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It is not time to further deleveraging, but rather "derisking"

Jacques de Larosière - President, **EUROFI**

The financial system has been significantly reinforced as a result of the efforts made by the Basel Committee for improving the quantity and the quality of capital, and strengthening market risk assessment methods. The introduction of a liquidity framework has addressed one of the notable existing regulatory shortcomings.

In practice, the tightening up of capital and liquidity regulations has resulted in a significant drop in the pace of balance sheet growth, while significantly strengthening capital levels, sometimes multiplying them by more than two times. In most cases market activities considered to be the most risky are now at a limited level between 10 and 20%.

In this way, confidence seems to be gradually returning: many institutions repaid their LTROs early (€137 billion in January 2013) and CDS premiums on eurozone banks have on average fallen during the past six months though certain comments on the Cyprus bail-out agreement impacted the banking sector.

However the consequence of the deleveraging of banks is that demand for loans among good-quality businesses and projects is not being met. A recent ECB survey reveals that, in 2011 and 2012, the cost of capital and difficult access to markets tightened lending conditions in a significant portion of the banks.

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With capital levels strengthened, U.S. financial players now focused on responsible growth

Terry Laughlin - Chief Risk Officer, **Bank of America**

Irrespective of which side of the Atlantic you find yourself, accommodative monetary policies, deleveraging and weak economic growth should be expected to have similar impacts. However, in practice, the response to the crisis has been very different in the EU and the United States. While U.S. banks have reduced their leverage and reliance on wholesale funding, European banks remained, on average, more reliant on wholesale funding and leverage levels remained comparatively high. Moreover, EU banks access to U.S. dollar funding has been strained, thereby putting additional stress on their balance sheet funding capabilities. Consequently, the EU banking sector remains more vulnerable to structural and cyclical deleveraging pressures.

While it may be argued that deleveraging is easier in the United States due to the depth of the U.S. capital markets and a stronger economy, the deleveraging process in the EU is nonetheless underway; although this will require continued behavioural change by both EU capital markets and investors to fill the gap and ensure the EU's economic potential can be realised.

While economic growth remains sluggish on both continents, banks in the EU and the United States face different challenges.

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Restoring confidence in EU banks: what has been done so far and remaining efforts

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

Since the outburst of the financial crisis and the roll-out of the G20 financial reform roadmap, European banks have undertaken significant changes to adapt to their new economic and regulatory environment and to rebuild market confidence. These efforts are not limited to increased levels of capital, higher liquidity ratios and business portfolio reassessment. They also include more robust risk management practices, increased transparency, strengthened corporate governance and improved crisis prevention and management tools (e.g. living wills).

Taking the example of Crédit Agricole, the changes are clear: our group has embarked on an ambitious deleveraging, risk reduction and capital consumption optimisation plan, which has helped boosting the group's financial strength. Likewise, our liquidity reserves and operating efficiency have considerably improved, and our group is now fully on track with FSB requirements regarding the preparation of a recovery plan. Loyal to our cooperative values, our customers remain at the very centre of all our adjustment efforts. Today, our priority is to fulfil our role as a leading financial partner of the economy, whilst continuing our efforts to comply with G20 reforms.

Whilst changes in the banking sector are far-reaching, it is clear that banks will not be able to restore market confidence alone.

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Specific financial services priorities of the Irish EU Presidency to relaunch EU growth

Michael Noonan - Minister of Finance, **Ireland**

The Irish Presidency is committed to progressing the financial regulatory agenda. A strong and well regulated financial services sector is essential to further economic growth and creating employment.

As Presidency, we have sought to balance the need to manage urgent demands arising from the crisis with the need to continue work on structural issues, in order to develop policies that can deliver a sustainable recovery. We have given absolute priority to all files relating to the promotion of the banking union, along the lines of the priorities outlined by the European Council.

We have achieved provisional agreement with the European Parliament on the Single Supervisory Mechanism (SSM), as well as agreement on the Capital Requirements Directive (CRD IV). These significant achievements are important steps towards restoring confidence and building stability in the European banking system.

We are also aware of the need to secure the financing of long-term investment in the European economy, as this is a key driver of growth and employment.

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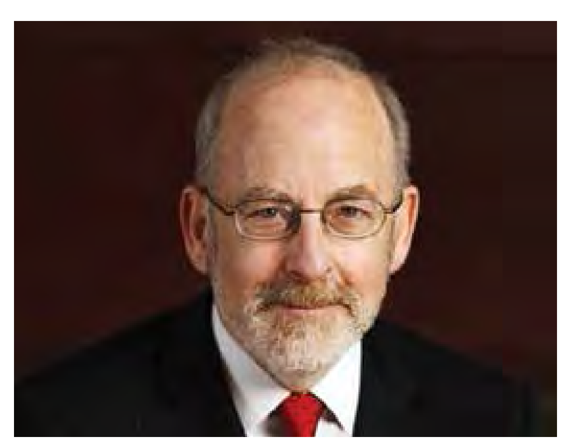
Promoting an effective flow of credit

Patrick Honohan - Governor, **Central Bank of Ireland**



Although the deleveraging of European banks has been achieved more by increasing capital and shrinking their claims on non-European borrowers than by active reduction in European lending, it is clear that credit conditions, especially for smaller borrowers, have remained generally tight since the crisis. Policymakers have not been inactive in this sphere. In particular, possible adverse side-effects of other policies, such as over-cautious plans for bank liquidity regulation, have received attention.

On top of its accommodating interest rate policy, and the open-ended provision of liquidity, the ECB moved at the end of 2011 to provide longer-term funding with its LTRO operations. Other EU Central Banks have also adopted accommodating policies and innovations to ensure and facilitate bank funding and provide liquidity support for bank lending to the real economy. These have had an important stabilising effect in cushioning the deleveraging taking place, and ensuring that it did not overshoot, with the result that shortage of liquidity is now not being assigned any great role in slowing credit provision to the real economy.

Lenders tend to assign most of the explanation of weak lending to weak loan demand, but it seems evident that bank risk appetite has also declined. To be sure, in a downturn, banks find it difficult to distinguish between creditworthy borrowers and non-creditworthy borrowers.

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Solvency II current architecture amplifies negative impact of low interest rates

Denis Duverne - Director and Deputy Chief Executive Officer, **AXA**

Today, insurers are facing macro-economic challenges which are not in their hands. The economic recovery is fragile and equity markets volatility remains above long term trends. European growth outlook is sluggish. But the most significant impact for insurers comes from the unique situation of low interest rates in the US and Germany, combined with highly volatile spreads in peripheral countries.

Central Banks have been adopting expansive accommodative monetary policies. In the short term, low interest rates may contribute to boosting depressed economies and ease pressure on indebted states. But they have pervasive effects in the long term. They disincentivise long term savings and prevent individuals from adequately equipping themselves for their long-term social needs. They do not reward long term horizons of investments and are detrimental to the economic discount rate determination used to value long-term investments profitability. Finally, unsustainable expansive monetary policy could pave the way for future instability with inflation associated with a sharp increase of interest rates. It may be the core of a next market bubble.

Low interest rates cut the yield obtained on new fixed income assets. They dilute investment margins overtime. They constrain reinvestment policies.

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Role of financial sector in overcoming growth challenges

Fostering structural reforms can counter the headwinds of deleveraging on growth

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

Historical experience offers some sobering insights regarding the impact of deleveraging on economic growth: typically deleveraging episodes are accompanied by recessions which tend to be unusually long.[1] There is one crucial factor – particularly in the current European context – that can compensate for the downward pressure of deleveraging on growth: productivity growth.

Pressing ahead with structural reforms to spur innovation and productivity growth is key. In order to achieve a dynamic, flexible and competitive economic environment in Europe, further product and labour market reforms are urgently needed. In a deleveraging environment, we need to ensure that credit can still be channelled to the funding of capacity-enhancing, positive net present value projects. Through its standard and non-standard monetary policy measures, the ECB has contributed to averting an abrupt deleveraging that would have stifled the possibility of directing credit to such activities. ■

1. See C. Reinhart and K. Rogoff, This Time is Different: Eight Centuries of Financial Folly, Princeton University Press, Princeton and Oxford, 2009.

EIB's support for investment is key to contain the cost of banking deleveraging

Werner Hoyer - President, **European Investment Bank (EIB)**

The financial environment in the European Union has not yet overcome the severe difficulties it has been facing since the outburst of the sovereign debt crisis. The bank dependent model of financial intermediation is still under stress as the banks are deleveraging. At the same time, the fiscal space available to public authorities is severely constrained. This poses short-term challenges to stem the contraction of investment and medium-term ones to develop a resilient financial architecture.

Nevertheless, on the medium term, necessary reforms have been introduced and respective measures are being taken by the EU institutions as well as each EU member state. Europe has a common goal and the path taken will show its determination and its coherent approach in solving these problems. Still, structural change and improvement in competitiveness will not materialise unless supported by appropriate investment on which future prosperity ultimately depends. The EIB has a crucial role to play to provide a coherent answer to the short-term and medium-term challenges.

The EIB has adopted a four-pronged approach to support the financing of investment in the European Union, both quantitatively and qualitatively. In early 2013, a € 10bn fully paid-in capital increase of the EIB was approved and the EIB has committed to increase its lending by about € 20bn per annum for the next three years to almost € 70bn of annual lending, spread more or less equally between strategic infrastructure, R&D, climate action and SMEs. Secondly, EU budgetary resources and EIB lending are combined to maximise financial support in more difficult regions or sectors.

Beyond these quantitative elements, the EIB is also extending the provision of technical support to develop better projects and better policies, for example PPPs. This should facilitate the transition to a more market based financing. Finally, the project bond initiative is now coming to the market with a pilot phase. It provides a tool to support real investment in strategic infrastructure financed by the capital market, further demonstrating the catalytic role of the EIB. ■

Promoting an effective flow of credit

Patrick Honohan - Governor, **Central Bank of Ireland**

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Policymakers in many countries have also taken, or are considering taking, additional types of initiatives to promote lending to the real economy.

Beyond what the Irish Government has been doing (including massive bank capital injections, SME loan guarantee schemes, direct credit mediation), these range from proposals to reintroduce or expand publicly-owned development banks to fiscal subsidies. The actual or prospective effectiveness of some of these measures remains a matter of debate.

The record of such initiatives in previous decades was mixed, particularly where they blurred the distinction between a loan and a grant.

If poorly designed or implemented, they could lead to substantial fiscal costs. Still, the need for an effective flow of credit – especially at long-term, for which the pre-crisis model of extravagant term-transformation by banks and bank-backed vehicles is broken – can hardly be doubted, and recent policy discussion papers, such as those of the EU Commission (Green Paper) and the Group of Thirty, are to be welcomed. ■

From financial fragmentation to Financial Union

Vítor Gaspar - Minister of Finance, Portugal

The introduction of the euro led to deeper financial integration. The money market, the sovereign and corporate bond markets integrated rapidly. Equity markets also followed the trend albeit maintaining a significant home bias. Nevertheless, financial integration was mostly confined to wholesale markets. The retail banking business remained largely parochial. Financial supervision was mostly national. During the first decade of the euro, this state of integration was considered adequate.

The behavior of Government Bonds since the mid-1990s is in line with the Delors Report: "market discipline cannot be fully relied upon because it is likely to be too slow and weak (in tranquil times) and too sudden and disruptive (under stress)". It also denies that bond market disruptions are rare. In some periods, market pressure may be non-existing or non-noticeable. But in exceptional times, it really is "sudden and disruptive".

The sovereign debt crisis led to the fragmentation of wholesale markets. The mechanism that ensured financial unity collapsed. The main conditions for a smooth functioning of the euro were no longer in place. The monetary policy transmission mechanism fragmented. Adjustment in the euro area became much more difficult.

Overcoming financial fragmentation is crucial. It is key to restore the monetary transmission mechanism. This will require realizing the banking union with a single supervisory mechanism, complemented by a common backstop for bank resolution and a common safety net for deposits. This endeavor requires further financial integration both in terms of depth and scope. ■

Lessons from crisis: structural reforms road to the sustainable growth

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

The economic downturn unleashed tight dependencies in the global economy, which we could call the domino effect of a vast scale. It proved that crisis has no borders and that the growth of the economy along with the fiscal discipline is of paramount importance.

I strongly believe that stimulation of the economy and expenditure control are highly compatible. The economic and financial crisis in the EU has also proved the need for continuity of structural reforms. They play a significant role in restoring the competitiveness and growth of the economy, and also contribute to the improvement of the quality of expenditure. It is a powerful tool for the redistribution of funds for the greater efficiency, especially when there are constraints on revenue.

The economic growth in Lithuania has been driven by exports and implementation of structural reforms. Most of them were related to the improvement of competitiveness in the labour market or business environment. Other reforms covered the pension, health care system and state property management. Additional structural reforms are still needed to reduce the unemployment; however, the continuity of on-going economic structural reforms (including social area, further improvement of business environment, stimulating R&D), as well as a sound fiscal policy, remain the core preconditions for Lithuania to achieve sustainable compliance with the Maastricht criteria leading to the fully-fledged EMU membership.

Since the outbreak of the financial crisis, a number of measures aimed at increasing the stability of the financial sector have been implemented. Lithuania has strengthened its ability to manage bank crisis situations by refurbishing regulatory basis - not only for bail-out, but also for resolution measures - and refined the deposit guarantees framework, thereby enhancing the depositors' confidence in the financial sector. Furthermore, the regulatory measures related to prudent risk management in the banking sector have been taken.

Common EU-wide financial sectors' rules are the main precondition for a well-functioning banking union. Well functioning Banking Union is an important element of sound EU single market, therefore, further development of this framework will be one of the major tasks for Lithuania during its upcoming Presidency of the EU Council. ■

Why we need a strong, safe and innovative financial sector to support growth

Greg Clark - Financial Secretary to the Treasury, **HM Treasury**

The global crisis has demonstrated the need for financial sector reforms to enshrine greater financial stability. And those reforms should reinforce stronger and more sustainable growth. In focusing on sources of growth, and acknowledging the short-term constraints facing banks, there is a need to consider more non-bank sources of finance as well as focusing on the role of long-term investors in providing sustainable financial support to the economy. It is vital that regulation facilitates, rather than constrains this.

