respect that for countries, the regulation of which is not substantially equivalent with Solvency II, temporary solutions are necessary but cannot be permanent and the permanent solution will be having International Capital Standards to sufficiently harmonise prudential requirements globally. In addition they stressed that in certain large countries, the regulators of international insurance companies are already coming to understand what Solvency II is, and beginning to elaborate something independent of the American regulation.

However beside these aspects, certain participants on the panel warned about the necessity to go beyond Solvency II, explaining that the number of failures in the industry has been reasonably good even since the beginning of the crisis. In addition they stressed that the industry has even improved compared to what it was six or seven years ago, thanks to the preparation of Solvency II during which they learned a lot, not only in terms of risk management. Many representatives of the industry advised then to be careful not to have regulatory inflation adding other layers of possibly inconsistent regulations.

Finally they stated that making sure that the European industry is sound, is more about having the day-to-day risk management embedded in the business, than using capital models, which are useful for identifying risks but not sufficient. It is putting them in adequate interaction with business and risk management practices that is vital.

A supervisor acknowledged that the E.U. has not any urgency regarding E.U. global insurance players; however some of them stressed that it is the interest of Europe to benefit from the existing political momentum to address the fact that certain E.U. insurance undertakings are global. Consequently they suggested that no one should be closed to any option or way forward in that respect, which benefits global resilience, and should in addition help Europe to eliminate some possible shortcuts required by the completion of Solvency II.

5. Single EU supervision for insurance undertakings

E.U. policies encouraging competition have been causing in different E.U. countries all sorts of problems whenever unreliable services providers have destroyed fair competition conditions, stressed a representative of the industry clarifying that in this context Solvency II does help to build a sound Single European market for insurance. However he warned that the behaviour and habits of people are very different, which explains why national regulations are very different. Finally he was of the opinion that for similar reasons insurers also need a single regulator.

Other representatives of the private sector illustrated the need to ask many questions: Who sets the reporting schedule for the groups that work in several European countries? What happens if two national regulators do not agree on internal models validated by the group supervisor? They also stressed the need to improve the rules to be applied to systemic insurance throughout the world and get global rules consistent with Solvency II.

Moreover some of them highlighted the fact that implementing E.U. legislations sometimes creates imbalances and gaps and in that respect having only one regulator, down the line, is imperative to have a more uniform application of the regulation, stronger coordination and no cross-border arbitrage. Eventually some of them said that, as it is about consumers, this would also require both reflecting on single ombudsman functions and guarantee schemes.

However, certain representatives of the industry questioned if only Solvency II would suffice to transform Europe from a juxtaposition of national supervisors towards a true genuine European supervision? However they said that before we have a single supervisor it will probably mean great progress if gradually we have a more and more European vision rather than a juxtaposition of national ones. Finally they concluded by saying that they would favour at least a very strong coordination and if possible, a single regulator.

The regulators for their part said that they do not have evidence for the need for a single supervisory mechanism at a certain point in time. A supervisor stressed that the roots for creating the single banking supervisory mechanism are not present in the insurance sector, e.g. the need to untie banking risk and sovereign risks, the need to keep banking supervision close to the central bank to develop better conditions for monetary policies and enable direct funding by the European stability mechanism. Consequently he said, reinforcing the integration of the supervision has only been a side objective: one cannot envisage a pure copy and paste on the single supervisor: insurance has its specificities. Finally he stated that the current EIOPA has the duty and powers to deliver a consistent implementation of Solvency II and that any evolution in that respect will depend on how EIOPA and national supervisors will implement Solvency II. In addition he was of the opinion that ginen the legal form of the European agency, a single supervision approach would never work and that as we already have so many challenges ahead we cannot add other ones.

Moreover, he said, in so far as we are still waiting to see what the binding mediation powers of EIOPA will give, the EIOPA has provided preparatory guidelines, and launched several works to harmonise supervisory practices throughout Europe e.g. peer reviews, a supervisory handbook, a risk assessment framework, best practice on supervising AMSB, a definition of a rule book for prudent person rule, for assessing technical provisions, a definition of the ORSA.

A representative from the public sector from a Member State also stressed that supervisors play both host and home roles and were accountable to EIOPA, so they have the right incentives to implement the regulation consistently. In addition he said that Pillar III of Solvency II would provide a huge amount of consistent data, which will provide better knowledge of the EU insurance sector as a whole.

A representative of the public sector also described the current governance practices within the EIOPA. He

stressed that there is now a clear European mandate and there are different views and at the end there is a vote the outcome of which is that even countries like France, Italy, and Germany have been outvoted in different cases.

Moreover he said that at the EIOPA there is no longer a secretarial type of approach as there is a common policy regarding supervision, the role of EIOPA as a supervisory authority, regarding supervisory colleges, in the field of internal models and the agreement on equivalent regimes, etc. Consequently, though the first budget of the EIOPA was 2 million, now it is 21. There he concluded stating that Europe has made the choice to close the 28 national rulebooks and adopted a very modern legislation, tested and discussed to an extent that no other legislation can claim. However he acknowledged that ensuring the credibility of the Solvency II regime still requires speaking with one voice and applying the framework very carefully as of January 2016.

6. Consumer protection

Though a panellist described the difficulties faced in some countries in the union, still there has been **less waste in the insurance sector** than in any other financial sectors during the crisis. However a regulator stressed that today insurers' reputation is worse than the one of bankers and stated that the industry has to worry about this. Consequently many from the industry said that the need might not be to target a sounder insurance sector in Europe, but to turn in priority to the policyholders.

A representative of the public sector agreed on that stressing that the three E.U. authorities should have in their mandate consumer protection issues. He also stated that you cannot separate consumer protection from the regulation of the industry. In particular he said that as the peculiarity of the insurance sector is the reverse liquidity cycle, the clients must have an incredible confidence and trust in insurance companies. Finally another panellist from the public sector reminded the audience that the main objective of Solvency II is not financial stability but consumer protection, and the fact is that this includes many things ranging from better information to improving the ability of undertakings to fulfil their promises.

In that respect one representative of the industry stressed that it is useless for insurance companies to be sound if they cannot guarantee anymore over a very long period of time the value of the capital or the value of pensions. Yet he said, the weight of regulatory capital is such that in the next months and years insurers could exit from certain products and rather offer defined contribution schemes for pensions. This questions, he concluded, what will be insurers' added value to beneficiaries and stressed the importance of whatever is now undertaken by the E.U. institutions, to make the public more aware of what insurers can provide and what they cannot.

It will be important in particular, since Solvency II will in some way entail more control on the risks that an

insurance company still keeps on the balance sheet, to highlight the risk that will consequently be left to the policyholders. This supposes taking care of contractual and disclosure issues, in order to be sure that policyholders make well-informed investment and insurance decisions.

Lastly these representatives of the industry stressed the need for a regulation applicable to pension funds, aligned with the ultimate goals, which are the protection of policyholders, and ensuring a level playing field between with pension funds and insurance companies whenever they deliver similar guarantees.

They explained that European beneficiaries of pensions should have the possibility to choose between different schemes because whatever financial institution like insurers, can be in a position of running that kind of product in a level playing field. The next step in this direction should be a reviewed IORP directive. They stated that in addition one just cannot imagine that there would be no Pillar I in such a directive and it would not be understood that English or Dutch pension funds might fail due to the absence of regulatory risk assessment tools in particular in a world where insurers are sound thanks to Solvency II.

Defining global insurance regulations

Objectives of the session

The objective of this session was to discuss the main regulations projected at the global level for internationally active insurance groups.

The discussion more specifically covered the challenges posed by the definition of the Basic Capital Requirements (BCR) which should primarily apply to Global Systemically Important Insurers (GSIIs) and which are expected to be a first step toward such an international regulation. The possibility of defining international standards coexisting with regional or national ones was also addressed.

The specificities of insurance business models were clarified during this session in order to avoid any inappropriate confusion with the approach used for the banking sector. The conditions for an improved cooperation among the supervisors of insurance groups at the global level were also tackled.

Background of the session prepared by Eurofi

In the context of the FSB's SIFI Framework endorsed by the G20 in November 2010, the International Association of Insurance Supervisors (IAIS) published in July 2013 a methodology for identifying Global Systemically Important Insurers (G-SIIs) and a set of policy measures that will apply to them. These policy measures encompass recovery and resolution planning, enhanced group-wide supervision in particular overseeing the development and implementation of a systemic risk management plan, and lastly High Loss Absorbency requirements (HLA) for Non-Traditional and Non-Insurance activities (NTNI) to be met by the highest quality capital.

Based on the methodology proposed by the IAIS on 2011, the FSB has identified an initial list of nine G-SIIs, which is expected to be up-dated annually starting from November 2014. The status and related mitigation measures, of major global reinsurers is to be decided in July 2014.

Some of the key implementation milestones are the establishment of the Crisis Management Groups (CMG) and the completion of the Systemic Risk Management Plans (SRMP) for the first 9 G-SIIs in July 2014, the development of related capital requirements by the 2014 G20 Summit, and the development and the agreement by the CMGs of the Recovery and Resolution plans including liquidity risk management plans by the end of 2014. Implementation details for HLA should be developed by the end of 2015, to be applied starting from 2019. HLA will be built on the global Basic Capital Requirements (BCR) for G-SIIs, which are expected to apply from 2015.

The IAIS has undertaken in parallel an effort to address the issues posed to the supervisors by Internationally Active Insurance Groups (IAIG), a Common Framework (ComFrame) for the supervision of IAIGs, which started in 2010. This framework, which is based on the IAIS Insurance Core Principles (ICP) seeks to improve the coordination of the supervision of IAIGs across jurisdictions to address their complexity and the international nature of their activity. It will define the criteria and process for identifying IAIGs, the requirements they are expected to meet, and lastly defines the process of supervision – e.g. supervisory process, enforcement, cooperation rules, and notably the role of the group-wide supervisor.

The IAIS has also decided to complement the Come-Frame with a risk based global Insurance Capital Standard (ICS). The completion of the ICS is scheduled at the end of 2016. It will apply to IAIGs from 2019 after refinement and final calibration in 2017 and 2018.

These efforts represent a consistent set of initiatives bent towards the definition of an international regulation expected to address both the issues posed by the globalisation of insurance companies and the necessity to face up to possible systemic risks emerging from certain activities undertaken by the insurers.

In this context, the BCR, which should allow a definition of the capital add-ons possibly required by G-SIIs, would repre- sent the first step of the ICS toward an application on all IAIGs. Furthermore these international standards are not thought of as additional constraints to the various sophisticated regulatory frameworks already in place in different geographies (Japan, Canada, Switzerland, Mexico, the E.U., etc.). They are expected more generally to contribute to their harmonisation. They should in particular contribute to defining at the global level common approaches to assessing the risk of the assets and the liabilities of insurance groups for the purpose of supervision, and define common categories of risk, propose common approaches to factor in diversification effects and internal models, etc.

The challenges posed by completing a sophisticated risk- based framework at the global level in a tightened timeframe, combined with the challenges raised by effectively taking into account the specificities of the insurance business model when it thus comes to assess and mitigate the possible systemic importance of insurance groups.

Indeed the regulators have to factor in that insurance is funded up-front, which gives insurance undertakings strong operating cash flows and frees them from any wholesale short-term funding. Moreover, to back their liabilities, which are generally medium and long term with controlled out flows, the insurers accumulate capital and have large amounts of investment under management. In general these investments are not exposed to the short-term liquidity risks faced by financial markets. In addition, traditional insurance risks, which are not correlated with economic cycles, get benefit from the geographic and activity diversification of insurance groups. Banks by contrast, are involved in credit risk, which is highly correlated with economic cycles the impacts of which on financial stability are amplified by

the maturity transformation of short-term liquid liabilities on longer-term loans.

In this context it is important to emphasise that financial institutions behave in different ways in the event of systemic stress. The business model of each sector has to be well understood and the consequences for regulation fully drawn. In that respect policy makers must refrain from applying bank like regulatory approaches. For the insurance sector, the absence of leverage on the one hand and on the other hand the "timing feature" that allows a significant period of time for winding up a failed insurance company, fundamentally make the overall systemic debate quite irrelevant for this sector apart from a very few specific activities. In particular High Loss Absorption capacities (HLA) should not be imposed across the entire balance sheet of insurance groups but focus on non-traditional or non-insurance activities and on the possible interconnectedness with the financial system. In addition considering insurance business model specificities, policy makers must seek to combine according to the different possible policy tools e.g. recovery and resolution planning, systemic risk management plan, enhanced group-wide supervision in particular overseeing the possible development of NTNI, the sizing of HLAs, the appropriate combination of HLAs and liquidity constraints, etc. -

In the E.U. the recent adoption of Solvency II raises specific concerns.

- The insufficient contribution of E.U. insurance groups involved in the implementation of the new regulatory framework.
- Inconsistencies between the European and the global framework in particular regarding the impact of risk diversification effects, diverging valuations approaches for long term guarantees, the role of internal models, etc.
- Specificities at the global level of the regulatory approach for reinsurers subject in the E.U. to Solvency II.

Summary of the session

1. The case for a global framework

Global trade is outpacing year by year the growth of all national GDPs and eighty percent of the global trade is facilitated by multi-national companies. Insurance companies need to respond to these trends as new risks are there e.g. cyber risks, supply chain risks and other dimensions. Furthermore the life of corporations and pensions market have and will completely change. In addition global risk diversification is a key feature that the insurance industry needs to continue to access.

However, despite this backdrop, we have seen, in particular since the financial crisis an increase of geographic, structural and operational silos with efforts like Solvency II in Europe and related derivatives defined in South Africa, Mexico, etc. We have also seen the US RBC and the Swiss Solvency Test (SST) systems. Insurance supervisory approaches have been fragmented. Consequently for example rating capital assessment models, which encompass regional and country variations now require an 11-month process for their annual update.

This situation has had two negative consequences:

- The supervision of international groups is insufficiently effective and efficient
- Regulatory compliance is costly

However beside these international issues, in a context where capital looks for the best profitable result regardless of geographical borders, international efforts to make regulations converge should primarily focus on those risks due to the interdependence of financial markets and players at the global level, which have been unveiled by the financial crisis.

2. Objectives of the global regulation

Consequently insurance companies that serve their clients in more than 100 countries are in favour of global regulatory and capital standards as far as they target certain objectives i.e. regulatory certainty, the increased efficiency and effectiveness of cross-border supervision, the establishment and empowerment of a single strong group wide supervisor, a level playing field between foreign providers being headquartered in different geographies, the avoidance of creating an additional layer on top of existing or emerging local regulations.

Such regulation should also comply with certain demands e.g. comparability: where the risk is the same it should be seen in the same way, the recognition of risk mitigation techniques - hedging by derivatives but also reinsurance as well as the use of derivatives for hedging.

In addition such standards should be risk-based, reflect the true economics of the insurance business and take the total balance sheet to make sure that nothing remains un-captured. In that respect regulators should recognise that the use of internal models has been a key tool in the increasing resilience of the sector both in terms of anticipating and withstanding risks (in particular natural risks). In addition, it is important that diversification is recognized as the key aspect of insurance, which has to be accurately reflected and encouraged.

Lastly standards should also adopt a three-pillar approach like the Solvency II framework. In particular pillar three is considered as a leap forward for market discipline, making public disclosure available to all stakeholders.

The definition of the global framework has also to address the current challenge, which is to combine resilience and growth. Indeed insurers at the moment are playing a critical role not only by contributing to financial stability - Solvency II is a key element of that - but also by further contributing to the financing of the economy by diversifying their investments in particular to the benefit of the infrastructure, corporate bonds and real estate.

3. The current global regulatory initiative

The global regulatory initiative aims at promoting an effective and globally consistent supervision of the insurance industry, through a global supervisory language that is clear, consistent, comparable and measureable, with two objectives: 1) the benefit and protection of policyholders and 2) contributing to global financial stability. The global regulatory standards will therefore apply globally, which means that to comply a jurisdiction might need changing its regulation to the extent needed.

Internationally Active Insurance Groups (IAIGs), due to their complexity and international character, need more tailored supervision than what is in IAIS Insurance Core Principles (ICPs), which are based on high-level principles. This is why, since 2010, the IAIS has launched the development of the ComFrame: a comprehensive, group-wide, supervisory and also regulatory framework of qualitative and quantitative requirements, which are specific to IAIGs., The ComFrame is an outcome-based approach. It includes supervisory requirements, which are also supported by non-prescriptive illustrative guidelines.

The IAIS considers that a sound capital and supervisory framework is essential for supporting financial stability and protecting policyholders. Accordingly it is committed to develop by the end of 2016 within the ComFrame, a risk-based global Insurance Capital Standard (ICS). The ICS will provide an objective, group-wide measure

of the capital adequacy for IAIGs that is comparable across jurisdictions at the global level. It will enhance supervisory cooperation and coordination. It will also contribute to the level playing field and mitigate regulatory capital arbitrage. The ComFrame will be adopted in late 2018, after a field-testing phase starting in 2014. During the field-testing, both the ComFrame and the ICS will be further refined and calibrated. Like for the ICP, the ComFrame will require from the Members of the IAIS to change their regulations. It will not be an additional layer of regulation.

The work undertook by the IAIS on Globally Systemically Important Insurers - G-SIIs - recognises the specificities of the insurance sector. Its assessment is that traditional insurance and reinsurance is unlikely to cause or amplify systemic risk. Consequently, in the 2013, the methodology for identifying Global Systemically Important Insurers (G-SIIs) was mainly based on non-traditional and non-insurance NTNI activities and on the interconnectedness of insurers to the financial system.
The 2013 G-SII policy measures cover recovery and resolution, enhanced group-wide supervision and higher loss absorbency (HLA), taking into account the specificities of insurance. HLA, which will be developed for G-SIIs by end 2015, will target the systemically important activities and is expected to particularly focus on NTNI. HLA will apply from 2019 to the G-SIIs designated in 2017. As a foundation for HLA for G-SIIs, the IAIS is developing as a first step, straightforward Basic Capital Requirements (BCR) by end 2014. HLA will be initially based on the BCR until a more comprehensive framework is established.

The IAIS is committed to develop the ICS, the global risk based capital standard for IAIGs, in 3 years. The IAIS will consider the work already done regionally, but this standard is not expected to specifically mirror any existing jurisdictional or regional capital standard. It will be a new standard applying globally for IAIGs and will possibly require some changes to existing regimes in order to achieve a greater common good globally.

But this is also an evolutionary initiative, which will go beyond 2016. Consequently the IAIS will consider possible implementation steps and transition phases in due course, and review the design and calibrations of the ICS over time. Similarly field-testing will continue beyond 2016. The interaction of the proposed ICS with existing regimes will also be particularly assessed. Field-testing is also expected to overcome any valuation challenge given that FASB and IASB are not converging to achieve a minimal level of comparability of balance sheets. Finally field-testing will also be a way to avoid unintended consequences.

Overall the global regulatory initiative is not only about capital requirements: the ComFrame is comprehensive, it also covers the risk management within the companies, corporate governance and of course the supervisory processes.

4. Mitigating systemic risk requires factoring in the differences between banking and insurance.

The differences between banks and insurance companies have profound implications for designing appropriate systemic regulations.

a. Differences between banking and insurance

Firstly the insurance business is not so global as banking and asset management. The products are highly country specific and there are very few cross-border operations

especially in life and health insurance and protection. In addition banks are "institutionally" interconnected through secured and unsecured interbank lending. In the Euro Bank area these operations represent 60 percent of the GDP. Insurance companies by contrast are standalone operators with no balance sheet connection even among the companies designated as systemically important (GSIIs) providing no contagion channels from one insurer to another.

In addition banks face an inherent liquidity risk: the largest items on a bank's balance sheets are deposits, the bulk of which are callable at will. For the Euro Area those deposits amount 120 percent of GDP. In particular no bank can have enough own resources to compensate for a substantial deposit outflow. Insurers do not face such a liquidity risk; they are paid up front, and are actually liquidity rich. Furthermore the bulk of their liabilities are subject to events that the policyholder does not control.

Thirdly banks create money (consequently banks liabilities constitute this money) and handle the payment systems. Therefore instability in the banking system immediately has repercussions on the real economy because it impairs the payment function and the use of the money. Insurers' liabilities by contrast do not constitute this money. They just represent an illiquid and conditional financial claim for policyholders.

Fourthly banks invest in long-term assets largely on the basis of shorter-term liabilities: their activity consists of maturity transformation through leverage. Conversely an insurers' business model is to invest the premiums paid by the customers, in assets, which match the maturity of related liabilities. Consequently, only banks are exposed to changes in funding availability and cost.

b. Some similarities however

However actually the choice of the 9 GSIIs, beside the fact that they are heavily exposed in life insurance results from the fact that they operate internationally. In the E.U. in particular, even if the banking industry is more international we have witnessed so far fewer divestments from international operations in the insurance industry than has been seen in the banking industry.

In addition both banks and insurers are investors in financial markets; both seek a broadly highly diversified portfolio encompassing all types of assets. In particular as investors they may hold each other's securities with banks holding insurance assets and vice versa. This may be a rationale for interconnectedness but has not given however rise to special regulation in the case of banks. Another element of interconnectedness is of course the use of derivatives, which insurers use mostly as end users not as go in betweens for hedging purposes. In the case of insurance companies, the derivatives however are collateralized whether they are traded on financial markets or bought from banks.

Another similarity is that banks and insurers are financial intermediaries. Insurers intermediate between savers and the economy; they channel funds and fulfil a function of capital allocation in the economy.

Finally one can represent within the financial system, the banking system as the inner circle, in which the degrees and the forms of interconnectedness are manifold and very large.

Insurers are like other investors in an outer circle of the financial system, mainly linked to one another via financial market investment.

c. The reinsurance market

One participant stressed that Reinsurance is a good example of how interconnectedness in insurance is misunderstood, as the potential for systemic events to develop within the interconnections is limited.

He clarified that Reinsurers provide global pools of diversified risk that provide by themselves protection for the insurers. Indeed they provide the diversification that the insurers might not get by themselves in their particular markets, he insisted. As such, reinsurance premiums represent around 5 to 10 percent of the gross insurance premiums.

He also said that, in the context of the failure of a specific insurance or reinsurance company, it is important to differentiate between ruin and loss. The impact of failure could be significant because of the important services provided to customers. However, the impairment tends to be limited to specific sectors and the market tends to recover swiftly as new competitors move in.

This issue was addressed by the 2010 study of the Geneva Association, which clarified the actual level of interconnectivity within the insurance sector. In this area balance sheet interconnectivity is not a threat.

He concluded by stressing that in the reinsurance market, substitutability is at its peak and has never been so high as measured by the unusually high alternative capital volume entering the sector.

5. A global regulation: what is at stake

The stakes are very high for both the industry and the regulators.

The insurers are concerned by the cost of doing business, by the level playing field and the whole management of the companies, which gets much more complex depending on the regulation. In addition the insurance

industries are at the lower end of the valuation curve. Even the banks up to today after the 2008 financial crisis, on average have a higher valuation the insurance industry being known for not being a true transparent one. Indeed few equity and bond investors understand this industry. Consequently the global regulatory process must be very cautious not to add any uncertainty.

The regulators are concerned because of their credibility, which will depend on the appropriateness of the regulation, its effectiveness and its overall coherence.

Furthermore in a context where the banking sector is vulnerable, it would be important to keep the insurer investment channel open for the real economy.

The industry has to have a proactive and constructive vote in this whole dialogue to identify required regulatory and supervisory conversions and develop some thoughtful leadership on what such a framework could look like.

National and global regulators have to address the fact that it is not encouraging for insurance groups to see how regional differences are quite impossible to overcome.

6. Issues raised by the global regulatory process

In the E.U. the recent completion of the lengthy legislative process to define the new regulation for insurance undertakings reduces any appetite for an early review of the rulebook. Moreover the risk is that the international framework adds to an already very sophisticated legislation.

Rather this international work is expected to learn from modern regulation such as Solvency II and Omnibus II, which benefit from a high level of scrutiny at political levels, at technical levels and at the stakeholders' level. The credibility of the new E.U. framework stems in particular from the fact that it succeeded through a painful but worthy struggle, to achieve a single legislation at the regional level while other countries have not even harmonised their various domestic jurisdictions.

The deep experience of the E.U. legislative process suggests that **the timeline is ambitious** as it takes time for these things to mature: five years had been necessary to complete Basel III, five to six for Basel II and seven years to establish Basel I including several rounds of field testing and quantitative impact studies, as well as significant variations of the framework in between.

In particular the envisaged regulation encompasses long-term risk, for which any adjustment can only be evaluated in a midterm or long term run. One should take sufficient time to really attest the macro and the micro impact and avoid any unintended consequences for the sector and its role in the real economy.

Furthermore, calibration is essential to make the BCR and HLA requirements **consistent with the Solvency II regime**. It is not certain if this task will be completed before the G20 meeting. To effectively supervise GSIIs, HLA would be stricter than solvency capital requirement coming from normal regulations (Solvency II): the speaker was therefore not prepared to envisage dumping Solvency II.

More generally the challenge underpinning calibration is that stacking backstops on top of other backstops does not make supervision better or more effective. Whether it is or not a burden on the industry is an issue, but primarily it is conceptually nonsense.

To follow the timetable – the G20 is expected to decide in Brisbane by November - we have to avoid over complicating the regulation in particular in the area of valuation, which is currently treated differently in the US, in Europe, and in other parts of the world. This will require an unprecedented level of discipline.
However the regulator has to address the fact that currently the level of adjustment required to put the balance sheets on a level playing field is substantial. The absence of agreement between the IASB and FASB in that respect is disappointing.

The regulations being defined in other parts of the financial services industry should not influence inappropriately the insurance industry, which has to remain focused on policyholder protection and take into account the specificities of the business model of the insurance sector that is **not comparable to banking**. Getting back to the core of what insurance regulation is all about is critical to strengthen not only the economic position of the industry but also its overall reputation.

An appropriate consultation process and involvement of the regional (European) institutions and stakeholders has to be guaranteed. When defining a framework at the global level one should be very careful of **democratic accountability**.
In addition the E.U. Parliament which has a say in the context of the implementation of Solvency II, on the decisions regarding the equivalence of the regimes at a global level, should be appropriately involved and informed about the development of the global framework.

7. Actual systemic risks in Insurance

In the insurance world the far higher risk for financial stability is very likely to be coming from a previously unknown number of insurance companies being infected by something happening somewhere in the financial sphere because a particular asset class or activity is infected. Main systemic risks in the insurance area will come from second order effects on a large number of insurance companies. To address this issue any concept based on just singling out a small number

of particular companies would weaken financial stability. Consequently we need a risk-based supervisory concept specific to insurance and not a small list of individual discrete companies, which is a concept only valid for the banking sector.

For the past fifteen years many insurance companies, maybe the insurance industry as a whole, tried to evade the reputation problem by looking less as insurance companies and more as a sort of investment bankers. The speaker recommends the insurance community to refocus on what insurance really is i.e. delivering security and risk mitigation through a collective business model based on an “economically organized solidarity” that he does not think is outdated.

8. Capital as such is no silver bullet

The BCR is a stepping-stone for the HLA. However capital as such is no silver bullet. Whatever amount of capital you demand, it would not be enough to address unregulated businesses, which is not well understood by the management. In the United States AIG required a 180 billion or so bailout. At this point in time the focus is too exclusively on the BCR. The risk is that you just put a factor on the BCR to define the HLA.

One option to be considered is that HLA capacities are related to the activities that create systemic risk. It should not be the fact that you have been designed as a GSII that triggers specific regulations. If an insurance company undertakes systemic activities then it should be regulated in line with those activities. It is also important to achieve a level playing field. Consequently a better and clearer definition of the NTNI is needed.

In such a context with the definition of the BCR as a basis for the HLA this year, we can still at least leave the door open to further amendments in 2015 and beyond to leverage stakeholder interactions and quantitative impact studies. In addition, if we introduce an essentially untested BCR in 2015, it should be on the basis of a reporting to supervisors but not with public reporting.

9. Recovery and resolution are key components of a global framework

Recovery and resolution arrangements are key components of a well-crafted risk management process. They should not be exclusively reserved to either GSIIs or possibly not even IAIGs. However the principle of proportionality needs to govern the process.

