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TAKEAWAY 01

Developing risk sharing is essential for improving stability in the euro area, and the CMU and Banking Union initiatives are a key part of it

Further cross-border risk sharing in the euro area and EU would spread out and thus reduce the impact of possible asymmetric shocks affecting individual Member States. At present this is much lower than in the US, and has decreased since the crisis. There are three main channels through which the risk of asymmetric shocks can be further shared: capital markets, the banking channel (i.e. private risk sharing channels) and fiscal transfers (i.e. public risk sharing). The fiscal channel at the EU level requires sufficient trust to be restored among Member States. A pre-requisite is indeed for all euro Member States to strengthen their fiscal positions and competitiveness, and to achieve sustainable debt levels, which requires significant structural reforms in many cases. Further integrating capital and banking markets in Europe is therefore an attractive way forward for improving sustainable risk sharing in the EU which is why the CMU and Banking Union projects that aim notably at further integrating EU capital and banking markets are essential.

In the short term, developing EU capital markets and notably cross-border equity markets should be a key priority, given that the banking sector will have less ability to provide capital intermediation in the future due to tougher bank regulation. This objective should be elevated to a higher political level in the discussion. Specific measures such as tackling the current debt/equity bias are essential in particular. However, EU savers are mostly risk adverse and need to change the way they look at financial markets and investment. This is also a key challenge for policy makers to address.

TAKEAWAY 02

Solving NPL issues and improving economic convergence within the Eurozone are essential for moving the Banking Union forward

The process of bank balance sheet repair has been too long and protracted in the EU. Although the recent stress test conducted by the EBA and the ECB confirmed the resilience of the EU banking sector, some parts of it still have high levels of Non-Performing Loans (NPLs), which restrict loan growth and curb profitability. This also contributes to the mistrust of investors regarding EU banks, challenges the enforcement of the new EU crisis management framework, hinders an agreement on EDIS and is therefore a significant obstacle to the achievement of the Banking Union.

Many technical options are available for addressing the NPL issue (e.g. reducing potential losses by the repossession of collateral by banks, transferring assets to a bad bank at market price, using securitisation schemes), but several conditions need to be fulfilled for an effective solution to be possible, including the improvement of national insolvency frameworks, appropriate judicial and out of court procedures, as well as proper NPL management within banks, all of this making it a challenging task.

Another pre requisite to completing the Banking Union (with a backstop to the Single Resolution Fund and EDIS) is the improvement of the economic convergence of all Euro Member States, since banks reflect the state of the economy. Such a convergence would indeed significantly contribute to cutting the nexus between banks and their sovereigns and help to de-risk the EU banking sector.

TAKEAWAY 03

The profitability of EU banks is deteriorating, affecting their capacity to lend, but changing significantly banking business models is challenging

Bank profitability in the EU is deteriorating both for cyclical reasons (prolonged period of low interest rates, sluggish economic growth) and more structural ones (higher prudential requirements, tough competition and over-capacity in some Member States). This is reducing their ability to lend and attract investors.

A change of banking intermediation business models is called for by many regulators, but the room for manoeuver is limited in the short term. Digitalization offers cost reduction and new service development opportunities but also involves high investments. Moving from interest income towards fee-based income is desirable but hindered by a high level of competition. Cross-border consolidation within the EU banking >>>

>>> sector is another option but hampered by the EU regulatory framework, which remains fragmented along national lines and by too big to fail rules. A further possibility is downsizing the banking sector.

In such an environment, it seems indispensable that EU regulators should see to it that the envisaged Basel measures are calibrated and phased in so that they would allow the European banking system to participate in the credit revival called for by the ECB. In this respect, it is important to adjust meticulously monetary policy and regulation.

TAKEAWAY 04

Addressing the unwarranted variability of bank RWAs is necessary, however the risk-sensitiveness of capital requirements should be preserved

Basel IV aims to reduce, with input and output floor proposals applying to capital requirements, the unwarranted variability of internal models observed with the implementation of Basel II rules, in order to restore the confidence of investors and supervisors in banks.