As banks continue to build up their resilience, there is a role for authorities in ensuring they do this in a way which does not harm growth. In the UK, we have set up a Funding for Lending Scheme, which gives strong incentives to banks to use this funding towards boosting lending to businesses and households. The scheme is not intended to move banks away from the process of adjusting their balance sheets and de-leveraging strategies, but complements it.

Companies are also seeking alternative sources of finance, a major source of which will be the securities markets. So it is crucial that market regulations such as the Markets in Financial Instruments Directive 2 are designed to promote competition and choice. Regulations must not impose unnecessary restrictions on the functioning of the markets at a time when companies – including small and medium sized enterprises, key engines of growth – will increasingly rely on them. And in thinking about long term, sustainable growth we must also look to the role of long term investors, especially the insurance and pensions industry. That is why it is critical we get regulatory reform of these sectors right, including agreeing the appropriate capital treatment for insurers who match predictable long-term liabilities with long duration assets. ■

Specific financial services priorities of the Irish EU Presidency to relaunch EU growth

Michael Noonan - Minister of Finance, Ireland

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Given the current constraints on both public finances and bank lending, the EU must improve the effectiveness of the financial system in channelling savings towards the financing of both infrastructure projects and also enterprises, in particular SMEs. The overall objective of the evolving regulatory framework in Europe is to secure greater stability in the financial sector and, importantly, ensuring a steady flow of long term investment will contribute to this. Building institutional investor's confidence so that they are willing to finance the long term investment that drives growth also necessitates greater financial stability. It is suggested, therefore, that fostering a more robust shared understanding of the interdependencies between financial stability and growth provides a strong foundation for delivering tangible solutions to the challenge of securing the long term financing of growth and employment in Europe. ■

The solution to the crisis is to stick to the Single Market

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

Fragmentation and less harmonisation is not the solution for Europe, nor is it a way for it to escape its current fundamental crisis of confidence. We see this in the banking sector, clearly illustrated by the high number of national exceptions present in the much needed final text on CRD4, just as we see it in many other fields.

The Single Market is based on common standards and controls and it provides a level playing field for companies, as well as reducing red tape. It is also an important tool for attracting investors from both inside and outside Europe. In a time of slow growth, all possible means to boost the economy should be used. The EU desperately needs investments.

The more "business friendly" and efficient it can appear on a globally competitive stage, the better. It is therefore important to have a clear set of commons rules, implemented in the same way, irrespective of the location within the EU.

The Single Market should further try to provide fairness between the Member States. At a time when differing strategies concerning tax avoidance and aggressive tax planning between Member States are rightly considered harmful, it would be strange to perpetuate grounds for "Single Market regulatory arbitrage" inside the EU.

Finally, regulatory fragmentation does not allow much needed ownership by Europe's citizens of the Single Market, and yet decision-makers cannot move towards further integration, or even completion, without their support.

A race to the lowest common denominator is not the answer. We all know that the exchanges between the EP and the Council are heated when negotiating legislative texts (in trilogues), as Member States continually argue in the national rather than the European interest. ■

Towards adequate liquidity ratios

Baudouin Prot - Chairman, **BNP Paribas**

Liquidity coverage ratios (LCR) are part of the set of measures proposed by the G20 in order to reinforce the stability of the banking sector, following the crisis that started in 2008.

The liquidity ratios proposed by the Basel Committee on Banking Supervision (BCBS) aimed at avoiding, in the future, any significant credit contraction in challenging times, but also at fostering economic growth. It is therefore crucial to ensure that there is enough liquidity in the system to finance the economy.

However, under the initial proposal made by the Basel Committee, the liquidity ratios would have led to substantial liquidity and funding shortfalls, particularly in Europe. Indeed, the Committee of European Banking Supervisors (CEBS) had calculated that, under this scenario, the gaps would have been in the range of EUR 1.8 trillion (long-term funding) and EUR 1 trillion (short-term liquidity), amounting to approximately 15% and 8% of EU GDP, respectively.

Given that the financing of the European economy relies, for historical reasons, primarily on bank lending (around 75% versus 25% in the United States, where capital markets play a more active role), the initial proposal would have been detrimental not only to the European banking sector, but to the European economy as a whole. At a time when re-igniting GDP growth in Europe is a priority, the consequences would have been extremely damaging.

Taking this into account, on 7 January 2013, the Basel Committee published a revised version of the proposed LCR, following the recommendations made by the European Commission. This move goes in the right direction. However, the scope of the assets that are eligible for the liquidity buffer must be further fine-tuned. In particular, central bank eligible assets should be included in this buffer.

The observation period, which is being calibrated by the European Banking Authority, should be used as an opportunity for further adjustments.

As a whole, adequate liquidity ratios must be put in place so that banks can fulfill their mission: financing corporates, States and households, that are vital to the future of the European economy. ■

The banking union and financial integration in the euro area

Benoît Cœuré - Member of the Executive Board, **European Central Bank (ECB)**

Unchecked financial integration poses significant risks to financial stability: it increases complexity and the risk of cross-border contagion and of sudden stops in capital flows. This increases the risk that financial markets become fragmented as a reaction to confidence and liquidity shocks, as has been observed in the euro area since the onset of the crisis. In this regard, not only the quantum of financial integration but also its quality matters. The establishment of a EU single rulebook, as well as the forthcoming banking union, will not only enhance financial stability but also reverse the trend of financial "de-integration".

When implemented, in 2014, the new Capital Requirements Directive and Regulation will set harmonised rules inter alia for capital, liquidity and compensation policies, thus creating a level playing field for financial institutions across borders. The Single Supervisory Mechanism (SSM), with the ECB at its core, will enforce the rules consistently across the participating Member States.

In the current national-based supervisory system, domestic banks with subsidiaries abroad are often encouraged to repatriate capital and liquidity from a country under stress or to ring-fence certain activities or business lines. However, this is not conducive to the stability of the euro area banking system as a whole and ignores the possibility of adverse feedback from instability elsewhere. The SSM, acting within a European mandate, can address these cross-border externalities, thus helping to reverse the retrenchment.

Finally, by supporting a high quality and more resilient financial integration, the SSM may also contribute to economic growth which, in the medium term, could further enhance the stability of the financial system in Europe. ■

Regulatory reform is crucial but conflicting objectives risk inhibiting economic growth

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

Four years ago, policymakers took decisive and coordinated action to boost economic growth and promote balanced and supportive regulation to help restore confidence. Progress is being made. Last month saw agreement on EU rules to implement Basel 3 and on a Single Supervisory Mechanism to underpin Banking Union. The next milestone will be agreement on EU rules on bank recovery and resolution and further steps towards Banking Union.

Nevertheless, many conflicts still challenge the restoration of growth:

- We want stability as well as growth and promote growth alongside austerity;
- We want banks to lend more yet also grow capital;
- We want more competition in financial services yet seem to resist the higher returns that would attract external private capital;
- We incentivise banks to lend ever more to governments yet agonise about what happens if they won't or can't pay;
- And while we've largely defined what we don't want the system to do, we have yet to define what we want it to look like when we are finished.

We can also observe some unwinding of the G20 commitment to a coordinated single global regulatory framework. Banking systems are becoming more national with 'home bias', further fragmenting the global financial system.

In a world of reduced returns, heightened uncertainty and questions about bank business models, equity capital raising is infeasible for many banks. The consequence is deleveraging across the banking system, inconsistent with restoring growth.

Finally, as banks must be able to accept risks in support of their customers they must also be capable of being resolved should they fail via an orderly, internationally co-ordinated process without destabilising the system or requiring public intervention. While all agree, achieving this remains a key incomplete challenge. ■

Impact of strengthened bank prudential rules on EU banks' ability to help economic recovery

François Pérol - Chief Executive Officer, President of the Management Board, **Group BPCE**

The prime objective of any European regulation must be to prepare for the future. Regulators cannot be cut off from reality. None of us pretends to ignore the risks our economies still face for years to come.

To ensure we exit the crisis and enjoy a return to growth, building a strong banking sector must be affirmed. Our banks are both key partners for our entrepreneurs and ambassadors of the eurozone, which, despite a relative calm, is still under pressure – the crisis in Cyprus being the perfect illustration.

Although the reforms undertaken in Europe are justified, they must not have a negative effect on the financing of the European economy. Further, they must not weaken the position of the eurozone's banks in a context of increasingly stiff competition with the rest of the world.

Nobody denies that the implementation of Basel III in Europe will impact on our ability to serve the real economy over the long term. We should be cautious about any suggestion that a shift from traditional European banking intermediation towards alternative market driven financing solutionswould provide the magic answer.

Unlike the US, the financing of our economies still relies mainly on banking intermediation. Ourcontinental models are not the cause of the crisis, and despite some difficulties, they have demonstrated resilience in an unprecedented economic environment.

Therefore, it is essential that this shift be gradual, "proportionate" and spread over time. One cannot abruptly change from an economy financed by credit to an economy financed by markets.

Whilst present in financial markets, European investment banks remain modest compared to major Anglo-Saxon banks. Market activities must be allowed to grow to meet the financing needs arising from European reforms. Full recognition of the universal bank model and market making activities is essential to develop our businesses, both large and small.

Supporting access to financing for SMEs is a strategic challenge. Any debate over alternative sources of finance must be pragmatic accounting for all stakeholders. Emergence of a specificfinancial market for SMEs must be based on models with proven economic potential for all professionals involved – including customers' expectations.

The banking industry is one of the major pillars of economic growth. Its ability to serve the economy should not be constrained..

Level playing field is fundamental. It must innervate all of the regulatory work. It is an essential condition for a free and intense flow of capital in global financial markets. ■

The vicious circle of the EU legislation

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

The G20 agreement to regulate every financial product, market and participant posing systemic risk was meant to be a global answer to a global crisis. Regulators across the world have been implementing these commitments at different pace and with different diligence. The European implementation should be finalized swiftly and in a coherent way not only in order to preserve the internal market, but rather to help completing it. Unfortunately, the decisive lesson from the crisis has not yet been learned. We are facing re-nationalization in the banking sector, accompanied by partial re-nationalization of banking regulation and supervision.

In particular, liquidity can still not be shifted freely between subsidiaries in different Member States. The setup of the Single Supervisory Mechanism would help only in a limited way, namely within the euro zone. Moreover, the emergency liquidity support provisions in the European Commission's proposal for the banking recovery and resolution framework still foresee a mandatory green light from the host supervisor whenever cash is being shifted. A number of ambitious regulatory proposals have been watered-down by Member States, in order to protect of their national banking champions, financing the national economy.

Since most regulatory measures have been insufficient to help overcome the crisis so far, the Member States keep adding additional reforms at the national level: Vickers' ring-fencing followed by French and German breakup proposals. All these proposals assume that two entities are more crisis resistant than one entity operating with the same amount of capital. The Commission has no other choice but to put forward a new legislative proposal, in the name of preserving the internal market. In the end, the legislative process will most likely water down this EU framework again. Let us be reminded that quality is better than quantity. ■

Is provisioning of EU banks in line with their level of risks?

Alejandra Kindelán Oteyza - Head of Research and Public Policy, **Banco Santander**

Since the onset of the crisis, large European banks have increased the amount of provisions by around 175 bn euros (2007-2012). When taking into account the rise in the level of capital that amounts to another 230 bn euros, the result is that the capacity to absorb future losses has increased by approximately 150%.

At the same time, financial institutions have reduced both the total assets and their total risk. The current levels of risk coverage are now at their highest level ever. Whether this loss absorption capacity is sufficient or not to cover future losses in the near future is a question that will depend more on the prospects of the European economy and financial stability. If, as we expect, we are approaching a turning point, we will see, sooner than later, the first signs of recovery in Europe and an improvement of the risk portfolios' performance (with a certain lag of NPLs over GDP improvements).

In addition, the positive institutional changes in Europe should eliminate "tail risks" that have been present in relation to monetary union. Therefore, the situation in a two/three year horizon should have improved substantially with regards to the capacity of the European banking sector to absorb potential expected or unexpected losses. Moreover, the rigorous exercises conducted by the EBA and national supervisors on the assessments of the quality of the banks' portfolios contribute to minimize "hidden" risks. This is particularly true for systems that have been subject to a special scrutiny, as is the case of Spain.

Looking forward, an adequate provisioning regime is essential to prevent future crisis. We should make progress in the convergence of accounting rules into a more forward-looking provisioning system that could anticipate better possible losses and allow us to take decisions accordingly. ■

Dealing with the negative impact of deleveraging – before it starts!

Patrick Brady - Director, Policy and Risk, **Central Bank of Ireland**

"Hegel remarks somewhere that history tends to repeat itself. He forgot to add: the first time as tragedy, the second time as farce."
Karl Marx

Despite all of the evidence from previous financial crises that deleveraging was a major factor in curbing economic growth, particularly the more recent experiences in Japan, we seem to have learned little and we have, up to now, failed to put in place systems and controls to limit both the size and pace of credit growth either domestically or on a more international basis. Most research suggests that following a financial crisis the period of deleveraging can last upwards of five years or more and, certainly in the early period, deleveraging has a significant negative effect on economic growth.

Rather than focusing on the current impact of deleveraging on the global economy, we should focus more on the wise words of George Santayana, "Those who do not learn from history are doomed to repeat it". We need to learn from our current experience and devise measures which will avoid not only the levels of unsustainable credit growth which we have witnessed here in Ireland and across the global economies, but also other macroeconomic developments which have contributed to financial distress.

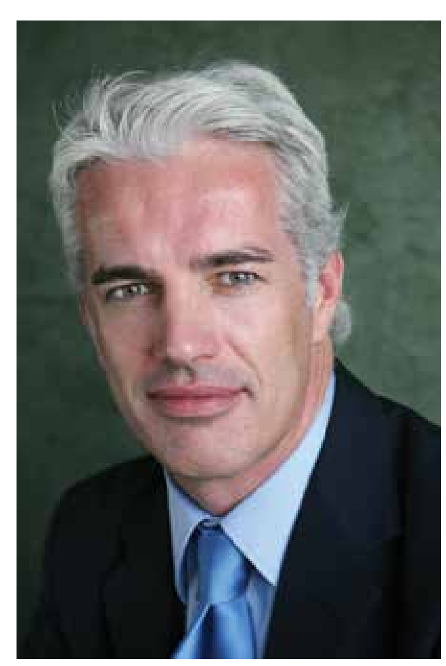
The European Systemic Risk Board has been actively engaged in developing a macro prudential toolkit with a range of instruments which would allow national macro prudential authorities to steer their economies out of danger and provide them with the necessary instruments to stem the growth of asset price bubbles.