Those new approaches force supervisors to face up to an impressive learning curve to absorb them. Though insurance usually provides more time. However there is a set of seemingly simple questions to be answered, like the definition of who should join the crisis management group, who at the global level should be associated with recovery proceedings provided that in each country five to eight institutions from ministries, to supervisors, might be involved. Such issues cannot be copy-pasted from the banking side.
In addition defining a recovery plan is a very sensitive process as you risk putting the most intimate and sensitive details of large institutions on the blackboard and publishing them on the Internet.

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

Objectives of the session

This session was devoted to discussing the progress made in the implementation of the G20 Pittsburgh commitments regarding OTC derivatives and banking requirements, the remaining inconsistencies across jurisdictions and the barriers to the coherent implementation of these commitments. The possible approaches and tools required to facilitate the cross-border implementation of rules that have equivalent outcomes were also examined.

Background of the session prepared by Eurofi

Strengthening financial regulation is a key objective of the G20 commitments agreed in 2009.

Cross-border implementation and global consistency of OTC derivatives requirements

Much progress has been made in the definition of OTC derivatives rules, but their implementation is taking longer than expected and differences in timing have appeared across the main jurisdictions.

The definition and implementation of requirements for transactions to be reported to Trade Repositories (TRs) is moving ahead rapidly in most G20 countries, but progress with central clearing requirements is slower and is still quite limited for trading requirements. The EU rule-making process is almost completed while the implementation of the rules is still work-in-progress. The US is somewhat ahead with swap trading, clearing and reporting obligations having been put in place by the CFTC in 2013. However the process is less advanced for SEC regulated swaps. Most Asian jurisdictions are further behind schedule due to specific domestic priorities.

Legislative progress is also being made in the area of margins for non-centrally cleared derivatives for which globally agreed standards were published in September 2013, although their implementation is not expected to begin until the end of 2015 in most jurisdictions.

Although the OTC derivatives rules defined have significant commonalities, there are many differences across jurisdictions in their detailed requirements.

Many differences remain between the EU and the US requirements regarding in particular the product scope (including exchange-traded and OTC derivatives in the EU), exemptions applied to non-financial corporations, reporting obligations and minimum risk management standards that apply to CCPs. Such discrepancies may create complexity both for direct participants and for the buy-side and potentially lead to liquidity fragmentation.

In the absence of an authority with the power to coordinate policy-making and enforce policies consistently at global level, which some market observers are calling for, developing international cooperation mechanisms among jurisdictions is essential to facilitate the cross-border implementation of these rules.

Major steps forward are being made in the OTC derivatives area, following the declarations made at the G20 Saint Petersburg summit "that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identical outcomes". However, how any international agreement on margin requirements for exchange-traded derivatives will be reached remains to be clarified.

The US CFTC and EU Commission (EC) first published a joint understanding of cross-border issues in July 2013, followed by a multilateral set of understandings announced in August by the OTC derivatives regulators group consisting of regulators from jurisdictions with large OTC derivatives markets. Further proposals are expected from the IOSCO task force on cross-border regulation set up in September 2013.

Furthermore a proposal was made by the EU Commission in January 2014 to establish within the EU-US Transatlantic Trade and Investment Partnership (TTIP) process a framework for regulatory cooperation in financial services.

While generally supporting such approaches to facilitate the cross-border implementation of rules in the OTC derivatives area, many industry players and observers stress that their impact will depend on the finer details of how "substituted compliance" (in the US) and "equivalence assessments" (in the EU) referred to e.g. in the CFTC / EC agreement will be designed and how the high-level principles proposed in these declarations will work in practice. Another issue to be overcome according to some regulators are the potential differences in the degree of supervision and enforcement of rules.

Regarding the practical implementation of these principles, progress has recently been made in the trading area where an agreement was reached in February 2014 between US and EU regulators to exempt from US trading rules European-approved platforms that trade derivatives, until equivalent EU rules come into force in around 2 to 3 years' time. Questions however remain regarding the way equivalence assessments should be conducted in practice. Some observers believe that there should be a certain degree of flexibility in such decisions in order to avoid a "zero-one" system by which a foreign jurisdiction is considered to be either equivalent or not equivalent with limited discretion.

There have also been discussions regarding the criteria to be used in such assessments and the degree of proportionality that may be allowed.

Cross-border implementation and global consistency of banking requirements

At the end of 2013, 25 out of the 27 main jurisdictions in the world had Basel III rules in place. Although the implementation of Basel III banking prudential requirements is phased-in as far as 2019, their implementation has been anticipated by the market in many cases creating major impacts for the profitability and activities of many EU banks in particular.

Differences have appeared in the rules applying to the banking sector.

Differences have emerged in the implementation of Basel III designed as minimum requirements e.g. related to the leverage ratio or to exemptions contained in CRD IV. There are also concerns in Europe regarding the US Fed's proposal to require foreign banks, previously exempted from US capital requirements when owned by a well-capitalized foreign bank, to create a local bank holding company subject to US prudential requirements. The justifications put forward by the US authorities include the increasing size of foreign banks' US operations, their interconnectedness with the US financial system and the possible risks associated with large intra-group funding costs.

Moreover the differences across banking structure reforms already implemented and proposed e.g. by the EU Commission are also stressed.

Differences in the level of bank intermediation and accounting rules across jurisdictions mean that the outcomes of Basel III requirements might differ quite significantly.

The impact of Basel III prudential requirements is expected to be quite different between the EU and Asia where bank-intermediation is dominant for retail and SME financing and the US where market-based mechanisms are much more developed, and where a significant proportion of the retail credits originated by banks are transferred to the Government Sponsored Enterprises (GSEs) which are not subject to Basel III requirements.

The unintended consequences resulting from inconsistencies in recovery and resolution plans (RRP) are also stressed.

Sufficiently integrated and consistent RRPs need to be in place for global financial groups in order to avoid local restrictions or lock-ups in case of stress, which may threaten the viability of such groups or frustrate the resolution actions of the home authority. Differences between the EU Bank Recovery and Resolution Directive (BRRD) and the US measures are stressed regarding in particular the scope for bail-in and loss absorbency requirements, with differences in the level of recapitalisation required in different jurisdictions.

Summary of the session

OTC derivatives reforms at the global level

Progress made in the implementation of the G20 commitments

A regulator explained that transaction reporting is the area where the most progress has been made at the global level. As of April 2014 fifteen jurisdictions across the FSB have some reporting obligations in place. The objective is that by the end of 2014 all jurisdictions members of the FSB will have trade reporting obligations in effect, which will be quite an achievement, even if the initial deadline of 2012 has been missed. At the moment only three countries have mandatory clearing obligations in place but by the beginning of 2015 there should be around 14 jurisdictions with such obligations in effect or at least under detailed consultation. These include large markets such as the EU, the US and Japan but also smaller ones like Australia, Canada, China, Hong Kong, India, Korea and Singapore. The use of trading platforms, which was also at the core of the initial G20 Pittsburgh commitments, is an area where less progress has been made. Apart from a few jurisdictions which already had such requirements in place such as Brazil, only the US has really moved forward with the trading requirement, although some other jurisdictions have also made concrete steps forward (such as the EU with the adoption of MiFID II / MiFIR).

As for Europe, a regulator stated that the EMIR requirements are near completion and the first CCPs have been authorised. The central clearing obligation still needs finalizing (i.e. identifying which OTC derivatives need to be centrally cleared and defining the phase-in periods for the counterparties concerned). Another area where rules need to be completed concerns margins for the bilateral clearing of non standardised OTC derivatives, because European regulators have been waiting for standards to be defined at the international level before moving forward with the legislative process. A consultation running until July 2014 was launched in April 2014 by the European Supervisory Authorities (ESAs) covering the risk management procedures for counterparties of non-centrally cleared OTC derivatives transactions, the definition of margin methods, operational procedures and the treatment of collateral as well as the procedures concerning intragroup derivative contracts. The importance of CCP colleges, notably to increase supervisory convergence within the EU, was also emphasized by the regulator. Such convergence discussions which take time will help to ensure that the objectives of a consistent application of EMIR and consistent supervision are achieved across the EU. The Q&As regularly published by ESMA also play a role in achieving a coherent application of EMIR across the EU.

An industry player added that there has been some progress over the last year at the cross-border level. Extra-territorial impacts of Dodd-Frank in the trading area have been averted (i.e. with the relief granted in February 2014 by the CFTC exempting EU approved trading platforms from the application of US SEF rules)[1]. Unfortunately the relief of the CFTC came too late and the marketplace had already found solutions to the problem. The CFTC has shown some willingness to work with the EU regulators on trading requirements and qualifying EU trading platforms, but there is still some fragmentation in the marketplace, the speaker believed.

Main issues to be addressed at the international level regarding the content and timing of OTC derivative regulations

A regulator emphasized that cross-border regulatory issues are becoming increasingly pressing with the progress made in the implementation of the G20 requirements. Ensuring cross-border compatibility of regimes matters for derivatives transactions because in the majority of cases such transactions involve counterparties located in different countries. Several issues need to be further worked on in this perspective. There are differences in the timing of implementation. This is the case for example of trading requirements for which there are significant differences between the US and the EU in the timing of implementation (rules have taken effect in the US whereas the technical implementation standards of MiFIR have not yet been adopted), although the rules themselves have many similarities. There are also differences in the specific regulatory parameters being adopted even if requirements are broadly similar (e.g. differences in the details of the transaction information that is required to be reported, in the calibration of CCP margins or in the degree of rehypothecation that is permitted for non-centrally cleared margining). There are also differences in broader design options which may create frictions, for example whether statutory recovery and resolution regimes are required for CCPs.

Another issue that is coming increasingly to the fore is the availability of market infrastructures such as trade repositories or CCPs to support cross-border activity and for example to clear products across multiple jurisdictions. This is not the case in some jurisdictions which will have to rely on infrastructures based in other markets to advance the implementation of the G20 reforms. Another question is how to sustain the compatibility of regimes over the long run, as jurisdictions will continue to adapt and reform their regimes both to reflect internationally agreed reforms and to respond to domestic policy concerns and priorities.

Regarding the international coordination of the implementation of OTC derivative rules, the "base case" is friction and problems a regulator stated. The short declaration of the 2009 G20 Pittsburgh summit on OTC derivatives has now been transformed into thousands

of pages of legal texts and there is very little chance that such detailed legal texts will be entirely consistent across regions. Regulators now have to make sure that the differences are as limited as possible and can be reconciled. This is the task notably of the ODRG (OTC Derivatives Regulators Group), which regularly reports the progress made to the FSB.

One difficulty, an industry player stressed, is that some regulators of G20 countries are asking both for a global harmonization of regulation in the OTC derivatives market and for retaining flexibility in their market in order to be able to implement rules according to local specificities if needed. These seem to be conflicting objectives because harmonization normally means cutting down the amount of flexibility. In the reporting requirements area there are many inconsistencies between the US, the EU and Asia concerning the types of transactions that need to reported (only OTC or also on-exchange), the timing (real time or not), the counterparties the requirements apply to (one counterparty or both), the information that needs to be reported and the format to be used. This makes the aggregation of data very difficult. Also as a result new designs are needed for trade repositories in every market. An explanation for such inconsistencies is that standards are not granular enough. Some believe this is the case for EMIR but also for Dodd-Frank. The speed of reaction of regulators is another issue. One example of this is Legal Entity Identifiers (LEI) which represent an open global standard that is widely accepted. Yet it took some time first for the FSB to agree on using LEIs, then for domestic regulators to do so and some regulators have still not adopted the LEI standard. This makes it very difficult to achieve the G20 goals of setting up trade repositories in order to analyze systemic risk. Nearly six years after the crisis started appropriate data and trade reporting is still not available, the speaker deplored.

A policy-maker explained that financial reforms and standards are like water, they always "seek the lowest point of gravity" so re-regulating global financial markets means working collectively and developing a global understanding. In 2013 there was much concern about fragmentation (i.e. different rules being applied in different regions of the world) but the issue around US SEFs and EU OTFs/MTFs[2] was solved at the last minute "through brinkmanship" (with the relief granted in February 2014 by the CFTC).

Regulators however face a "real conundrum", the policy-maker believed. Following the definition of the Pittsburgh G20 commitments several countries moved very quickly to reform their OTC derivatives regulation but regulators worked within the parameters of their own laws which resulted in frameworks that give legal certainty and a level playing field only within the confines of these national laws. The rules that were passed therefore do not always work across borders. This explains some of the issues that the regulatory community is facing at present. In this case the first mover advantage has been detrimental to the functioning of the overall market because it has led to differing timing sequences and requirements in different jurisdictions.

An industry player agreed that the challenge of the global implementation of the G20 agenda on the derivatives side is that very high level aspirations have ultimately been implemented through national systems without clear, consistent and detailed global standards which means that an enormous amount of work is then required from regulators to try to reconcile, after the fact, inconsistent systems so that there can be a functioning global marketplace.

A policy-maker agreed that encouraging a better synchronization of timing going forward is essential. The fact that MiFIR and EMIR have been adopted can be commended but comparability assessments are difficult to do unless the full set of rules is in place, which is not the case at present. The trading and clearing mandates therefore need to come into effect in the EU as soon as possible in addition to the reporting mandate (which has been operational since February 2014).

The policy-maker added that although the trade reporting mandate is in place in many G20 jurisdictions it is still very much a work in progress. The data provided still needs to be "sifted through" in order to ensure sufficient quality and figure out how they can be used. In the US the CFTC and the Office of Financial Research of the US Treasury have recently agreed on a joint programme to assess the quality of the data that are being reported and define the use that can be made of them. There is also work at the international level conducted by the FSB to determine how the data can be reconciled across trade repositories and used internationally.

In the coming months specifying EMIR clearing rules will be the main challenge at EU level an industry participant pointed out. What products are clearable, on what date and with which types of participants needs to be defined with sufficient clarity. Some additional issues to be addressed in the EU were mentioned. Issues related to the frontloading provisions of EMIR (which require outstanding swaps to be cleared if they belong to a product class that is later mandated for clearing) will hopefully be solved[3]. The FTT proposal is another issue that needs to be addressed. It will probably be put in place the speaker thought although it is likely to bring neither resilience nor growth. The question now is how to mitigate its impacts and how the EU can learn from the experiences of some Member States (e.g. France, Italy, UK…) in order to develop a solution with limited negative consequences and that achieves some of the goals that were set out. Collateral is also going to be a huge issue going forward (the supply and demand of collateral, the ability to produce the collateral required, the models for the calculation of collateral…).

The fact that more fairness is needed in the international financial system was also mentioned by a

regulator. Moving uncleared OTC derivatives to central clearing is not only about risk mitigation it is also about fairness. A parallel can be made with the trade negotiations underway between the different regions of the world.

Possible ways forward for improving cross-border cooperation

Several speakers on the panel stressed that much progress has been made by regulators over the last five years in engaging in more bilateral and multilateral discussions. Cooperation is happening at all levels and is working: informal meetings gathering together the policy-makers and regulators of the main jurisdictions involved in OTC derivatives markets, bilateral and multilateral cooperation (e.g. within the FSB, CPSS-IOSCO, the ODRG). A policy-maker believed that although there are some difficulties along the way regulators usually end up agreeing on 95% of the issues.

Going towards a global regulatory power that could force further consistency across regulators however seems difficult to establish, an industry speaker stated. Neither IOSCO nor any other group of regulators can succeed in the task of forcing regulators to be consistent at the international level the speaker thought. Derivative regulation is too complex and detailed and regulators will always find a way to introduce specificities in the legislation if they want to. Such differences are the symptom of a "distinct lack of trust" within the marketplace and among domestic and international regulators leading to protectionist attitudes. Building trust is therefore the core solution to such issues. There has been a positive evolution over the last two years in the relations between European and US regulators in particular. The industry is also being consulted much more the speaker thought. But progress still needs to be made in practical terms. The IOSCO taskforce on cross-border regulation is a "wonderful opportunity" to fix some standards. Such an approach should however be pragmatic and focus on specific areas in order to provide some "small starting blocks" on which trust between regulators can be built. Moreover it should not be over-expansive trying to come up with a single solution for all regulations across the marketplace.

A regulator explained the focus of the work of the IOSCO task force on cross border regulation which is raising many expectations. The task force is not specifically focused on the problems of cross-border coordination of OTC derivatives issues. It is studying more broadly the cross-border tools that are being employed by jurisdictions that are members of IOSCO in order to develop the toolkit that may give regulators options how to respond to cross-border issues. A consultation paper should be available by the middle of 2014 with a final report planned for the end of 2014. The survey makes a list of the cross-border approaches that IOSCO members currently use. These range from direct registration to passporting and include mechanisms such as substituted compliance, mutual recognition, equivalence assessments, exemptions from some or all registration requirements or unilateral recognition of the foreign regime. The challenges facing such cross-border approaches have also been identified. Eight main challenges were pinpointed: (1) the absence of universal principles to guide cross-border regulatory actions; (2) the fact that regulators often do not get information on the overseas regulatory requirements and processes early enough; (3) the need for more clarity on the underlying objectives and timing pursued by regulators which goes together with the issue of trust which cannot be developed without such elements; (4) the lack in some cases of international regulatory standards and of consistency in implementing them; (5) the difficulty of establishing whether outcomes are similar in an outcomes-based approach; (6) limitations to the oversight of cross-border activities that can be performed by domestic regulators and enforcement agencies; (7) access to data and documents; (8) the unintended consequences of rules (e.g. extraterritorial consequences, some of which are intended whereas others are unintended).

IOSCO can provide regulators with assistance and guidance in order to foster a further convergence of cross-border regulatory approaches and consistency of their implementation in many ways: providing guidance for compatibility or equal balance of regulations; organizing depositories of information (e.g. a central information repository has been set up by IOSCO with regard to clearing mandates which will help jurisdictions to find out where and how such determinations are being made); using IOSCO regional committees as platforms to share concerns and develop common approaches (a constructive dialogue is going on between IOSCO's Asia Pacific Regional Committee and the EU Commission for example regarding the implementation of rules in Asia, as Asian markets are getting affected by Dodd Frank and EMIR rules); providing capacity building and technical assistance especially to emerging markets that are also getting affected by cross-border approaches. An example of a multilateral instrument that can also be used is the multilateral memorandum of understanding of IOSCO on enforcement. A similar tool could be developed on supervisory cooperation.

There is however a discrepancy between the ambitions of the G20 to implement reforms in a way that promotes an integrated global financial system, reduces fragmentation and avoids unintended costs for businesses and the tools that are currently available to implement such rules on a cross-border basis, a regulator stressed. There is no specific guidance on this latter issue and national and global regulatory bodies are expected to "be able to make things happen". There is a need for a firm basis in international law such as a treaty to really make progress and reconcile the ambition to manage global markets with the fact that implementation is local.

Tools such as equivalence assessments (used in the EU) and substituted compliance (used in the US)[4] exist to solve the issues raised by the cross-border implementation of regulations, a policy-maker emphasized. These are totally different approaches though. In the equivalence system the EU defers entirely to the regulation and enforcement of a third country once an equivalence decision has been adopted. Equivalence decisions that the EU Commission is working on take some time because twenty-three countries are being looked at even if the priority is given to the United States and Japan. These are very important decisions because accepting equivalence for systemically important central counterparties (CCP) for example means exposing EU banks to deals that are cleared by those CCPs and potentially importing risk into the EU. Standards that need to be applied when a jurisdiction defers to another is a second element. The standards of the foreign country that is being deferred to need to be assessed even if they are considered to follow international CPSS-IOSCO standards because there may be some "fudges", the policy-maker stressed.

A regulator was favourable to a system that can enable regulators to rely on each other when rules achieve the same outcomes. Some progress has been made in the US with the use of substituted compliance but much improvement still needs to be made on the operational side in order to achieve greater international coordination.

Ex ante coordination and granularity of standards

The lessons of the implementation of the G20 commitments for future reforms are that ex ante international coordination on rules is needed before jurisdictions regulate as well as a synchronized timing of rules, a policy-maker believed. This needs to be done upfront rather than waiting for differences to appear after legislation is passed. International standards must also give more certainty. Moreover, the process needs to be better monitored and the impacts of regulatory decisions appropriately addressed at the international level.

Another issue is the granularity of standards.

The difficulty with coordinating the implementation of the rules derived from the G20 commitments, a regulator believed, is the absence of standards agreed beforehand at the international level. The availability of templates and standards agreed at the international level at the beginning of the process would help to ensure a more consistent implementation across regions. On the standard setting front, the international standards or principles for Financial Market Infrastructures (FMIs) are a good first step but they are not granular enough.

Standards for bilateral clearing are much more granular and this should help to achieve consistent application. The work on margins for uncleared derivatives trades is the litmus test for such an international approach and for determining whether the G20 has been successful in the financial area a policy-maker stated. If rules are not common the business will go to the "lowest point of gravity" i.e. where the rules are the weakest. In such a case the G20 process will have failed because there will be insufficient incentives to move OTC derivative trades to central clearing. A second test is whether the US can really deliver substituted compliance on a cross-border basis with CCP (Central Counterparty) or DCO (Derivatives Clearing Organisation) relief.

More granular international standards should be developed first in some cases in order to be subsequently used by domestic regulators a regulator added. Equivalence approaches can also be used more easily with more granular standards.

A policy-maker agreed that granularity is particularly important when regulators try to defer to each other. Regulators should have taken time to drill deeper and to agree on the essential details of the rules when engaging on the implementation of the G20 commitments. This could not have been done at the time unfortunately and one sees now the consequences of this in the on-going cross-border issues and equivalence decisions.

Banking requirements at the global level

Progress made in the implementation of the G20 commitments for banks

An industry player stressed that there is a "consistent and common high level G20 framework" available for banks in the same way as for derivatives. The difference

though is that the Basel Committee has a mandate and a tradition, unlike IOSCO, of developing very detailed rules which eventually become not only the framework but actually "the letter" of national implementation.

This however does not guarantee totally consistent implementation, as has been shown by divergences regarding the Credit Valuation Adjustment (CVA) charges for example, but divergences are quite transparent and easily identified. As a general rule implementation, unless there is a significant departure from Basel rules, should be consistent on a global basis.

A regulator emphasized that the FSB has been tasked by the G20 with considering the effects of the structural banking reforms that are being put in place or are proposed by different jurisdictions (such as the Volcker rule and the foreign banking organization requirements in the US and structural separation requirements proposed in the EU). The assessment of these reforms and proposals has started and a report is due to be published for the G20 leaders' summit in November 2014. The FSB is not against such reforms because they are specifically designed to deal with the too big to fail problems which are a core part of what the FSB is addressing. But the unintended consequences of such measures on specific markets in particular need to be further assessed.

Another regulator agreed that too big to fail issues are a key priority that includes structural banking reforms.

A policy-maker explained that the US is going to continue to work with the EU to promote a "vigorous" implementation of the Basel III standards. This includes ensuring that risk weighted assets are assessed consistently across jurisdictions and that Basel's high quality capital and liquidity standards are met. In that regard the work being done by the Basel committee on bank supervision is supported by the US as well as some technical work being done by EBA. The US also supports the recent agreement on the leverage ratio at the Basel supervisory committee. The key part now will be getting a globally consistent leverage ratio for the largest banking institutions. The US is going to urge for a rapid adoption of the new standard by their international counterparts. US regulators are also considering a stronger leverage ratio beyond the Basel III minima for the largest US banks.

Challenges to be addressed in the implementation of global regulatory standards for banks

According to an industry participant, the main challenges which will probably require addressing on the banking regulation side are the differences in supervisory practices and the possible departure from a risk-based framework in some cases.

Much good work has been done by the Basel Committee on Banking Supervision (BCBS) with audits performed of the risk weighting practices in both the trading and the banking book. Work is also being done by Basel to identify specific areas of national discretion and to determine whether such discretion should remain. This should help to establish further supervisory consistency. The issue however is that these differences in supervisory practices (both different interpretations of the requirements and divergences in supervisory practices) are used by some regulators as an argument for moving from a risk based framework to a standardized framework. This inclination which is quite understandable would be extremely dangerous, the speaker emphasized. Measures such as the leverage ratio intended to serve as backstops or floors run the risk of being miscalibrated in such a way that they overwhelm the risk-based system and become binding. For firms such as banks whose ultimate function is to be risk-taking entities intermediating risk and the capital formation process it is critical that the risk-based framework should not be abandoned. In the same way, the trading book review which is being consulted upon is turning it into a consistent framework that may undermine the risk based one.

A regulator stressed that backstops were justified because one cannot trust entirely the risk based or standardized model.

Another industry player stated that although everyone shares the objective of achieving consistent regulation at the worldwide level and the long term objective of reducing systemic risks and eliminating the need to have recourse to taxpayer money in the future, the short term impacts of the requirements proposed are not equivalent in Europe in the US and in Asia. This is due to the differences in the current structure of the financial

systems (e.g. the importance of bank financing in the European economy compared to the US). Although banking rules are common their outcome across regions will be different, at least in the short term.

Accelerating the implementation of common rules may have two consequences: negative impacts on the financing of the EU economy and the creation of an unlevel playing field between the US, EU and Asian financial industries.

The unlevel playing field could be aggravated by differences in rules affecting banks. One example is the so-called "Tarrullo rule" whereby non-US banks have to comply with specific US local rules regarding liquidity and capital[5], which creates additional costs notably in terms of liquidity management. Such a rule does not exist for non-EU banks operating in Europe. Another issue is bank structural reforms. Structural measures have been defined in France, Germany and in the US. But there is still much uncertainty regarding possible European rules in this area (following the Liikanen report and the subsequent EU Commission proposal[6]) and what could be the future model of banks in this context e.g. with regard to market making activities.

Achieving a consistent implementation of these shared objectives is the main challenge. Having more cooperation at the international level is clearly needed. But this is not only a question of consistency, it is also a matter of having a fair approach across regions taking into account the real impacts of rules on economies and on the financial industry. The European banking industry is currently liable to losing market share due to the differences in the impacts of regulations between Europe and the rest of the world, the speaker believed.

An industry player commented on the challenges of implementing a recovery and resolution framework for Global Systemically Important Financial Institutions (G-SIFIs).

Recovery is no longer the major issue because most G-SIFIs now have workable recovery plans in place. The main challenge now is the resolution part. There is however a strong connection between the two which should be further considered by regulators. If an institution has a very robust recovery plan in place this should by default mean that the chances of arriving at a point of resolution are relatively remote. More attention needs to be paid to assessing the quality of both plans in connection. Another issue is the delineation between the two. Pushing higher the demands for viability reduces the scope for recovery plans. Other issues are associated with applying recovery and resolution plans in different environments e.g. a Single Point of Entry (SPE) environment[7].

Differing recovery and resolution regimes across jurisdictions would create much complexity in trying to manage the differences between regimes and potential chaos in the event of a resolution. Some evidence that regulators have common views on the resolution framework is needed by the end of 2014 following the publication of the FSB guidelines, as well as agreements between home and host authorities defining what could happen in the event of a resolution, the speaker claimed.

Regulators are already engaged in cross-border cooperation, but when looking at the way some Crisis Management Groups (CMG)[8] which have been running for a few years function, there is a risk that such committees might drift into a set-piece arrangement focusing on consensual issues rather than getting to grips with some tougher issues related to potential recovery and resolution. In addition regulators do not interact sufficiently, the speaker thought and industry players often act as an "unofficial conduit" between them. One should avoid CMGs becoming one-off events. They should rather be part of an on-going sequence of dialogue and engagement between regulators.