Unlike many non-EU regulators, many of their EU equivalents are deeply concerned lest these Basel IV proposals should reduce the risk sensitivity of capital requirements, which is necessary for incentivising sound risk management practices in the banking sector. In addition, the proposed framework would have a significant adverse impact on low risk financial business and may significantly increase capital requirements for many EU banks, going against the objective set by the Governors and Heads of Supervision (GHoS) and the G20 Leaders in this regard.

To manage such challenges, the conditions for providing appropriate transparency on modelling practices and outcomes need to be better defined in particular, as well as achieving an effective harmonisation of supervisory practices for validating and monitoring internal models.

This debate is happening at a moment when the insurance sector is developing the use of internal models with the implementation of Solvency II, and when data and modelling tools are increasingly being used with big data and Fintech applications.

TAKEAWAY 05

Although proportionality seems necessary in the implementation of Basel rules, it raises competition and stability issues that must still be addressed

A concern regarding the “proportionality” of bank regulation is gaining momentum. Proportionality seems necessary in the implementation of the Basel rules currently being revised (regarding e.g. credit risk, trading book review, etc.), since in the EU they will apply to all 8,400 European banks while implementation in the US is limited to internationally active banks and also given the importance of bank financing for the EU economy. These revisions are indeed expected to impose fixed costs and investments, which will be unaffordable for smaller EU banks.

However, further clarity regarding how proportionality can be applied is required. In the EU some advocate notably for the identification of a limited number of parameters upon which the supervision of the smallest banks could focus. Others are in favour of the approach used in the US, featuring thresholds for the application of rules, differentiating very large banks from the others.

In any case there is a need to find the right balance between proportionality for small banks and an effective level playing field.

TAKEAWAY 06

There is no need to change CMU objectives with Brexit but Brexit could change the nature of the CMU project

Brexit is no reason for changing the CMU objectives and actually could make them even more relevant because EU27 is more dependent on bank financing than EU 28. An acceleration of the CMU was called for. Brexit however makes CMU deliverability more challenging because capital markets are mostly concentrated in the City. Some panellists moreover emphasized that the current proposals regarding securitization will not allow a relaunch of the EU securitization market.

The impact of Brexit for the EU financial sector is difficult to evaluate at this stage because there is no comparable event, but it is likely to >>>

>>> be quite significant. In the short term, the scale of the City will be difficult to reproduce in Continental Europe. Some panellists felt that this would delay decisions to move out of London and that solutions needed to be found to keep the UK in the CMU project to a certain extent e.g. with an appropriate position on passporting or third-country regimes. The cost, complexity and operational risk of transferring activities and disentangling UK / EU interdependencies was also stressed.

Several speakers were hopeful however that Continental Europe could eventually further develop its existing financial centres. Moreover EU27 or the Eurozone could potentially go towards more convergence than EU28 over time and should therefore be the main focus of CMU efforts.

TAKEAWAY 07

The CMU offers opportunities for smaller EU capital markets but proportionality is called for in order to tackle related cost and competition challenges

There are many underdeveloped capital markets in the EU notably in the (Central and Eastern Europe) CEE region. The CMU aims to develop all EU capital markets including these. Some panellists emphasized that CEE capital markets should be developed in such a way that they can be integrated into the EU capital market. This integration approach would make CEE economies more resilient to external shocks and create potential synergies with larger EU capital markets (e.g. dual-listing, additional sources of venture capital...). Other panellists emphasized the cost impact for local players of EU rules which may weaken local capital market ecosystems and their possible uselessness given that domestic SMEs are mainly financed locally. They also stressed the difficulty for local financial players to develop with the bigger deals being all handled by players based outside the CEE region.

Proportionality was asked for in the application of CMU rules, taking into account the size and stage of development of local markets in order to avoid overregulation and the reduction of market diversity in Europe. Some also suggested that further State support could be considered to kick start local markets in some cases.