In the context of unsustainable credit growth, such instruments may include counter-cyclical capital buffers, the imposition of leverage, loan-to-value and loan-to-income ratios or sector specific requirements.

Undeniably, unsustainable credit growth and private indebtedness have been significant contributing factors to the current financial crisis. It is essential that national Macro Prudential Authorities, be they Central Banks, Financial Services regulators, Finance Ministries or a combination of these, have the necessary tools to act swiftly to avoid a recurrence of this current tragedy. ■

The concerning trend of financial balkanization

Garrett Curran - Chief Client Officer, **Credit Suisse**



To restore stability and confidence to the banking sector we need increased capital, a banking union, and banks that do not threaten the economy with disorderly failure.

Chronological and substantive divergences across bank reforms aggravate their already considerable complexity. Most notably, layering new structural reforms on top, before the cement is dry on the prudential foundation beneath, creates potentially damaging uncertainty for bank investors.

Viewed individually, the majority of reforms have merit, especially from the perspective of increasing bank stability. However, their aggregate impact on systemic stability and economic growth is less clear. The cost and availability of bank credit will be impaired, as sovereigns reduce banking system subsidies; and as banks delever and restructure in response to tighter capital, liquidity and resolution rules, and pass through a portion of their increased funding and operating costs.

The concerning trend of financial balkanisation leads to a reduction in cross-border capital flows and inflates financial risks and costs. Securities market reforms may lead to increased transparency and commoditisation, but the flipside will be increased trading costs, a reduction in liquidity, and fragmented markets.

With about 75% of the EU economy financed through traditional bank lending, the impacts will be felt broadly, although SMEs may be hardest hit. Non-bank financial sector actors will be hit both indirectly by the banking and market reforms, and directly, as bank prudential regulation spreads to the buy-side.

To mitigate balkanisation and increases in the cost of bank credit, we must reduce regulatory uncertainty where possible, and build flexibility into implementation.

We must rebalance credit provision towards market sources, and ensure that forthcoming reforms to address trading book capital, securities markets, collateral and shadow banking do not undermine this crucial objective. ■

Restoring confidence in EU banks: What has been done so far and remaining efforts

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

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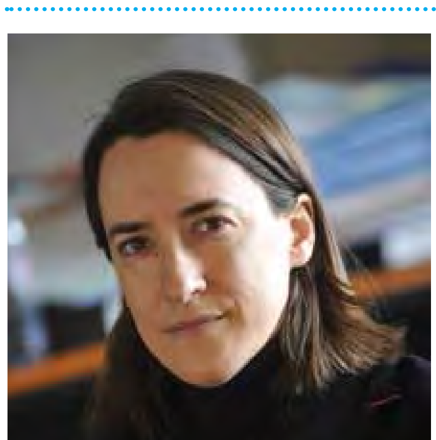
They need a stable and predictable macroeconomic and regulatory environment to pursue their efforts. In this context, it is crucial that regulators finalise current reforms and focus on the globally coherent implementation of this new prudential regulatory framework. Furthermore, policy-makers should avoid introducing new measures that may jeopardize banks' efforts to stabilize the system and restore confidence.

In particular, they should await structural changes that could have severe unintended consequences for the European banking system and the financing of the EU economy.

As recognised by the Liikanen Group itself, the financial crisis did not originate from banking structures. Therefore, it would be perilous to rush reforms in this area. Equally important is to carefully reconsider those regulatory reforms – e.g. the financial transaction tax – that are likely to create significant market distortions at both EU and global level and/or severely damage financial activities that are vital for the financing of the economy and the management of European citizen's savings. Needless to say, restoring confidence in the EU banking system will further require ambitious macroeconomic measures to strengthen the Eurozone and EU economy.

The creation of the banking union creates a historical and welcome step in this regard. The challenge now is to develop a realistic and credible plan for its realisation. Last but not least, market confidence is unlikely to return if it is not backed by dynamic employment and growth perspective. This in turn will require a clear strategy for SME/corporate financing and long-term investment. The Commission's Green Paper on long-term investment provides a step in that direction. ■



Completing the regulatory update: the next challenges

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

The intensity of the crisis provided a clear momentum in order to update the regulatory framework, extend the reach of supervisory oversight to avoid the migration/development of risk outside the regulated sector, and strengthen the financial sector's resilience. Such initiatives have been unprecedented: banks have substantially increased the quantity and quality of their regulatory capital, inadequate regulation and/or supervision of markets or actors is being addressed, a more comprehensive macroprudential oversight of the financial system has been developed, etc. Overall, this upgrade is fostering a safer and more resilient financial system with clear long term macroeconomic benefits: in the long run, the economy needs a healthy and prudent financial sector with an ability to responsibly take on risks.

However, what the "new normal" will look like is still partly unclear and as the bulk of the reforms is now entering implementation, we are facing a sensitive transition. Although regulators and supervisors were always aware of the implementation burden and recognised the uncertainty surrounding the adequate calibration of the reforms, at the present stage the costs associated with this transition to "new normal" are under particular scrutiny, given the still weak macroeconomic environment.

Supervisors and regulators have the responsibility to ensure the effective delivery of comprehensive strengthening of regulation, while also monitoring the implementation, pragmatically calibrating and adjusting the reforms with respect to a delicate balance and ensuring that the comprehensive agenda developed so far adds up to a consistent package. ■

National supervisors' involvement in the SSM is key in addressing current risks

Danièle Nouy - Secretary General, **Autorité de contrôle prudentiel (ACP)**

Extensive policy support, commitments that "the ECB is ready to do whatever it takes to preserve the euro" and, finally, the announcement of the outright monetary transactions have significantly improved financial conditions within the European banking sector since mid-2012. As a result, banks have generally experienced a notable improvement of their situation, although access to funding has remained constrained for weaker institutions and led to an increase of asset encumbrance. Market participants also reacted positively to the announcement by the Basel Committee on Banking Supervision of the revised liquidity coverage ratio. Improved conditions should help banks and financial institutions to recover and face the challenges posed by the economic downturn.

Currently, the weak macro-economic outlook for 2013 coupled with lasting sovereign uncertainties still represents a major threat. In this context, breaking the adverse link between banking and sovereign risk would allow a recovery of banks' funding market. Setting up the Single Supervisory Mechanism (SSM), to be ultimately complemented with the other planned European mechanisms, is therefore an overriding priority.

The economic downturn may lead to further deterioration in the asset quality and profitability of banks. Prudent asset valuation thus remains a primary objective for banks, auditors, investors and supervisors. This issue is resolutely being addressed by regulators and supervisors and will be boosted by the establishment of the SSM, which will further enhance the current level of supervision. EU national supervisory authorities must play their full part in this process. Their knowledge and technical expertise is irreplaceable for the European financial stability. ■

Regulatory disadvantage to SMEs is unacceptable

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

The 2008 financial crisis has triggered the already frequently cited wave of regulation. The call for a stable financial system is right and proper and also in the interests of the regulated banks. There must be no repeat of 2008.

However, I would like to focus on the borrower side. Germany, as a country, is characterised by small and medium-sized enterprises (Mittelstand). This concept covers 3.6 million businesses, employing a total workforce of 25.6 million. SMEs have weathered the crisis amazingly well. With an equity ratio averaging 19.8%, they are well equipped for the future.

The financial market structure in Germany mirrors the economic structure. This means that Germany has a wide diversity of about 1.700 regionally operating banks like savings banks, cooperative banks and small commercial banks which, in contrast to big banks, also tend to have an SME structure. They form the financial backbone of SMEs, 44% of those loans are held by the Sparkassen-Finanzgruppe.

Incomprehensibly, the widespread political view that it is desirable for regionally operating banks to be made subject to the same rules as internationally operating big banks persists. The costs arising e.g. for savings banks are disproportionately high – the regulatory benefit, on the other hand, is low.

The internationalisation of supervision is also being felt by SMEs. Despite clear data confirmed by the Deutsche Bundesbank, the EBA refuses to leave the capital adequacy requirement for SME loans at the present Basel II level.

According to the 'regulatory paradox', however, it is not possible to act as though bank regulations have no impact on lending. Anyone who overregulates the main financiers of SMEs must not overlook the consequences that this will have. It is not uniform rules, but differentiated regulation which is the order of the day. Therefore, it is to be welcomed that the final outcome of the EU implementation of Basel III takes into account the positive risk profile of SME lending business and provides reduced risk weight for loans to SMEs. ■

Understanding the adequacy of provisions across the EU requires some key steps to be in place

Piers Haben - Director, Oversight, **European Banking Authority (EBA)**

The first step to understand the adequacy of provisions across the EU is how to assess and compare provisioning levels when we currently have no consistent way of doing so across the EU. Fear not. The EBA has already taken steps to build definitions for non-performing assets and forbearance, concepts undefined so far but which are under consultation now. Still, definitions are just a first step.

The next step is understanding provisioning in the context of the banks risk profile and underlying asset quality. Confidence in EU banks is undermined by a lack of certainty over risk profiles and asset valuations, not just provisioning. The problem and solution thus lies in broader issues such as correct loan classification, origination and monitoring, collateral monitoring and re-pricing, effective programmes for the management of NPLs and arrears and forward looking provisioning policies.

After successful recapitalisations in EU banks, and the breathing space provided by bold ECB action, tackling residual asset quality is now key. Much action has been taken in individual countries, but clear and consistent information for EU banks as a whole is now essential to lay to rest concerns that there are still pockets of vulnerability in EU banks, which taint the entire sector. Supervisors must play their part. Other elements fall squarely to banks' management.

The need for better governance of loan origination, monitoring and arrears management, combined with forward looking risk management and provisioning policies, has never been greater. Clear forward looking actions, which are transparent and widely understood, are key to addressing this uncertainty across the EU. The EBA is doing its part in definitions and in working with responsible authorities to assess and address asset quality. ■

Achieving the impossible? Raising prudential standards during an economic downturn

Pamela Walkden - Group Treasurer, **Standard Chartered Bank**

The global financial crisis laid bare the vulnerabilities of the banking system and has prompted significant and prolonged efforts to increase global banking standards with the development and implementation of an unprecedented set of regulatory reforms. It is right that banking standards should be improved, particularly around risk and liquidity management, but the extent of the reforms are clearly having an impact on the real economy by constraining the ability of banks to lend.

Equally, it should not be a surprise that bank lending has been affected by the economic downturn, as banks tightened their underwriting criteria. Deleveraging is part of a normal and necessary post-crisis adjustment and helps banks to cope with higher impairments and lower demand. However, the response following the recent crisis has been exacerbated by the need to increase capital and liquidity levels during the same period, and is leading to substantial deleveraging across the European banking sector. In its October 2012 Global Financial Stability Report, the IMF estimated that there would be a reduction in banks' assets of $2.8 trillion by the end of 2013 based on its sample of 58 large EU banks.

We are seeing fragmentation in the way in which internationally-agreed regulations are being applied across jurisdictions, as well as the development of additional reforms in some markets. It is critical that the pursuit of higher prudential standards be coordinated effectively by regulators and policymakers and applied consistently, rather than piecemeal approaches being adopted. Only then will we see a global banking system that is both resilient and capable of supporting economic growth. ■

With capital levels strengthened, U.S. financial players now focused on responsible growth

Terry Laughlin - Chief Risk Officer, **Bank of America**

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In the EU, the banks' role in financing the real economy is larger, thereby requiring that the banking system have appropriate levels of liquidity and capital to support the EU's economic recovery. To this end, the ECB has played a critical role in stabilizing the banking system.

One key difference when comparing the EU and U.S. markets and the current growth outlooks could be investor confidence, which is currently increasing in the United States on the back of the growing economic strength of American households with recent job growth, just one indicator of a potential economic upturn not currently recognized in the EU.

Many commentators have argued that the greatest driver of bank deleveraging is the higher capital requirements being demanded by regulators on a global basis, together with the current liquidity constraints particularly affecting eurozone banks.

The progress made by U.S. banks as highlighted by recent announcements of intentions to return capital to shareholders contrasts starkly with the capital constraints affecting the EU banking sector. Given this situation, additional time will be required for EU banks to execute their deleveraging programs and build their capital levels to support sustained economic growth across the Eurozone.

In the EU and United States alike, the need to truly understand the global consequences and complexities of G20 cornerstones like Basel III and OTC derivatives regulation, and to safeguard compatibility between their different regimes, is imperative to ensure we have fully effective and synchronized global banking regimes in the future. Banks across the globe have had to adapt to a vast amount of complex new rules. Now the dust should be given time to settle.

Future regulatory initiatives should be consistent not only at micro level, but also at macro level. It is good to empower banks' shareholders. But, if we want shareholders to adopt long term strategies and encourage long term investment, then the business needs predictable rule-making and long-term commitments have to remain profitable. ■

The banking union and its positive impacts

José Manuel Campa
Professor of Economics and Finance,
IESE Business School

The creation of the banking union is a necessary, though complex process, for the stabilization of a well functioning financial market in the euro area. Beyond the benefits for financial stability from the banking union, there are also potential positive effects of a single supervisory mechanism and tighter coordination among supervisors on the information provided to markets by banks. These effects could be clearly seen in three areas of reporting information.

First of all, at the core of the banking union is the single supervisory mechanism jointly with a much stronger coordination of all relevant supervisors within the EU.

This will decrease the possibility of discretionary implementation of supervisory practices and the application of national specific regulations that currently make comparability of risk profiles, capitalization and other financial information of banks difficult to compare.

As for better information and better comparability on the measurement of risk weighted assets in financial institutions, there are currently large differences in the risk weights used in internal risk models across institutions both within one jurisdiction and across jurisdictions.
The BCBS points out that a sizeable portion of market-RWA variations is due to supervisory decisions, which are often not disclosed, provided that other important sources of variation are modelling choices made by banks. Information along similar lines is also provided by the EBA and banking analysts. The existence of a single supervisor should enhance the implementation of homogeneous standards.