1. An agreement was reached in February 2014 between US and EU regulators to exempt from US trading rules European-approved platforms that trade derivatives, until equivalent EU rules come into force in around 2 to 3 years' time, alleviating fears of liquidity fragmentation in the market. The CFTC issued two no-action relief letters which allow US swap dealers and major swap participants to execute swaps transactions on qualifying EU-regulated multilateral trading facilities, without further regulatory approvals from the CFTC. The agreement follows concerns that differences between Europe and the US in the detail and implementation timelines for new OTC derivative market rules would split the market in two, thereby potentially damaging liquidity and driving up costs for market participants.
2. SEF: Swap Execution Facilities, OTF: Organised Trading Facilities, MTF: Multilateral Trading Facilities
3. The frontloading rule raises issues because cleared and non-cleared swaps are subject to very different cost structures, and could therefore be mispriced at inception. The provision is contained in the European Market Infrastructure Regulation (EMIR), which also contains a way to fix the problem. The requirement only applies to trades that have a certain amount of time left to run – a minimum remaining maturity – and legislators agreed in April 2014 to set the minimum remaining maturity at a sufficiently high level so as not to encapsulate any derivative contracts in the frontloading requirement.
4. Substituted compliance describes the circumstances where the Commission's (CFTC) general policy would be to permit non-U.S. swap dealers ...whose swaps activities might bring them within the scope of certain Commission regulations, to use compliance with regulations in their home jurisdiction as a substitute for compliance with the relevant Commission regulations. Source CFTC December 2013
5. Concern has emerged in Europe regarding the US Federal Reserve's proposals part of its 2014 regulatory programme, to require foreign banks, which were previously exempted from US capital requirements when owned by a well-capitalized foreign bank, to create a local bank holding company subject to US prudential requirements. This change is justified, according to US regulators, by the increasing size of the US operations of foreign banks, their interconnectedness with the US financial system and the risks associated with large intra-group funding costs.
6. Proposal for a regulation on structural measures improving the resilience of EU credit institutions (29.1.2014)
7. SPE involves the application of resolution powers at the top holding or parent company level by a single resolution authority, most probably in the jurisdiction responsible for the global consolidated supervision of a group. The assets and operations of particular subsidiaries are preserved on a going concern basis, avoiding the need to apply resolution at a lower level within the group. (Source FSB – Recovery and resolution planning – Nov 2012)
8. There should be a Crisis Management Group ("CMG") developed for each global SIFI. Each CMG will be comprised of representatives from the regulatory bodies in the home and key host jurisdictions for that company.

Suggesting key priorities for the forthcoming EU Commission

Objectives of the session

The objective of this session was to suggest and discuss key priorities for the forthcoming EU Commission in the financial area.

Background of the session prepared by Eurofi

Since July 2007, the world has faced, and continues to face, the most serious and disruptive financial, economic and social crisis since 1929. The very existence of the Euro was under threat between the spring of 2010 and the summer of 2012, due to the repercussions of a crisis that originated in the United States, but also and above all due to the fiscal imbalances and the insufficient competitiveness of several Member States and the links between banks and their sovereign.

Much has been achieved during the last four years to prevent future crises.

In 2010, there were no arrangements in place to deal with Member States losing market access. This absence created major uncertainty in markets about the way forward.

With the European Supervisory Mechanism (ESM) and the two-pack, a permanent funding instrument and a governance framework have both been created. This has been a major step forward and will ensure that in the future, the euro area is better prepared to respond to such crises.

Europe has also been working on implementing the G20 agenda, the aim of which is to ensure that all financial activities and players are well regulated and effectively supervised in order to prevent the development of systemic risks. During the four past years, the EU Commission has indeed proposed 28 legislative texts (including CRDIV, Mifid 2 / MiFIR, EMIR, AIFMD, Solvency 2...) in that respect.

The new EU supervisory authorities were also set up following the de Larosière report and played a key role in addressing the consequences of the crisis and ensuring a consistent transposition of directives and regulations across the EU. The introduction of simple majority (or, in some cases, qualified) voting rules providing the European Authorities with the means to make decisions, is also a significant step forward.

The Banking Union which is probably the biggest project since the euro itself and which the EU Institutions are close to finalizing is another major improvement. The Banking Union has the potential to significantly contribute to the re-integration of financial markets in Europe and is fully consistent with the objectives of the Single Market It will also ensure that investors and no more taxpayers will assume the burden of paying for failing or risking to fail banks.

After years spent developing common rules for the EU financial services sector the monetary union is now badly fragmented following the sovereign debt crisis.

After 10 years of economic deviations, the sovereign debt crisis hit the Eurozone in 2009-2010. It has abolished years of efforts since the introduction of the Euro to further integrate EU financial markets. This crisis has indeed created a deep fragmentation across the Eurozone financial markets. In a monetary union there should indeed be one single set of interest rates in all parts of the Union, but this is no more the case since 2010.

Besides the lasting spreads on sovereign securities between the periphery countries and other Eurozone countries such as Germany and France, non performing loans are increasing in the periphery which deters banks from lending and periphery banks have heavily invested in domestic sovereign bonds. Moreover EU banks have diminished their cross-border activities. In addition, national authorities have sought to protect their domestic economies and national taxpayers by ring-fencing banks' capital and liquidity positions to protect them hindering the activity of cross border banks and the freedom of capital movements.

In parallel the integration of retail markets is at a standstill. Yet building a more unified EU financial market is the only way for Europe to achieve the scale needed for providing appropriate financing conditions and products to its enterprises, citizens and states.

The next five years ahead – towards completing the Single Market and the Union

Euro area citizens are still suffering from the inevitable adjustment process following years of accumulated imbalances. Unemployment remains unacceptably high. The years to come are therefore about creating a more perfect Union that caters to these objectives.

The time has come for Europe to define a fresh conception of its financial services markets. It is absolutely essential to re-launch an integration of the internal market and together to invest in projects for the future. Europe must also equip itself with the means of remain a key player on the international scene.

The achievement of an integrated European market would indeed stimulate innovation, intensify competition in banking services, widen consumer choice and reduce the costs of intermediation, which are all needed to improve the performance of EU financial services and its contribution to the economy. Such an evolution will offer economic players improved financing and investment conditions, boost capital productivity and ensure a better allocation of assets, thereby fostering a proper match between savings and investment.

This means in particular: developing a new financing model for the EU economy and particularly SMEs and long term projects, including an EU private placement market and an appropriate ecosystem for EU midcap equity markets. Moreover achieving an effective single market requires a more consumer- friendly financial system and a strengthened EU retail payments market. Defining a common recovery and resolution framework for Financial Market Infrastructures and improving the efficiency of post trading arrangements, reviewing the IORP directive in order to face up to pension needs are other key priorities in that respect. In addition, reinforcing Europe's financial and accounting sovereignty is urgently needed in order to take into account the specificities of EU financing mechanisms in the definition of global rules and their impacts on the EU economy. Improving governance within the EU financial sector is also necessary: regulation is not a substitute for good governance.

Furthermore, Member States need to keep their promises to correct imbalances and to reform the structure of their economies. Debt burdens remain high in many countries and the deleveraging process continues to impede growth. Fiscal policies have to be brought effectively in line with the provisions of the Stability and Growth Pact and of the Fiscal Compact. This concerns all Member States, not just those who looked at some point into the abyss of losing market access. This concerns also the European institutions, which have to ensure that common rules are thoroughly and evenly applied. This is the only way for Europe to reduce gaps in its internal competitiveness.

Delivering on past commitments also means keeping the promise made by Heads of States or Governments in June 2012 to complete the Banking Union. It means a swift transposition of agreed directives into national law and a stringent application of the adopted regulatory framework. It also means that a Single Resolution Mechanism, which is a strong second pillar of the Banking Union, needs to be agreed before the end of this legislature.

Creating a more efficient Union also requires filling the remaining gaps in the architecture of the Economic and Monetary Union, which should remain the long term objective of the EU as outlined in the Four Presidents Report in 2012.

Summary of the session

New Commission old challenges

The key priorities for the forthcoming EU Commission will have much in common with those of the current one. "When you refer to some of the documents from Mr Barroso or Mr Barnier, you find a lot of similarities in what one could expect the forthcoming Commission to achieve" a leader of industry stated. However a lot has been achieved – and some achievements were unthinkable four or five years ago-, much remains to be done, he said. The crisis is indeed not completely over and the job is not finished.

"Among the priorities, finishing the work in progress is the first one. Implementation is also going to be critical and calibration will be essential" he added. What Europe needs more than anything else is a very healthy banking system. According to him, facilitating the access of SMEs and corporates to financings should be high on the agenda. "We have to take into consideration alternatives to alleviate some of the credit shortage we can observe", he underlined.

He concluded by stating that it is important to reduce the increasing fragmentation of regulation across the globe and to maintain an effective dialogue in order to resolve these global issues.

Building the right regulatory framework to support growth

The highest priority for Europe is to increase its growth potential and to create new jobs and reduce unemployment in Europe. During the last five years, the EU institutions have defined the new regulatory environment of the banking system.

According to a banker, the first priority is to stop the fragmentation process of the European financial market. The banking union is the answer to this issue.

The second priority is to ensure a level playing field for the European banking industry compared to the American players which is not granted today.

This speaker stressed that there is a contradiction between the new prudential regulatory framework which clearly favours the market-based financing and the bad image of market activities, market players and instruments in Europe. If Europe does not tackle this contradiction Europe risks not to be able to finance its own growth. We need to be more pedagogical and explain why market activities do not hold more risk than credit activities for example. He also explained that we cannot develop an EU market based economy if at the same time legislators and regulators are promoting structural banking reforms and the breakup of the universal banking model. If at the global level such a proposal would have been promoted, he noticed that this would not be an issue. But in the US the universal banking model is the main one. So separating banking and market activities in Europe would weaken EU banks compared to American ones and jeopardize the capacity of Europe to create an effective market based financing capacity.

He pointed out that the project of establishing a tax on financial transactions (FTT) in some EU countries (and not in all EU member states or in the US) is another example of a decision which would hinder the development of EU capital markets and reduce European market based financing capacity. These examples show that we need more consistency and coherence at the global level in the definition of the regulatory framework.

Defining at the EU level a private placement regime and a high quality, transparent and standardized securitization market is also necessary in this new financial regulatory environment even if, for the time being the market is very immature, in France in particular, regarding these alternative financing instruments.

He made it clear that today in Europe there is no difficulty for prime SMEs (presenting low risks) to obtain credit. According him "one of the key issues for the next Commission is to find ways to restore the financial solidity and the quality of credit of SMEs in order to facilitate their access to bank lending".

Lastly, he stressed that the profitability of European banks will also be a key challenge to be addressed by the new Commission. The return on equity of the EU banking system is below the returns provided by other industries. If we want to establish in Europe a strong financing market activity, we have to ensure that the banking industry is in a strong position and creates value for the economies and the shareholders, he concluded.

Assessing the impacts of the new banking regulatory framework before taking additional regulatory initiatives

Following the large number of legislative texts adopted by the EU institutions, we should now assess their impact on the banking sector and their capacity to finance the real economy.

In its communication on long term finance published in March 2014, the EU Commission describes three actions which should represent three key priorities for the new EU institutions.

First the Commission should make an assessment of the appropriateness of the new prudential requirements

concerning long term finance. It is indeed important to analyze possible interactions between different banking regulations and observe their impacts on the banking industry and the real economy.

Second, there is a need to find a right balance between improving the resilience of the banking system to liquidity shocks and avoid excessive restrictions that discourage long term finance.

Third the calibration of the Net Stable Funding Ratio (NSFR) is of great importance and has to be defined very carefully. This is very crucial for the ability of banks to channel funding to the real economy. If this exercise fails then the availabilities of banks, especially of small ones to lend to the economy will be endangered, he explained.

Fighting against nationalisms and making sure the euro will survive

An MEP reminded the audience that "in the next 5 years, the major issue might not only be to see if the calibration of regulatory frameworks is appropriate or to fine tune SSM and SRM – even if it is necessary and will be on the agenda of the upcoming EU institutions- it is to make sure that the euro will survive". And the euro will only survive if we are able to develop a new institutional framework giving a new direction to the citizens. Many people in EU member states are supporting extremist parties that want to close the borders, which means less business and less future for our children. Protectionism seems very popular in some countries such as France and the levels of rejection of Europe are very serious.

In such a difficult context, we need to strengthen the Eurozone, not against the rest of the EU but to provide growth and perspectives for the populations. This requires in particular a reorganization of the EU Commission – if we keep the Commission as it is with 28 member states portfolios, it would not be the best team to manage this – and a good President of the Commission and his designation will have to take into account the results of the EU elections, as the Lisbon treaty calls for.

The monetary Union needs an element of fiscal transfer to be successful

Another MEP stated that Europe is at a very critical cross roads. "If we don't take the right avenue, we risk destabilizing the European Union and losing the level of integration already achieved, "he stressed. The work of the Commission should be more focused and more effective. Despite the effort and the number of regulatory proposals adopted during the last four years, we do not have a fully integrated market and fragmentation is still characterizing Europe in the financial area. The new Commission will have to ensure that we can overcome this financial fragmentation and strengthen integration while avoiding a split between the Eurozone and the non-Eurozone countries and this is not an easy task.

Moreover, competencies have to be redistributed. Over the past decades, too many tasks have been given to the Commission. There are a few areas that have to be dealt with at the European level. But there are others where member states can do it as well as Brussels.

According to this MEP, if we want the Eurozone to survive, there are two options. In the first case, member states are disciplined and respect economic rules (six pack, two pack, fiscal compact...). So nothing goes wrong. But this is unlikely. So he pointed out that the alternative is some sort of fiscal and economic unity. That means a progression towards an EU transfer union. There is indeed no economic or fiscal unity without some transfer element in it.

Rehabilitating responsible securitization can be a valuable financing tool for European companies, consumers and investors

A leader of the industry started his speech by observing that Europe has made tremendous progress on both systemic risk and investor protection. So looking at the implementation of these measures and letting people catch their breath might be a high priority for the next Commissioner. This speaker also noticed that market finance which was not well perceived in Europe two years ago is now better considered and "this is a major turn in the right direction to diversify the source of financings in Europe" he said.

This speaker continued his remarks by underlining that with the current prudential regulatory framework, the banks, even well capitalized, are incentivized to buy sovereign bonds rather than to lend to SMEs. In addition, with the Solvency II framework, investors who are natural buyers of securitization are less encouraged to invest in such securities. Given the different requirements in the different countries, an EU wide securitization for SMEs seems unrealistic. In any case securitization must be transparent, simple and based on good products and investors should also make their own analysis. This speaker reminded the audience that the financial crisis started in the US with bad loans to individuals. "if the original underlying product is bas, it doesn't matter what you do with it, it is still going to be bad", he said. "We have also to ensure that bundled products are clear and presented in an understandable manner. 18 different tranches with inverses and twists and all sorts of degrees of difficulty may be win in the Olympics, but I think in securitization it has gone a lot too far" he added.

In the US, there is the emergence of Business Development Corporations (BDC°. These companies have been

created to help small companies grow in the initial stages of their development. BDCs are very similar to venture capital funds. Many BDCs are set up much like closed-end investment funds and are actually public companies that are listed on the NYSE, AMEX and NASDAQ. A major difference between a BDC and a venture capital fund is that BDCs allow smaller, non-accredited investors to invest in start-up companies. Some of the reasons why BDCs have become popular is that they provide their management with permanent capital , allow investments by the general public and use mezzanine financing opportunities. The speaker concluded his intervention by proposing that Europe should look at this kind of structure which could be an alternative to securitisation.

Financial regulation needs to support job creation

Growth and job creation are the key priorities for politicians all across Europe. Statistics show that the creation of jobs comes from smaller companies. There are still some key issues to iron out to ensure that financial regulation supports SME growth.

Revitalising the securitization market as well as the creation of the European Long Term Investment Fund are good ideas in this perspective, a leader of the industry stated. "The key word for the securitization process is transparency but we also need the buy side to become larger and larger. This is a key challenge because investors don't find it attractive to look at investment in smaller companies. There is currently not enough attention paid to fund raising" he added. The main function of the securities stock exchanges is notably to secure efficient fund raising and risk distribution for all sectors of the economy.

Some specific issues need to be addressed and the speaker detailed two of them.

- Initiatives to promote active investment and ensure that pension funds to a significant extent invest in EU listed companies and SMEs.
- Tax incentives for investment in listed SMEs. In some EU countries, it is not attractive to be listed because ta is higher on dividends if you are listed.

Coming from a company being active in Europe and in the US, the speaker pointed out that there is a need to find a way to have regulatory actions even more coordinated between Europe and in the US on financial issues, "because financial sectors are moving more and more together and it is really a hassle that we still have on a lot of details and differences in rules, which creates a lot of extra costs and problems."

The review of the Insurers and Occupational Retirement Provision (IORP) Directive should be a top priority

The time has come to convince people that Europe can do something for them and to fight against the divorce between citizens and EU institutions. Employment is of course a key challenge in this respect but a speaker of the industry addressed another one: "pensions". Europe should provide an adequate regulatory framework to guarantee that its level of pensions will be kept. This is not obvious at all when we think about the variety of the differences between pension schemes across the different member states.

For insurers such policyholder protection standards will result from the implementation of the Solvency II framework that will introduce a common European risk-based regulatory framework for insurance companies as of 2016. So isn't important to adjust the EU pensions regulatory framework? If not, we would create dramatic unfairness between categories of European citizens following the system they can accede to. Europe needs to ensure a level playing field between insurers and pension funds.

What should be an EU regulatory framework for pensions? What criteria should be met? This speaker asked. He stressed that beneficiaries and policy holders should all benefit from an adequate level of protection.

Some quantitative elements are required in this framework. This leader of the insurance industry was worried because in the last proposal of the Commission nothing was planned on this subject.

Moreover beneficiaries should be very "transparently informed", he added. It is essential that beneficiaries make informed decisions about their retirement plans. Any differences should be made apparent to the beneficiaries periodically, in a clear and understandable way.

A last point is that beneficiaries must subscribe and must be able to subscribe products which match their expectations. He concluded by stating that "if insurers are not able to deliver some kind of reasonable guarantees over the very long term, they are useless."

Recommendations for the future EU regulatory regime for retail payment services

A leader of the industry made recommendations for the future EU regulatory regime for retail payment services. The payment landscape is changing. Many new payment operators are competing in the market following the implementation of the Payment Services Directive (PSD). In the rapidly changing payments market, this representative of the industry stressed that it is important to adhere to guiding principles when refining the future regulatory regime. These principles need to include legal certainty, regulatory consistency, proportionality, technological neutrality, the fostering of financial inclusion and the promotion of a single market for retail payment.

According to him, creating a common supervisory framework for non-bank payment providers should be a key priority. In that context, the competences of the European Banking Authority (EBA) should be enhanced. The EBA needs to be given the resources to effectively fulfil these new functions and a specific non-bank stakeholder group should be set up to advise the EBA on payment issues.

Preparing for the increasing digitalisation of commercial payments should be a second key priority for the new EU institutions. The rising digital economy needs indeed adequate online identification procedures which are available to account holding and transactional payment operators such as money transfer operators. In this area, the speaker stressed that Europe needs to harmonise electronic identification and -authorisation tools to better support the growing field of digital non-face-to-face transactions.

Lastly, this representative of the payment industry explained that Europe needs a holistic approach

to remittance regulation. Remittance services are impacted by a multitude of regulatory initiatives both at the EU and global level (e.g. FATF). Not enough attention is being paid to the overall impact of all new rules on remittances and on the incentive structure of market participants. "It is time for a holistic approach to remittance regulation and the Commission should set up a special unit in charge of remittances" he concluded.

Regulation is not a substitute for good governance.

The financial system has been reinforced during the last four years but confidence has not yet been fully restored. "It will net be restored by piling up and accumulating additional regulations" a speaker of the industry stated. In the EU some 30 pieces of regulation – many of them containing hundreds of pages- as shown by the 2013 PwC annual Corporate Director Survey, he emphasized that regulations did not prove successful in increasing investor protection or increasing public trust in the corporate sector. He added that an analysis of the composition of the Boards of 15 major European banks shows an increased number of experts and specialists who have doubled on those boards at the expense of senior executives. That means that a proportion of experienced decision makers able to take decisions in the current complex environment has decreased at a pace which raises corporate governance issues.

This is why reinforcing the importance of quality-governance, culture, experience and behaviours should be a high priority for the new EU institutions. "I believe that looking at those qualitative aspects is an alternative or a complementary way to ensure financial stability" he pointed out. It implies that supervisors should take responsibility for their judgements. "And this is a challenge which must not to be underestimated," he said. It requires more than assessing compliance with rules. "It does imply risk in making that judgement. In the context of a general sense of irresponsibility of our society, I think this is a gauntlet that we collectively need to pick up", he stressed.

Solutions for households to provide adequate long-term savings for the real economy

To get sustainable growth and jobs, long term investment is needed. "According to the Green Paper of the EU Commission on long term investment, households are the main source of funds to finance investments. They have mostly long term savings goals (home purchase, children's education, retirement). But those households have been shying away from equities and prefer short term financings" a representative of financial services stated.

He stressed that some of the reasons are the often poor performances of intermediaries in delivering reasonable returns and tax incentives. For example in France, the biggest tax incentives are in on sight savings accounts instead of favouring long-term savings. So "what we need for households to provide long term investment is to ensure that they get a reasonable return, or at least do not lose money in real terms", he explained.

According to this speaker, there are four priorities to achieve this:

First we need to promote equities and shareholder engagement again back to the end investors and improve the governance of listed companies and investment intermediaries. The upcoming review of the shareholder rights directive is a key step to make progress in this respect.

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

The third priority is to improve European financial supervision and the enforcement of existing investor protection regulations.

Fourth: stop tax discrimination against Eu savers. "Let's tax vice instead of ransoming virtue like iy is done in modern republics" Albert Camus, Nobel Prize of literature said in 1957. The artist is always right, the speaker concluded.

J. de Larosière's concluding remarks:

Thank you very much I'm not going to make a statement to sum it up because I think your presentations have been very clear and have pointed to some obvious musts for the future Commission.

I'll just say that I have been impressed by the thoughtfulness of what you all said. I appreciate the institutional governance aspect that has been underlined by Sylvie Goulard and Mr Klinz. These are matters, of course, which are not in our own competence, professionally, but personally I believe that we need a profound change in the structure of the Commission itself, the way it works, the way it is organised. This implies a change in treaties that could simplify and avoid the excessive cost of intergovernmental arrangements.

I think without changes of this type, it's going to be very difficult to continue to navigate this Union.

So I would endorse these ideas and in particular the one put by Mr Klinz, which is that at some point we're going to have to move to a fiscal union, and if we want to move to a fiscal union, we have to call a spade a spade. There will be some forms which can be very limited by the way of transfers, but I really believe that the functioning of the monetary union can only be successful if, at some point, you have an element of transfer, backed of course, by the proper conditionality. That's what the

United States have done since the inception of their country. They have accepted a form of federalisation of debt incurred by the individual states that had participated in the War of Independence, but it was a very conditional system, whereby the individual states had to comply with fiscal discipline. If you have that, then you can accept an element of transfer which is in fact necessary when you have a heterogeneous set of members, countries, in the Union, which is and was the case of the United States.

So I think we're going to have to move in that direction and I would say that we have to do it in the next legislature. Because if we muddle through continuously and stay between a rock and a hard place, things are not going to develop into the major challenge which is to restore growth and jobs which have been repeated by all of you, and to restore confidence in the system.

So I take all your points on the need to avoid too much complication and too much addition in regulation; I take your points on calibration; I take your points on sound corporate governance, on the need for long term financing and the need to reward, as Mr Prache said here, the virtuous performance of households, which are the pillar of all long term investments. I take your points on the need to increase the vitality of our financial market, which is still, to some extent, insufficiently deep and comprehensive. I take your points on the need to avoid a contradiction between over regulating the banking sector on the one side and saying that we have to move towards a more finance market type mechanism. These contradictions are indeed lethal.

And I'll make a last point which you have not made. That's my contribution to the discussion. I think we need a Commission and a Parliament; it's less true for the Parliament because it has shown the characteristic I'm going to indicate. We need a Commission that is truly a European Commission. Now this seems tautological because we know that the Commission is European, but in fact, if you analyse work, regulatory work, of the Commission over the last years, you will see that most of what it has put in regulation, has been inspired by international players, which have very different interests and very different basic conditions in the way banking and financial systems work.

I'll put this as a suggestion, if we want to have a Commission that truly believes that it is a European Commission, then it has to fight for Europe. Not in an aggressive way against other centres, but it has to fight for Europe and take into account its strengths and its weaknesses; correct the weaknesses, enhance the strengths. Then I think we would have more confidence in it. So maybe it's a pious wish, but Europe is a very vast and powerful set of countries. It's almost the same GDP as the United States, four times more important in terms of its banking systems. It's less important in terms of its market system, but it's one of the major players in the world and I think it shouldn't be too shy and too respectful of other centers.

So that's how I understand a true international line. So with this, I would like to declare closed this very interesting session. Thank you very much.

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SPECIFIC CONTRIBUTIONS

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

Jacques de Larosière
President, Eurofi

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

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

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

Yet, resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. Besides the low margins and the high levels of indebtedness of enterprises in many EU countries, several factors are hindering credit provision.

Nonperforming loans in periphery countries are high, which deters banks from lending. Furthermore, the failure of several banks has either left SMEs with no bank or finding difficulty switching to another bank. In addition, the poor sovereign ratings of these countries lead to high credit rates which strongly impact the profitability of enterprises and their capacity to borrow.

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

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

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

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

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

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

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

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Expected evolution of bank and market intermediated financing and of the competitiveness of the EU financial system following on-going reforms

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

I. The targeted form of market based financial mechanisms, and the speed at which an economy can shift toward them strongly impact the evolution of the banking sector

1. Financial industry representatives as well as EU policy makers frequently allude to the differences between US and European financial mechanisms. In particular they usually stress that in Europe[1] banks provide more than 70% of the financing of the economy while it represents an inverse proportion in the U.S. Many of them underline in that respect the role of market finance in the economy.

   The need to compare the two ways for financing the economy is triggered by the fact that the share of market finance strongly influences the scale of the regulatory capital, liquid assets etc. required to finance the economy and eventually the cost of financial resources.

   Given that banking regulators have considerably tightened capital and liquidity requirements in response to the financial crisis, the definition of the most appropriate arrangements to access to market finance is critical for policy makers and the industry to define the appropriate evolutions in the context of increased regulatory constraints. It is also necessary to induce the required evolutions of the role of the banking sector.

II. The share of market finance and the role of the public sector in the securitisation market are key differences between US and EU financial mechanisms

2. Actually the United-States economy has a long history of directly accessing to investors. Indeed in a context where Eurozone and US economies have comparable sizes (e.g. the Eurozone corresponds to 70% of the US economy as the Eurozone represents 13.5% of the world GDP and the US 19.5%[2]), the outstanding U.S. bond market debt amounts[3] to $40 trillion, twice the amount of the euro-denominated debt[2] and in the Eurozone non-financial-corporation debt-securities only represent2 1/8 of American non-financial-corporation debt-securities.

3. More precisely beside Treasuries - 33% of the market - the share of Corporations' debt is roughly 20% of the American debt market. Mortgage securities represent around 26,9%[4] of the American outstanding debt and Municipalities 10%. In this context the ABS segment, which includes the CDOs backed by corporate bank debt, only represents 4% of the bond market. In Europe all type Assets Back Securities (ABS) weigh $1.1 trillion only.

4. American housing financial arrangements, and in particular the Federal involvement, which more than ever supports mortgage securities issuance - have a huge influence on the respective role of market finance and banks in American financial mechanisms. These arrangements had primarily been created to alleviate banks and ease their economic contribution mainly on the basis of a deep secondary mortgage market, supported by dedicated federal entities and a guarantee scheme[5]. Consequently, currently commercial banks and saving institutions only hold $4,351 billion (31%) of the current outstanding US mortgage-loans, which reach $13,119 billion. Federal and related Agencies hold $4,956 billion (38%) and mortgage pools or trusts, 90% of which are currently guaranteed by Federal related agencies - e.g. Government Sponsored Enterprises (GSEs) - hold $2,931billion (22%).

III. The impacts of the shape of financial mechanisms are manifold: cost of regulation, liquidity of assets, efficiency of monetary policy, risk profile of banks, etc.

5. Federal-housing financial-mechanisms dramatically reduce the involvement of the balance sheets of banks in the financing of the American economy. All in all[6] US banks hold 40% of household debt while EU ones hold 86%, and in addition US banks hold 35% of nonfinancial corporate debt while European banks shoulder 87%. These arrangements lead to very different regulatory costs and burdens from those triggered in European financing mechanisms. In this context assuming that risks are similar in both geographies - the new international banking regulation - higher loss absorbency capacities from capital buffers, heavier capital charges posted, reduced maturity transformation and leverage - are expected to cost the EU banking system twice what it should in the US.

6. Some observers however wonder whether non-bank financing mechanisms are safer and raise the question of their real cost in terms of capital and liquidity. They underline in that respect that non-bank financing mechanisms can pose systemic problems.