TAKEAWAY 08

Tackling the legal and fiscal obstacles to cross-border capital markets is essential for the CMU but the level of ambition required is still under debate

Much progress has been made with the adoption of European securities and derivatives regulations and the implementation of TARGET2-Secutities (T2S), which will allow the further harmonization of trading and post-trading functions and processes. The need to improve the consistency of legal and fiscal rules impacting capital markets was acknowledged by all panellists, however there was some disagreement on how far such efforts should go given the difficulty of harmonising legal rules related to civil law and fiscal rules considered as a part of national sovereignty.

Improving insolvency rules and processes for businesses appears to be the main priority. However some speakers were in favour of pushing harmonization as far as possible (e.g. achieving minimum standards), while others felt more comfortable with an incremental approach such as the one initiated by the European Commission.

There was the same type of division regarding securities laws and taxation. Some priorities were however mentioned, such as tackling conflicts of securities laws, establishing a common approach for managing withholding taxes and addressing the current debt / equity bias.

Further assessments are underway and at this stage the EU Commission does not exclude an ambitious CMU programme in this area.

TAKEAWAY 09

A stronger end-investor focus is needed in regulation and supervision in order to develop capital markets in the EU

The intermediation of capital through markets is not working well at present in Europe. There is no shortage of financial resources but a significant amount is kept in cash, investment is weak and only a limited amount of investment fund assets (10%) are invested in EU corporate securities.

Asset management is crucial for delivering the CMU but a stronger focus is needed on the end-investor throughout capital market regulation and >>>

>>> supervision. A first objective is ensuring that there is an appropriate range of investment products available, adequate incentives and sufficient investor confidence: cheaper and simpler products and an appropriate balance between actively managed and index funds are needed as well as appropriate tax incentives for long term investment e.g. concerning ELTIFs. A second challenge is developing cross border fund distribution in the EU which involves expanding open-architecture with the support of digitalization, achieving a consistent implementation of investment fund rules across the EU and setting up common marketing rules together with the appropriate supervision of cross-border products and distributors in the investor's home country. A third aspect is providing appropriate investor advice and information with the development of digital advice in conjunction with human advisors and a review of the PRIIPs proposals in connection with UCITS pre-existing requirements.

In addition, the debt equity tax bias needs addressing to encourage more equity issuance and investment and further initiatives are required to make European savers more comfortable with risk-taking and educating them about long term investment.

TAKEAWAY 10

Fintech experiments are reaching tipping points but application to wide-scale processes is still fairly remote and additional cyber-risk potential needs to be tackled

Financial services have been technology-based for decades but Fintech applications are now reaching tipping points. They are being tested both for developing new business models and optimizing existing processes. They can support the financing for SMEs with crowd-lending / investment concepts leveraging innovative risk models and by facilitating access to advice with digital solutions. In terms of optimizing pre and post-trading processes, blockchain is the most promising technology. Many tests are underway for specific activities / instruments but there is no wide scale use case in the post-trading area yet (e.g. in the context of T2S) due to legal, operational and harmonization issues in particular.

The cyber-risks that this new technology might contribute to augment are another issue that is closely monitored by regulators and may be addressed by existing global and EU cyber-security frameworks (CPMI-IOSCO and NIS Directive). EU texts have moreover been introduced to make sure that Fintech and cyber-security developments do not reduce consumer protection or financial stability. Domestic regulators are also developing regulatory sandbox concepts to test new ideas in a live environment. Panellists generally believe that regulation should be neutral vis-à-vis these new developments in any case.

TAKEAWAY 11

Better addressing non-bank systemic risk requires specific activity-focused approaches that consider the entire financial ecosystem

Assessments are being conducted in asset management and insurance sectors in particular aiming at identifying potential systemic risks, given the magnitude of client assets at stake in these industries and their interconnectedness with the banking sector.