The third is in the application of accounting rules. This has been an area of reform that has proven difficult in the global agenda and where more and faster progress is needed. Common rules already apply across the EU in this area. However, in practice, we see significant variations across national jurisdictions. The banking union should also enhance the coordination of accounting rules across jurisdictions. ■

A practical approach for ensuring more consistent RWAs in Europe

Manuel González Cid - Chief Financial Officer, **Banco Bilbao Vizcaya Argentaria**

In recent months, significant steps have been taken to analyse differences in RWA across banks, both at global and European levels. The conclusion arising from this is that a significant part of these differences, around half in loan portfolios, are not justified. This is clearly a step forward, but significant work remains to be done. The nature of these unjustifiable differences should be clarified, and domestic supervisory practices could be one of the potential explanations.

The imminent challenge for regulators and the industry is shifting from these useful analyses to specific measures that allow for recovering a level playing field for European banks and restoring confidence for investors.

It is time to move from the recognition of differences to measures that will close the gap between the current situation and an acceptable one.

We are increasingly convinced that any measure adopted as a result of these analyses should preserve the advantages of a capital framework with risk sensitivity. This framework creates proper incentives for prudent risk management, an outcome that could be jeopardized by simplistic or standardised options.

With this aim, we propose a threefold approach: first, enhancing and harmonizing disclosure through common templates for all institutions; second, being able to identify and address those practices among domestic supervisors that objectively count for a significant part of the unjustifiable differences in RWA across banks. The objective is to have very detailed guidelines at hand regarding key elements, such as the time period used for model calibration and the definitions of economic cycle and default; finally, taking advantage of the upcoming Single Supervisory Mechanisms in order to create mixed supervisory teams in charge of the approval and validation of internal risk based models. ■

Differences in risks need to be recognised in risk weights

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

Basel II introduced the Internal Rating Based (IRB) Approach to capital, partly with the objective of creating incentives for banks to better understand the risks they face.

The consequence was increased complexity, as risks in reality differ from institution to institution and from jurisdiction to jurisdiction. Lately, the costs and benefits of the increased complexity have been queried, not least because of differences in risk weights across institutions.

Capital requirements for banks using internal models are based on the observed development of relevant data in the markets where the banks operate. Structural differences between different markets are thereby taken into account, including differences in legal frameworks such as creditor rights. These differences matter greatly, but they are difficult to quantify by other methods than looking at the actual history of PDs and LGDs. The recent study by the EBA does not address these differences.

In the EU, it takes anywhere from 6 months to 6 years to foreclose on a mortgage depending on the jurisdiction. Everybody in the mortgage business knows that there are substantial downsides to LGDs the longer the foreclosure process takes. This should be recognised in risk weights.

Foreclosures can be very traumatic events for borrowers depending on the social safety nets, and politically there is an obvious pressure to intervene. However, making it more difficult to do foreclosures has implications for the risks and price of providing mortgages to all borrowers.

These considerations should not inhibit initiatives to harmonise the way risk weights are estimated, e.g. ensuring that estimates are based on data from years when the financial system was subject to intense stress. But the objective should be to harmonise the methodology, including the estimation period, and not the risk weights. ■

The search for truth and meaning

Ralf Leiber
Managing Director, Group Finance, Head of Strategic & Capital Planning,
Deutsche Bank AG

In order to manage and supervise – or divest and invest – we try to understand bank's business models and the resulting risks and rewards. When forming our judgments, we rely on available financial information about the past and predictions about the future. At the end, model based cash flow projections are at the heart of not only company valuation but also solvency, leverage and liquidity regulation.

Times of crisis (alias financial crisis) put such models to the test and challenge assumptions and projections made. Bank internal as well as regulatory models are particularly questioned, as is evidenced by so many reports and comments issued about the reliability (or lack thereof) of bank's risk models – and the integration of internal model results into regulatory calculus, in particular risk weighted assets.

To address perceived and real shortcomings, the Basel Committee on Banking Supervision has issued significant amendments to the previous market risk framework, tightened the definition of capital and developed a formal liquidity and leverage regime. In essence, all these changes are an attempt to improve the regulatory model for measurement of bank safety.

Such amendments should largely be applauded, but how do we restore trust in risk management and regulatory model results? Here, it will be critical to understand the difference between truth and meaning. For example, it may be true that one bank has a larger balance sheet than another – but what does it mean when one is based on IFRS and another on US GAAP, or in case one bank's assets are of highest quality and the other's are principally risky uncollateralized loans?

Well designed and well understood risk models are our only hope to provide answers to inherently complex predictions about future risks and rewards and hence bank safety. But such models have to be based on global standards, and model assumptions must be made transparent and results properly explained to give them meaning.

We need to see more - not less - initiatives like the Enhanced Disclosure Task Force's recommendations on risk disclosure, or the BCBS's report on the regulatory consistency of risk-weighted assets for market risk. ■

Restoring confidence in RWAs

Piers Haben - Director, Oversight, **European Banking Authority (EBA)**

"Le doute est inconfortable. La certitude est ridicule".
Voltaire

Questions about the reliability of RWAs in European banks often appear in analysts' reports. These questions merit considered responses, dealing with both substance and perception. We shouldn't, however, pretend we will move to a state of complete certainty. Even the leverage ratio doesn't provide that. However, we can surely inform the doubters better.

A starting point is to provide context. Simple comparisons between US and EU banks fall at the first hurdle of comparability – different metrics and different financial systems mean simple "home grown" comparisons between banks' assets are challenging. But many of the questions a have deeper undercurrent, which deserves a response. Our role as regulators should not be to make market participants completely comfortable, or sure. Nonetheless, we should strive to inform their questions as fully and consistently as possible.

For regulators this means thoughtful and in depth, analysis of RWA drivers. Whether it be data, portfolio classification, underlying asset quality, the stage of IRB implementation, or early recognition of defaults, all can impact RWA outcomes, but for very different reasons. And that's before we get into the model assumptions and validation techniques.

That is why the EBA is undertaking top-down analysis, hypothetical portfolio exercises and bottom-up analysis on both low default and high frequency portfolios such as residential mortgages and SMEs. These three stages are necessarily time consuming but worthwhile and they are, of course, performed in close collaboration with the international work of the Basel committee. Our job is to analyse these RWA differences, and to communicate carefully what we are doing. Then, and only then, should we take well informed policy decisions to address concerns about RWA consistency, whilst maintaining a focus on risk management.

For banks, the main job is to improve risk management and ongoing oversight of models with a tendency towards conservatism. It also means, at the very least, greater transparency about their models, their assets and ultimate RWA outcomes. The challenge we hear from analysts is that comparisons are difficult. One more for the regulators, perhaps. ■

Improving banks' risk disclosure practices will help to restore investor confidence

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

Loss of investor confidence in the banking industry is an enduring legacy of the financial crisis. Recovering this confidence will take time. Improving practice around risk disclosure and evaluation of risk-weighted assets (RWAs) is an essential foundation.

The wide variance amongst banks in reported RWAs as a proportion of total assets is a major issue. Analysts point accusingly at the use by some banks of less conservative models than others to calculate risk weights. Studies suggest the answers may lie in the differing composition of bank balance sheets and a lack of consistency in the regulatory buffers applied for model uncertainty. Others note that all models used to calculate capital consumption are approved by regulators.

Understanding variance in RWA levels is frustrated by a lack of available information to facilitate comparison of bank capital levels and movement between periods on a like-for-like basis. Greater visible consistency in the application of regulatory principles is a vital prerequisite to restoring confidence in capital utilisation.

The answer is not to move to simpler models. A retreat to Basel I or standardised weightings, which make little allowance for risk, would be a retrograde step and could create perverse incentives to increase risk in pursuit of enhanced returns.

The Enhanced Disclosure Task Force report, Enhancing the Risk Disclosures of Banks (Oct 2012) is a major step forward in improving risk disclosure. The principles it lays down provide a firm foundation on which to build transparent, high-quality risk disclosures that enable users to understand a bank's business and risks and link these to capital consumption and financial performance.

Together these constitute an important first step towards clearing much of the opaqueness of banks' business and capital models. ■

RWA: reverting to Basel 1 is not the solution

Etienne Boris - Senior Partner, **PwC**

The variability of Risk Weighted Assets across time and across institutions has cast doubts on their reliability, preventing analysts to compare banks and further deteriorating confidence.

Following the implementation of Basel 2, the RWA of European banks are largely driven by models. These models are developed by banks and validated by their supervisors. The lack of confidence on RWA calls for the industry and supervisors to provide more clarity or more convergence.

There are many legitimate reasons for such variability including differences in banks' business mixes, in regulatory regimes, in the proportion between internal models versus standard models and in business and risk practices. All of these factors must legitimately lead to different RWA. As risk measurement is also a matter of judgment, there is an inherent limit to model and RWA harmonization even for the same risk exposure.

The simplest path to resolve this issue would be to revert to non risk-based capital requirements like Basel 1 or the leverage ratio. But simple does not mean right. This would deny the different risk realities described above and lead to regulatory arbitrage, disincentivizing banks and their supervisors to truly monitor risk, ultimately increasing systemic risk.

The right solution is to build on the current framework and improve it around three axes.

First, improve transparency. A lot has been done through the work of the Enhanced Disclosure Task Force, however some areas should be further researched, for example, the disclosure of back testing results or the granularity of disclosures.

Second, improve comparability. The recent study of the Basel Committee on trading book RWA showed that some key assumptions explain a material part of RWA differences. Further consideration should be given to harmonize key parameters that can have a material impact on model outcomes.

Third, improve controls and supervision consistency. As models are validated by supervisors, it is therefore key to have consistent validation. The forthcoming supervision of large banks by ECB is an opportunity in that respect. Finally, external assurance on RWA should be considered as it can help build confidence. ■

Is there a future for risk-based capital ratios?

Stefan Blochwitz - Head of Division On-site Inspections, Implementation of International Standards at Department of Banking Supervison, **Deutsche Bundesbank**

Do we need risk-based capital calculation? The discussion about a new capital framework, known now as Basel II/II.5/III, began in 1999. At that time Basel I, the first risk-based capital framework for banks, which was based on an almost flat risk-weighting of banking assets, exhibited clearly visible deficiencies. Firstly, it gave the wrong incentive to banks by tempting them to invest in high-risk assets with a higher expected return on equity compared to lower-risk assets. Secondly, financial innovation created a wide dispersion between regulatory and supervisory requirements and banks' internal risk management.

The reasons for moving from Basel I to Basel II are still valid today, so that any meaningful regulatory and supervisory framework must be based on risk based capital requirements. Implementation matters! Since there is a need for risk-based capital requirements, the important question of its proper implementation is raised.

The recent financial crisis and the ongoing discussion about complexity and comparibility of capital ratios teach us some fine lessons. Firstly, risk-based capital calculation reaches its end when applied to assets with insufficient information to quantify their risk. Therefore, these techniques should be restricted in its applica-tion to assets with enough information for its risk assessment. Secondly, the discussion on risk-based capital should not be limited to pure figures only; risk management and governance processes are equally im-portant. A lower capital charge is an incentive for better risk management. Lastly, risk-based capital calculation implies that risk weighting reflects the riskiness of assets. Therefore one has to be aware that risk weights are not easily comparable across banks. ■

Capital requirements should remain risk sensitive

Bjørn Erik Naess - Group Executive Vice President and Chief Financial Officer, **DNB Group**

Basel II/III has been criticized for being too complicated, and some regulators have proposed to move back again to more simple and transparent methods. In some areas, like the treatment of trading positions and derivatives business in investment banking, it is almost by nature very difficult to capture the true risk positions. That is one lesson learnt from the financial crisis. In this context, an improved standardised approach for calculating RWA, on which the Basel Committee is currently working, will be welcome as a good reference point for assessing risks.

The main risks for most of the commercial banks are related to the traditional lending activities. In this area, Basel II and the introduction of IRB-systems -whereby the regulatory requirements are based on internal models for credit risk- have been a major step forward. This reform, formally introduced in 2007, just ahead of the financial crisis, has improved risk management and it has probably resulted in a more conservative risk profile in many banks, by giving incentives for low risk lending. This process started years before 2007 and meant that many banks were better prepared when the financial crisis struck in 2008. The dynamics created by the regulatory framework will be even more important in the future, when these rules will become binding constraints for the banks to a much higher degree than before.

EU's implementation of Basel III through CRR/CRD IV allows national regulators to extent the international capital requirements significantly. The key reference is still the RWA. Thus, it is more important than ever that risks, i.e. RWA, be measured broadly in the same manner across banks and jurisdictions. Otherwise, the real and effective capitalization might be very different, which would jeopardize a level playing field. More international harmonization on the regulatory side is needed as well as better disclosure and more transparency regarding the banks' IRB systems. ■

Comparability and consistency of Risk-Weighted Assets: the impossible mission?

Carola Schuler - Managing Director, Banking, **Moody's Investors Service Limited**

The complexity of the computation of risk-weighted assets (RWA) and limitations in public disclosures have prompted market scepticism about the accuracy and reliability of capital ratios. Recent surveys by the European Banking Authority (EBA) and the Basel Committee showed that dispersion in RWA could not be fully explained by banks' public disclosures. Hence, under the current complex framework on capital, which offers a large variety of modelling choices and approaches and permits different interpretations of the Capital Requirement Directive, there is a need for banks to better explain their RWA to regulators and the markets.

In order to address some identified shortcomings, regulators will likely look at modelling choices and the appropriateness of disclosures. We anticipate that regulatory initiatives will foster some convergence of models, thereby leading to a larger degree of consistency and comparability across firms. Further, the Basel Committee advocates a leverage ratio to complement current capital regimes and to address the pitfalls involved with risk-weighted assessments.

For now, regulators rely on the Tier 1 capital metric that may prompt regulatory intervention in case of a bank's distress. While this measure may be imperfect, it is broadly accepted and disclosed. Moody's has therefore incorporated this ratio into its analytical framework, alongside other tools such as stress testing and scenario analysis. We thus strive to compensate for the imperfections of reported Tier 1 (and RWA) by looking at the behaviour of financial resources and assessing banks' resilience to asset quality shocks, based on our own assumptions. ■

EU crisis management in the context of the Banking Union

Uachtaránacht na hÉireann ar Chomhairle an Aontais Eorpaigh
Irish Presidency of the Council of the European Union
eu2013.ie

The key to eliminate too-big-to-fail: effective resolution regimes

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

It is critical that policymakers put efforts into establishing a credible strategy for resolving banks when they fail, regardless of their size, their inter-connectedness and their complexity. This requires the ability to impose discipline on the managers, shareholders and junior debt holders of large failed banks. The challenges of resolving Fortis, Dexia and Lehman Brothers—just to name a few—made it clear that resolution regimes would need to be revamped, and arrangements be put in place to prevent disruptive and value-destroying uncoordinated local resolution actions.