7. Regulatory costs to the American economy are also alleviated. Indeed Fannie Mae and Freddie Mac are exempt from bank regulations and may in particular maintain capital/asset ratios less than 3%. In addition, in the wake of the subprime crisis, these entities have been supporting the whole American mortgage market since 2008, holding reduced levels of regulatory capital if any: in 2008 the total equity deficit of Freddie Mac was $30,634 million and the one of Fannie Mae $105,150 million. In the same vein, 2012 leverage ratios of Freddie Mac and Fannie Mae are respectively 0,4% and 0,2%[7]. Yet currently most of securitisation programmes and consequently securitisation markets, are supported by the GSEs guarantee. Similarly the Federal Housing Agency, which currently guarantees up to 33%[8] of American purchase mortgage originations (4% in 2006), is required to hold 2% capital ahead of its liabilities. The same risks in the balance sheet of a community bank require 8%.

8. Eventually American banks have a very different risk profile from the one of EU banks. On the one hand bank deposits in the US are far less exposed to the housing risks, which are transferred to Federal entities or to a less extent to investors. On the other hand U.S. banks offload large amounts of the lower-risk assets they originate (mortgages attract in the EU RWA of say 15%) while they maintain in their balance sheets assets most of the riskiest assets they originate. Consequently their risk profiles are actually difficult to compare with those of their European alter ego.

9. In addition, partly as a consequence of the systematic offloading of banks' balance sheets in the US, loans to deposit ratios of American banks are about 85% while European ones nearly reach 130%. Consequently American banks have reduced needs to access the wholesale liquidity and face reduced efforts to comply with the new liquidity regulations.

10. Lastly in the U.S. the fact that a large part of mortgage loans, which are securitised benefit from Federal guaranties, significantly enlarges the much-needed pool of high quality collateral. This helps to answer the increasing need of such assets to perform market transactions, imposed by the various new market and banking legislations (tightening of margining policies and collateral haircuts, de-netting of repo agreements within banks' balance sheets for assessing the leverage ratio, regulatory limitation of the asset encumbrance, high quality liquid assets to comply with the liquidity ratio, etc.). Furthermore, the large size of those securities benefiting from Federal guaranties increases the impact of the monetary policy of the FED, in particular on mortgages. It is worth noting in that respect that the FED was holding in November 2013 about 13% of the outstanding U.S. mortgage debt. These assets represented 36% of Federal Reserve Balance Sheet at that moment.

11. Due to the differences in the shape of their financial sector, the combined consequences of the tightening of banking regulations are leaving differentiated marks in both sides of the Atlantic.

IV. The architecture of the financial sector influences its profitability

12. In addition it is worth noting that European banks apparently operate in a more competitive context. Indeed, before the financial crisis their net income amounted in average[9] to approximately 0.58% of total assets. After the crisis it is 0.22%. In the United States these ratios are respectively 1.07% and 0.69%. On average the operating expenses in the EU – about 1.35% of the assets - are lower than those of U.S. banks (2.81% and 3.15 before and after the financial crisis). Lastly European banks apparently did not widened lending spreads in similar proportions to American ones (respectively +22bp and + 34 bp).

    In such a context the capability of the EU banking sector to increase its capital, when growth will require it, by accumulating retained earnings is reduced. Also reduced is its capability to attract investors: in the EU after the financial crisis the Return on Equity (ROE) is about 3.9% in average while it is above 7% in the U.S.

13. Though it is not easy to sort out what are their specific contributions, there is no doubt that the peculiarities of the architecture of financial sectors play a key role[10] in that respect. In particular they are necessarily instrumental to allow the U.S. 96% of the banks, which are classified as small business and the median size of which employs 39 people – to continue financing the economy. In the U.S. 38% of the banks have been in business for more than 100 years. These observations suggest reflecting on the possible role of certain constituents of the American system. Beside the secondary market for mortgages, the role in this market of the GSEs, the servicers, and securitisation, the role of the 12 Federal Home Loan Banks (FHLBs) - cooperatives created the Great Depression - is certainly critical to provide low-cost funding (so-called advances) to these small banks (the members of the FHLBs are the community or saving banks, loan associations (thrifts), credit unions etc. (7600)), and preserve their access to finance during financial downturns. Indeed these arrangements may be considered as a form of industrial integration of specific parts of the financial value-chain, namely the holding of certain

assets in particular mortgages and the refinancing of such assets. One may raise the question of the influence on the competition landscape in the U.S. that such industrial integrations have.

V. The challenges ahead for the E.U.: anticipating the evolutions of the financial sector and mobilising the public sector to launch an effective EU securitisation market

14. Despite the differences between American and EU financial mechanisms, in the wake of the financial crisis the representatives of national regulators from both areas agreed on a single and common set of regulations for banks.

15. Such regulatory impacts are naturally expected to trigger a significant reduction of the role of the banking sector in Europe. However the reduction of the role of banks is proving challenging in the EU as evidenced by the intense debates linked to the financing of SMEs and infrastructures in Europe. Indeed these debates are making it clear that banks will remain instrumental at least for originating the financings and liaising with customers, and more importantly to deal with the fact that accessing financial markets is probably out of reach for the smaller infrastructure projects and businesses. Beside this, EU investors and financial markets are far from being ready to replace banks.

16. Indeed the E.U. is still characterised by the fragmentation of financial markets (bankruptcy law, securities law, in particular), the central role of bank financing and apparently strong competition within the banking sector. One issue is therefore to anticipate the likely evolutions that the new banking regulations are expected to provoke in the banking landscape: an accelerated reduction of the number of banks? Cross border mergers? An evolution of the pricing of financial products? Etc. It is also important to understand the likely timetable of such an evolution as the challenge for the E.U. is to be able in due time, to accompany the financial needs of recovering economies. Lastly one should also identify the success factors still missing in the E.U. to use further any market finance provided e.g. loan pricing by banks, introduction of single regimes for issuing debt, securities, critical size of financial markets, etc.

17. As soon as they have re launched their housing activity, the Americans will start reforming the role of the so-called GSEs. They are already thinking about the reduction of the implicit Federal guarantee benefiting GSEs and tax payers involvement and trying to define a specific back stop to face up to a possible dry up of mortgages primary or secondary markets. However the involvement of the public sector in the mortgage market raises many concerns. In the U.S. many argue for the elimination of GSEs, though no consensus has already emerged and the role of GSEs in the long run is still an open issue. However, one can bet that the U.S. will not give its “distribute to originate” up, nor the role the public sector plays to foster or support its efficiency in particular during economic downturns.

18. Learning from the American experience, securitisation – and mortgage securitisation due to the size of this asset class - should play a key role in developing market finance in the EU, it should free up scarce bank capital and liquidity, which are needed to finance other types of economic players, and reduce the regulatory cost of financing the economy in the EU. An appropriate definition of the public sector involvement is key to achieve a rapid transformation of EU financial mechanisms, bring together critical mass (common EU legal frameworks are required) and attract EU and global investors. It is key also to avoid moral hazard and create new forms of possible finance-sovereign negative feedback loops.
    More generally the role of the single market and the setting up of optimal conditions for competition are also key elements, which should trigger policy action.

1. Michel Barnier, 4èmes entretiens du Trésor, Paris, le 13 décembre 2013.
2. 2012 - ECB data.
3. The outstanding U.S. bond market debt amounts $39 343 billion while outstanding amounts of euro-denominated debt are about €19 950 billions i.e. #1/2 the American bond market. In the Eurozone non-financial corporations represent only 6% of the half sized euro-denominated debt-security market, while American corporations have a share of 24% in the American bond market - 3rd Quarter 2013 data.
4. MBS amount to $10. 6 trillion among which Federal agencies represent $2.4 trillion (6% of the American debt-market).
5. In 1938 - far before the development of securitisation - the Congress chartered Fannie Mae, not to lend money directly to consumers (the primary mortgage market) but to "support liquidity, stability, and affordability in a secondary mortgage market, where existing mortgage-related assets are purchased and sold" . In 1970 the Congress chartered Freddie Mac to complement existing Federal arrangements. Shortly before Ginnie Mae was created to "allow mortgage lenders to obtain a better price for their mortgage loans in the secondary mortgage market, whenever they benefit from the Federal Housing Agency (FHA) guaranty" (i.e. loans to low- and moderate-income American households, currently more than 50% of American mortgages) but also "to help bringing funds from worldwide investors into the U.S. housing market", so as "the lenders can then use the proceeds to make new mortgage loans available". Eventually Ginnie Mae issued in 1970 the first mortgage-backed security (MBS) in the United States.
6. Credit Intermediation in the United States - BNPParibas research – Céline Choulet May 2012.
7. Freddie Mac total assets amounted to $1,989,856 millions and those of Fannie Mae amounted to $3,222,400 millions in 2012. Freddie Mac has $8,827 millions of total equity while Fannie Mae has $7,224millions.
8. http://economistsoutlook.blogs.realtor.org/2013/02/22/just-how-big-is-the-fha-2/
9. How have banks adjusted to higher capital requirements - Benjamin H. Cohen - BIS quarterly Sept 2013.
10. The business of banking: what every policymaker needs to know – American Banker Association, 2012.

Providing appropriate financing tools for EU SMEs and midcaps

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

Banks are by far the main source of external financing for non-financial companies in the EU, covering 50 to 90% of their needs, depending on their size. The share of bank financing, as well as funding costs tend to be higher for SMEs (legally defined in the EU as enterprises with a turnover ≤ € 50 million and no more than 250 employees) and smaller middle market enterprises or midcaps[1], for which publicly available information and visibility about their projects and management capabilities is limited[2]. In the absence of a legal definition at EU level, midcaps are referred to in this paper as a proxy for the "middle market" which comprises enterprises with a turnover ranging from € 50 million to around € 1 billion.

In the US commercial banks and savings institutions are also the leading source of credit for small businesses (defined for most sectors as companies with no more than 500 employees)[3]. Direct market-intermediated financing (e.g. by non-bank institutional investors or venture capital firms) plays a larger role than in the EU but only represents a limited share of the overall US small business financing. The difference however with the EU is that market mechanisms supporting bank financing are generally much more developed in the US, with the role played by the Government Sponsored Enterprises (GSEs), which indirectly impacts the lending capacity of US banks to small businesses. The GSEs indeed purchase a significant proportion (up to 70%) of credits originated by retail banks (mortgages, consumer credit, auto loans…), thus freeing up capital to support lending by banks to their retail and small business clients.

Bank financing will be impacted by the Basel III capital and liquidity rules being implemented notably in the EU, which are expected to raise the cost of credit and reduce the availability of long term loans. SMEs and midcaps based in countries with poor sovereign ratings are moreover penalised by the impact such ratings have on their financing conditions[4].

Statistics published by the ECB in its survey on the access to finance of SMEs in the euro area indicate signs of credit rationing for SMEs[5] in some EU countries. This issue which first emerged in periphery countries (where loan rejection rates currently range between 20 and 35%) could touch other EU states. In France and Italy for example the proportion of bank loans facing obstacles (rejections, partial coverage or loans refused by the borrower because of a high price) has been increasing and was respectively of 29% and 48% during the second semester of 2013 according to the ECB survey. More generally new bank lending to SMEs appears to have declined by nearly 50% since the pre-crisis peaks in major Eurozone countries according to statistics compiled by the IIF[6]. This situation can be explained by a combination of demand and supply factors. However some observers believe that this could be a prelude to a decrease of credit supply in certain EU countries caused in particular by rising prudential constraints being progressively put on banks and the insufficient profitability of many EU banks limiting their capacity to raise additional capital.

Initiatives conducted by the ECB should help to reduce the fragmentation of financing conditions across EU member states: the ECB sovereign bond purchase programme (OMT facility), which is designed to ensure that bank funding is not a source of financial fragmentation in the EU[7] and the Banking Union which should help to strengthen the EU financial sector. Work is also under way conducted by the EIB to develop a common methodology for the credit scoring of SMEs and midcaps aiming to foster the provision of more complete and objective information on their intrinsic risks and to limit the sovereign risk bias in such assessments.

Many measures have been proposed by the EU public institutions since the beginning of the crisis to facilitate the financing of EU SMEs and midcaps and foster economic growth.

Besides the actions launched to strengthen the EU banking sector (e.g. with the Banking Union), regulatory frameworks for venture capital funds and European Long Term Investment Funds (ELTIF) have been adopted with the objective notably of channelling investments to unlisted companies and a specific label for growth SME equity and bond markets was created in MiFID II to increase their visibility and the adoption of common standards. Actions have also been put in place on a domestic level to implement private placement regimes (e.g. in France). Moreover the EIB has stepped up its financial support in favour of SMEs, increasing its funding to enterprises and their banks as well as the provision of guarantees for portfolios of SME loans and securitized SME financing instruments[8]. Furthermore, capital requirements more favourable to SME

loans have been introduced in CRD IV. The Eurosystem has also reduced haircuts on SME ABSs posted as collateral for its regular monetary policy operations taking into account the introduction of the ECB loan level data transparency initiative supported by the European Datawarehouse ABS repository[9]. A consultation was in addition recently conducted by the EU Commission (EC) on peer-to-peer lending (crowdfunding).

Following the green paper on long term financing published by the EC in March 2013, a high level expert group set up by the European and Financial Committee (EFC) and chaired by A. Giovannini and J. Moran published in December 2013 a broad range of short and medium term recommendations covering SME financing in particular ("Finance for Growth") and aiming to increase their access to capital markets. The report endorses the on-going initiatives mentioned above and makes some additional proposals regarding notably the access to appropriate corporate and credit data on SMEs[10], the cross-border investment of funds in SME loans and the setting up of an EU platform for mini-bonds[11].

A self-initiative report of the EU Parliament on long term financing drafted by W. Klinz and adopted in February 2014 covers similar ground. The role national and multilateral (EIB) development banks can play in supporting SME financing is stressed as well as the possible contribution of vehicles such as ELTIF and transparent securitisation mechanisms. The Commission is also called upon to propose an EU framework for less liquid investment funds [than UCITS] in order to channel the short-term liquidity of private households into long term investments and provide additional retirement solutions.

The priorities to be pursued in the short and medium term respectively for SMEs and midcaps however still need to be completely established, taking into account their potential impact, the time required for implementing them and possible emergencies to be addressed in certain countries or industrial sectors.

Suggestions have been made in this regard by the industry[12]. Concerning SMEs, given their dependence on bank financing, the expansion of the support provided by public banks or agencies (loans or guarantee programmes), the revitalisation of SME securitisation and developing an improved access to reliable information in order to facilitate credit provision by alternative providers are the main actions proposed[13]. As for midcaps, which have less difficulty in accessing market-intermediated funding, the development of a European private placement regime possibly expanding existing domestic frameworks, the expansion of EU high yield bond markets and efforts to improve the consistency of EU bond legislations are proposed, as well as actions to encourage equity financing and promote IPOs (e.g. rebuilding an appropriate ecosystem, better balancing incentives for bond and equity financing[14], adapting rules for SME and midcap issuers).

Developing an overall perspective on the financing needs of SME / midcap issuers and investors is also put forward as a priority by many industry players, in order to achieve a general and consistent approach of the regulation of the different instruments available (i.e. equity, bonds, loans, securitised products…) and ensure their coherence.

An idea that has gained traction in the past months for SMEs is revitalising loan securitisation in order to refinance SME loans and alleviate SME financing constraints for banks[15]. The objective is to complete the current acceptance of ABS as collateral for Eurosystem credit operations which provides banks with liquidity but does not increase their lending capacity as they have no impact on banks' balance sheets. The ECB notably has called for the development of high quality plain vanilla products capable of being rated and priced in a simple way. Several actions have been initiated by the private and public sectors but these have only had a limited impact so far (the PCS Prime Collateralized Securities initiative[16] and proposals made by the EIB and the EC to set up a joint securitisation instrument for new and possibly existing SME loans potentially combined with a joint guarantee instrument, both involving the use of EIB and structural funds[17]).

Relaunching EU securitisation markets on a sound basis (which should help to amend the deteriorated image of these products since the financial crisis) seems feasible. It however requires overcoming several obstacles in the short term. The sharp increases in capital requirements for securitisation exposures mandated in Basel III and Solvency II are due to be reviewed by Basel and the EU Commission[18]. Common mandatory standards will also need to be defined and implemented at EU level for structuring and managing simple and transparent securitisation products[19]. Moreover, solutions are required to increase the rates and margins of bank loans in order to make them sufficiently attractive for investors when securitised. The absence of standardised and easily accessible information on SME loans is also pointed out, although some mechanisms such as ECB loan level data transparency initiative combined with existing domestic credit risk databases[20] could be the starting point of the system required.

Given the urgent need to step up lending in the EU, solutions involving the intervention of public institutions such as the ECB and / or national central banks (in order to impose appropriate quality standards based on the current criteria used for accepting SME loans as eligible collateral in central bank refinancing operations, support the emergence of securitisation conduits and purchase eligible loans temporarily, if needed to foster the launching of the market) and the EIB (in order to offer some guarantees for the securities issued) are proposed in order to revitalise the EU securitisation market in a relatively short timeframe.

1. Middle market enterprises are usually considered to have revenues ranging from € 50 million to around € 1 billion. There is no legal definition of middle market enterprises at EU level at present. In France, intermediate-sized companies (ETI) are defined as companies with a turnover comprised between € 50 Mio and € 1.5 Bio and no more than 4999 employees.
2. Additional arguments include the fact that SME loans are riskier therefore requiring a portfolio of loans with greater diversification and on-going monitoring, which are more easily achieved by banks. Most SME financing is also short to medium term and much of it is related to working capital needs which are not easily compatible with market-based financing solutions.
3. The most widely used, and SBA-endorsed (Small Business Administration), sizing criteria for small businesses in the US is the following - the business must have no more than 500 employees for most manufacturing and mining industries, and no more than $7 million in average annual receipts for most nonmanufacturing industries.
4. Spreads between periphery countries and Germany / France for example are quite persistent (+100 to +300 bps).
5. Source ECB: SAFE survey on the access to finance of SMEs in the euro area – April to September 2013. Around one third of SMEs that applied for a bank loan in 2013 faced obstacles according to this survey: 12% of SME loans were rejected (up to 35% in periphery countries), 16% of SMEs received less than applied for and the remaining percentage refused the loan because the cost was too high.
   In the UK the trend is similar. According to a survey commissioned by TheCityUK (October 2013) bank lending to SMEs has been declining continuously since 2010 at an average rate of approximately -4% / annum. Rejection rates have risen from 8% to 19% between 2007 and 2012 for overdraft loans and from 6% to 23% for term loans.
6. Source: IIF: Restoring financing and growth to Europe's SMEs – 2013 conducted in 6 Euro-area countries: France, Ireland, Italy, the NL, Portugal and Spain.
7. The OMT weighs on domestic sovereign yields and activates laxer refinancing mechanisms for banks, extending temporarily eligible collateral. It is designed to ensure that bank funding is not a source of financial fragmentation in the EU.
8. The EIB group provided financing to the tune of € 75.1 Bio in 2013 corresponding to an increase of 37% compared to 2012. Within the EU the amount reached € 67.1 Bio (an increase of 42%). Within this amount the support provided to SMEs amounted to € 21.9 Bio.
9. ABS and credit claims are accepted as collateral for Eurosystem credit operations. In June 2012 the ECB extended the pool of eligible collateral to include SME-loan backed ABS with a second best credit rating of at least BBB-. The ABS loan-level initiative establishes specific loan-by-loan information requirements for asset-backed securities (ABSs) accepted as collateral in Eurosystem credit operations. Loan-by-loan information requirements for residential mortgage-backed securities (RMBSs) and ABSs backed by SME loans began on 3 January 2013. The European Datawarehouse launched in 2011 provides the means to collect and distribute standardized loan-level ABS performance data.
10. Proposals include setting up an EU SME credit risk database and a corporate information portal, developing credit assessment systems where they are not available and implementing a unique EU company identifier. These databases and processes could build on those managed by some member states and the ECB as well as on the actions initiated by the EIB to develop a common methodology for the credit scoring of midcaps and SMEs.
11. Mini-bonds introduced in Italy allow the issuance of short / medium term and convertible bonds by unlisted mid-sized SMEs and small midcaps. These mini-bonds are eligible for listing and subject to the same tax regime as bonds issued by listed companies.
12. For example: AFME – Unlocking funding for European investment and growth – June 2013 ; IIF: Restoring financing and growth to Europe's SMEs – 2013.
13. Other measures are proposed such as the development of credit mediation services and the review of laws concerning personal guarantees and sureties in order to make them less protective. Strengthening the financial structure of EU SMEs is also proposed, although this goes beyond the scope of this paper.
14. Equity is penalized compared to debt by its tax treatment since interest paid for debt is tax deductible.
15. Covered bonds are an alternative instrument for outsourcing financial risk used in many EU countries, but with such instruments the credit risk stays with the bank which does not increase its capacity to lend since there is no impact on the related capital requirements.
16. PCS aims to reinforce asset-backed-securities as sustainable investment and funding tools for both investors and originators by providing criteria and self-assessment tools, but only a limited number of operations have been structured on this basis in the EU so far.
17. The EIB and EC made proposals to the Council in June 2013 to set up a joint securitisation instrument for new and possibly existing SME loans potentially combined with a joint guarantee instrument, both involving the use of EIB and structural funds. It however appears that these proposals have not received so far significant support from member states as these funds are already allocated to specific domestic projects in many cases.
18. The review of capital requirements for securitization exposures in Solvency II should be possible on the occasion of the definition of the delegated acts by the EU Commission.
19. Definition of securitisation, standard requirements in terms of information disclosure and product structuring…
20. An extensive credit data base is managed by the Banque de France and 3 national central banks have credit assessment capabilities: Spain, Germany, Austria.

Mitigating systemic risks in the asset management sector

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

Investment funds are regulated in the EU at the product level for funds sold to retail investors (UCITS directive) and at the management company level for funds sold to professional investors (AIFMD). These regulations cover many potential risks (such as leverage, liquidity and operational risks). Assessments of the risks posed by the "shadow banking" sector, however, showed that existing fund regulations do not directly address some systemic risks which may be amplified by factors such as the interconnectedness of funds within the financial system and their exposure to run risks. The risks identified concern in particular Money Market Funds (MMF) and funds using securities financing transactions such as securities lending and repos[1].

MMFs have been the main focus of regulatory projects so far in the EU and the US. Requirements have been proposed notably for mitigating the specific risks posed by Constant NAV MMFs (CNAV), which according to regulators are liable to develop a false sense of risk-free asset and to create potential run risks and first-mover advantages[2].

Securities financing transactions (SFT) i.e. securities lending and repurchase agreements (repo), and rehypothecation, used in particular by investment funds, have also been covered by a recent proposal of the EU Commission to regulate their reporting and transparency, because of their possible role in raising interconnectedness within the financial system. This proposal aims to provide the information necessary to facilitate the monitoring of SFT by supervisors, develop appropriate policy tools if needed and remove the uncertainty about the extent to which financial instruments have been rehypothecated. It introduces requirements to report transactions to a central database and to improve transparency towards investors regarding such transactions[3].

Broader assessments of the systemic nature of asset management activities and entities have been conducted by international (FSB and IOSCO) and US regulators (Office of Financial Research (OFR) of the US Treasury) in the context of the work on the identification of non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs)[4].

These reports attempt to identify the channels whereby investment funds may transmit risks across the financial system. Connections within the financial system created for example by counterparty or credit exposures and the disruptions to financial markets potentially caused by large liquidations of assets by a fund are the main channels pointed out. The OFR report also stresses the growing connections asset managers have among themselves e.g. through funds of funds.

In terms of scope, the FSB consultation clarifies the fact that systemic implications should primarily be assessed at the fund level, where exposures to the financial system are created[5], but asks whether the focus should be extended to families of funds with similar strategies or to asset managers together with the funds they manage[6]. The OFR focuses more on asset management activities as the starting point for assessing vulnerabilities.

The factors that could potentially make investment funds risky have also been analyzed by the FSB and the US OFR. Size is considered as a factor of risk by the OFR. The OFR questions the potential impact the failure of a major asset management entity may have on the financial system. The FSB proposes to use size as an initial filter (the threshold for investment funds would be set at $ 100 billion in net assets under management)[7] to identify the funds on which to focus further analysis. Further potential risk indicators or filters put forward by these reports include interconnectedness, leverage and complexity, a potential lack of substitutability of certain funds[8], the cross-border dimension and redemption risks which may lead to first mover advantages. The OFR suggests that "reaching for yield" and herding behaviours are additional risk factors that need to be considered. Another issue the OFR report stresses concerns the gaps in the data on asset management activities that impede effective macro-prudential analysis and the oversight of asset management firms and activities: data gaps regarding in particular "separate accounts" managed on behalf of large institutional investors, as well as securities lending and repo transactions.

In the EU work on the recovery and resolution (R&R) of non-banks has focused so far mainly on financial market infrastructures and insurance companies. The EU Parliament Econ Committee recently acknowledged in a report on the recovery and resolution framework for non

bank institutions (October 2013) that the size and business model of asset managers "do not typically present systemic risk" and that significant safeguards already exist in the EU notably with asset custody rules[9]. The Committee's report states that more work needs to be done on an international basis in this area based upon improved data collection and analysis and calls on the EU Commission to further assess the systemic risks associated with asset managers[10]. Additional assessments are justified, the report stresses, by the growth of "much larger" asset management firms, many of whom are "exploring new business opportunities that could fundamentally change their business models and over time increase their systemic importance"[11]. An effective securities law regime is also pointed out as a way by which many of the issues involved in case of failure of a large cross-border asset manager could be mitigated.

A significant number of commentators, including think tanks, academics and policy makers, as well as industry participants have raised points of contention with the analysis of the possible link between asset management and systemic risk put forward in these regulatory initiatives and assessments that will need to be taken into account in their future steps.

These commentators and asset managers firstly refute that systemic risk resides at the management company level, arguing that asset managers primarily act as agents. Unlike banks they are not direct participants in the financial markets, they do not act as lenders or counterparties and do not invest on their own account. Market and counterparty risks are borne by the investors in the fund and investment decisions are made at fund level. Asset managers, as a company are therefore mainly exposed to operational risks, according to them, explaining why their balance sheets are considerably smaller than those of banks and insurance companies. Where the risks mentioned above may materialize is at the fund level. This requires product level regulations, which may be completed by rules covering specific activities or practices (e.g. securities lending, repo, collateral...) and addressing issues such as legal ownership of assets or investor protection.

In addition, they emphasize that risks are not correlated with the size of the assets under management, since larger asset managers tend to manage a more diverse range of funds (as their client base tends to be broad with different client segments seeking different investment solutions) and to have a more developed risk management function.

Secondly, industry players stress that many of the risks mentioned particularly in the OFR report, are already addressed in the EU by existing fund and derivative frameworks: UCITS and the AIFMD which together cover all funds distributed in the EU (including in particular restrictions to the assets in which funds may invest, leverage limitations, diversification rules, liquidity requirements) and EMIR covering derivatives exposures, due to be completed by legislative proposals regarding MMFs and the transparency of securities financing transactions.

Moreover, some additional issues identified during the financial crisis are being addressed by EU regulators. This is the case for example of Exchange Traded Funds (ETFs) for which specific guidelines were proposed by ESMA in 2012[12]. ETFs are indeed usually structured as UCITS in the EU, but raise interconnectedness issues with the banking sector which are not directly covered by the UCITS directive. The difficulty of tracking asset ownership in the case of re-use and the interconnectedness such practices create are another concern of regulators for which the transparency rules recently proposed for SFT could be an answer[13].

Suggestions have also been made that the consistency of regulatory reporting across jurisdictions could be improved in the EU (e.g. reporting on private / alternative fund, swap data, securities financing).

Finally, these commentators and industry players generally believe that specific plans for recovery and resolution are unnecessary in the case of asset managers. As assets are held in trust by a custodian (depository) and segregated (unlike a bank where the depositor has a contractual claim against the bank), investors are assured to get their assets back in case of failure of the asset manager. These rules will be further tightened in the EU with the implementation of the UCITS V and AIFM directives. If an asset manager goes bankrupt the management of the fund where assets are invested can be moved to another management company demonstrating substitutability at the entity level, industry players claim.