A first conclusion of these assessments is that potential systemic risks in non-bank activities have to be addressed in a specific way and differently from those stemming from banks. Asset management clients for example are exposed to market risks, whereas banks decide to a large extent what to do with assets.

Secondly, addressing non-bank systemic risk requires looking at the entire financial ecosystem in a cross-sectorial manner in order to identify the sources and amplifiers of systemic-risks. Risks are indeed difficult to identify ex ante and crises can arise from areas that are not predicted in advance. Assessments of risks in the asset management and insurance sectors should moreover focus first on activities rather than entities. Finally, the new financial and monetary context should also be taken into account, as past patterns for assessing risk may be inappropriate.

Tackling systemic weaknesses in the non-banking sector requires using a specific and wide range of tools (e.g. liquidity management tools, stress testing, recovery and transition planning, etc.) beyond additional capital charges. It was noted however that dealing with run risks and building 'fire breaks' in an optimal way still remains challenging. Moreover, when the designation >>>

>>> of some systemic entities is needed (notably some insurance companies, since designation was not considered as an appropriate way forward for asset managers) a sound and predictable legal process should be used, in order to enable financial institutions to proactively manage such a risk and the resulting regulatory constraints.

TAKEAWAY 12

Further consistency of capital market reporting requirements is needed at the global level, as well as removing the legal barriers to accessing data across jurisdictions

Much progress has been made in the collection, harmonization and sharing of market data, notably OTC derivatives data, at the EU and global levels with the implementation of Trade Repositories (TRs) and the roll-out of identifiers (legal entity, product and transaction identifiers) underway. There is moreover ongoing work to complete data in other parts of the financial industry that have systemic significance. At the global level remaining issues concern legal barriers to accessing data across jurisdictions and the quality and consistency of OTC derivatives data in particular, which affect its usability and sharing. Concern has also been expressed in the EU about the unnecessary regulatory burden related to EMIR reporting requirements and other reporting rules applying to capital market participants.

Improvements are needed in the consistency of reporting requirements across jurisdictions at the global level and in the use of appropriate formats and structures for reporting the data (e.g. messaging protocols), as well as in governance processes to monitor data standards and processes over time. A review of domestic data privacy and protection rules was also proposed in the perspective of the objective put forward by the FSB to remove all barriers to sharing data by mid-2018. Finally, investigating the use of blockchain technology in the area of data and reporting was also suggested.

Some optimisations of data management processes are also underway at the EU level with a streamlining of reporting requirements, ongoing work on the standardisation of financial data and proposals to further centralise data management at the EU level. Additional improvements could include changes to the EU law-making process in order to achieve more flexibility in the setting of standards, as well as moving towards a more holistic regulatory approach by type of product or activity (e.g. investment funds or securities transaction activities) in order to foster consistency.

TAKEAWAY 13

In spite of the historic agreement on COP21 objectives, much remains to be done to clarify their implications in the financial sector

The agreement on COP21 goals was a turning point regarding climate related challenges. However, it is not yet clear what their practical implications will be in the financial sector in particular.

One first question is how private long term investors will exit, partially or totally, stocks that are carbon related and what will happen to stranded assets. A second issue is how these investors will gain a better understanding of infrastructure investments likely to reduce carbon and of their related risk and return. One significant obstacle in this respect is regulatory instability, which has reduced investments in renewables into loss-making investments.

The further development of a new green bonds asset class is an appropriate solution for financing the carbon transition since it will help to improve awareness and analytics regarding climate-related investment as well as answer different investment needs. Much analytical work is also needed to improve the existing set of indices in order to facilitate investment in environment-related stocks. The recommendations of the FSB task force on climate related financial disclosure should help to develop an understanding of climate related risks leading to a stronger focus of investors and credit rating agencies on these risks. Finally, there is also a need for workable projects on the ground and more technical assistance is necessary. Public banks are becoming very active in this area and will serve as a catalyst.