The Key Attributes of Effective Resolution Regimes (2011) provides the framework and principles to enhance resolution regimes. But while sweeping legislative reforms are strengthening national frameworks in several countries, removing constraints to cross-border cooperation remains difficult. This would require several steps: empowering and encouraging cooperative solutions among resolution authorities, eliminating provisions that trigger automatic actions in one jurisdiction as a result of resolution actions in another, and providing for transparent and expedited processes to give effect to foreign resolution measures.

But even further steps will be needed to address the challenges of cross-border cooperation. First, as the need for public support during resolution cannot be ruled out, an ex-ante understanding of how costs would be shared across borders is vital. Developing principles upon which authorities can approach this discussion is therefore essential. Second, authorities require joint strategies for resolving large and complex institutions without jeopardizing financial stability. The recent FDIC-Bank of England initiative to develop joint "top-down" resolution strategies sets a precedent that warrants broader imitation. Achieving effective resolution is a must in order to address the too-important-to-fail problem. ■

Bail-in: need to manage expectations and outstanding issues

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

During the financial crisis, authorities lacked proper powers and tools to organise the orderly resolution of failing financial institutions and had to inject public funds to manage market confidence and avoid major market instability. In response, the Commission has proposed a EU recovery & resolution regime based on a "no-more-bail-outs" philosophy. The resulting bail-in tool is expected to enhance the resilience of the EU financial system.

However, bail-in will have serious implications for both banks and their investors. It will impact bank funding models, and pricing of bank debt. Rating agencies have notably hinted that unsecured senior debt could be downgraded between 1 and 3 notches. Investors' appetite for bailinable debt is unclear, but given the more difficult price discovery process, they may favour banks with strong capital buffers to reduce the probability of bail-in. For bail-in to be effective and its impact mitigated, more clarity and predictability are therefore paramount. This means strictly framed national discretions, where relevant, on the scope of bail-in and harmonised triggers and objectives.

Crédit Agricole considers that bail-in should only be envisaged once the bank has reached its point of non-viability, triggering resolution, with the aim to preserve value and help continuity of critical functions. The bank could then be orderly wound-down, put into a bridge bank, sold to a new purchaser or fundamentally restructured.

Within this framework, Crédit Agricole supports a broad scope for bail-in where only secured depositors and creditors are excluded and where creditor hierarchy is strictly respected. Senior unsecured debt bail-in must only be used to facilitate an orderly market exit.

While EU level harmonisation of the bail-in regime is key, one size does not fit all banking models. Care must be taken that the conversion mechanism does not conflict with the specific governance structure of cooperative banks: as bondholders become new shareholders, existing cooperative shareholders could lose control of their central bank which would be in direct contradiction with their cooperative status. ■

Setting the framework for integrated resolution in Europe

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

In the last years, we saw cross-border banks that needed large bail-out packages from their domestic sovereign, as well as domestic banks recapitalised through European support packages. The crisis showed that this disalignment is not sustainable, and puts the Single Market under serious strain.

The roadmap for a banking union reshapes the EU institutional setting of supervision (the single supervisory mechanism - SSM) and resolution (the single resolution mechanism - SRM). The SSM is being established, but in order to break the vicious circle between banks and their sovereigns, common supervision cannot be decoupled from common resolution mechanisms, shared financing of resolution and a common backstop.

Exclusive reliance on national budgets to support the banks, also in the case of EU-IMF programmes, has been hampering the functioning of the Single Market: both market participants and authorities have driven repatriation of assets and stricter allocation of capital and liquidity in each jurisdiction. Cross-border banking activity has substantially reduced.

Once completed, the banking union should contrast this trend of national segmentation and provide a robust underpinning for an integrated banking market. Ideally, this should point to the need to extend the remit of the SRM to the whole Union. Instead, if the jurisdiction of the SRM is restricted to the countries participating in the SSM, there is a risk that some degree of segmentation remains in the Single Market, as a consequence of the different underlying safety nets on which European cross-border banks would rely.

To prevent this scenario, the SRM should be accompanied not only by a common resolution toolkit for the whole Union, but also by clear and binding criteria, agreed among the parties involved, for burden sharing with respect to cross-border groups operating across the Union. Recent experience shows that voluntary agreements are not enough: when a crisis materializes, the strong incentives to diverge from the original agreements need to be set-off by credible, binding arrangements. For this purpose, a European Authority should ensure that these agreements are put in place under a common umbrella and are effectively enforced in a crisis. ■

Reducing EU banking single market fragmentation through EU resolution framework

Jerzy Pruski - President of the Management Board, **Bank Guarantee Fund, Poland** & President and Chair of the Executive Council, **International Association of Deposit Insurers (IADI)**

The EU single banking market is characterised by oversized cross-border banks, many of which qualify as G-SIFIS, and by relatively weak domestic safety nets, which lack effective resolution regimes, have fledgling deposit insurer schemes and, until recently, were without EU-level financial stability arrangements. The fragmented and deficient EU financial stability framework cannot cope with the cross-border nature of the rapidly growing EU banking sector. Three key steps are urgently required to overcome the aforesaid shortcomings.

First, at the EU level, the approval of the Directive on Deposit Guarantee Schemes and the Bank Recovery and Resolution Directive is needed: both are crucial for establishing robust and harmonised domestic safety nets. Moreover, it is highly advisable to overhaul the institutional structure of domestic safety nets, taking into consideration extensive international experience.

Second, it is of utmost importance to complement the existing Single Supervisory Mechanism by the introduction of the Single Resolution Mechanism. From the list of options, a newly created resolution authority seems most attractive. The scope of covered entities, division of tasks, rules for financing resolution funds and the conditions for participation in both mechanisms should be as similar and consistent as possible. The SRM, supported by a strong domestic financial stability frameworks, is instrumental to override the inefficiencies and fragmentation of the EU single market for banking. In order to avoid introducing new fragmentation between euro zone countries and non-euro economies, the issue of the latter's participation must be addressed.

Finally, to enhance the resolution framework and to rupture the link between sovereign debt and banks, restructuring the banking sector in line with the Liikanen Report should complement the new financial stability framework. ■

The clarity and transparency of resolution regimes will drive investor reactions

Bernard de Longevialle - Managing Director - Lead Analytical Manager, Financial Services EMEA, **Standard & Poor's Rating Services**

Investor appetite for European bank debt is driven by multiple factors, including risk appetite and risk reward analysis. Opportunities in other sectors and regions are also key considerations when allocating assets. From this viewpoint, the ongoing introductions of national and EU-wide resolution regimes are significant developments that weigh on investor appetite. Investors need to undertake more fundamental analysis than in the past to assess the risk of bank failures and the likelihood of burden sharing.

While the objective of protecting tax payers has already led to frequent bail-ins of bank junior creditors, there are still many uncertainties regarding the scenarios in which senior creditors could be bailed-in. The impact of resolution frameworks on appetite for European bank debt will hinge on two main factors: clarity and transparency. Investors will become more demanding in terms of ability to assess both the probability of default and the loss given default of instruments. This will require enhanced capacity to assess banks' risk profiles, clarity about the regulatory trigger points for bail-in for each category of instrument, clarity about instruments' subordination in case of resolution, and information on the amount of assets available to cover losses and reimburse creditors based on their position in the liability waterfall. Current uncertainties regarding future bail-in conditions, as well as existing disclosure shortfalls, limit investor capacity to assess each of these points.

Unless significant progress is made in terms of regulatory and bank disclosure, there is a risk that the move towards European resolution regimes will structurally undermine investor appetite for European bank debt and lead to pro-cyclical behaviors in times of crisis. ■

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EU crisis management in the context of the Banking Union

Uachtaránacht na hÉireann ar Chomhairle an Aontais Eorpaigh
Irish Presidency of the Council of the European Union
eu2013.ie

Implications of the introduction of a EU Single Supervisory Mechanism for the European Recovery and Resolution Framework of banks

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

The introduction of the Single Supervisory Mechanism for banks serves the objective of breaking the negative interdependence between banks and sovereigns. This objective cannot be fully achieved without establishing a Single Resolution Mechanism for banks, the resolution counterpart of the Single Supervisory Mechanism.

The pending proposal for a Bank Recovery and Resolution Directive includes a harmonised resolution toolkit for national resolution authorities and a framework for their co-ordinated action in the resolution of cross-border groups.

The Single Resolution Mechanism could go further by centralising the decision-making process at the European level while drawing upon the organisation, expertise and experience of national resolution authorities.

The Single Resolution Mechanism should be supported by appropriate funding arrangements to finance resolution action. It should be held to the highest degree of transparency and accountability towards the European Parliament and national parliaments while ensuring confidentiality during the procedure.

A Single Resolution Mechanism could avoid the risk of being captured by national interests (in particular in the resolution of cross-border banks) and could ensure homogenous treatment of resolution. It would benefit from significant economies of scale and from the advantage of pooling expertise and knowledge.

It would have a broader perspective and a better understanding of possible spill overs. Centralisation would also help reduce delays that could endanger the effectiveness of the resolution process particularly in the case of cross-border groups. ■

Depositor treatment in an efficient EU resolution framework

Per Callesen - Governor, **Danmarks Nationalbank**

A Single Resolution Framework is a central element in the construction of a solid banking union. Rightly designed, it will be critical in breaking the adverse sovereign bank feedback loop, and with it the fragmentation of banking conditions in the EU.

Two elements stand out: that the framework contains a credible financial backstop, and the degree to which it can forward the harmonized use of creditor bail-in.

Bail-in is critical, but as recent experience shows, it can also be tricky to use. Key elements of an efficient bail-in regime are inter alia legal certainty and having correct incentives in place regarding the hierarchy of claims. As part of negotiations of the Directive that will set the rules under a common framework, there has been advocacy for the idea that insured deposits should be awarded preferential treatment in a resolution. Caution is needed. Insured depositor preference, while possibly protecting scarce deposit guarantee funds in the short term, would imply upending the principle of no creditor worse off (than in liquidation).

Reduced contributions from the deposit guarantee scheme would narrow the financing base of resolution. Had insured depositors been given preferred status during recent bank resolutions in Denmark, the necessary haircut to fall on other unsecured creditors would have been increased substantially.

Changes to the pecking order would naturally affect investor sentiment. While unlikely to be a major problem in good times, depositor preference could in times of heightened tension lead to bank funding markets freezing sooner. That would increase banks' reliance on public liquidity and capital back-stops.

Given fear of contagion from inflicting the tougher haircuts to non-deposit creditors, authorities may refrain from using the bail-in instrument at all. That could challenge the potential of single resolution providing European banks with a level playing field. ■

Effective resolution requires a robust cooperation framework amongst regulators

Steve Hottiger - Managing Director, Head Group Governmental Affairs, **UBS AG**

During the financial crisis of 2008 it became clear that the global financial system was not equipped to handle the failure of large, internationally active (and even sometimes small, domestic) banks. Therefore, regulators across the globe agreed that, in addition to more robust capital and liquidity requirements, the development of regimes to enable banks to fail in an orderly manner was a key component for a credible answer to the too-big-to-fail problem.

For that to be effective, one of the single most important conditions is that the various national regulators involved act collectively in a coordinated way. While this is widely acknowledged, progress in establishing key components like agreed processes for cross-border crisis management or the mutual recognition of foreign resolution measures has been slow so far.

Resolution authorities today are still inherently national and thus no single resolution authority will have the comprehensive legal authority needed to resolve a financial institution with cross-border activities. The proposed single mechanism for resolving banks under the EU Banking Union will hopefully address this concern to a significant degree in respect of participating EU institutions. But in relation to other institutions, robust coordination mechanisms and agreed tools to ensure effective resolution of global systemically important banks are yet to be developed. In this context, it is important to avoid national bias and there should be no jurisdiction-based discriminatory ring fencing or national depositor preference.

We acknowledge challenges relating to effective cross border resolution such as recognition of third country legal contracts and confidentiality issues around cross-border information sharing. Nevertheless, it is essential to establish international agreed regimes, which ideally should be formalized into legislation or regulatory mandates, as in the absence of such regimes and their enforceability in relevant jurisdictions, international bank resolutions may not be possible. ■

An RRD with a predictable, powerful bail-in tool can restore our financial foundations

Wilson Ervin - Vice Chairman, Group Executive Officer, **Credit Suisse**

Recent events remind us of the dangers lurking beneath the surface and threatening growth, stability of the current banking system and the integrity of sovereigns. Europe is making significant progress to address these with the Resolution and Recovery Directive. The RRD must pass into effect with a powerful, clear and predictable bail-in tool to successfully rebuild a more stable European banking system.

A good resolution regime will only work if it has sufficient resources. A "double equity" requirement for major banks would be a simple and effective standard. If a severe crisis destroyed 7% of RWA, banks should have enough regulatory capital or bail-in-able securities to recapitalize the institution with a fresh equity layer of at least 7%.

This layer does not require a specialized new class of "bail-in bonds", which would be counterproductive if investors perceive an implicit guarantee on existing bonds. Banks should be free to add a voluntary layer of "buffer debt", within the context of a comprehensive bail in regime. Over time, we believe the market will gravitate positively toward structures that include a buffer layer to protect senior creditors and act as a "watchdog" for risk.

Some believe that bail-in should follow a strict pari passu system, where liabilities are treated identically to bankruptcy. This approach has major economic drawbacks. It could confound the ability to bail-in senior bonds, thereby reducing loss absorbency resources and more likely resulting in disorderly solutions and bail outs. An effective system must protect critical "operating liabilities" that are essential for the functioning of the overall financial system – liabilities that could spark runs or exacerbate systemic risk.

Bail-in must "scope in" sufficient resources, but it must also "scope out" sensitive liabilities. A "presumptive path" that shows investors how bail-in can work in the context of a particular institution will help enhance credibility. It will also help avoid the need for ad hoc actions, which can compound political and market stress.