1. The FSB identifies in the policy framework for "strengthening oversight and regulation of shadow banking entities" published in August 2013 several types of collective investment vehicles other than MMFs exposed to shadow banking risk factors (e.g. maturity / liquidity transformation and liquidity) and run risks including credit investment funds, ETFs, credit hedge funds and private equity funds. Different policy toolkits are proposed including tools to manage redemption pressures, tools to manage liquidity risks, limits on leverage, restrictions on the maturity of portfolio assets.
2. A proposal for regulating MMFs was made by the EU Commission in September 2013 with a vote scheduled at the EU Parliament initially in April 2014 (now postponed). It notably includes the introduction of a 3% buffer (cash reserves) for Constant NAV funds (CNAV) which aim to maintain an unchanging value. In parallel, discussions are ongoing in the US regarding proposals made by the SEC to address structural features of MMFs (which differ to a certain extent from EU ones).
3. Regarding rehypothecation the proposal is made to set minimum conditions to be met by the parties involved, including written agreement and prior consent.
4. The FSB published for consultation in January 2014 assessment methodologies for identifying NBNI G-SIFIs. A process of identification of non-bank SIFIs has also been launched in the US steered by the Financial Stability Oversight Council (FSOC). A report was released for consultation in September 2013 by the US Treasury's Office of Financial Research (OFR) detailing the possible vulnerabilities that the asset management industry could create in the financial system.
5. Other reasons include the fact that the assets of a fund are separated and distinct from those of the asset manager and that data is available on an individual fund basis.
6. The FSB suggests that the focus of the assessments could be broadened to families of funds following a similar investment strategy, asset managers on a stand-alone entity basis or the asset management entity, given that the investment strategy and the risk management practices for example are determined at the level of the asset manager, according to the FSB.
7. In the case of hedge funds an alternative threshold is proposed to be set at a value between $ 400 – 600 billion in gross notional exposure.
8. The FSB report indicates that funds are generally highly substitutable (except some highly specialized ones) and that funds close on a regular basis with negligible or no market impact. There may be some concern however with highly leveraged hedge funds, according to the FSB for which one can imagine a scenario in which an orderly wind-down or transfer of assets to a new manager is more difficult.
9. In particular client assets are segregated and held with custodians and can therefore be transferred to another asset manager.
10. The EU Commission is asked to take into account the scope of the activity of asset managers in this assessment and to use a comprehensive set of indicators such as size, business model, geographical scope, risk profile, creditworthiness and whether or not they trade on their own account and are subject to requirements regarding the segregation of the assets of their clients.
11. e.g. funds engaging more in the financing of EU enterprises and long term projects which may result in increased credit risk transfer to the asset management sector and counterparty risk – Source report of the Econ Commission of the EU Parliament on the recovery and resolution of non-banks.
12. ESMA guidelines on ETFs and other UCITS (July 2012) include measures for improving the safety of ETFs such as: clear labeling of products, disclosure of holdings and financial exposures, standards for diversifying counterparties and quality of collateral, disclosure of fees and costs. These guidelines also require UCITS engaging in efficient portfolio management techniques (EPM) such as securities lending, repo to inform investors clearly about these activities and the related risks. All revenues generated by these activities net of operating costs should be returned to the UCITS. When a UCITS enters into securities lending arrangements it should be able to recall at any time securities lent or to terminate the agreement. UCITS receiving collateral to mitigate counterparty risk from OTC derivatives transactions or EPM techniques should ensure that it complies with qualitative criteria and diversification rules.
13. There is also a project to address this issue in the context of a securities law legislation covering a broader scope of instruments.

Financial Market Infrastructure reforms

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

1. Significant evolutions are expected in the post-trading market with the implementation of the CSDR and T2S

A political agreement was reached on the Central Securities Depository Regulation (CSDR) at the end of 2013. The last technical discussions at trilogue level have just been completed and the text is now scheduled to be considered in the plenary session of the Parliament mid-April 2014. The agreed regulation defines the role of the 30 or so CSDs which operate in the European Union (handling the settlement of securities trades and securities registration and safekeeping). It also provides harmonised settlement rules (such as an alignment of settlement cycles on T+2).

Under the CSDR agreement CSDs will face prudential and organizational requirements. A compromise was found among EU policy makers for some pending contentious elements. These include the conditions under which banking services ancillary to settlement may be provided by a CSD: higher capital charges will be imposed and supervisory cooperation will be mandated in authorizing and supervising such banking services. Settlement discipline measures which were another pending issue were also agreed. Participants who fail to deliver securities on the intended settlement date will be subject to penalties and will face mandatory "buy-in" requiring the assets to be bought back in the market at market price and then delivered to the non-defaulting counterpart. A certain degree of flexibility is however foreseen, tailored to the needs of SMEs and specific transactions such as repo agreements, as well as for cleared transactions.

The CSDR level II (regulatory and implementation) standards are due to be defined by ESMA by the end of 2014 and delegated acts will be prepared by the EU Commission[1] so that the regulation may be implemented in 2015. Challenging issues include the definition of appropriate settlement discipline standards and the timing of the implementation of these standards with respect to the schedule of TARGET2-Securities (T2S). Regarding T2S the issues are to avoid differences in rules across CSDs operating in the T2S environment and also to manage the timing between the availability of the CSDR standards and the operational launch of T2S.

The adoption of unified settlement rules with the CSDR should facilitate the implementation of T2S. The objective of T2S is to improve the cost effectiveness of cross-border settlement thanks to a centralization of DVP (Delivery-versus-Payment) settlement in central bank money aimed at facilitating the establishment of links between CSDs. The objective is to foster a reduction of cross-border settlement fees and of the liquidity needs (and related capital requirements) of market participants by a pooling of cash and collateral. The platform is due to be launched by the ECB between June 2015 and February 2017 in 4 successive waves of implementation. For T2S the current challenge is to maximize the volumes on the platform and to expand coverage of instruments / markets. For the moment there will be 24 CSDs and 18 Central Banks participating in the project. The main issue for market participants in the short term is determining how they will connect to T2S either directly (for either cash or securities or both: the so-called Directly Connected Participants or DCP) or indirectly (via a local CSD or intermediary participant), as well as whether they decide to become DCPs, for which markets and at what pace.

The implementation of T2S is expected to transform the environment of CSDs and custodians fostering greater competition. Competition is anticipated to increase between custodian banks on a cross-border and regional basis. There has also been discussion about the expansion of competition between CSDs and custodian banks. At this stage, one global custodian wishing to leverage collateral management and issuer services opportunities has launched a CSD. The main focus of regional / global custodians so far is on enhancing their T2S coverage and offering and on separating settlement services and asset servicing. Some CSDs are pursuing projects to diversify the services they provide in the custody area, in the perspective of the upcoming outsourcing of their settlement services to T2S.

The final outcome of these evolutions is however difficult to anticipate. Despite the positive effects greater competition might provide, some observers are concerned that such changes may trigger more fragmentation among service providers in the short term and potentially blur the delineation between market infrastructures and intermediaries and the scope of application of regulations. Others believe that the CSDR

and T2S might not provide sufficient harmonization for cross-border settlement to develop significantly. Indeed, T2S has been focused on settlement harmonization, while the asset servicing areas continue to be highly fragmented on a national basis. Initiatives have however been launched to address the latter issue in the context of T2S (the T2S Corporate action sub-group to deal with corporate actions on flows) and under the aegis of the EBF and AFME (Corporate Action Joint Working Group to deal with corporate actions on stocks). Standards have been produced which are now awaiting implementation. The need for a common framework for securities (the project of an EU Securities Law Legislation) in order to tackle notably conflicts of law is also often cited in this context, however there are no proposals officially tabled so far by the EU Commission.

2. Defining an appropriate recovery and resolution framework for Financial Market Infrastructures (FMIs) is the main forthcoming challenge following the adoption of EMIR and the CSDR

CCPs will concentrate a large part of the risks related to derivatives transactions with the implementation of the clearing obligations of EMIR[2] by the end of 2014. BCBS and IOSCO indeed estimated in a recent impact study that the proportion of centrally cleared OTC derivative trades would rise from 28% to 53% over the coming years[3]. This will provide many benefits for the market, but also increase the risk of CCPs[4]. The failure of a CCP is a low probability risk but may have extremely high consequences for the market. EMIR already requires many risk mitigation measures[5], designed to ensure that CCPs can survive "extreme but plausible market conditions" and notably the default of the two largest clearing members to which a CCP has exposure. These measures are due to be completed by a recovery and resolution framework providing additional crisis prevention and management tools in order to address cases where the "ordinary" recovery tools required in EMIR have failed and where there is a need to restructure the CCP.

Following a consultation paper published in 2012 by the EU Commission on the recovery and resolution (R&R) of non-banks and proposals made at the global level by CPSS-IOSCO, the Commission is expected to publish a proposal for the R&R of CCPs by the end of 2014. The EU Parliament also adopted a self-initiative report covering the R&R of non-banks at the end of 2013.

In this perspective, several questions remain to be solved regarding CCP R&R: (i) the objective of such a framework (i.e. the extent to which the continuity of services should be ensured vs the benefit of organizing a fast liquidation of positions in some cases); (ii) how to allocate losses between defaulting, non defaulting members and potentially their customers or other investors; (iii) how to take into account the interdependence between a CCP and its clearing members many of which are likely to be GSIFIs (Global Systemically Important Financial Institutions) particularly if many banks choose indirect access to clearing services; (iv) the appropriate toolbox for allocating losses (i.e. cash calls, margin haircuts, tear-ups...) and the way to address different asset classes / market segments within a CCP.

Broader issues also need to be clarified in this context, including (i) the delineation between R&R procedures and ordinary risk management processes (e.g. CCP default waterfalls) as well as between recovery and resolution phases, (ii) the organization and the role of the resolution authorities at the EU and the domestic levels (i.e. whether there should be several authorities for a cross-border FMI or a single EU resolution authority) and (iii) the way to handle the R&R of a cross-border CCP operating in jurisdictions with different rules.

Although CCPs are considered to be the priority, the EU R&R framework is expected to also cover (I)CSDs, possibly in a second stage, due to their critical role in the functioning of EU financial markets. In addition to handling the settlement of securities trades and the safekeeping of securities, CSDs and the ICSDs are indeed expected to play an increasing role in the management of collateral (providing collateral optimization and transformation services) and many CSDs are expected in particular to expand, following the implementation of the CSDR and T2S into new commercial services and offerings some involving risk-taking, which some believe may increase their exposure to systemic risk.

A possible R&R framework for (I)CSDs should complement the CSDR provisions and take into account the specificities of CSDs and ICSDs. CSDs do not have default waterfalls at present, as they are currently not exposed to credit risk[6]. Many observers also point out that several R&R tools cited in the context of CCPs are not applicable to CSDs. These include cash calls and margin haircuts as well as loss allocation mechanisms[7], which may create incentives for CSD participants to become indirect. The specificities of (I)CSDs operating with a banking license and exposed to credit risk will also need to be further assessed. One issue is defining the R&R framework such entities should be subject to (i.e. the banking or the FMI framework or both, and to what extent these frameworks need to be coherent and could complement each other). Another issue is approaching their risks appropriately. Such FMIs indeed stress that the banking activities they perform (that are expected to expand with the implementation of T2S) are limited in their scope, comprising mainly custody services and intra-day credit operations which are normally fully collateralised. Some observers however suggest that distinctions should be made in the R&R framework and possibly capital requirements between core CSD services and ancillary banking services, the latter being exposed to some risk-taking (e.g. in the R&R tools and the way they should be used, depending on

whether a defaulting participant is only a participant in core CSD services or also a user of the latter ancillary services).

3. The reporting of data on derivatives transactions to TRs launched in February 2014 needs to be closely monitored

The mandatory reporting in the EU of all on and off-exchange derivative trades to a Trade Repository (TR)[8] by all counterparties[9] in a derivative contract, as well as by the CCP used for clearing the trade, started on 12 February 2014. The objective of this reporting is to enable regulators to identify and analyse potential risks associated with derivative markets. TRs are commercial firms that centrally collect and maintain the records of derivatives contracts reported to them. Six TRs have so far been registered by ESMA in the EU and others are expected in the future[10]. The registered TRs will be directly supervised by ESMA and cover all derivative asset classes: commodities, credit, foreign exchange, equity, interest rates and others.

Several issues will need to be closely monitored during the implementation of these TRs. The fragmentation of TRs and the reconciliation and aggregation complexity this may lead to is the main issue stressed. Several TRs located in different jurisdictions may indeed operate for the same asset class and counterparties have a free choice of the TRs they report their transactions to[11]. The FSB is currently evaluating the possible impact and feasibility of different models for aggregating this data, with different degrees of centralization. ESMA is also assessing ways to reconcile the data that will be reported in the EU by both counterparties involved in each trade. The on-going implementation of a system of Legal Entity Identifiers (LEI) should also help to identify the participants in trades. The magnitude of volumes that will be reported and the potential difficulty in keeping track of all the data has also been stressed (the basic information on each contract comprises up to 80 fields including counterparties involved, the product, the price, etc… although not all will be applicable to all reports). Another issue is that the rules have not yet been clearly defined for on-exchange products (ESMA asked for a delay in the implementation of the reporting of on-exchange derivatives which was refused by the EU Commission). The difficulty of aligning the reporting under EMIR with the one under MiFIR[12] has also been pointed out (given the fact that MiFIR implementation standards are not yet defined) as well as the differences between EMIR and Dodd Frank requirements (e.g. only one-sided reporting under Dodd Frank, real-time reporting under Dodd Frank…).

1. The list of CSD ancillary services and the amount of settlement discipline fines will be handled by delegated acts for example.
2. Derivative products eligible to the EU clearing mandate are currently being defined by ESMA.
3. Source: FSB 2013, Fifth OTC derivatives progress report.
4. Four main benefits of central clearing were identified by B. Coeuré (ECB) in a recent speech (23 January 2014): improved margining and risk management methods; introduction of default and clearing funds in order to mutualise potential losses in a transparent and predictable way; multilateral netting of exposures requiring a reduced amount of collateral for a given level of risk protection; reduction of information asymmetries in the market place. The possible negative side effects of central clearing are also stressed in this speech: growth of risk concentration both nationally and internationally; internationalization of CCPs requiring effective due diligence; risk of crisis propagation owing to greater mutualisation and the greater risks in the event of a participant default which may spread to other participants; regulatory arbitrage and race to the bottom if the rules are not sufficiently consistent.
5. Including prudential requirements, disaster recovery planning and the implementation of a default waterfall and default fund.
6. At present CSDs only face operational and legal contingencies and the non-payment of fees.
7. Mechanisms allocating remaining losses to non-defaulting participants.
8. Lifecycle events such as give-ups or partial termnations also have to be reported. Valuation updates and collateral posted will also have to be reported.
9. According to EMIR, any EU counterparty which has concluded a derivative contract is covered by the reporting obligation. The following counterparties will therefore have to report their trades to TRs: CCPs, clearing members, MiFID investment firms executing trades on a trading venue and other counterparties to derivative contracts. Clearing members and their clients need to report separately. Reporting of the details of the derivative contract may however be delegated to a firm capable of fulfilling the function e.g. dealer, exchange, CCP, service provider. In case of delegation the compliance responsibility however remains with the delegating firm. Reports have to be made on T or T+1.
10. The registration of these TRs means that they can be used by the counterparties to a derivatives transaction to fulfill their trade reporting obligations under EMIR.
11. Complexity may however be reduced if market players choose to concentrate most of their reporting on one TR, which is what is what some observers expect.
12. Derivatives traded on EU trading venues are covered by reporting rules under both EMIR and MiFIR. MiFIR covers the actual trading of derivatives, whereas EMIR is about post-trading arrangements.

Addressing the risks and mobilisation challenges of expanding collateral use and re-use

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

I. Collateral mobilization is due to become an increasing challenge, but many solutions are being put in place by the private and public sectors

Increasing demand for collateral due to risk aversion, regulatory requirements and monetary policy combined with constraints on its supply could lead to greater scarcity in Europe

The use of collateral has strongly risen in the EU since the financial crisis with risk aversion and concerns over counterparty and sovereign risks. There has been increased demand for secured short and long term bank funding[1], higher levels of collateral asked in funding transactions and an increase in the notional amount of collateral posted in OTC derivatives transactions since 2007. The demand for high quality assets (HQLA and HQA[2]) is expected to increase further in the coming years with the forthcoming implementation of regulatory measures designed to improve the resilience of banks and insurance companies (Basel III liquidity capital ratio[3] and new Solvency II capital requirements) and requirements to mitigate risks from counterparty credit exposures in centrally cleared and uncleared derivatives transactions, which will all be implemented progressively between 2015 and 2019[4]. The on-going liquidity operations of the ECB are another factor driving increased secured funding in the euro area (LTRO Long Term Refinancing Operations)[5].

Limitations being put on the re-use of collateral and stricter asset segregation rules notably in the context of EMIR[6] as well as tighter collateral requirements for UCITS[7], may in parallel reduce its availability. While recognizing the role that collateral re-use plays (increasing its velocity and availability and potentially reducing transaction and liquidity costs), many regulators are concerned by the possible difficulty of tracking the ownership of re-used assets, their potential unavailability in case of counterparty default and the interconnectedness created by such practices, which may amplify market stresses. The absence at present of a legal framework in the EU covering the use and re-use of collateral and the preservation of ownership rights has often been cited in this context. The legislative proposals recently made by the EU Commission (EC) to improve the reporting and transparency of securities financing transactions (SFT), which are in line with the FSB proposals endorsed in September 2013 by the G20 on securities lending and repo transactions, should help to mitigate some of these risks. This proposal indeed notably aims to remove the uncertainty about the extent to which financial instruments have been rehypothecated, introducing requirements to report transactions to a central database and to improve transparency towards investors on the rehypothecation of financial instruments (prior consent of the providing counterparty would be required as well as information on the risks involved). It also requires rehypothecation to take place after transfer of the collateral[8].

Another factor pointed out by many industry players isthe multiplicity of collateral rules in different EU regulations (i.e. EMIR, uncleared derivatives rules, UCITS, etc…) which in some cases differ or possibly contradict each other (e.g. UCITS engaging in collateral transformation will not be able to use its proceeds to post it into a CCP and comply with EMIR). This creates operational complexity and may affect collateral liquidity and supply. There is also concern regarding the consistency and accuracy of the terminology used in different legislations (for example re-use and re-hypothecation which are used indiscriminately in many cases[9]).

The main issue to be addressed is the allocation of collateral across multiple asset pools and providing access to appropriate collateral.

The threat of a global collateral crunch previously mentioned as a possible result of these evolutions has nevertheless been dismissed by many regulators. Current estimates at the global level by the BIS indeed suggest that the combined impact of bank liquidity regulation and OTC derivatives reforms could generate an additional collateral demand of around $ 4 Tio when at the same time the supply of collateral assets is known to have risen by $ 10.8 Tio between 2007 and 2012 (outstanding amounts of AAA- and AA- rated government securities)[10]. In the EU the situation seems somewhat less favourable with a potential greater scarcity of good quality collateral expected in the coming years. Figures published by ESMA in February 2013 indicate that demand for collateral should increase by € 2.4 Tio in 2014[11] while the supply is expected to only grow by € 0.85 in the same period[12]. The total supply will however continue to outsize demand by nearly a 3 to 1 factor (supply of HQA in the EU of around € 11.8 Tio as of 2012 compared to a total demand of around € 4.1 Tio).

The situation may however vary across jurisdictions with possible temporary shortages of HQA in some countries e.g. where government bonds are perceived as risky by market participants (some periphery countries) or where the level of government bonds outstanding is low (some – mainly non-EU - countries running a budget surplus). In addition the collateral market is fragmented across multiple asset pools (mainly safekept by CSDs / ICSDs and custodian banks) with collateral often managed in silos, which may hinder access to assets, reduce liquidity and increase potential for mismatches. Fragmentation could further increase with an expansion of market infrastructures (following the implementation of the EMIR and CSDR regulations) and stricter asset segregation rules (e.g. within CCPs), some stress, potentially augmenting operational complexity and costs.

The main issue to be addressed is therefore not the overall supply of collateral but its allocation across multiple asset pools and providing access to appropriate collateral in order to comply with regulatory requirements and secure transactions. Specific concern is also raised by buy-side players who do not always have the ability to raise the collateral required in a short period of time (e.g. due to insufficient cash positions[13]) or who might be impacted by additional requirements imposed by shadow banking rules on repos needed to secure cash loans.

Solutions are being put in place by the private and public sectors to optimize the use of the existing collateral supply

Actions have been taken within the Eurosystem since 2008 to relax eligibility criteria and to extend eligible collateral in bank refinancing operations, which has helped to increase the availability of collateral in the Eurozone[14]. Other measures put in place by the ECB will facilitate the cross-border use of collateral, such as the suppression of repatriation requirements as of May 2014[15], the integration within the Eurosystem's collateral framework of cross-border triparty collateral management services[16] and the widening of the collateral framework to accept marketable assets denominated in foreign currencies. The implementation of TARGET2-Securities (T2S) by 2015-16 will also facilitate the delivery against payment in central bank money of collateral transactions within the EU on a domestic and cross-border basis[17]. Moreover the Single Supervisory Mechanism (SSM) should further facilitate the cross-border integration of EU securities markets.

Several private sector solutions also contribute to avoiding a shortage in collateral assets. These include services such as tri-party collateral management, entity-level and market-level collateral optimization and collateral transformation[18]. Partnerships are also being developed by EU market infrastructures with providers outside the EU in order to facilitate a more efficient mobilization of collateral at the global level. Concerns have however been raised by some regulators regarding the risks that an excessive use of collateral lending or transformation services may create: increased inter-connectedness leading to higher risks of contagion, higher maturity and funding risks as such transactions may have a shorter maturity than the transactions they are used for and reduced transparency if such transactions are not reported. The legislative proposals recently made by the EU Commission to improve the reporting and transparency of securities financing transactions (SFT) should help to mitigate such risks by providing supervisors with the information necessary to facilitate the monitoring of SFT and to develop appropriate policy tools if needed: introducing requirements to report transactions to a central database and to improve transparency towards investors on the practices of investment funds engaged in SFTs. These issues are being addressed in parallel by the FSB at international level in the context of the on-going shadow banking initiative.

Collateral optimization might also lead to a decrease in the overall quality of collateral assets used in the financial system, some believe, which will require the use of appropriate risk management frameworks (covering in particular haircuts and concentration limits).

Additional solutions are envisaged both by the private and the public sectors to increase the stock and liquidity of available collateral

One of the solutions envisaged in Europe for increasing the supply of collateral is to develop the pool of securitized credit claims (which are under-used as a source of collateral at present). In comparison the US market benefits from a large pool of collateral created by the securitization of a significant part of the mortgage loans originated by US banks many of which benefit from federal guarantees[19]. Regulators are favourable to the development of such products in the EU, provided that they do not lead to more complexity and opacity or increase the heterogeneity of claims. Initiatives are currently being conducted in certain jurisdictions to go towards such an objective for example with the refinancing vehicle set up in France issuing bonds guaranteed by credit claims[20]. Measures have also been taken by the Eurosystem to alleviate the costs of using credit claims as collateral[21].

CCP practices are another area where evolutions could be envisaged. Possible actions include cross-margining (i.e. the sharing of pledged collateral across different cleared assets) and expanding the range of eligible collateral (e.g. accepting some high quality corporate bonds as is the case in the US where such actions are negotiated between the authorities and the industry). But these changes will probably remain limited given the need to preserve market integrity and investor protection and the current fragmentation of the EU market.

Further standardizing collateral requirements across the EU within given usage classes (e.g. collateral used in the context of CCPs or for a given currency…) has also been proposed in order to promote liquidity within the relevant asset markets. Sufficient diversification of collateral should however be preserved at the overall level.

The creation of an EU securities law (SLL) defining more broadly the legal framework applying to securities and

securities transactions in the EU has also been considered by the EU Commission, although no proposal has been tabled for the moment. Such a framework could notably lead to the provision of a common legal framework for the use and transmission of collateral and address some pending issues related to asset ownership and traceability which appear in particular when assets are lent, re-used / re-hypothecated[22] or used in collateral transformation transactions. The added benefits such a framework could bring in the context of collateral transactions in addition to the proposals made by the EC regarding SFT mentioned above however need to be further assessed[23].

II. The increasing use of collateral has important implications for the functioning and structure of the financial system that are currently being assessed

The BIS and the ESRB have raised concerns about the possible impacts that an increasing recourse to collateral may have on the functioning and stability of the overall financial system and about the current lack of transparency on the extent of collateralization[24].

Increased collateralization raises asset encumbrance[25] which may have negative effects if it becomes excessive including: increasing the risks of unsecured creditors (bondholders, depositors) in the event of a default with a reduced availability of assets and augmenting liquidity risks for banks (if there are insufficient unencumbered assets that can be sold or repoed out). Asset encumbrance may also gradually eliminate unsecured financing making it too costly and pushing encumbrance even further, which may reinforce liquidity problems in particular[26] and reduce incentives to monitor banks' risks.

Higher use of collateral may also favour pro-cyclicality. During economic downturns the effects of the economic cycle on bank leverage and credit supply can be amplified when the share of collateralized financial transactions is greater. For example, falling collateral asset values in the covered bond pool mean that the pool has to be replenished or that assets need to be replaced to maintain the desired credit ratings of the secured debt outstanding. Similarly higher haircuts and falling asset values require more assets to be pledged to raise a given level of repo funding or to meet initial margin requirements on derivatives exposures. Such increased demand for collateral assets can then lead to significant asset sales and to institutional investors pulling back from securities lending and similar activities in times of financial stress.

Actions are under way in the EU to improve the data available for monitoring asset encumbrance and collateral positions.

In the context of the implementation of the Capital Requirements Regulation (CRR) which requires the financial institutions concerned to report to the competent authorities the level of their repo agreements, securities lending and all forms of asset encumbrance, the EBA is currently developing reporting templates[27] that should be implemented in all banks by the end of 2014. This will provide a harmonized measure of asset encumbrance and a comparison of the reliance on secured funding across institutions and will allow supervisors to assess the ability of institutions to handle funding stress. Such data should help creditors to assess the actual risks they face and improve the pricing of funding as well as facilitate institution-level and macro-prudential supervision.

In addition, repositories collecting data on securities lending and repo transactions (such as those mandated in the recent proposal of the EU Commission aiming to enhance the transparency of SFT transactions[28]) should help supervisors to better evaluate and monitor such exposures, detect potential risks building up at institution, asset class or market level and better anticipate changes in market behaviour. In the US efforts are being made by the industry to share the data available on tri-party repo for example. But this is difficult to reproduce in the EU where only 15% of the collateral market is in tri-party (the rest being handled bilaterally) as opposed to the US where most of tri-party collateral management services are handled by two main institutions.

Putting backstops on asset encumbrance or on covered bond issuance has also been considered. The LCR however already involves a buffer of unencumbered assets to be held as insurance against liquidity shocks.

1. Increase in the use of repos for short term funding and of covered bonds for longer term financing and decrease in unsecured debt since 2007. The reliance on secured funding varies across banks depending on their activities and on national market practices and legislations (e.g. use of covered bonds for long-term financing higher in certain countries such as Germany, Scandinavia…).
2. High Quality Liquid Assets (HQLA) include only assets that qualify in meeting the LCR requirement. Key characteristics of these assets, which comprise mainly cash and government bonds are their low credit and market risk. HQA include all assets that market participants can use to meet collateral requirements in derivative transactions.
3. Introduction of the liquidity coverage ratio (LCR) under Basel III between 2015 and 2019, requiring banks to hold a sufficient amount of HQLA, to survive a significant stress scenario lasting for one month. The new definition of the LCR proposed in January 2013 should lower the expected aggregate shortfall of the EU banking sector in terms of HQLA. Introduction in parallel of the Solvency II framework with new capital requirements (e.g. debt instruments with high ratings will have a preferential regulatory treatment).
4. EMIR mandates the central clearing of standardized derivatives (imposing stricter standards for initial margin requirements on derivatives transactions in the form of cash or HQA, partly offset by increased netting expected from central clearing and requirements for CCPs to segregate member and client collateral). The central clearing mandate is being implemented in the EU between mid-2014 and mid-2015. The list of eligible contracts is however not defined yet. The BCBS and IOSCO have recently proposed margin requirements for uncleared derivatives (with exemptions for physically settled FX forwards and swaps and a threshold of $ 50 Mio). The requirement to collect and post initial margin is due to be phased in over a 4 year period beginning in December 2015 and the requirement to exchange variation margin should become effective on 1 December 2015.