Together with the SSM, a strong, predictable bail-in regime will help rebuild the financial foundations of the EU on a stronger footing. An RRD with these powers gives us a critical tool to reduce the reputational risk to the ECB and banking union of disorderly bank failure, and help untangle the corrosive sovereign/bank feedback loop. ■

Protection of financial stability and public funds at the heart of the EU reform

Danièle Nouy - Secretary General, **Autorité de contrôle prudentiel (ACP)**

The EU resolution framework is a key initiative, which aims at setting up efficient prevention, early intervention and resolution tools and also at protecting financial stability and public funds by making the banking system more responsible.

Indeed, from October 2008 to October 2011, the European Commission approved €4.5 trillion of state aid measures to financial institutions (equivalent to 37% of EU gross domestic product). Therefore, the Commission's proposal for a recovery and resolution directive, which is currently under discussion, provides clear objectives to protect not only financial stability but also public funds.

To reach these objectives, resolution authorities will have a new powerful instrument: the bail-in tool. It will ensure that resolution authorities have the power to restructure the liabilities of a distressed financial institution by writing down its unsecured debt and/or converting it to equity. This tool will enable resolution authorities to achieve a prompt recapitalization of the distressed institution where contractual arrangements failed to absorb losses during the past crisis. As for creditors, they will benefit from specific safeguards: they will bear losses after the shareholders and will not incur greater losses that those incurred if the institution would have been wound down under normal insolvency proceedings.

Thus, this well-balanced scheme will ensure the effectiveness of the bail-in tool to protect taxpayers and financial stability, by allocating bank losses to its creditors. The adoption and the entry into force of a European resolution framework is therefore a priority that I strongly support. ■

The Eurofi High Level Seminar 2013 Newsletter

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Payment services: trimming the lawn or letting the flowers grow?

Gertrude Tumpel-Gugerell - Former Member of the Executive Board, **European Central Bank (ECB)**

10 months to go – from February 1st 2014 payment transactions will look the same all over Europe. The integration efforts of the last one and a half decade after the introduction of the euro have offered great opportunities. Financial service providers have expanded their markets geographically, consolidated their business lines and merged here and there.

But there are still considerable differences in organization and costs of this business, not to speak of fees. We still see fragmentation along national borders - technical standards are not harmonized yet and are used as excuses for keeping the fragmentation. At the same time, we see a high concentration in the cards business.

Regulators have aimed at creating a safe and reliable environment for customers as well as opening the business towards non-banks in a fair manner. Non-banks traditionally specialized in other services, not necessarily of a financial nature, such as telecommunication or mobile operators, offer now payment services which are not yet provided by banks, in particular in the e- and m-payments segment. Internet start-ups, with their flexible organizational structure, have entered the payments business as well.

Innovation was mainly driven by these new market players satisfying niche customer needs, and banks have been coming under pressure in one of its core business areas. In order not to lose ground in this booming business, banks should seek for cooperation. The customer might not care who performs his or her payment transfers – what counts is the security, safety and reliability. In this context, both sides can benefit from each other: banks have the financial strength and the trust of their clients, non-banks the innovative capacity.

In this changing environment, regulators are facing new challenges. The primary goal of regulators is ensuring the stability and efficiency of payment systems. Due to the diversity of market players, further cooperation with other authorities such as competition and telecommunication authorities needs to be analyzed. At the same time, innovation should take place and competition must be ensured. The costs to society of providing retail payment services are substantial and amount to 1% of GDP - too much for not making it more efficient. ■

'Mobile payments': an opportunity for greater collaboration across industries

Claudia Cassinari - Head of Payments Market Infrastructures, **Society for Worldwide Interbank Financial Telecommunication (SWIFT)**

Wikipedia defines 'mobile payments', as "mobile money, mobile money transfer, and mobile wallet, and generally mobile payments refer to payment services operated under financial regulation and performed from or via a mobile device. Instead of paying with cash, cheque, or credit cards, a consumer can use a mobile phone to pay for services, and/or goods".

Although the concept of using non-coin-based payment systems is very old (e.g. barter), modern technology has accelerated adoption of mobile payments through increasingly smart mobile devices. In fact, we can safely say that the combination of easy access to technology, and changes in the social and cultural environment, have revolutionized mobile payments and will continue to do so. With the exponential growth of people possessing a smartphone enabling them to interact with scanners or other intelligent devices at the point-of-sale, and the growth of platforms and applications supporting or enabling initiation of customer transfers via a mobile device, this trend towards mobile payments will continue to increase.

Based on this reality, it is essential that banks cooperate to ensure that their customers will continue to benefit from an easy, secure and efficient customer payments experience, however their payment is initiated (mobile or more traditional payments). A key example is that customers need to benefit from the single market in the EU, and be enabled to make payments using the new European Single Payments Area (SEPA) scheme. All relevant providers need to work together to ensure that customers benefit fully from new payments technology and it does not make sense to limit the cooperation to just the banking community, knowing that the stakeholders in this environment go well beyond the banking industry. It is only through cooperation and collaborative approaches across the entire payments chain, as well as across industries, that the objectives of easier payments, including cross border payments through schemes like SEPA, can be achieved. ■

Internet payments – security must be a key consideration

Maurice McGuire - Director of Financial Operations, **Central Bank of Ireland**

Electronic payments are far more efficient than their paper equivalents and the public are being encouraged to use them more and more, but people will not change their payments behaviour unless they are convinced that the more modern payment methods are at least as safe as the old ones. This issue is particularly important in Ireland at the moment, as we embark on our National Payments Plan initiative, aimed at improving national competitiveness through increased use of electronic payments.

Payments made over the internet are more vulnerable to fraud than traditional payment methods but, at the same time, more and more transactions are taking place 'online', so it is essential that internet payments are made more secure. This depends on responsible behaviour being adopted by everyone involved in the process. With this in mind, the Eurosystem has published its 'Recommendations for the security of internet payments', which I believe to be an important step in the ongoing fight against payments fraud.

The recommendations were developed by the European Forum on the Security of Retail Payments (or SecuRePay), a co-operative initiative by relevant EU/EEA authorities aimed at facilitating a common knowledge and understanding of issues related to the security of all aspects of electronic retail payment services. The recommendations – which in essence set out what should be considered 'best practice' in the area of internet payments – are principally addressed to payment services providers, the governance authorities of payment schemes and other market participants, such as e-merchants, and will be implemented by 1 February 2015 at the latest.

In the modern business environment, new payment methods develop quickly and are no longer constrained by national borders; likewise, no one regulatory body can claim to have all of the necessary expertise to effectively police these developments. The work of international bodies like SecuRePay will, in my view, become ever more important in combating fraud and enhancing trust in internet and other new electronic payment methods. ■

Payment Services: unlocking the digital economy for the European consumer

Hikmet Ersek - President and Chief Executive Officer, **The Western Union Company**

In recent years, EU policy makers and regulators have had to focus their attention on the financial crisis, understandably. Within the G20 framework, great progress has been made to bring stability to financial markets. In Europe, this is culminating in the banking union.

Now it seems time to refocus some of the energy back into the EU's ultimate objective: the Single Market. Technology and the digital economy are leading the way. They reflect changing consumer patterns and preferences. I applaud the Irish Presidency which has made the digital economy a priority. The importance of safe e-payments for e-commerce is well known.

Western Union is at the forefront of innovative payment products. This is through WU.com (our online money transfer platform), pre-paid cards, e-remittances, as well as our business solutions for corporate clients. Remittance services are also fundamental to financial inclusion, as well-documented by the World Bank.

The Payment Services Directive (PSD) has been one of the success stories of the Single Market. There are now more than 550 authorised payment institutions in Europe and the number is growing.

Commissioner Barnier's initiatives under the Single Market Act 2 on the revision to the PSD and a proposal on e-invoicing will be crucial. Western Union similarly welcomes efforts to conclude negotiations on e-identification.

Work is also ongoing on the revision of the data privacy rules. We understand preparation is underway for a Single Market Act 3, which will focus specifically on the digital economy. Payments do not stop at Europe's borders. Payment services should be based on international standards and safety features. These need to respond to modern consumer choices and technological innovation while at the same time fostering competition between the different means of payment and payment providers.

Financial services regulation and supervision will need to meet all these requirements. Why could we, for example, not strive towards a technology neutral and fully harmonised anti-money laundering regime in the EU? We also need to rethink how home and host state supervisors cooperate in a digital environment. It is now the time for a G20 initiative in the payment space. ■

The payment sector at historical crossroads for banks

Philippe Wahl - Chief Executive Officer, **La Banque Postale**

The payment sector is experiencing a revolution leveraged by technological breakthroughs such as smartphones or contactless payment, the soaring expansion of electronic business and the development of new digital services. Hence, customers' expectations and behaviors are evolving as well creating opportunities.

These changes are positive for the efficiency of the sector and should be welcomed. Nevertheless, vigilance is required because trust, risks, credit and thus regulation are involved in payments. Fraud, problems in data storage creating confidentiality risks etc. may erode customers' trust in the payment system and thus induce serious impacts on the global economy. In order to protect customers, a regulatory framework and supervision must be ensured for all kinds of payments whether they are provided by banks, payment services providers or any third parties such as overlays: same business, same rules.

Having this in mind, banks face two main challenges. The first challenge is to be able to compete with new entrants and keep a direct relationship with the customers. Being a partner of all customers in all situations is not only a business priority, it is at the heart of our mission and in the interest of our clients.

Second, is about having economic incentives for investing in new payment schemes. On this matter, the war against the multilateral interchange fee system increases the cost burden for households. It also creates a highway in which "three-party payment" systems (such as American Express or Paypal) will thrive, although such systems are more expensive and less universal than four-party ones (such as Visa or Mastercard). Adequate interchange fees must be rehabilitated in order to restore investment incentives and fair competition. ■

Innovations in retail payments and the role of central banks

Klaus Löber - Head of Secretariat, Committee on Payment and Settlement Systems, **Bank for International Settlements (BIS)**

The retail payments market is undergoing profound changes. A market that was dominated not so long ago by a small number of traditional payment instruments provided by financial institutions is now witnessing the emergence of many innovative solutions, based on new technologies and offered by new actors frequently coming from outside the traditional financial sector.

There are many reasons behind these changes. The availability of new technologies is, of course, the main precondition for many of these innovations, but there is also an increasing demand from the general public for secure, fast

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Market-based finance can help support growth

Peter Fisher - Senior Director, **BlackRock Investment Institute**

Europe faces several more years, and several trillion euros, of further deleveraging before the banking system will return to health. There are various estimates for the costs of new prudential standards for banks and of writing down asset values to more realistic levels. But whatever the costs turn out to be, there is a need to finance economic growth – a need that banks will struggle to fulfill.

To finance growth, it seems unlikely that Europe will pursue aggressively expansionary fiscal and monetary policies – like those being adopted by Japan. While the European Central Bank significantly expanded its balance sheet in response to the crisis, this process has already begun to reverse.

Fiscal targets will continue to be postponed, modestly loosening fiscal policy, but this process alone is unlikely to fill the funding gap.

In this setting, Europe should encourage non-bank financing channels – market-based finance – in order to help fill the funding gap for both public and private investment capital. Instead of treating market finance as an infection that might endanger your banking system, Europe should embrace capital markets and securitization as complementary to bank finance and as a means of recycling capital among European countries while your banking union is under construction.

These are your household, corporate and public savings – reflected in the assets of European investment funds, sovereign wealth funds, and central bank reserves. Do not discourage these sources of investment by lumping them together with shadow banking.

Rather, encourage them to provide the investment you need while your banking system is impaired, by fostering an attractive environment for non-bank sources of European savings to support growth. ■

Triple deleveraging and schizophrenic regulation

Eric Chaney - Chief Economist, **AXA**

The credit bubble that devastated the global economy when it burst in 2008 is casting a long shadow. Consumers are deleveraging their balance sheet, banks are shrinking assets to comply with tighter ratios and governments are tightening fiscal belts. Hit by this triple deleveraging, no wonder real economies are struggling. The sole albeit powerful stimulus is central banks inflating their own balance sheets to levels not seen since 1945.

This unpleasant reality begs three questions: Is it the right time for governments to cut debt? Are central banks not administering a medicine worse than the disease? How should banks and insurers react?

Starting with governments, it is fashionable to lambast austerity as self-defeating. In reality government debt is a counter-cyclical option when initially low, not when flirting with 100% GDP . Yet, if austerity is a sensible strategy, much depends on its implementation: cutting investment where it is low is as counterproductive as raising taxes where their burden is excessive.

Turning to central banks, quantitative policies are responsible for ultra-low bond yields and rich valuations in credit. This may sow the seeds for bubbles, but alternatives look worse: ending quantitative policies and hiking rates would trigger a bond sell-off and a double dip. Dangers will appear later, when money supply accelerates, if central banks do not deleverage their balance sheets on time. Inflation may then come back with a vengeance.

Banks and insurers must therefore adapt to low interest rates and a significant risk of inflation in the medium term. For long-term investors, investing in equities should be part of the solution. This is also what central bankers wish and what regulators implicitly stated when drawing the lessons of the debt bubble.

And yet, financial re-regulation makes investment in equities so costly in capital that this option is almost dead. Isn't this a blatant contradiction and an obstacle to global recovery? ■

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and convenient payment instruments that adapt to new commercial needs and channels. In emerging economies, some innovations bring about the possibility to offer payment services to large sectors of the population that are either unbanked or underbanked.

From a regulatory perspective, the introduction of innovations is a challenge for central banks and other regulators, as a delicate balance has to be found in order to increase the market efficiency and improve competence in a level playing field, while simultaneously ensuring the security of new developments.

In this rapidly changing environment, an important question that is increasingly being asked is what should be the role of central banks. A first challenge in this new environment, and not the least, is to monitor and keep abreast of the new services and technologies. Central banks should also review whether their oversight frameworks are adapted to the new and emerging landscape.

The role of central banks can also be important to promote standardisation and interoperability of new initiatives, and to foster an effective communication policy that enhances transparency and provides guidance to the market. ■

Navigating the straits between abrupt deleveraging and moral hazard

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

Monetary policy makers in the euro area – and in the EU more broadly – have reacted resolutely to the crisis by reducing interest rates to historically low levels and engaging in non-standard monetary policy measures. This helped prevent an abrupt deleveraging that was threatening to take hold of the economy. The high level of private and public debt with which some EU economies entered the crisis was exerting pressure to deleverage. If left unchecked, this pressure could have triggered a destructive and self-reinforcing downward spiral of asset fire sales and contraction, potentially compromising our price stability objective.

Maintaining these very supportive policies for too long can, however, also have undesirable side-effects. In the long-run, a misdirection of resources will undermine the growth potential of our economies. It is therefore of utmost importance that economic actors beyond the monetary policy domain – both in public policy and in the business arena – continue addressing the underlying structural weaknesses that are affecting our economies. Concretely, this implies (i) further strengthening structural reform efforts, (ii) making rapid progress towards the appropriate institutional environment for stable and integrated financial markets with the establishment of the Single Supervisory Mechanism and Single Resolution Mechanism, and (iii) emphasising the responsibility of the financial industry itself to resolve the structural balance sheet problems in the euro area banking sector.

For financial institutions, this predicament has important implications. Only structural balance sheet repair can sustainably restore banks' lending capacity to the real economy. Authorities entrusted with micro and macro-prudential oversights need to be attentive. ■

The unintended consequences on bank intermediation of durably low interest rates

Olivier Garnier - Group Chief Economist, **Société Générale**

The conventional wisdom is that when interest rates are close to zero, they can only go higher. Thus, much of the current attention is focused on the risk of a sudden rise in interest rates when central banks start exiting from unconventional policies. However, the Japanese experience shows that both short and long risk-free rates can stay very low for a protracted period of time. And, as far as the eurozone is concerned, our view is that the latter scenario deserves at least as much consideration as the former.

The challenges posed to pension funds and insurance companies by durably low interest rates are well known. But even in the Eurozone, where bank intermediation dominates, a prolonged period of ultra low and flat yield curves could ultimately have very distortive effects. Indeed, while such an environment might entice institutional investors to take excessive risk in order to meet their obligations, it might have the opposite impact on bank lending behaviour.

First, banks' net interest margins (loan-to-deposit rate spreads) would be squeezed out. Second, money market activity would be seized up as money market funds would be driven out of business and banks prefer to accumulate excess deposits at the central bank instead of lending their liquidity for a negligible return. The outcome would be a retrenchment of bank intermediation, at the expense of SMEs which do not access security markets. At the same time, desperate yield-hunting investors could create bubbles in some segments of direct market finance.

Moreover, instead of mitigating these unintended consequences of durably low interest rates, the new regulatory standards may exacerbate them by pushing banks to borrow longer and lend shorter, and by denting further the RoE of lending activity. ■

It is not time to further deleveraging, but rather "derisking"

Jacques de Larosière - President, **EUROFI**

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According to the IMF, in European economies in or on track for a recession, which are three-quarters financed through banking intermediation, while markets finance three quarters of the American economy, deleveraging could reduce the output by almost 1.5%, whereas it would hit US output for 0.5%. The IMF estimates that, in 2012 and 2013, this trend will be particularly marked in the European countries under pressure, where it could cut down almost 7% of GDP (from 2011).

In addition, policymakers must be aware that the markets cannot provide all the financings they impose to banks. For example the introduction of the Net Stable Funding Ratio, would require European banks to tap the markets of an estimated €1.300 billion of additional long-term resources[1].

Capital increases are already proving difficult and deleveraging is translating into a reduction in credit and weaker growth. It may be desirable to reduce the role of banking intermediation in Europe. But in view of the many dangers on the horizon and provided that Basel 3 will be implemented in Europe from 2013 whereas the regulators, in their wisdom, had set a phasing in period through to 2019, we believe that the time has come to make a pause before envisaging additional banking regulations (structural reforms, financial transaction tax, etc.). What is important at this stage is to focus very carefully on the quality of the risks of financial institutions.

A number of initiatives are working towards this: harmonisation of RWAs and monitoring of risk at European level with a single supervisor (Banking Union), improving asset valuations and provisioning quality. In that respect forbearance practices require particular attention and the delay with globally defining consistent forward-looking accounting standards for provisioning impairs banks' credibility. The macro prudential oversight, the lack of which has been highlighted by the Subprime, the Spanish, the Irish etc. real-estate asset bubbles, also deserves more focus at the EU and global levels.

It is not time to further deleveraging, but rather "derisking". ■

1. Basel III Monitoring exercise – EBA – March 2013

Solvency II current architecture amplifies negative impact of low interest rates

Denis Duverne - Director and Deputy Chief Executive Officer, **AXA**

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In some markets, over the long term they may lead to a negative gap between asset yield and guaranteed liabilities. This is not the case in France, due to the low average guaranteed interest rate, but what has happened in the previous decades in Japan and Switzerland may happen in the future in Europe.

Large insurance groups have strived to adapt to this new situation. Appropriate Asset Liability Management has led to a lengthening of asset durations in line with the lengthening of the duration of liabilities triggered by the decline of interest rates.

Products have been redesigned with lower options and guarantees, crediting rate adjustment and changes in surrender features.Diversification away from general account savings products into unit-linked and structured products has also helped. Finally, the growth of protection and health products has further improved this diversification.

In its current design, Solvency II amplifies the impact of the low interest rates environment on insurance companies' earnings and balance sheets. Solvency II values assets at Marked to Market (MtoM) and liabilities at market consistent economic value (MCEV), where swap rates are used to discount liabilities.

The increase in the discounted value of liabilities is much larger than the gain on fixed income assets due to the impact of market spreads widening on asset valuation. Therefore, embedding effective counter-cyclical tools in Solvency II final format is necessary. It will not remove all consequences for insurers of the low interest rate environment. But it will smooth the procyclical effects of Solvency II.

Insurance companies did their homework and mitigated the impact of low interest rates. It is now up to regulators and supervisors to deliver the appropriate prudential framework in the final phase of Solvency II negotiations.

It will allow the insurance sector to maintain its dual role as a provider of long-term savings and retirement solutions and as a long-term investor in the European economy. ■

The need for a coordinated response to the current low interest rate environment

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


Credit photo : EIOPA Frankfurt am Main

Persistent low interest rates affect insurers in different ways. On the liabilities side, they lead to an increase in firms' obligations in today's terms and, consequently, to a deterioration of their financial position. On the assets side, low interest rates have an adverse impact on investment results and increase the reinvestment risk of assets. This problem is even more pronounced where guaranteed rates of returns have been offered to policyholders.

The accounting methodology used, be it market valuation or historic cost accounting, does not change the underlying challenge, but has an impact on the relative speed at which the impact of a prolonged period of low interest rates would become visible. In a risk-based prudential regime like Solvency II, which uses market values, the impact would be more transparent. This is why it is important that insurers do not store up risks that may crystalize suddenly with the implementation of Solvency II. EIOPA believes that any delay in the full implementation of Solvency II should be used as a window for national competent authorities (NCAs) and insurers to deal with the issue.

Unsustainable business models, in particular, should face challenges from supervisors at an early stage and it is expected that insurance undertakings should be encouraged to resolve their own problems. National competent authorities should actively engage with insurance undertakings in exploring private sector measures to address the risks raised by a prolonged period of low interest rates. They should take into consideration the maintenance of the stability of firms and policyholder interests in this engagement. National supervisory authorities should explore with insurance undertakings measures to improve undertakings' own financial resilience. This is especially important in relation to "in force" business, where measures such as increased reserving are likely to be the only options.

EIOPA highlighted the potential solvency risks arising from this situation in its stress-test of 2011 and in the Risk Dashboard at the end of 2012. The Authority believes that it is crucial to have in place joint actions against a long-lasting low interest rate environment. Against this background, EIOPA issued an Opinion on Supervisory Response to a Prolonged Low Interest Rate Environment. In this Opinion we recommend a coordinated supervisory response to the long-lasting low interest rates that goes along the following lines:

First, NCAs should intensify the monitoring and supervision of insurance undertakings identified as having greater exposure to the risks posed by a low interest rate environment. This should follow a clear escalation of supervisory activity dependent on the situation of the individual firm being considered.

Second, NCAs should actively assess the potential scope and scale of the risks arising from low interest rates in their national markets and report their findings back to EIOPA.

Third, EIOPA will coordinate a further exercise to quantify the scale and scope of the risks arising from such an environment.

By coordinating these actions, EIOPA is committed to ensure a consistent supervisory approach and a fair and equitable treatment to policyholders. In this regard, it should be stressed that private sector solutions are fundamental, but they cannot take advantage of the information asymmetry and must be designed in a way that does not mislead policyholders. ■

Keeping the momentum towards Solvency II

Danièle Nouy - Secretary General, **Autorité de contrôle prudentiel (ACP)**

Solvency II represents a major overhaul for insurance regulation in Europe. It is therefore not surprising that the development of such an ambitious project takes time. The "Long Term Guarantee" Assessment (LTGA) that is currently carried out across Europe will bring additional and concrete elements to discussions on the Omnibus 2 Directive, which aims at improving quantitative aspects of the new supervisory framework. This should help determine whether implementing various adjustments to valuation principles is a relevant solution, or whether it just makes Solvency II more complex and less transparent, whereas simpler tools may be available to reduce the impact of market volatility.

Yet, these remaining uncertainties do not mean that we cannot move ahead on other key elements of Solvency II, and that efforts made by undertakings and supervisors to prepare to this new regime are useless. Solvency II is not just its pillar 1 (quantitative requirements): its risk-based approach also relies heavily on its pillars 2 (governance and ORSA) and 3 (reporting), which are today largely stabilized.

This is why I strongly support EIOPA's proposal for guidelines on requirements for the preparation of undertakings and supervisors to the 2nd and 3rd pillars of Solvency II, starting from 2014. It will help bring about further improvements in internal organization, risk management and data quality that are not just regulatory constraints, but are highly beneficial to undertakings. It is essential to prepare to Solvency II in a common way, while also enabling to take into account the level of preparedness of each national market. ■

Solvency II - Stay prepared!

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

From a sarcastic point of view, some might say that Solvency II starts to resemble the famous theatre play 'Waiting for Godot'. From a political and a regulatory point of view, there is no waiting, but more time to prepare for the right, crisis-adjusted solutions in the future European framework for insurance and reinsurance regulation. It is now EIOPA's duty to conduct an assessment on long-term guarantees in the life sector and, in particular, to provide strong supervisory advice on those measures that are being discussed most controversially among co-legislators and stakeholders.

As rapporteur on the Omnibus II Directive, I initiated the EIOPA study on an ex-ante basis to ensure that decisions on the treatment of long-term guarantees will be taken under full democratic scrutiny at the level of the framework directive. Based on EIOPA's final report, the co-legislators intend to resume negotiations on the outstanding topics as quickly as possible. It is our goal to conclude Omnibus II within the present term of the European Parliament.

If Solvency II now came into effect in its original shape, the effects on the industry and the markets would be immense, given the extraordinarily high market volatilities and the low interest rate environment. More reflection is certainly useful. At the same time, we should try to prevent a 'patchwork of laws' situation, where Member States start to implement a light regime of Solvency II including specifications that are primarily nationally driven.

An increase of fragmentation will only be to the detriment of European undertakings. A coordinated and constructive European approach in the preparation and implementation of Solvency II is in our best interest. There shall be continuous progress towards a timely application of Solvency II. I am confident that a saying will deem to be true in the end: "Good things come to those who prepare". ■

Low interest rate environment – Challenges for long-term investors

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


Credit photo : Schafgans DGPh BaFin

The yields on high-quality fixed-interest securities have been very low for some time now. The sovereign debt crisis and also the European Central Bank's liquidity facilities are exacerbating the problem. We are having to deal with the notorious two sides of the same coin. For highly-indebted countries and also for credit institutions battered by the financial crisis the policy of cheap money may be a sensible, if not even essential, expedient – in order to buy time. But for long-term investors – especially insurers and pension funds – it is a threat.

Does Solvency II provide the right regulatory answers when interest rates are low? Clearly, a risk-based system provides the right answers in principle. The rule-book provides for market-consistent valuation of assets and liabilities. This implies that financial guarantees and policyholder options entered into force will have to be explicitly taken into account when valuing technical provisions in future. This will render their value transparent, which is a good thing.

However, economic reality could be overstated by adopting this approach; market-based systems are fundamentally pro cyclical. There is therefore a danger that Solvency II and the proposed accounting standards will penalise long-term contractual relationships. By now, though, a number of instruments that are intended to prevent that have been mooted. Their suitability and any potential side effects are currently being tested in an impact assessment. That's good, for only with a suitable long-term guarantee package can Solvency II ensure an appropriate, risk-oriented capital base in future.

Solvency II goes beyond Pillar I. The requirements of Pillar II, and in particular the Own Risk and Solvency Assessment (ORSA), will contribute significantly to preparing the insurance industry for the future. The ORSA will, for example, require insurers, as part of their planning, to adopt a multi-year perspective when calculating the amount of capital they need to hold. This will make the consequences their strategic decisions have on the amount of capital needed transparent ex ante. That is one of the reasons why BaFin promotes early introduction of the ORSA ahead of the implementation of Solvency II.

Last but not least, Solvency II describes but doesn't resolve the challenge posed by an ongoing low interest environment. It is the insurers themselves who must work towards a solution, supported by prudential supervisory measures and possibly selective regulatory changes. ■

Next steps in insurance regulation

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

It is a matter of consensus that the insurance sector urgently needs a modernised prudential and supervisory framework based on a realistic evaluation of risks. That is why the "Solvency 2" initiative was conceived, ten years ago now, with the full support of stakeholders, including the insurance sector. The Solvency 2 directive was adopted by Council and Parliament in 2009.

Since then, asset values have continued to fall, and low interest rates are endemic in certain (but by no means all) parts of the EU. This is a challenging environment for insurers and supervisors, but it is also precisely the kind of situation which a modernised risk-based supervisory regime should be able to deal with.

However, we want to make sure that risks are correctly evaluated under the new regime with no "artificial volatility" on insurers' balance sheets, recognising situations where insurers' assets and liabilities are closely matched and where assets are held to their maturity. This would also favour long-term investment, in line with the Commission's Green Paper on this subject of 25 March 2013.

Discussions on these matters are taking place in Council and Parliament in the context of another piece of legislation (confusingly known as "Omnibus 2"). The European Authority for Insurance and Occupational Pensions is assisting by carrying out a technical assessment of various possible mechanisms to deal with the issues linked to insurance products with long-term guarantees. The results of this study are expected in June, following which we expect discussions at political level to start up again, with a positive will on all sides to compromise and achieve an agreement.