5. Central bank repurchases of HQA have taken significant quantities of collateral assets out of the market but the corresponding creation of central bank liabilities has replaced these assets with high quality claims on the central bank. As a result, combined with adjustments to collateral eligibility, net HQA supply is likely to have increased (Source BIS)
6. Both CCPs and counterparties to non-centrally cleared derivatives transactions will face restrictions on the rehypothecation of collateral posted with the implementation of new rules as well as collateral segregation rules. "One-time" rehypothecation will be permitted for uncleared derivatives subject to a number of strict conditions
7. The collateral requirements defined in the ESMA guidelines for ETFs and other UCITS (July 2012) determine rules regarding the type of collateral a UCITS may receive, the usage a UCITS may make of it and the way securities lending operations may be handled. These include strict limitations to the re-use or pledge of non-cash collateral received by UCITS (which should not be sold, re-invested or pledged), rules regarding collateral liquidity and the usage of cash collateral, credit quality and diversification requirements, as well as requirements to establish a haircut policy.
8. The counterparty receiving financial instruments as collateral will be allowed to rehypothecate them only with the express consent of the providing counterparty and only after having transferred them to its own account.
9. Rehypothecation is the term used in the recent proposal of the EU Commission on regulating the transparency and reporting of SFT. This proposal contains a definition of rehypothecation.
10. The implementation of the LCR was evaluated to lead to a shortfall of HQLA of $ 2.3 Tio. OTC derivatives reforms have been estimated to further increase the demand for HQA by $ 0.7 Tio for non-centrally cleared derivatives (total initial margin required to collateralize exposures) and by $ 0.1-0.7 Tio for centrally cleared derivatives. CGFS paper N°49 – Asset encumbrance, financial reform and the demand for collateral assets – May 2013. These amounts however remain uncertain. The additional demand for HQLA related to the introduction of the LCR is difficult to evaluate because it is believed that banks will adjust their behavior to limit their increased need for such assets e.g. replacing short term with long term funding sources in part. In the insurance sector the portfolios of safe assets are expected to increase quite significantly. Regarding OTC derivatives there have been different evaluations of the increase in collateral demand ranging from several hundred billion to several trillions.
11. This increase in demand would be due according to ESMA to the repo market (+ € 1 Tio), the LCR (+ € 1.2 Tio) and OTC and exchange traded derivatives (+ € 0,24 Tio)
12. The Dutch Central Bank in 2012 also indicated that demand for HQLA is expected to grow by € 2 Tio in the coming years when at the same time the supply may only grow by € 1.5 Tio.
13. Cash is needed to cover the variation margins required in CCPs. The fact that much of buy-side assets are held in custodial networks at present is another issue cited.
14. Extension in 2007 of the "single list" of eligible assets (common to all Eurosystem credit operations) to non marketable assets such as credit claims and non marketable retail mortgage-backed debt instruments (RMBS) and credit quality threshold enlarged to BBB-minimum credit requirements except for ABS (for which there is a AAA rating level required at issuance and A rating level over the lifetime of the transaction)
15. Abolishing the repatriation requirement will allow for example a German bank wanting to use as collateral a French government bond for refinancing with the Bundesbank to send it directly from Euroclear France to the Bundesbank without going through Clearstream
16. The integration of third-party collateral management services (provided by independent third party agents who manage collateral transactions on behalf of their clients) into the Correspondent Central Banking Model (CCBM) of the ECB will make such services available to all euro area counterparties on a cross-border basis (and not only to some of them) regardless of the location of the counterparty and of the tri-party provider. This will allow for a considerably more efficient delivery of collateral to the Eurosystem
17. T2S will allow a more efficient cross-border settlement in the EU, thus supporting easier mobilization of collateral from where it is generated to where it is needed. Given the expected wide range of T2S participants, the delivery of collateral to Eurosystem NCBs and CCPs will become swifter and more efficient. (Source EA Zautzik, Bancad'Italia, Eurofi newsletter)
18. Tri-party collateral management services may notably help to move collateral more efficiently. Collateral optimization services use platforms and processes to optimize the sourcing, allocation, transfer and monitoring of collateral. Collateral transformation involves custodians or institutional investors providing HQA from their balance sheets through securities-lending type transactions to clients in exchange for lower quality collateral plus a fee.
19. This process involves the Government Sponsored Enterprises (GSEs) such as Freddy Mac and Fannie Mae
20. This vehicle provides a common issuance structure for the participating banks and standard transparency and risk management requirements.Requirements include a standard legal documentation and common risk control measures regarding e.g. the eligible credit claims, a ban on tranching and the segregation of risks among participating banks.
21. Measures include the implementation of relatively automated procedures for the use of credit claims as collateral by some euro area NCBs and the introduction of a framework for the cross-border use of credit claims by the Eurosystem (see Occasional paper of the ECB on "The use of credit claims as collateral for Eurosystem credit operations" (June 2013)
22. Many players indeed stress that the legal context of concepts such as re-use or re-hypothecation should be better defined and that more clarity should be brought regarding the chain of intermediation in order to avoid collateral being used without the consent of the owner.
23. An EU SLL could help to develop a more horizontal approach to collateral transactions in EU legislation. Beyond this an EU SLL would have a broader scope since it would apply to all securities transactions. It would therefore probably involve clarifying the book-entry systems that can be used in the EU and the applicable laws, which is quite challenging.. There are two main systems underlying the ones used at present in Europe: the direct holding system used in Continental Europe and the trust or indirect holding system (the latter is also used in the US and Canada). Under the system of direct holding of securities, investors are given ownership rights over securities. Under the trust or indirect holding system, intermediary entities to which the securities are issued to in the first place hold the securities on behalf of investors but also own the beneficial rights over those securities. Investors in this case own an entitlement or interest in these securities. Some industry players have also suggested that collateral re-use could be limited to assets posted through a transfer of title (as opposed to a transfer of security interest or a pledge) in order to facilitate the tracking of ownership. In this case the collateral receiver becomes the new owner of the collateral and there would be no difficult to track ownership.
24. See notably the BIS « Asset encumbrance, financial reform and the demand for collateral assets » - Report from the Committee on the Global Financial System – May 2013. Banque de France Financial Stability Review – April 2013 – contribution on "Collateral scarcity and asset encumbrance: implications for the European financial system" by the Nederlandsche Bank Financial Stability Department
25. According to the EBA, asset encumbrance is the result of an institution creating a legally binding preferential claim on its assets or on financial items it had received as collateral under other transactions in favour of a selected group of its creditors. Asset encumbrance is thus characterized by the loss of a previously enjoyed level of control over assets or collateral received. The current median level of encumbrance in a sample of EU banks is around 25% according to a study by the ESRB (Dec 2012). Covered bonds affect asset encumbrance as the assets remain on the bank's balance sheet. RMBS products affect encumbrance only to the extent that the issuing bank provides implicit or explicit guarantees or retains the RMBS on its balance sheet. Repos may be offset by reverse repos reducing net asset encumbrance.
26. Such problems may however be partly mitigated by the LCR
27. Large institutions with a balance sheet value equal or more than 30 Bio € will have to furnish also information on the characteristics of encumbered and unencumbered assets in a detailed breakdown of balance sheet items and the asset encumbrance information under hypothetical stressed scenarios (i.e. contingent asset encumbrance)
28. The ECB has also been supporting the project to build a trade repository for repo transactions which are of particular importance for EU central banks for the implementation of monetary policy and for financial stability considerations, since the provision of central bank liquidity to the banking sector is based in the euro area on repo operations.

Cross-border implementation and global consistency of OTC derivatives and banking requirements

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Strengthening financial regulation is a key objective of the G20 commitments agreed in Pittsburgh in 2009. Work is underway to implement them in domestic regulations in the different areas covered by the G20 commitments: banking sector, capital markets, insurance sector.

Some observers however stress that the data and monitoring systems currently available are insufficient to identify and manage risks appropriately in the global financial system (particularly Credit Default Swap exposures, interconnectedness within the shadow banking system and with banks...) and argue that this may affect the effectiveness of the policies being drawn up.

1. Cross-border implementation and global consistency of OTC derivatives requirements

Much progress has been made in the definition of OTC derivatives rules, but their implementation is taking longer than expected and differences in timing have appeared across the main jurisdictions. This may create temporary legal uncertainty and legal arbitrage risks.

Although the definition and implementation of requirements for transactions to be reported to Trade Repositories (TRs) is moving ahead rapidly in most G20 countries with implementation phased-in over the course of 2014, progress with central clearing requirements is slower according to the FSB[1] and is still quite limited for trading requirements. In the EU the rule-making process is almost completed while the implementation of the rules is still work-in-progress. The reporting of OTC derivatives trades to TRs started in February 2014 in the EU but the clearing mandate of EMIR is not expected to be implemented before Q3 2014 and MiFIR trading requirements for standardised OTC derivatives will probably not be implemented before 2016. The US is somewhat ahead with swap trading, clearing and reporting obligations having been put in place by the CFTC in 2013, which are since being continuously developed further. However the process is less advanced for SEC regulated swaps. Most Asian jurisdictions are further behind schedule due to specific domestic priorities.

Legislative progress is also being made in the area of margins for non-centrally cleared derivatives for which globally agreed standards were published in September 2013, although their implementation is not expected to begin until the end of 2015 in most jurisdictions.

Basel III prudential standards, meant to act as an incentive towards central clearing with enhanced standards are also in effect in around half of FSB jurisdictions at present.

Although the OTC derivatives rules defined have significant commonalities, there are many differences across jurisdictions in their detailed requirements, reflecting presumably different local market conditions and domestic legal frameworks.

Such discrepancies may create complexity both for direct participants and for the buy-side and potentially lead to liquidity fragmentation. Several differences remain between the EU and the US requirements regarding in particular (i) the product scope they apply to (which includes both OTC and exchange-traded derivatives in the EU and only OTC derivatives (swaps) in the US), (ii) the exemptions applied to non-financial corporations which are wider in the EU due to the application of thresholds (iii) reporting obligations (transactions must be reported by both counterparties on a T+1 basis in the EU whereas US rules dictate that reporting take place in real time with only one counterparty required to report in the US), (iv) minimum risk management standards that apply to CCPs (e.g. EU CCPs must maintain sufficient financial resources to withstand the failure of the two clearing members to which they have the largest exposure, whereas in the US they must only have resources to withstand the failure of the clearing member to which they have the largest exposure).

In the absence of an authority with the power to coordinate policy-making and enforce policies consistently at global level, which some market observers are calling for, developing international cooperation mechanisms among jurisdictions is essential to facilitate the cross-border implementation of these rules and preserve the global dimension of derivatives markets.

The objective of regulatory and supervisory cooperation is to avoid overlaps, contradictory requirements and limit extraterritorial effects. Major steps forward are being made in the OTC derivatives area, following the

declarations made at the G20 Saint Petersburg summit "that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identical outcomes". However, how any international agreement on margin requirements for exchange-traded derivatives will be reached remains to be clarified.

The US CFTC and EU Commission (EC) first published a joint understanding of cross-border issues in July 2013, followed by a multilateral set of understandings announced in August by the OTC derivatives regulators group consisting of regulators from jurisdictions with large OTC derivatives markets. A key understanding of this latter group is that a flexible outcomes-based approach should form the basis of assessments regarding equivalence or substituted compliance. The group also agrees that a stricter-rule approach should apply to address gaps in mandatory trading or clearing obligations and that jurisdictions should remove barriers to Trade Repositories (TRs) regarding the access of authorities to TR data and the reporting to TRs (i.e. avoiding inconsistent rules across jurisdictions and suppressing restrictions due to domestic privacy laws).

A task force on cross-border regulation set up by IOSCO in September 2013 is also expected to make recommendations by the middle of 2014 regarding the conceptual approaches and tools to be used to regulate cross-border securities markets and the role IOSCO should play in this context. A feasibility study has also recently been launched by the FSB of options for how information from TRs can be aggregated and shared among authorities, the results of which will be published in the first half of 2014. Some industry players however point out that the current differences in the data elements required e.g. between the EU and US will remain an obstacle to such aggregation efforts and need to be addressed in parallel.

Furthermore a proposal was made by the EU Commission in January 2014 to establish within the EU-US Transatlantic Trade and Investment Partnership (TTIP) process a framework for regulatory cooperation in financial services. Regulatory cooperation - also with regard to the financial markets as necessary annex of any free trade - would be based according to the proposal on several principles including joint work to ensure timely and consistent implementation, mutual consultations in advance of any measures and a commitment to assessing whether the other jurisdiction's rules are equivalent in outcomes.

While generally supporting such approaches to facilitate the cross-border implementation of rules in the OTC derivatives area, many industry players and observers stress that their impact will depend on the finer details of how "substituted compliance" (in the US) and "equivalence assessments" (in the EU) referred to e.g. in the CFTC / EC agreement will be designed and how the high-level principles proposed in these declarations will work in practice (i.e. whether there will be one set of rules even if differences subsist in the detailed requirements). Another issue to be overcome according to some regulators are the potential differences in the degree of supervision and enforcement of rules (even if the rules themselves are considered to have similar outcomes) which naturally also impact the market participants' cost calculations and thereby have a double effect with regard to a level playing field.

Regarding the practical implementation of these principles, progress has recently been made in the trading area where an agreement was reached in February 2014 between US and EU regulators to exempt from US trading rules European-approved platforms that trade derivatives, until equivalent EU rules come into force in around 2 to 3 years' time, alleviating fears of liquidity fragmentation in the market[2].

Questions however remain regarding the way equivalence assessments should be conducted in practice. Some observers believe that there should be a certain degree of flexibility in such decisions in order to avoid a "zero-one" system by which a foreign jurisdiction is considered to be either equivalent or not equivalent with limited discretion. There have also been discussions regarding the criteria to be used in such assessments and the degree of proportionality that may be allowed. In the context of the recognition by the EU authorities of foreign CCPs some regulators have suggested that equivalence assessments should be based on commonly agreed standards (e.g. IOSCO standards), when possible, rather than national laws which are the product of processes in which foreign jurisdictions have not taken part. Others consider on the contrary that domestic rules should be the starting point if a jurisdiction is to defer entirely to the laws and supervisory system of the foreign jurisdiction when rules are equivalent (which is the approach of the EU for example) and believe that such an equivalence approach is quite workable provided that it focuses on the equivalence of outcomes and does not adopt an excessively granular approach.

2. Cross-border implementation and global consistency of banking requirements

At the end of 2013, 25 out of the 27 main jurisdictions in the world had Basel III rules in place. Although the implementation of Basel III banking prudential requirements is phased-in as far as 2019, their implementation has been anticipated by the market in many cases creating major impacts for the profitability and activities of many EU banks in particular.

Differences have appeared in the rules applying to the banking sector.

Basel III rules are designed as minimum requirements and differences have emerged in their implementation across regions. Such differences may create level playing issues and regulatory fragmentation. Examples mentioned by industry players include differences in the definition of the leverage ratio based on differing accounting rules across jurisdictions (which are not expected to converge in the short term) or provisions contained in the EU Capital Requirement Regulation (CRD IV) which would exempt EU banks from holding capital against counterparty credit risk for trades with sovereigns and provide reduced requirements for corporates.

In addition Basel III does not define specifically how capital and liquidity should be allocated within a cross-border financial group. Concerns have emerged in Europe regarding the US Federal Reserve's proposals part of its 2014 regulatory programme, to require foreign banks, which were previously exempted from US capital requirements when owned by a well-capitalized foreign bank, to create a local bank holding company subject to US prudential requirements. This change is justified, according to US regulators, by the increasing size of the US operations of foreign banks, their interconnectedness with the US financial system and the risks associated with large intra-group funding costs[3]. Foreign banks stress that they would be required with such a rule to comply with specific capital and liquidity requirements for their US operations reducing their capacity to manage liquidity and capital positions on a global basis.

Fragmentation trends within the Eurozone have also been emphasized (e.g. limitation of amounts foreign banks can transfer out to the parent company based in a foreign jurisdiction), but these should progressively disappear with the implementation of the Single Supervisory Mechanism (SSM) notably.

Moreover the differences that have emerged between the banking structure reforms already implemented in some jurisdictions (e.g. reforms adopted in France and Germany, the US Volcker rule) and proposals made notably in the UK and by the EU Commission, that may touch global financial groups, are stressed by industry players.

Differences in the level of bank intermediation across jurisdictions and accounting rules mean that the outcomes of Basel III requirements might differ quite significantly across regions.

There are major differences at present in the functioning of the financial system between the EU and Asia where bank-intermediation is dominant for retail and SME financing and the US where market-based mechanisms are much more developed. In the US a significant proportion (up to 70%) of the retail credits originated by banks (mortgages, consumer credits…) are transferred to the Government Sponsored Enterprises (GSEs) which are not subject to Basel III requirements, thus off-loading these credits from the banks' balance sheets. The outcome of Basel III capital, liquidity and leverage requirements are therefore quite different for EU, Asian and US banks. These differences may be further increased by differing accounting rules.

The unintended consequences resulting from inconsistencies in recovery and resolution plans (RRP) are also stressed.

Sufficiently integrated and consistent RRPs need to be in place for global financial groups in order to avoid local restrictions or lock-ups in case of stress, which may threaten the viability of such groups or frustrate the resolution actions of the home authority. The implementation of an EU R&R framework for banks consistent with the "key attributes of effective resolution regimes" drafted by the FSB should contribute to this objective, provided supervisors and resolution authorities cooperate efficiently, which may require some changes in the mandate of supervisors. Differences between the EU Bank Recovery and Resolution Directive (BRRD) and the US measures are also stressed regarding in particular the scope for bail-in and loss absorbency requirements, with differences in the level of recapitalisation required in different jurisdictions.

1. According to the FSB by the end of 2014, almost all jurisdictions will have some trade reporting requirements in effect. For central clearing most large market participants' interest rate and credit derivative transactions are being cleared and several large OTC derivative markets including the EU, HK, Japan, Singapore and the US plan to have specific clearing mandates in place by end 2014.
2. The CFTC issued two no-action relief letters which allow US swap dealers and major swap participants to execute swaps transactions on qualifying EU-regulated multilateral trading facilities, without further regulatory approvals from the CFTC. The agreement follows concerns that differences between Europe and the US in the detail and implementation timelines for new OTC derivatives markets rules would split the market in two, thereby potentially damaging liquidity and driving up costs for market participants.
3. According to D. Tarullo (testimony on Dodd-Frank implementation - 6 Feb 2014), prior to the crisis the Fed's approach to regulating the US operations of foreign banks rested on substantial structural flexibility for the foreign bank, substantial reliance by the Fed on the supervisory and regulatory framework of the foreign bank's home country and substantial expectations of support by the parent foreign bank of its US operations. This change is justified by the fact that the US operations of foreign banks in the years leading up to the crisis grew much larger and became much more complex and interconnected with the rest of the US financial system. For example 5 of the top 10 US broker dealers are currently owned by foreign banks and together hold almost $ 1.2 Tio in assets. The US operations of large foreign banks also became much more dependent on the most unstable sources of short term wholesale funding and established very substantial net credit exposures to the parent foreign bank in the years leading up to the financial crisis. As a result during the crisis these banks were heavy users of the Fed's liquidity facility.

Suggesting key priorities for the forthcoming EU Commission

This document was drafted by Eurofi with input from its members. It does not engage in any way the Greek EU Presidency nor the Greek Financial Authorities.

Executive Summary

Since July 2007, the world has faced, and continues to face, the most serious and disruptive financial, economic and social crisis since 1929. The very existence of the Euro was under threat between the spring of 2010 and the summer of 2012, due to the repercussions of a crisis that originated in the United States, but also and above all due to the fiscal imbalances and the insufficient competitiveness of several Member States and the links between banks and their sovereigns[1].

Much has been achieved during the last four years to prevent future crises.

In 2010, there were no arrangements in place to deal with Member States losing market access. This absence created major uncertainty in markets about the way forward.

With the European Supervisory Mechanism (ESM) and the two-pack, a permanent funding instrument and a governance framework have both been created. This has been a major step forward and will ensure that in the future, the euro area is better prepared to respond to such crises.

Europe has also been working on implementing the G20 agenda, the aim of which is to ensure that all financial activities and players are well regulated and effectively supervised in order to prevent the development of systemic risks. During the four past years, the EU Commission has indeed proposed 28 legislative texts (including CRDIV, Mifid 2 / MiFIR, EMIR, AIFMD, Solvency 2...) in that respect.

The new EU supervisory authorities were also set up following the de Larosière report and played a key role in addressing the consequences of the crisis and ensuring a consistent transposition of directives and regulations across the EU. The introduction of simple majority (or, in some cases, qualified) voting rules providing the European Authorities with the means to make decisions, is also a significant step forward.

The Banking Union which is probably the biggest project since the Euro itself and which the EU Institutions are close to finalizing is another major improvement. The Banking Union has the potential to significantly contribute to the re-integration of financial markets in Europe and is fully consistent with the objectives of the Single Market. It will also ensure that investors - and no more taxpayers - will assume the burden of paying for failing - or risking tofail - banks.

After years spent developing common rules for the EU financial services sector the monetary union is now badly fragmented following the sovereign debt crisis.

After 10 years of economic deviations, the sovereign debt crisis hit the Eurozone in 2009-2010. It has abolished years of efforts since the introduction of the Euro to further integrate EU financial markets. This crisis has indeed created a deep fragmentation across the Eurozone financial markets. In a monetary union there should indeed be one single set of interest rates in all parts of the Union, but this has no longer been the case since 2010.

In addition to the lasting spreads on sovereign securities between the periphery countries and other Eurozone countries such as Germany and France, banks have focused their sovereign exposure on their own domestic sovereign bonds in which they have heavily invested. Moreover EU banks have diminished their cross-border activities. National authorities have also sought to protect their domestic economies and national taxpayers by ring-fencing banks' capital and liquidity positions to protect them from hindering the activity of cross border banks and the freedom of capital movements.

In parallel the integration of retail markets is at a standstill. Yet building a more unified EU financial market is the only way for Europe to achieve the scale needed for providing appropriate financing conditions and products for its enterprises, citizens and states.

The next five years ahead – towards restoring the Single Market and completing the Union

Euro area citizens are still suffering from the inevitable adjustment process following years of accumulated imbalances. Unemployment remains unacceptably high. The years to come are therefore about creating a more perfect Union that caters to these objectives.

The time has come for Europe to define a fresh conception of its financial services markets. It is absolutely essential to re-launch an integration of the internal market and together to invest in projects for the future. Europe must also equip itself with the means of remaining a key player on the international scene.

The achievement of an integrated European market would indeed stimulate innovation, intensify competition in banking services, widen consumer choice and reduce the costs of intermediation, which are all needed to improve the performance of EU financial services and their contribution to the economy. Such an evolution will offer economic players improved financing and investment conditions, boost capital productivity and ensure a better allocation of assets, thereby fostering a proper match between savings and investment.

This means in particular developing a new financing model for the EU economy and particularly for SMEs, midcaps and long term projects involving a greater role for market-intermediated financing. Priorities include building an EU securitization market to improve SME financing, developing bond and equity financing for midcaps (notably with an EU private placement market and an appropriate ecosystem for EU midcap equity markets) and a bond market to support long term financing.

Moreover achieving an effective single market requires a more consumer-friendly financial system (providing notably appropriate investor protection and a suitable mix of investment products) and a strengthened EU retail payments market. Enhancing the safety and efficiency of EU Financial Market Infrastructures (FMIs) with the implementation of on-going reforms (MiFID II / MiFIR, EMIR, CSDR), the launching of T2S and related harmonization efforts and an appropriate recovery and resolution framework for FMIs are key to EU securities and derivatives markets. Increasing the transparency and safety of securities financing transactions such as securities lending, repos and asset rehypothecation is also an important objective in order to mitigate the risks associated with such transactions which are necessary in particular to facilitate the management of collateral.

Reviewing the IORP directive in order to face up to pension needs are other key priorities to be considered. In addition, acquiring a stronger position on the international regulatory scene is also urgently needed for Europe in order for the specificities of EU financing mechanisms and the impacts on the EU economy to be better taken into account in the definition of global rules. Finally, improving governance within the EU financial sector is also necessary, as regulation is not a substitute for good governance.

Furthermore, Member States need to keep their promises to correct imbalances and to reform the structure of their economies. Debt burdens remain high in many countries and the deleveraging process continues to impede growth. Fiscal policies have to be brought effectively in line with the provisions of the Stability and Growth Pact and of the Fiscal Compact. This concerns all Member States, not just those who looked at some point into the abyss of losing market access. This concerns also the European institutions, which have to ensure that common rules are thoroughly and evenly applied. This is the only way for Europe to reduce gaps in its internal competitiveness.

Delivering on past commitments also means keeping the promise made by Heads of States or Governments in June 2012 to complete the Banking Union. It means a swift transposition of agreed directives into national law and a stringent application of the adopted regulatory framework. It also means that a Single Resolution Mechanism, which is a strong second pillar of the Banking Union, needs to be agreed before the end of this legislature.

Creating a more efficient Union also requires filling the remaining gaps in the architecture of the Economic and Monetary Union, which should remain the long term objective of the EU as outlined in the Four Presidents Report in 2012. This report was prepared by the President of the European Council in close cooperation with the Presidents of the Commission, the Eurogroup and the European Central Bank proposes to move, over the next decade, towards a stronger EMU architecture, based on integrated frameworks for the financial sector, for budgetary matters and for economic policy.

Detailed proposals

1. Implementing the Banking Union (SSM, SRM, BRRD, DGSD) to reverse fragmentation and resume financial integration

European banks have already made strenuous efforts to repair their balance sheets. The comprehensive assessment conducted by the ECB should increase significantly the level of transparency of Eurozone banks, repair their balance sheets and restore confidence by assuring stakeholders that banks are sound and trustworthy.

A successful review and subsequent restructuring of banks identified as too weak would probably start a gradual healing of Europe's banking system. If so, bank funding conditions could return to normal in the course of 2015.

Only a secure and credible EU financial regulatory and supervisory architecture can be expected to reverse the financial fragmentation within Europe and to provide for a resumption of Europe's progress toward creating a genuine single market. Establishing the Single Supervisory Mechanism, strengthening the nascent supervisory authorities (EBA, ESMA, EIOPA) to achieve a common rulebook and promote the Single Market and

putting in place a Single Resolution Mechanism, credible and efficient, should indeed break the vicious link between sovereigns and banks.

Shifting some recapitalization needs and the supervisory functions to the center of the Union would be an additional important step forward to establish an effective confidence in the banking sector of the Eurozone. Without such a fiscal backstop banks would, in the event that bail-in and the resolution fund are insufficient, continue to depend on the strength of their respective sovereigns. In order for such a backstop to be credible, decisions about its use should be taken at the European level, and it should be available as soon as the SRM becomes operational. It would help restore an integrated financial market[2] and foster long term growth in Europe.

But, of course, this objective can only be effectively achieved if the States pursue vigorously their own adjustment efforts and the Union makes determined steps towards fiscal and political solidarity. As long as a lingering doubt remains in the minds of many investors on the sustainability of the Union (and it is that doubt that explains the high yields of the periphery), the system will be fragile. The Banking Union is not a panacea and cannot be a substitute for good policies, but it can help to strengthen the process and to move towards a true monetary Union as long as it is convincing and well-conceived.

Improving the EU macro prudential framework is also a necessity. Some might argue that with the upcoming Banking Union, there is no need for an EU-wide macroprudential organization. The ECB could perform that role for the members of the Banking Union, and other members would do it nationally. That would be a grave mistake. Europe needs, as a Union and a powerful single financial market, a "sailor at the top of the mast "who looks at possible systemic dangers. Europe needs an independent body that looks beyond its borders and is also concerned by possible contagious effects of national policies. Thus subsidiarity would be preserved, and a clear division of responsibilities would be defined with Central Banks and National Regulators (see the keynote speech of Jacques de Larosière, "Financial Supervision in the EU, Brussels, May 2013).

2. Developing a new financing model for the European economy

Further developing market-based financing mechanisms

As expressed by M. Madelain in the Eurofi Athens newsletter, "over the long term, stability and growth may be complementary. Over the shorter term, with recovery in sight, policymakers' choices on banking, insurance and financial services regulation will affect the real economy".

Resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. However, with the implementation of international capital and liquidity requirements the cost of credit will increase and its availability will diminish in particular for longer maturities due to liquidity constraints. In addition, the insufficient profitability of many E.U. banks is reducing their access to market financing sources needed to increase their capital and therefore their lending capacity.

In parallel specific actions to improve the profitability and the financial soundness of SMEs seems a prerequisite in many EU countries.

Larger companies and mid-caps, which have access to capital markets have anticipated this evolution by diversifying their financing resources, but this is not the case of SMEs, which are very reliant on bank financing due to the lack of data and the proximity relationship needed to assess their risks. The same is true for households.

Providing rapidly additional or more cost effective sources of financing through market-based mechanisms should be one of the top priorities of the next legislature provided such mechanisms do not create additional systemic risk or investor protection issues.

Building an EU securitization market to improve SME financing in the EU.

Developing an E.U. securitisation market seems necessary in order to refinance SME loans and alleviate SME financing constraints for banks.

Relaunching EU securitisation markets on a sound basis seems feasible but requires overcoming several obstacles in the short term, such as the sharp increases in capital requirements for securitisation exposures mandated in Basel III and Solvency II, the current low margins of bank loans and the absence of standardised and easily accessible information on SME loans.

Given the urgent need to step up lending in the EU, solutions involving the intervention of the ECB and national central banks (in order to impose appropriate quality standards based on the current criteria used for accepting SME loans as eligible collateral in central bank refinancing, support the emergence of securitisation conduits and purchase eligible loans temporarily, if needed, to foster the launching of the market) and the EIB and national public banks (in order to offer some guarantees for the securities issued) are proposed to help revitalise the EU securitisation market in a relatively short timeframe.

Building an EU private placement market and an appropriate ecosystem for EU midcap equity markets

Midcaps (turnover comprised between 50 Mio € and around 1 Bio €) have less difficulty in accessing market

intermediated funding than SMEs (turnover < 50 Mio €), but developing EU level markets and instruments for such companies is necessary in order to facilitate their financing. A legal EU definition of such companies, the development of a European private placement regime (possibly expanding existing domestic frameworks), the expansion of EU high yield bond markets and efforts to improve the consistency of EU bond legislations are proposed, as well as actions to encourage equity financing and promote IPOs (e.g. rebuilding an appropriate ecosystem, better balancing incentives for bond and equity financing[3], adapting rules for SME and midcap issuers).

Developing an overall perspective on the financing needs of SME / midcap issuers and investors is also put forward as a priority by many industry players, in order to achieve a general and consistent approach of the regulation of the different instruments available (i.e. equity, bonds, loans, securitised products…) and ensure their coherence.

Making Europe more competitive globally by investing in long term projects

If Europe wants to remain a leading global player in some sectors, we urgently need to launch three genuine strategies, as explained by Michel Barnier in his speech "Shaping a new competitive Europe" (Bilbao, 3 March 2014). We need a fresh start for a competitive European industrial sector. This requires new common investments to support strategic sectors such as nanotechnologies, micro and nano-electronics, advanced materials and industrial biotechnology. We also need cheaper energy supplies through a common energy policy. Europeans indeed pay three times more for their natural gas than Americans. Energy is therefore a natural candidate for new, common, investments to secure European future competitiveness. Third, we need Europe to be a digital continent as far as the digital economy is a real driver for growth and jobs.

These policies require significant investments and therefore appropriate financings.

Developing an EU capital/bond market to support long term financing

Banks are by far the main source of external financing for infrastructure projects in the EU but long term loans are expected to be more expensive or scarcer with the implementation of Basel III capital requirements and liquidity ratios. This explains why the transition from a bank- dependent financing of infrastructure to a more capital market has also to be achieved rapidly.

Long term investment has been a concept continuously repeated by political leaders and investors but little has been achieved concretely with the exception of the capital increase of the EIB (10bn euros). The long term-guarantees package that should be adopted by the EU Commission in the coming weeks is of paramount importance in that respect in order not to discourage insurance companies from investing in long term investments.

Building an efficient EU financial market for EU infrastructure projects needs additional regulatory or EU public initiatives in two key areas: infrastructure project procurement processes should become market and investors friendly and cost effective. It is also important to reduce the information asymmetry and the cost of due diligence and to inform over time on the economic and attractiveness and risk of EU infrastructure securities and loans.

3. Ensuring the safety and the efficiency of EU Financial Market Infrastructures

Trading venues and post-trading infrastructures are key elements of the functioning of EU securities and derivatives markets.

The implementation of on-going regulations (MiFID II / MiFIR, EMIR, CSDR) aiming to enhance the safety and efficiency of EU Financial Market Infrastructures and the implementation of T2S and related harmonization efforts which should improve the cost effectiveness of cross-border settlement are essential reforms for the EU capital markets.

The outcome of these reforms which will foster greater competition in the market among infrastructures and between infrastructures and custodians will however need to be closely monitored. Some observers are concerned that such changes may trigger more fragmentation among service providers in the short term and potentially blur the delineation between market infrastructures and intermediaries and the scope of application of regulations. Others believe that the CSDR and T2S might not provide sufficient harmonization for cross-border settlement to develop significantly. The need for a common framework for securities (the project of an EU Securities Law Legislation) in order to enhance the consistency of securities laws, beyond the harmonization efforts under way (e.g. in the area of corporate actions) will need to be examined.

Lastly, defining an appropriate recovery and resolution framework for Financial Market Infrastructures is the main forthcoming challenge following the adoption of EMIR and CSDR. CCPs will concentrate a large part of risks related to derivatives transactions with the implementation of the clearing obligations of EMIR by the end of 2014. The failure of a CCP may have extremely high consequences for the market. This is why the Commission should rapidly publish a proposal for the recovery and resolution of CCPs.

4. Increasing the transparency and safety of securities financing transactions (SFT)

SFT such as securities lending, repo and asset rehypothecation transactions are key elements of secured

financing operations and collateral management which are becoming fundamental to the functioning of the financial market with the implementation of Basel III and OTC derivatives rules and the increased risk-averseness in the market following the crisis. SFT indeed enable to optimize the use and circulation of good quality assets which are due to become scarcer with the higher demand for such assets and the persisting fragmentation of EU FMIs.

SFT however raise systemic risk concerns as they increase the interconnectedness within the financial system as well as safety issues when assets are re-used (if the ownership becomes difficult to track). Proposals were recently made by the EU Commission to help mitigating such risks by improving the monitoring and transparency of SFT. In addition the way to achieve greater consistency of rules governing collateral and SFT transactions in the different EU legislations (e.g. EMIR, UCITS V…) needs to be further assessed.

5. Some priorities for the integration of the EU retail financial market

Retail financial services play a major role in the everyday life of European Union citizens. In spite of some legislative initiatives that have been launched in the past years both in terms of consumer protection (Key Information Document for investment products) and EU integration(SEPA, basic payment account), retail financial markets however remain fragmented, and further efforts are needed before such services can be bought and sold across European Union borders without hindrance.

Ensuring appropriate retail investor protection and providing a suitable mix of products in order to foster investment

As stressed by S. Goulard in the Eurofi newsletter issued for the Athens seminar, "to make the financial system more consumer-friendly would enable it to attract more funds and to soften the near-dogmatic risk aversion which currently hangs in the air. Risk-free products do not cover the funding needs nor the expected return on investments of consumers. Diversification of funding, information, transparency and proportionate risks are a combination which needs to be focused on in order to fuel more funding".

At a time when investors are bearing increasing responsibility for their financial futures, not investing is simply not an option–both for the financial security of investors and the overall health of the global economy. As such, investors need a robust regulatory regime that protects their rights and fosters the efficient functioning of capital markets. Importantly, protecting investors does not mean prohibiting them from taking on investment risk. Rather, it means proper risk management and understandable disclosure.

Effective regulation to foster economic growth and build greater resilience to market volatility must take the needs of end-investors into account. Rather than focusing on whether investment in liquid or illiquid assets is the best way forward to drive economic growth, the focus should be on ensuring that investors can manage both long-term and short-term liabilities. Sustainable growth will come from capital markets which are consistently able to offer a suitable mix of instruments, from corporate bonds to infrastructure, to meet investors' needs.

Strengthening the EU regulatory regime for retail payment services

Payments are the "oil in the wheels of the Internal Market". It is of major importance that those wheels run smoothly and safely. The SEPA Regulation adopted in 2012, aims to create the reality of a European Single Market for retail payments. Credit transfers and direct debits in euro are now made under the same format: SEPA Credit Transfers and SEPA Direct Debits since the implementation of the SEPA regulation in February 2014.

In times of rapid technological advancements and related changing consumer behaviour it is important to adhere to guiding principles when refining the future regulatory regime for retail payments within the EU. Amongst these principles are legal certainty, consistency, proportionality, technological neutrality, the promotion of the Single Market and the fostering of financial inclusion.

As proposed by G. Angelini in the Eurofi Newsletter (March 2014) specific initiatives to strengthen the future EU retail payments market should include:

- Creating a common supervisory framework for non-bank payment providers. The competences of EBA and of the ESA Joint Committee should be enhanced in this respect.
- Giving the European Retail Payments Board (ERPB) political focus. The ERPB should ensure the consistency of policy objectives, promote legal certainty and evaluate whether the EU payment regulatory framework meets its objectives.
- Preparing for the increasing digitalization of commerce and payments. The rising digital economy needs adequate online identification procedures which are readily available to both account-holding as well as transactional Payment Service Providers (PSPs). EU-wide harmonized electronic identification and –authorization tools need to be developed to better support the growing field of digital non-face to face transactions.
- Defining a holistic approach to EU remittance regulation allowing for an increased but fair competition.

6. The IORP Directive review should also be a top priority for the European Commission

European society is ageing. Occupational pension funds are part of the solution for meeting the challenge of

an ageing society and they are essential for long-term investment and thus European growth. Pension systems must adapt. The existing European Directive on occupational pension funds dates back to 2003. It aims to create a single market for occupational pension funds and to improve their functioning. However, those objectives have only been very partially achieved. The directive needs to be reviewed. There are three areas where improvements can be envisaged: solvency, governance and transparency.

For insurers, such high policyholder protection standards will result from the forthcoming Solvency II framework that will introduce a common European risk-based regulatory regime for insurance companies as of 2016. Solvency II will cover all activities of insurers, including in the occupational pensions area. Insurance companies are, like pension funds, important providers of occupational pensions. Both insurers and institutions for occupational retirement provision (IORPs) offer long-term guarantees and engage in long-term investments. It is therefore important that both types of providers are subject to appropriate rules, in order to guarantee a high degree of protection to policyholders.

7. Europe must acquire a stronger position on the international regulatory scene

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

As explained by S. Goulard in the Eurofi Athens newsletter, "this has not yet been achieved, because for some inside the EU they consider that keeping their own few (remaining) powers matters more than increasing joint powers. National competent authorities still need to play a role, given their knowledge of the national markets, but they should be able to delegate the representation of the European interest completely to the appropriate level, in order to better influence the discussions in those global fora. One must not forget that the systems put in place build on the expertise of national systems to increase tenfold at the EU level and recognize that the relevant level for decision making in this sphere is the EU level".

In March 2013, the EU Commissioner for Internal Market and Services, Michel Barnier, mandated Philippe Maystadt to examine ways of reinforcing the EU's contribution to International Financial Reporting Standards and improving the governance of the European bodies involved in developing these standards. In this respect Mr Maystadt's final report published on 12 November 2013 recommends, as a favoured option, reorganising the current EFRAG with a view to increasing its legitimacy and representativeness. The report is part of a broader debate on accounting standards, which also takes into consideration international developments in this field and the evaluation of the Regulation on the application of the IFRS, planned for the end of 2014.

8. Regulation is not a substitute for good governance

An excess of regulations creates a false sense of security and ignores the critical importance of governance, culture and behaviours. Financial regulations generally cover quantitative criteria, but these are no substitute for safe and sound corporate governance and appropriate behaviours.

Yet, qualitative criteria must be taken into account to help restore financial stability. As mentioned by Etienne Boris in the Eurofi Athens newsletter "Experience, Competencies, Courage and Diversity that are crucial for good governance need to be assessed by supervisors".

Regulatory stability is needed while more focus is put on reinforcing the importance of quality-governance, culture and behaviours. Recognizing the crucial importance of such qualitative soft criteria for financial stability and assessing them implies that supervisors must take responsibility for making such judgments. That goes beyond assessing compliance with the rules and is a challenge not to be underestimated. The architects of the EU single supervisory mechanism must fully recognize this, as the closeness required to make sound judgments will be naturally challenged. "In a context of general sense of de-responsabilization characterizing our modern society, this clearly is a gauntlet we collectively need to pick up" Mr Boris writes.

1. The more sovereigns were downgraded by the markets, the more they called on their banks to finance their debt. And that, in turn, reverberated negatively on banks. Banks had to be rescued by their sovereigns, which then damaged further these states' public finances.
2. See speech by Vitor Constancio, Vice President of the ECB at the BAFT-IFSA 2013 Forum – 29 January 2013 – Frankfurt: The project "aims at addressing the « financial trilemma » which can be defined as the impossibility of achieving at the same time financial stability, financial integration and maintaining national financial policies in an integrated market".
3. Equity is penalized compared to debt by its tax treatment since interest paid for debt is tax deductible.

Calibration of banking prudential requirements and expected impacts on lending

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Basel III's leverage ratio

William Coen

Leverage ratio requirements should be differentiated

Post-crisis bank regulations: pro-cyclical

Prof. Dr. Steve H. Hanke

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

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

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

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

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

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Financing the recovery: issues and policies

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

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

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

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

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Europe's next challenge: financing growth

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

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

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

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

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

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Reviving the economy: funding and liquidity on solid financial ground

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

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

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

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

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Promoting growth-orientated financial reforms: a universal bank perspective

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

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

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

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

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Systemic regulation of insurance: the challenges ahead

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

Credit photo : Patrick Messina

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

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

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

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New finance for growth in Europe

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Revitalising the market for loan-backed ABS

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

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

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

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

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

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

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

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

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

Jacques de Larosière - President, **Eurofi**

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

Yet, resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. Besides the low margins and the high levels of indebtedness of enterprises in many EU countries, several factors are hindering credit provision.

Non-performing loans in periphery countries are high, which deters banks from lending. Furthermore, the failure of several banks has either left SMEs with no bank or finding difficulty switching to another bank. In addition, the poor sovereign ratings of these countries lead to high credit rates which strongly impact the profitability of enterprises and their capacity to borrow.

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

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

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

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

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

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

of return of bank loans compared with usual financial assets.

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

Deleveraging together

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

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

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

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

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

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

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

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

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

Deleveraging – a way for sustainable growth

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Reviving the economy: funding and liquidity on solid financial ground

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

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

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

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

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

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

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

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

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

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

Only a sound financial system can support growth

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

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

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

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

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

Corporate credit: disintermediation has its limits

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

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

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

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

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

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

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

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

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

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

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

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

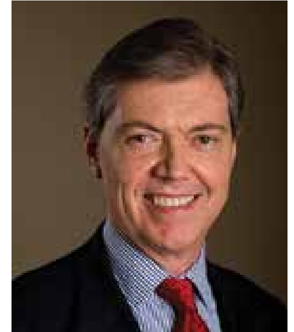
For economies to expand, money must expand, and traditionally this has been the contribution of deposit takers, who in addition to mediating savings can lend money to fund specific economic activity, whether consumption or production, against a contract to repay. Unrestrained credit expansion lies at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

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

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

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

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



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

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

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

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

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

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

Mixed versus bank-based financial systems

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

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

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

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

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

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

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

Risks associated with banking over-regulation for the European economy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

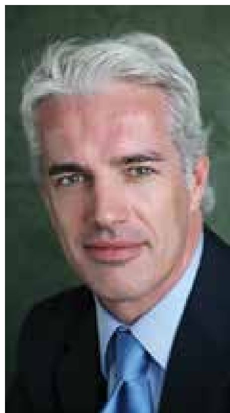
We believe that an objective and comprehensive assessment of the effects of financial services regulation on the wider industry would be useful to highlight any inconsistencies between different types of financial services regulation and jurisdictions. Any unintended consequences could be properly assessed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

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

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

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

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



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

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

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

The way out of the European corporate financing dilemma

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

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

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

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

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

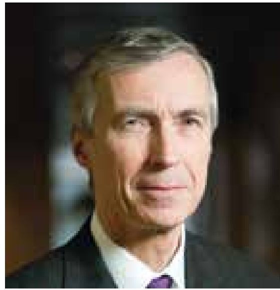
More than EUR 400 billion of net corporate bond issuances by Eurozone companies since the beginning of 2009 is a positive sign, but activity was primarily limited to large caps. Avenues to provide better access for SMEs could include standardized bond structures or sound pooling of loans / securitization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

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

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

Challenges posed by the calibration of liquidity and leverage ratios

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



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

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

- With respect to the Liquidity Coverage Ratio (LCR), it is paramount that the liquidity buffer accounts for Committed Liquidity Facilities contracted with Central Banks. It must be priced at the current Central Bank liquidity facility price level. This would facilitate the substitution of the ECB VLTRO with CLFs, effectively replacing cash contributions with a simple commitment. It would also lead to a possible monetisation of corporate credits by Central Banks. It would not seem unreasonable to expect Central Banks to grant collateralised liquidity commitments, in compliance with their role as lenders of last resort, the LCR itself representing a permanent severe liquidity stress.

- On the leverage ratio, netting of repos and of credit derivatives should be authorised in the calculation as it is currently the case under the CRR, including for cash and securities. A gross approach for repos would disproportionately increase the capital requirements for this activity. This would dislocate interbank funding markets and dramatically reduce the liquidity of bond markets and more specifically sovereigns. This would be in total paradox with the recognized necessity for financial markets to substitute banks in their corporate credit role. It would also hinder efficient diffusion of the monetary policy deployed by the ECB.

- On the Net Stable Funding Ratio, still in its inception, an early calibration in December 2009 would have required European banks to call on financial markets for around €1,300bn of additional resources with a maturity period over one year. The new calibration proposed by the Basel Committee in January 2014 has only but insufficiently softened this requirement. If the current proposal was to be maintained, it would imply additional financing requirements with maturities beyond one year, which the markets will simply not be able to absorb.

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

Two sides of the coin: internal models and leverage

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

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

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

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

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

Global liquidity standards – the way ahead

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

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

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

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

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

Basel III's leverage ratio

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

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

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

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

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

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

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

The first step is to realize where our strength comes from

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

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

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

Alas, this has not yet been achieved, because for some inside the EU they consider that keeping their own few (remaining) powers matters more important than increasing joint powers. When looking at it from a cross-sectorial perspective, the creation of truly Europeans actors (ESMA, EBA, EIOPA) or actors specific to the euro area (SSM, potentially SRM) is a step in the

right direction, but the legislative process or their daily functioning show that there are still some reluctances to recognise that this is the best option for the EU as a whole. National competent authorities do still need to play a role, given their knowledge of the national markets, but they should be able to delegate the representation of the European interest completely to the appropriate level, in order to better influence the discussions in those global fora. One must not forget that the systems put in place do not replace national systems but build on their expertise to increase tenfold at the EU level and recognise that the relevant level for decision making in this sphere is the EU level. ■

Leverage ratio requirements should be differentiated

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

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

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

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

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

Post-crisis bank regulations, pro-cyclical and dangerous

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

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

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

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

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

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

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

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

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

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

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

Differences of risk weighting among banks of the Eurozone

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

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

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

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

Risk weighted assets: measuring loss potential

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

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

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

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

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

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

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

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

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

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

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

Bank resolution: nearer to fruition

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Financial integration and the Banking Union

Roberto Nicastro - General Manager, **UniCredit**

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

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

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

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

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

Credibility and crisis stress testing

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

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

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

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

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

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

The price of bail-in

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

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

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

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

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

Implementing the Banking Union, the SRM and the BRRD

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

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

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

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

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

SSM – Uncertainty all round

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

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

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

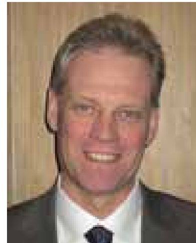
Getting capital raising right

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

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

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

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



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

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

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

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

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

Bail-in – One size does not fit all

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

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

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

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

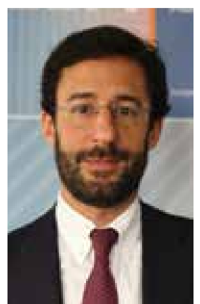
We have been successful if prices on bank debt reflect the risk of the institution and the fear of bail-in does not cause contagion if a systemic crisis were to set in again. There should be bail-in for banks that have pursued unsustainable business models, but caution should be applied in a systemic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

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

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

The new regime for resolution and the Single Market

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



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

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

Can we fuel our SMEs with market based funding?

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

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

Why? The simple answer, jobs.

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

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

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

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

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

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

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

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

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

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

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

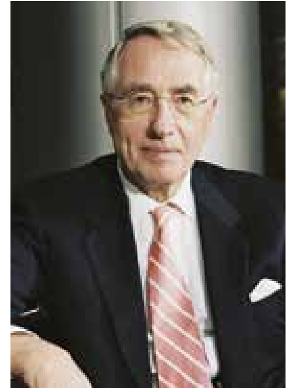
The action of IFIs and NPBs is therefore facing the challenge of a rising need to share the higher credit risk on SMEs whereas ensuring sound credit risk management to maintain the highest credit standing. A new business model is therefore needed reinforcing the use of four instruments:

- Structural funds: the joint proposal of the SME Initiative by the European Commission with EIB represents an important example of how the use of structural funds could be optimised. With the new MFF and the past experience of a sub-optimal allocation of structural funds, risk sharing instruments using the capabilities of the EIB Group operating in close cooperation with NPBs represents a promising venue to leverage public resources to absorb excess risk and mobilise private capital.
- Securitisation: a loan portfolio risk is tranched so as to allow the allocation of risks with different investor categories reducing concentration and increasing the resilience of the system. Notwithstanding its past misuse, in particular in US, the lesson learned during the crisis could reinforce its management by means of more transparency and standardisation as the example of the PCS labelling demonstrates. The expected reinforcement of the EIF capital acknowledges the importance of the activity of the Fund to guarantee mezzanine tranches of securitisation transactions facilitating the revitalisation of the securitisation market.
- Private equity: equity remains too scarce in Europe considering the undercapitalisation of most SMEs. The development of the private equity market is key to accompany the growth of SMEs. Whereas EIF remains a steady investor in this sector more participants are needed. The Commission proposal for the creation of an ELTIF instrument if limited to equity and quasi-equity investments on SMEs could fill this market gap.
- Regulation for growth: if a reinforced regulation remains essential to ensure an enhanced resilience of the system, thoughts are needed to consider preferential regulatory treatment of instruments involving public money and fostering growth and employment. Public banks are directly or indirectly subject to regulation and their action and related economic impact shall not be impaired by the unwanted consequences of a too strict regulatory framework. ■

Supporting SMEs is crucial for sustainable growth and employment

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

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



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

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

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

Ensuring reasonable regulation of SME / midcap financial instruments

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

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Credit photo : Schafgans DGPh BaFin

A balanced SME financing in Europe

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

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

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

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

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

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

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

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

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

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

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

Fostering a renewed and enhanced financing framework for SMEs throughout Europe

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Over the last years, Athens Exchange has been working on a series of initiatives in order to provide solutions to the issue of SME funding, namely the development of listed funds which will attract foreign investment and channel it to SMEs, the

promotion of the bond market in order to provide access to debt capital for SMEs and mid-sized companies and the promotion of the alternative market, in order to allow companies to attract investors into their capital through Initial Public Offerings (IPOs).

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

Combined actions needed to boost IPOs

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

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

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

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

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

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

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

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

SME financing: the securitization way to go

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

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

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

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

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

But a fully functional securitization market comes with caveats.

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

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

Supporting the financing of long term projects

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

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

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

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

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

Policy measures for sustainable EU bond market integration

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Infrastructure investing. It matters

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

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

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

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

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

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

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

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

Credit photo : EIOPA/Frankfurt am Main

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

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

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

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

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

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

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

Engaging long-term investors in financing infrastructure is making progress

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

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

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

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

It is not for the public sector to select "the appropriate" model for engaging institutional investors, but the challenge for the public sector at this moment is to adjust its own procedures for the tendering of infrastructure and of the key milestones in the

financing process so as to facilitate the involvement of capital market investors. ■

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

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

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

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

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

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

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

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

Infrastructure financing: current trends and perspectives

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

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

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

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

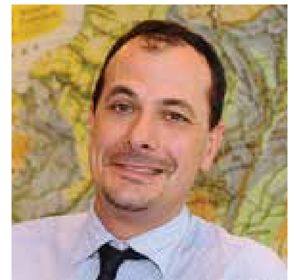
Another alternative to commercial bank loans lies in bond financing. For years, it has been described as a tool tailored for big projects, given its transaction costs and lengthy process. But, in the course of 2013, the Marseille bypass ("L2"), has been bond financed by Allianz, for a mere 165 M€. It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

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

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

A holistic approach toward unlocking financing for long term investment

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



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

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

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

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

As a result of the new regulatory framework, credit institutions will have to increase their capital basis and/or deleverage their balance sheets. Deleveraging will be necessary from a prudential point of view, but there must be not underestimating of the negative effects thereof on the real economy. We may be confronted with a credit-less recovery, even though commercial banks currently provide over 80% of financial intermediation in Europe.

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

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

Addressing vulnerabilities in asset management activities

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

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

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

A focus on activities will help us:

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

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

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

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

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

Systemic risk in investment funds – Fact or spectre?

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

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

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

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

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

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

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

Systemic risk starts with leverage

Barbara Novick - Vice Chairman, BlackRock

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

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

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

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

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

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

Addressing systemic risk in the asset management sector

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

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

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

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

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

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

Systemically important asset managers

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

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

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

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

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

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

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

Targeted changes to EU investment fund rules

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

Via the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD), all EU investment funds (or their managers) are subject to oversight at EU level. The approach taken in the EU is based on a distinction between relatively strict safeguards and prescription for funds that can be marketed to retail investors (i.e. UCITS) and greater flexibility, at least with respect to such elements as eligible assets and leverage, that is appropriate for funds sold to professionals (i.e. AIFs).

Notwithstanding this comprehensive coverage of the EU fund sphere, there is a need to introduce specific rules in relation to certain entities and activities. In particular, the issues around money market funds (MMFs) are well known and have been subject to extensive debate at EU and international level. While it should be noted that MMFs are already subject to ESMA's guidelines of May 2010, it is equally clear that more needs to be done to tackle the potentially systemic nature of these funds.

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

ESMA's guidelines on ETFs and other UCITS issues of December 2012 already took action to address those risks by recommending better disclosure of SFTs and setting out qualitative criteria for collateral received. To some extent, therefore, the UCITS legal framework (as supplemented by ESMA's guidelines) is already broadly in line with the proposal on SFTs. In addition, the AIFMD foresees disclosure of similar information by AIFMs both at the pre-investment stage and in the context of regular reporting.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CSD regulation and TARGET2 - Securities - The upcoming challenges

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In addition, as long as standards have not been agreed, it is practically impossible for CSDs to commit to a launch date for the new regime. This leads to the legitimate question of whether this new regime should be implemented in each of the CSDs joining T2S or, whether it would be more cost-effective (and safer) to implement it only once, and centrally in T2S. ■

EU derivatives' reporting goes live

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

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

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

So far, reporting has gone well. However, given EMIR covers both financials and non-financials, some issues remain in terms of on-boarding, legal entity identifier (LEI), harmonisation of codes, and improving data quality. We see the number of new clients of the TRs and of pre-LEIs issued continues to rise. Besides solving teething problems, there is a temptation...

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

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

FMI Reforms: securing the benefits through standardisation

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

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

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

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

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

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

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

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

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

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

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

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

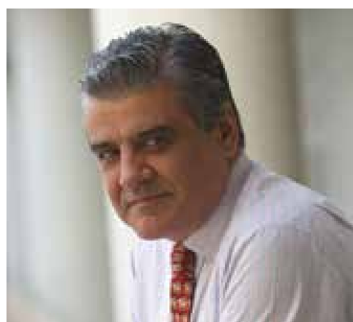
Post-trade reforms: implementation is the key

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

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

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

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



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

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

Recovery and resolution of CCPs and CSDs

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

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

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

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

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

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

Resolution and recovery of CCPs: some important questions

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

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

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

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

And once continuity of a CCP's critical functions has been achieved, what then? How should the CCP be restructured? Should positions and collateral be portable between CCPs, as they are between clearing members?

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

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

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

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

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

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

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

Key steps to improve the supply and use of collateral

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

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

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

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

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

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

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

Collateral – Transforming financial interconnectedness

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

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

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

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

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

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

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

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

Mobilisation of collateral – How Eurosystem initiatives fit with market initiatives

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

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

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

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

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

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

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

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

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

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

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

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

Given the expected wide range of T2S participants, the delivery of collateral to Eurosystem NCBs and CCPs will become swifter and more efficient. Tri-party collateral management services will

be supported by the platform, thus facilitating interoperability among different service providers. Hence, T2S will reduce the current fragmentation of collateral pools among CSDs: the securities held at different CSDs in T2S could become, de facto, a single pool of collateral. Finally, T2S will bring greater competition among custodians and collateral management service providers, enabling better quality and wider access to these services by market participants. ■

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

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

Over the recent years, different studies have investigated the future demand for collateral. Whilst the findings differ in terms of magnitude of a possible shortage of collateral in the system, all papers agree

that demand will significantly increase. This will be driven by a number of changes; above all, regulatory change is a key driver by introducing central clearing for derivative contracts as well as the requirements for uncleared derivative transactions as proposed by BCBS-IOSCO. Similarly, the introduction of the Basel III Liquidity Coverage Ratio will have a similar effect.

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

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

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

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

Collateral mobility and securities financing

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

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

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

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

Regulatory concerns about excessive asset encumbrance

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

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

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

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

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

It will also allow supervisors to assess the ability of institutions to handle funding stresses and can be incorporated into crisis management, as it will allow for a broad assessment of the amounts of assets available in a resolution situation. Asset encumbrance disclosure by institutions

is of vital importance for market participants to better understand and analyse the liquidity and solvency profiles of institutions, and thereby increases the market discipline of banks. ■

Collateral mobility and transparency: a continued regulatory focus

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

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

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

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

Regulatory considerations and collateral implications

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

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

There are three key issues that impact collateral management:

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

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

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

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

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

LEAD SPONSORS

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Towards a proportionate implementation of Solvency II

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

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

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

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

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

Lessons learnt from Solvency II more rules than principles

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

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

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

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

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

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

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

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

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

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

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

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

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

Europe must safeguard the competitiveness of its insurers, globally

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The (Re-)calibration dilemma

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

Credit photo : EIOPA/Frankfurt am Main

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

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

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

Solvency II details must remain true to regime's goals

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

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

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

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

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

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

The Greek insurance market welcomes the implementation of Solvency II

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

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

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

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

SAVE THE DATE

Next Eurofi event
with the forthcoming Italian EU Presidency

The Eurofi Financial Forum 2014

10-11 & 12 September
Milan, Italy

- Forum organized in association with the forthcoming Italian Presidency on the eve of the first informal Ecofin meeting of the new legislature
- Main theme: Key priorities of the new EU Commission and Parliament in the area of financial regulation

IAIS committed to developing a capital and supervisory framework for IAIGs

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

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

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

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

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

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

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

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

Global regulation: an approach for market development and financial stability

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

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

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

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

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

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

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

Global capital standards must acknowledge difference between banking and insurance

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

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

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

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

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

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

Aligning global capital standards with Solvency II

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

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

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

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

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

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

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

Systemic regulation of insurance: the challenges ahead

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

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

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

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

Credit photo : Patrick Messina

Credit photo : EIOPA/Frankfurt am Main

Global capital standards will reinforce the international level playing field

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

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

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

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

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

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

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

Insurers business model and systemic risk – A limited risk

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

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

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

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

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

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

Global insurance standards: involvement of EU level and coherence necessary

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

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

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

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

Legal challenges and how to solve them

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

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

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

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

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

Credit photo : Schafgans DGPh BaFin

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

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

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

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

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

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

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

G20 Commitments: addressing implementation inconsistencies

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

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

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

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

We think the following three examples need to be addressed.

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

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

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

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

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

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

Making OTC derivatives markets safer - completing the job in 2014

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

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

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

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

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

Beyond reform design and national implementation, the FSB is increasingly focused on the effectiveness of reforms in supporting the G20's underlying

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

Regulatory convergence key to G20 derivatives reform

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Providing for a coherent regulatory package – beyond national borders

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

Credit photo : Schafgans DGPh BaFin

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

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

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

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

The path towards stable transatlantic financial market

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

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

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

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

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

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

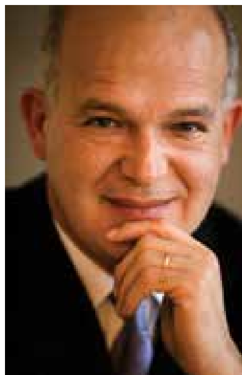
The EU therefore proposed that the Trans-Atlantic Trade and Investment Partnership (TTIP) establishes a framework for regulatory cooperation in financial services.

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

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

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

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



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

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

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

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

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

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

Unintended consequences resulting from inconsistencies in RRP regimes

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

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

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

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

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

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

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

The Eurofi High Level Seminar 2014 Newsletter

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New commission, old challenges

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Financial market regulation needs to support growth and job creation

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

Europe is slowly showing signs of recovery. Growth and job creation is a key priority for politicians all across Europe. Thereby it's also crucial that growth and job creation are the overall objectives when regulating the financial markets.

The main function of the securities exchanges is to secure efficient fund raising and risk distribution for all sectors of the economy. Research shows that IPOs create jobs.

Furthermore it allows companies to grow independently, and thereby it supports the retention of intellectual property gains in the local economy. It also gives investors, including retail investors, a possibility to take part of the productivity gains in different industries.

That's why it would be important to see regulatory measures hit the right targets and incentivise IPOs. Regulators need to acknowledge that the securities exchanges are part of the solution. Transparent markets have helped contain the crisis.

Although the MiFID agreement is broadly a good thing for financial markets, there are some key issues to iron out to ensure that regulation is hitting the target and supports SME growth. The Commission is focusing a lot on refurbishing securitization, which was the very core of the financial crisis, but there is currently not enough attention paid to fund raising.

The long term trend, as shown by the OECD research paper, is that the number and volume of IPOs is declining. Europe must prioritize IPOs and promote incentives for companies to go public.
Some specific measures need to be addressed:

- Initiatives to promote active investment and ensure that pension funds to a significant extent invest in high performing EU listed companies and SMEs.
- Tax incentives for investments in listed SMEs.
- Foster the use of EU structural funds to support funding of SMEs not only in the seed phase but also when they grow and want to tap public markets.

With a common goal of achieving growth and job creation, I'm convinced that Europe will recover and that the exchanges will be a vital part of this challenge. ■

Much has been done, more is to do

Sylvie Goulard - MEP, Committee on Economic and Monetary Affairs,
European Parliament

The situation is improving but we should not allow this to blind us: there is much more to do. The biggest challenges are probably to realise the financing needs of the real economy and to reduce inequalities. This challenge raises a wide range of further stakes. Long-term investment has been the concept continuously repeated by political leaders and investors and yet little has been achieved concretely, with perhaps the exception of the famous and painful "Omnibus 2" dossier with the long-term guarantees package in the field of insurance. The proposal on European Long-term Investment funds was presented late in the mandate and more work needs to be done by the two co-legislators.

Another stake is to make the financial system more consumer-friendly, which would enable it to attract more funds and to soften the near-dogmatic risk aversion which currently hangs in the air. Risk-free products do not cover the funding needs nor the expected return on investments of consumers. Diversification of funding, information, transparency and proportionate risks are a combination which needs to be focused on in order to fuel more funding. To revive the internal market it is essential to move from words to actions: even Member States that used to be in favour of the internal market now use this argument to build fences. The recognition of clusters within the EBA sadly illustrates this. The revival of the internal market would also help to reduce the fragmentation that is harming Europe's SMEs the most.

Finally, one must really break the links between the financial services industry and political leaders: this means that work is needed on governance and on sovereign debt financing.

For the past 5 years, the Commission has spared no efforts to act and produce proposals, even though one may have preferred speedier actions on some issues, sometimes bolder proposals or even (the threat) to withdraw the proposal if the legislative process would have significantly transformed the ambition of its original proposal. At the time of writing these lines, a number of critical issues like Indexes and Benchmarks or the Money Market Funds have not been settled. This is a sign that continued or renewed efforts are necessary.

Besides the content of the financial industry legislation to come, the new Commission will have other types of challenge: to continue and deepen its close cooperation with the new Parliament, pressure the Council to face reality and live up to the commitments of the European Council and last but not least to receive the recognition by the citizens of the effectiveness and legitimacy of European decisions. ■

Protect investor rights, foster economic growth

Barbara Novick - Vice Chairman, **BlackRock**

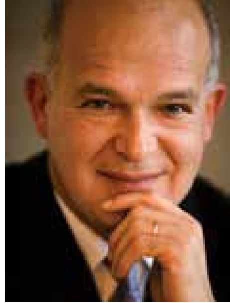
Investors need to trust that their rights will be observed, that the investment advice they receive is in their best interest and that the structure of capital markets will support their investment. Investors' trust in the financial system was shaken by the 2008 crisis, which revealed weaknesses related to the quality of advice, the sale of products inappropriate to investor needs, and lack of transparency and information. Today, they are equally concerned by challenged liquidity in a variety of markets and proposals that would use client money to prop up failing central clearing counterparties. At a time when investors are bearing increasing responsibility for their financial futures, not investing is simply not an option–both for the financial security of investors and the overall health of the global economy. As such, investors need a robust regulatory regime that protects their rights and fosters the efficient functioning of capital markets. Importantly, protecting investors does not mean prohibiting them from taking on investment risk. Rather, it means proper risk management and understandable disclosure.

Effective regulation to foster economic growth and build greater resilience to market volatility must take the needs of end-investors into account. BlackRock believes the key regulatory building blocks include transparency, investor protection, and facilitating responsible growth of capital markets, while preserving consumer choice and assessing benefits versus implementation costs. Rather than focusing on whether investment in liquid or illiquid assets is the best way forward to drive economic growth, the focus should be on ensuring that investors can manage both long-term

and short-term liabilities. Sustainable growth will come from capital markets which are consistently able offer a suitable mix of instruments, from corporate bonds to infrastructure, to meet investors' needs. The greater the policy focus is on delivering a supportive regulatory framework, the greater investors' ability will be to invest in assets which support long-term growth. ■

Building the right regulatory framework to support growth

Séverin Cabannes - Deputy Chief Executive Officer, **Société Générale**



The 2009-2014 mandate of the European Commission has been marked by the intense reshaping of the European banking sector: the Commission delivered on most of the G20 commitments to reform the European banking sector and has laid the groundwork for the banking union, which will be a cornerstone to strengthen European economies.

Europe top challenge is now to foster its growth potential, to create new jobs and reduce unemployment. While the current reforms have strengthened the European financial sector solidity and reduced drastically the systemic risk in Europe, any future reforms should focus on growth and employment.

A first challenge will be to concretely implement the banking union. It represents a huge technical, organizational and reputational challenge for Europe. The banking union will be a key to restore and reinforce European growth potential. Moreover, to accompany European firms in their international development, pan-European financial institutions must be able to emerge among the circa 9000 banks in Europe. The forthcoming Commission must encourage this evolution through an adequate regulatory framework and the deepening of the single market. If not, the only alternative would be for European firms to work with larger American or Asian banking groups.

A second important step will be to accompany the transition towards a new financing model for the European economy. Indeed, regulatory reforms encourage greater reliance on capital-market financing. Since early 2009, the substitution of bank credit in the financing of non-financial institutions by alternative debt instruments is clearly visible. However, access to funding remains potentially problematic for institutions or corporates unable to tap capital markets (as SMEs).

The construction of a high quality, unified, securitization market in Europe will be a key in this new context. The Basel III driven evolution of the European corporate sector financing mix could become more difficult to accommodate if inappropriate regulations limit the capacity of universal banks to provide holistic financing solutions to their clients. Moreover, the project of establishing a tax on financial transactions (FTT) in some European countries will hinder the development of capital markets and ultimately reduce European financing capacity and growth potential. ■

Regulation is not a substitute for good governance

Etienne Boris - Senior Partner, **PwC**

The financial system has been reinforced as banks reacted to the crisis and through new regulations. Tightening bank regulation was necessary. Yet, confidence is not fully restored and it will not be by piling up additional regulations. Excess regulations create a false sense of security and ignore the critical importance of governance, culture and behaviors.

In the EU some 30 pieces of legislation have been introduced since early 2010. The new Capital Requirements Regime stretches to some 436 pages of text, 686 articles, and 198 implementing measures or guidelines. The new MiFID II regime will require over 100 implementing measures. That's without Solvency II, AIFMD, CRA, BRRD, Corporate Governance code of conduct and many other principles, recommendations, guidelines, etc. The whole regime in Europe has undergone a fundamental, quintessential overhaul. Those regulations generally cover quantitative criterions. Yet, as recognized by behavioral economics and finance, human behaviors are not always rational but influenced by emotional choices. This is also recognized in the FSB thinking: *"At the crux of this supervisory*

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IORP Directive review should be top priority for European Commission

Xavier Larnaudie-Eiffel - Deputy General Manager, CNP Assurances & Chief Executive Officer, **CNP International**

Insurance companies are, like pension funds, important providers of occupational pensions. Both insurers and institutions for occupational retirement provision (IORPs) offer long-term guarantees and engage in long-term investments. It is therefore important that both types of providers are subject to appropriate rules, in order to guarantee a high degree of protection to policy holders.

For insurers, such high policyholder protection standards will result from the forthcoming Solvency II framework that will introduce a common European risk-based regulatory regime for insurance companies as of 2016. Solvency II will cover all activities of insurers, including in the occupational pensions area.

On the other hand, a review of the IORP Directive is long overdue. Beneficiaries could thus be exposed to different levels of risk from similar products with a long-term guarantee, depending on the type of provider and legal context.

Solvency II can be used as a basis for the review of the IORP Directive, provided that the outstanding issues in Solvency II are appropriately resolved and that the specific characteristics of pension funds are taken into account. Such an approach would not only lead to a high level of protection for all beneficiaries of occupational pensions, but would also ensure a level regulatory playing field for insurers and pensions funds.

The revised IORP Directive should include quantitative, qualitative and reporting elements - the first, second and third pillars of Solvency II. While all pillars are essential, the third should not be neglected, as providing high-quality information will allow policyholders to make informed decisions about their retirement plans. Any differences in providers or products should be made apparent to the beneficiaries periodically, in a clear and understandable way.

Given the imminent introduction of Solvency II, it is of the utmost importance that the European Commission treats the review of the IORP Directive as a priority. ■

Recommendations for the future EU regulatory regime for retail payment services

Giovanni Angelini - Senior Vice President and General Manager for the European Union, **Western Union**

In times of rapid technological advancements and related changing consumer behaviour it is important to adhere to guiding principles when refining the future regulatory regime for retail payments. Amongst these principles are legal certainty, consistency, proportionality, technological neutrality, the promotion of the Single Market and the fostering of financial inclusion.

Specific initiatives to strengthen the future EU retail payments market should include:

- Creating a common supervisory framework for non-bank payment providers. The competences of EBA and of the ESA Joint Committee should be enhanced. I welcome EBA's role under the revised PSD and AML Directives. The EBA needs to be given the resources to effectively fulfil these new functions and specific non-bank stakeholder groups should advise it on payment and AML matters.
- Giving the European Retail Payments Board (ERPB) political focus. The ERPB should start its work swiftly and have broad and balanced representation of all EU payment sectors. The ERPB should ensure the consistency of policy objectives, promote legal certainty and evaluate whether the EU payment regulatory framework meets its objectives.
- Preparing for the increasing digitalization of commerce and payments. The rising digital economy needs adequate online identification procedures which are readily available to both account-holding as well as transactional PSPs. EU-wide harmonized electronic identification and –authorization tools need to be developed to better support the growing field of digital non-face to face transactions.
- Holistic approach to EU remittance regulation. Remittance services are affected by a multitude of regulatory initiatives at EU and international level (e.g. FATF). The compliance bar is rising in various areas: AML, data protection or security requirements to name just a few. How do these rules interact and what market impact to they have? Many non-bank remittance operators have lost their bank account or cannot open one. What incentives are being created for stakeholder in the remittance market? It is time for a holistic approach to remittance regulation, starting with the European Commission which should identify a unit in charge of remittances. ■

Don't shoot into your own foot, Europe!

Karl-Peter Schackmann-Fallis - Executive Member of the Board, **German Savings Banks Association (DSGV)**

A flood of regulation threatens the role of European banks as intermediaries between depositors and the real economy. In post-crisis European politics we observe an increasing tendency to turn away from conventional and traditional models of financing the European economy and a preferred orientation by policy makers towards capital market oriented systems as they are dominant on the other side of the Atlantic. I plea to continue our successful Continental European financial culture.

We feel that European legislation and regulation is trying to deliberately implement elements into the European financial system that have a detrimental effect on the European way of financing. In the last couple of years we have seen a continuous disadvantaging of traditional corporate finance by "punishing" balance sheet-based supply of financial products to the real economy, an increasingly heavy regulation on bank loans, soaring capital requirements, liquidity standards with a tendency to "punish" corporate finance and the essential banking function of maturity transformation, an unmasked sympathy for capital market driven forms of finance (as expressed in the EU-Commission's Green Paper and recently by the Commission's Communication on long-term-financing of the European Economy), aiming at "pushing back" the house bank principle.

These policies could threaten the smooth functioning of European finance, could cause tremendous problems for the real economy, especially for financing the small and medium sized enterprise sector, and could ultimately undermine the economic basis for our European social and economic model.

We are not against opening alternative ways of finance in Europe by using capital market based instruments. But we plead to regard these purely as complementary elements, opening up and widening the opportunities on the basis of a European Economic Model and its mainly bank-based financing of the economy that has developed over centuries and that has facilitated the development especially of our SME sector very well. We should not saw off the branch we are sitting on, Europe should not shoot into her own feet. ■

What should be the main priorities of the forthcoming EU Commission in the financial services area?

Pervenche Berès - Chairwoman and MEP, Committee on Employment and Social Affairs, **European Parliament**

The main priority of the upcoming EU Commission in the field of financial services has to be the structural reform of the banking sector and to prevent the excessive concentration of risks within a few "too big, too complex and to interconnected" banking institutions. To this respect, the recent proposal of the Commission is going in the good direction but has been put on the table too late: I consider that it would have been necessary to propose it earlier in 2010 in the aftermath of the financial crisis.

I hope that a new progressive majority in Europe will be sufficient to get from the European Commission an ambitious proposal on mutual societies which have proved to be resilient during the massive economic and financial turmoil we experienced, notably due to their specific democratic governance and their long term approach. Regulations of the European supervisory authorities have to be revised in order to ensure a more direct and comprehensive intervention at the community level to ensure a level playing field approach aiming at preventing fragmentation of the markets and at enhancing the effective protection of retail investors.

From an institutional perspective, I can only hope that the European Commission will now demonstrate a more proactive attitude with respect to the defense of the interests of retail investors and consumers, as I have experienced it with the proposal for regulation on Key Information Document for Investment Product (KIDIP), where its initial choice was to limit the scope of understandable information for the only packaged - and complex- products!

Finally, time has come for a genuine change of institutional paradigm for the Commission by stopping to act as the general secretariat of the European Council which has demonstrated the failures of its intergovernmental logic: due to the so-called efficiency and reactivity of governments, the European Union only get a non-satisfactory "too many, too late" process unable to close the gaps of the banking and the financial regulation and to achieve the rebuilding of the financial market allowing a long term financing of the real economy. ■

Ensuring reasonable regulation of SME / midcap financial instruments

Dr. Elke König - President, **Federal Financial Supervisory Authority (BaFin), Germany**

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Small and medium-sized enterprises (SMEs) are the backbone of the European economy. Traditionally, they are financed primarily through their principal banks. Like the SMEs themselves, these banks benefit from the privileges of the "package for small and medium-sized enterprises" which has been enshrined by the Basel Committee on Banking Supervision in the Basel II framework and which lives on – without any fundamental changes – in Basel III. The European Union is even more generous than the Basel Committee: in the implementation of Basel III, it effectively exempted loans to SMEs from certain aggravations posed by the new accord.

Despite these privileges, since the global financial crisis many of these companies have started – voluntarily or unvoluntarily –to look at other financing forms in addition to traditional bank loans. More and more companies are therefore turning to the capital markets – which basically is to be welcomed because this broadens their financing basis. That said, resorting to the capital markets involves high costs. For small companies, the limits of what is feasible are quickly reached. The bigger the company is, the more it is able to cope with the cost burden. For midcaps, it may well be rewarding to carefully establish the know-how and capacities needed for such a move.

However, coupons on the market for SME bonds are witnessing an increasingly larger spread. As far as their size, industry and financing requirement are concerned, issuers are also becoming increasingly heterogeneous. Added to this is that in Germany a number of economically distressed companies with questionable or little diversified business models have been seen tapping the so-called gray market or issuing bonds which, despite seemingly good ratings and the well-sounding label "Mittelstand", have defaulted within a short time.

The financing of SMEs therefore also affects investor protection. Transparency and comprehensibility of investment offerings are, thus, key and a lot of discussion takes place right now in Europe and Germany. What possibilities might be considered? For one thing, the ad hoc obligation could be expanded. A prospectus obligation for offerings hitherto exempt from such publication requirement might also be helpful. A product classification might show investors how complex and risky an offering is and the investment horizon for which it is suitable. Moreover, certain products may be distributed only via authorised institutions or undertakings.

Markets for SME loans need to broaden for sure, but we also need to consider the soundness of offerings from the private investors' perspective. ■

Financing the recovery: issues and policies

George Provopoulos - Governor, **Bank of Greece**

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What can policymakers do to restore adequate financing conditions for the economy?

In the short term, a key policy action is to ensure that banks resume their role as financiers of corporate activity and investment, especially in those parts of the corporate sector which rely more heavily on banks.

Given the limited amount of resources, it is important that they are used to finance high-productive, export-oriented firms and sectors in order to improve allocative efficiency of economic resources. To the extent that creditless recoveries are suboptimal outcomes associated with impaired financial intermediation, policies should aim at recapitalizing weak banks, addressing market fragmentation and relaxing credit constraints of banks to cushion the effects of deleveraging on the economy.

As a long-term strategy, developing market standards will allow equity and bond markets to gain ground. This will increase available funds for long-term investment, contribute to long-term sustainable growth and increase the resilience of the corporate sector during periods of banking sector stress. The development of a deep EU securitization market for corporate loans will provide capital relief to banks, improve risk sharing and increase banks' lending capacity. ■

A holistic approach toward unlocking financing for long term investment

Thomas Groh - Deputy Assistant Secretary, Insurance Division, Directorate-General of the French Treasury, **Ministry of Economy and Finance, France**

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The financing of long term investments is a multifaceted issue. We must address the long-term financing challenge in a comprehensive way, taking into account all the issues at stake.

On the supply side, a crucial aspect relates to the ability of the financial system to effectively and efficiently channel household savings to long-term investments. Financial regulation, provided that it is well-designed, should not restrain long-term investments.

This encompasses many topics, from the ability of banks to arrange these transactions and contribute to their financing to enabling capital market financing and ensuring institutional investors' effective ability to step in as long-term financing providers (within an prudential framework that effectively reflect the specificities of these asset classes and through the development of the necessary skills and expertise to manage these assets and the related risks). This also includes the availability of suitable financial hedging products that play an important role in some areas (such as project finance) or the need to ensure that accounting standards to the long-term investors are congruent with their business model.

However financial regulation is only one of many influences on the provision of long-term finance.

On the demand side, there is a need for ensuring a strong pipeline of viable long term investments. Other key factors such as regulatory and fiscal predictability, legal certainty (and contractual enforceability), etc. are often pointed out by practitioners and appear to strongly affect demand factors.

From a more comprehensive perspective, long-term financing issues (especially green growth) also relate to price signals such as tax incentives or could require targeted public schemes designed to unlock private financing consistency in a consistent and sustainable manner. ■

Promoting growth-orientated financial reforms: a universal bank perspective

Jean-Paul Chifflet - Chief Executive Officer, **Crédit Agricole S.A.**

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Last but not least, banks have increased transparency, strengthened their corporate governance and improved crisis prevention and management tools, thereby anticipating the new "banking crisis resolution" regime that regulators and policy-makers are currently shaping up.

Clearly, all these improvements are welcomed steps. However, it is equally critical that the right balance is struck so that regulatory reforms do not end up unduly hampering the financing of the real economy. Indeed, whilst adjustment is necessary, it also bears a cost and generates market uncertainty. This is particularly true for liquidity which remains a critical issue for banks and the financial system as a whole. In this context, it is important in our view that regulators and policy-makers move from purely "constraints-based" financial reforms towards more "growth-orientated" measures. In order to achieve this, authorities should consider the following priorities: First, give sufficient time to financial institutions to implement the complex set of G20 reforms. Before adding a new layer of regulation, authorities should take stock of existing rules and ensure these have been correctly and consistently implemented.

Second, make sure proper impact assessment studies (cross-sectoral and cumulative) are conducted to estimate the benefits and costs of regulation, not just on the financial sector, but on the economy as a whole. The impact of the liquidity ratios (LCR and NSFR) as well as leverage ratio should be assessed as a priority since their final calibration is likely to have a very far-reaching impact on the financing of the real economy. As a general principle, liquidity and capital requirements should be assessed against the risk profile of financial institutions, in line with the Basel 2 philosophy. The interaction between Basel 3 and the Solvency 2 regime should also be carefully looked at.

Third, preserve the diversity of the European banking and financial landscape through proportionate rules and careful consideration of the specificities of European banks' business models.

Finally, policy makers should aim to find a healthy balance between safe financial systems and economic growth. Financial firms should remain competitive and innovative within a framework of long-term and stable growth. In this context, a special focus should be put on the re-launch of healthy securitization markets, a key channel to re-boost the financing and growth of the European economy. ■

Regulation is not a substitute for good governance

Etienne Boris - Senior Partner, **PwC**

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approach is an understanding, by both the financial institution and the supervisor of the institution's risk culture, in particular whether it supports appropriate behaviors and judgments within a strong risk governance framework".[1] Experience, competencies, courage and diversity that are crucial to good governance need to be assessed by supervisors. A safe and sound corporate governance, culture and appropriate behaviors do not result from an accumulation of quantitative rules.

The quality of governance and in particular the composition of Boards is impacted by regulations and codes of conducts. As shown by the 2013 PwC Annual Corporate Directors Survey, regulations didn't prove successful in increasing investor protections or increasing public trust in the corporate sector. Also, an analysis of Boards' composition of 15 major European Banks shows an increased proportion of specialists. They have doubled in the last 10 years from 15 to 30% at the expense of experienced senior executives. The proportion of experienced decision-makers in complex and international environments is decreasing at a pace that is ominous for the quality of governance.

Regulatory stability is needed while more focus is put on reinforcing the importance of quality-governance, culture and behaviors. Recognizing the crucial importance of such qualitative soft criterions for financial stability and assessing them imply that supervisors must take responsibility for making such judgments. That goes beyond assessing compliance with rules and is a challenge not to be underestimated. The architects of the EU single supervisory mechanism must fully recognize this as the proximity required to make sound judgments will naturally be challenged. In a context of general sense of deresponsabilization characterizing our modern society, this clearly is a gauntlet we collectively need to pick up. ■

1. FSB, Guidance for more effective supervision of risk appetite and risk culture at Financial institutions (18 november 2013) – Consultation open until 31 January 2014

Europe's next challenge: financing growth

Michel Barnier - Member of the European Commission responsible for Internal Market and Services

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The completion of the Banking Union is the core element of the EU's response to reducing fragmentation. To foster alternative sources of finance the Commission will publish in March a Communication on long term financing which will present a set of actions in order to: mobilise private sources of finance, making better use of public funding, developing European capital markets, improving SMEs access to financing, attracting private finance to infrastructure delivering on the Europe 2020 objectives, and enhancing the framework for sustainable finance. ■

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