As for the date of application of Solvency 2, this is currently set at 1 January 2014, and this upcoming deadline should concentrate minds and facilitate an agreement. ■

Solvency II – quick introduction, but resolve problems first

Dieter Wemmer - Member of the Board of Management and Chief Financial Officer, **Allianz SE**

Sound risk management is the sine qua non for sheltering insurers and their clients against any kind of risks, be it inherent to the business, products or markets. Therefore, it is of utmost importance to get Solvency II ready as quick as possible, and in the right way.

The delays in Solvency II now provide the unique chance to clarify issues and if necessary also change the so far envisaged regulation. From my point of view, the following areas need still further amendments.

Capital requirements for some kinds of assets need to be reworked. This holds true not only for sovereign debt with its current zero rating, but even more so for equity and all long-term investments. It is key that inherent risks are appropriately dealt with, but investments must not be too restricted if they are long-term and well diversified. On the other side, we reject any politically or economically desirable requirements.

The necessity to find a solution for long term guarantees is evident and we hope that the testing exercise leads to reaching more transparency and final conclusions there, taking differing products in the prevailing markets into account. There is no time for finding new concepts; therefore the solution should be based on the elements tested in the long term guarantee impact assessment. The problem of group solvency is not yet adequately resolved. We still lack clarity around fungibility and transferability of excess capital. In order to make an insurance group even more resilient to crises, it should be assured that any excess capital can be hold on the ultimate parent's company level. Only this possibility ensures that capital can be provided to any subsidiary in the group that may need additional capital at short notice, and this without any restrictions.

Of course, the best solvency rules cannot prevent companies from further developing their business models, products and strategies. In particular, insurers will have to change their product landscape towards products that (at least partly) transfer risks of their long term guarantee products to their policy holders. In addition, prices for long term guarantee products might increase. It will be the crucial task for politics and regulators to find a balance between calculating adequate capital requirements and affordable old age provisioning. It remains to be hoped that the current market environment comes back to normal, with less volatile markets and not artificially low interest yields. Only in a stable environment all industries can thrive and prosper, to the advantage of all customers and the whole economy. ■

In tough times, the sooner the better for Solvency II

Yann Le Pallec - Executive Managing Director, **Standard & Poor's Rating Services, EMEA**

The prospect of a prolonged period of low interest rates in the EU and fragile economies across the region are negative rating factors for several insurance companies. Uncertain and evolving regulations only serve to further reduce investor confidence in the sector because the impact of the economy and outcome of Solvency II on insurers are linked.

Insurance companies most exposed to low interest rates and weak economic growth are life companies that provide guaranteed returns to policyholders. Many of these companies have been downgraded recently or carry negative rating outlooks.

Though delayed, Solvency II is still needed. Solvency I is virtually devoid of incentives for good risk management and lacks capital requirements for asset risk. Its shortcomings are evidenced by the diverse forbearance measures currently in use. Continuing uncertainty over the future regulations affects important restructuring of business models or investment decisions.

The current monetary and economic context and adoption of Solvency II (specifically the proposed assumptions to be used for liability discount rates) are linked in two ways. The EC has asked EIOPA to study the continued availability and affordability of products containing long term guarantees, and the future investing behaviour of insurers affecting the financing of infrastructure projects, securitisations, SMEs, etc. These regulatory topics are deeply intertwined with the prospects for the European economy. For this reason, further significant changes in the Solvency II are likely to result, and pragmatism is likely to prevail over principles. In the meantime, we commend EIOPA for its efforts of to maintain momentum in the Solvency II project through the interim measures it announced in December 2012. ■

Insurers' perspective on low interest rates and potential sharp rises in interest rates

Philippe Brahin - Head Governmental Affairs & Sustainability, **Swiss Reinsurance Company**

While the current low level of interest rates is meant to facilitate economic recovery as well as aid the de-leveraging process, there are also unintended consequences, particularly over the long run: creation of asset bubbles, overheating in emerging markets, uncompetitive companies kept alive and a shift in focus away from addressing structural reforms.

Low interest rates constitute a transfer from savers to borrowers. This is especially the case now with real interest rates negative in most markets. Insurers, particularly life insurers, and pension funds are institutional investors that suffer from low yields.

Some 12% of global financial assets are managed and invested by the insurance industry. A reduction of one percentage point in interest rates ultimately results in lost investment income of about USD 255 billion per year for insurers.

Low interest rates in a low growth environment lead to lower returns for asset classes, thus leading to additional pressure on profitability. However insurers do not generally react to low interest rates by shifting their asset allocation towards more risky assets, as these usually require more capital. Also, insurers have very long-term liabilities, thus they need long-duration assets.

If the economy recovered more quickly than expected and the tightening of monetary policy came too slowly, we could experience a sharp rise in both government bond yields and inflation. Such a scenario would be a problem for insurers, particularly for those with large savings books and/or casualty books.

The accounting frameworks also lead to a distorted view of the impact of interest rate changes. While assets are accounted at market prices, liabilities are often accounted at book value. Spare equity capital would largely disappear as interest rates rise.

Policymakers need to maintain their attention on the implications to investors of interest rate volatility. Given the current record low interest

rates and the decline of the "tail-risks" from the EU debt crisis, interest rates could now spike upward, creating serious problems for long-term investors. ■

New challenges for European insurance companies

Frédéric Lavenir - Chief Executive Officer, **CNP Assurances**

Europe is the first insurance market in the world. Approximately 5,000 insurers hold 45% of the overall institutional market (about 9,000 billion euro). Current low interest rates reduce the attractiveness of life insurance products in euro, reduce margins and affect companies holding important volumes of guaranteed rate contracts.

The impending roll-out of Solvency II and Basel III implies at least maintaining and possibly increasing capital. Amidst a sluggish economic environment, insurers have solid and perennial assets: a healthy business model resting on strong fundamentals, well identified risks, as well as a culture of prudential management.

Powerful and durable development of the activity rests on the increasing need for protection of private individuals, companies and institutions, the financing of retirement benefits, and on the new financial needs of an ageing population. Most of the European States are engaged in a reduction of their social welfare spending and this creates opportunities for insurers to provide new products and services.

Profitability can be recovered by a reengineering of the guaranteed rate products, an emphasis on euro diversified contracts and, in line with Solvency II, a diversification towards risk products, which are less affected by low interest rates. Life insurers need to increase their investments in long duration assets.

On the marketing side, rethinking of distribution models and product ranges in a digital and direct-access perspective will generate opportunities for competitive advantages and increase of customer value.

Other insurance opportunities lie in health insurance and dependent care insurance which have a bright future and a strong social utility, particularly if they know how to take advantage of technologies like telemedicine.

Organisations have to adapt, companies have to reduce their running costs, while retaining skills and strengthening corporate culture likely to foster creativity and innovation. ■

European public banks: new actors in the EU economic and industrial policy framework?

Franco Bassanini - Chairman, **Cassa Depositi e Prestiti SpA**

Europe is not investing enough in its future growth, notably in key areas such as SMEs, infrastructure and innovation. Private banks are either unwilling or unable to provide the necessary long-term finance, and national budgets for capital expenditures are heavily reduced. The transition to a more capital market (hybrid) based financial system in Europe will take time before it reaches the necessary magnitude.

In this context, national development banks (NDB) have a crucial role to play. The change is already on the way. Common long-term new financial instruments have been designed by NDBs together with the EIB (with endorsement of the EU); additional resources have been mobilized to support the economy during the crisis, by financing infrastructure and SMEs, either directly or through the banking system; new European and domestic long-term equity funds have been launched to invest in infrastructure projects and strengthen company capitalization; and similar new large common debt and/or guarantees funds for PF initiatives may be created.

Thus, the challenge of NDBs and European banks, that foster growth and investment, must be at the top of the European Agenda. This means a partial paradigm shift in the EU economic policy framework. NDBs become new instruments of the EU exit strategy from the crisis. But what about competition and state aid policies, since they enjoy state guarantees and special financing conditions? Our answer is that NDBs must be "complementary" and not in "competition" with private banks; they are "catalysers" of private national and international investments (thanks to their reputation and high technical skills in financing long term); they are able to consider risks and durations that, at the moment, the market is not able to take; they must be "market conform" and play a subsidiary role in times where banks are not providing the necessary financing to the economy. So they may become stable actors in the European financial system that will emerge in the post-crisis phase. ■

Infrastructure is essentially a partnership story

Benjamin Sirgue - Global Head of Aircraft, Export & Infrastructure Finance, **Natixis**

Infrastructure projects emerge when several parties (public grantor, contractor, operator, off-taker) decide to enter into a long-term partnership agreement between themselves to deliver an essential asset for the community. 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 overtime regularly reassessed to reflect the performance of those transactions. This knowledge is key to the existence of infrastructure debt which is not otherwise readily available.

Institutional investors such as insurance companies are looking for duration to match invested assets and policyholder liabilities. Infrastructure assets meet this objective while offering an enhanced yield. The question is therefore what the best combination of the banks skills with the involvement of institutional investors in the infrastructure debt market is.

In our view, partnership, which is the essence of infrastructure, should extend to the relations between banks and institutional investors willing to finance infrastructure. Indeed, this solution, like the one Natixis successfully put in place with Ageas in 2012, allows the investors to benefit from the origination and structuring skills of the banks without losing the final say on the investment decision. The investors are also benefiting from the banks' servicing and portfolio management skills during the life of the loan relying on a strong alignment of interest, as the bank commits to hold a part alongside the investor.

One of the critical needs for partnerships to materialize is the need for transparency. We need more transparency from public entities on their future pipeline of transactions at the European level. We also need more transparency by loan providers in the performance of the debt instruments in order for the insurance and pension fund regulators to properly calibrate the capital charge for infrastructure debt investments. More transparency is also needed on pricing of transactions post-closing, allowing the constitution of publicly available benchmarks that are needed for valuation of loans by investors and for the pricing of European project bonds similarly with what makes the Canadian project bond market successful and efficient.

With regards to regulatory priorities, it is essential that European authorities reassure the legal and fiscal certainty of long term partnerships in Europe, including through the development of a pan-European public-private infrastructure partnership model. Partnership is a long run and requires education and flexibility. That is why Natixis decided to endow a 3-year research program on infrastructure debt characteristics with EDHEC Risk Institute, which has recently released a first paper on portfolio construction with infrastructure debt. ■

Addressing the investment challenge in European infrastructures

Jean-Pierre Jouyet
Chief Executive Officer, **Caisse des Dépôts et Consignations (CDC)**

Promoting a sustainable growth in Europe relies significantly on a pan-European investment policy in economic infrastructures. The most recent EC estimates indicate a total requirement of over 1,500 trillion euro until 2020, ranging from transports to energy networks.

In the current economic context, the main issue is to address the contradiction between the long term returns of economic infrastructures and the scarcity of public and private financing. Member states' budgets are heavily constrained by their debt and deficit levels, at a time when private financing faces difficulties in providing long term credit. There is a broad consensus on the role of public financing as a means to bring back private sector investments in infrastructures. But in order to maximize the leverage effect of public budgets, public banks should complement EU initiatives and address the current market failures through new financing instruments.

The deepness of the infrastructure financing market could be enhanced by channelling long term savings. The prerequisites would be to mitigate project risks, in order to allow for regular cash flow grade investments. Together with EU funding, public banks would manage the risks that the market cannot take, through dedicated funds or project bonds. These instruments will have to address Greenfield as well as Brownfield and big as well as middle-sized projects, all across the EU 27. Thus, the challenge faced by public banks is to design complementary initiatives, avoiding overlaps and competition between them. Furthermore, these new financing instruments should take on board private investors at the earliest possible stage.

These requirements are quite demanding, but should they be met, these initiatives would address the current failures of the infrastructure market in Europe. Caisse des Dépôts and the other European members of the Long Term Investors' Club are currently working with the European Commission on this crucial issue. ■

Supporting the financing of long-term investment in Europe

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

On its way towards smart, sustainable and inclusive growth, the EU economy needs large-scale long-term investment. The financial crisis has not only reduced the capacity of governments to finance public investment, but has also probably affected the ability of the financial sector to provide enough financing for productive long-term investment projects. As banks are undergoing a necessary deleveraging and adapting to new regulatory requirements, one question is whether Europe's dependence on bank financing will give way to greater direct capital market financing.

Aiming at a broad policy response, the European Commission has recently released a Green Paper to determine what can be done to overcome barriers to long-term financing while preserving financial stability. A range of issues are being put up for discussion, including the impact of the calibration of the regulatory framework on the capacity and incentives of financial institutions to undertake maturity transformation, the efficiency and effectiveness of financial markets in offering long-term financing instruments, as well as corporate governance, accounting and taxation issues. A follow up action plan will be proposed still this year.

The Commission also supports joint public-private long-term investment more directly via financial instruments. They use a limited amount of EU budget funds to share risk with the EIB and national development institutions so as to unlock greater volumes of private finance. A good example is the Project Bond Initiative that aims at credit-enhancing infrastructure PPPs so as to make bond financing by institutional investors possible. Other similar risk sharing instruments focus on the financing of innovation. The Commission will considerably expand the use of such instruments during 2014-2020, both at EU level and at the level of structural funds. ■

Supporting long-term financing and the role of the EIB

Ben Knapen - Permanent Representative in Brussels, **European Investment Bank (EIB)**

The financial crisis has pushed financial stability to the top of the regulatory agenda. In doing so, there is a risk that undue difficulties are imposed on the financing of long-term investment, possibly reducing medium-term growth potential. The Commission's Green Book recognises this issue and should help achieve an acceptable balance between financial stability and growth.

A key principle is that diversity among financial institutions (banks, insurers, asset managers, pension funds, long-term public financiers) needs to be recognised, and that the financial architecture should be organised in such a way that roles and tasks are allocated according to the respective comparative advantage of the broad classes of actors. This is the best way to ensure that the limited resources we have are put to best use.

The EIB is increasing its direct financing for long-term investment in infrastructure, innovation, SME and climate change. Beyond its own lending, EIB is supporting the transition towards a more capital market based financing architecture. Firstly, we are increasing technical assistance to support policies and projects in order to improve their quality, but also to make them easier to finance in the capital market. Secondly, as many capital market investors do not yet have the credit analysis capacity to carry out an in-depth assessment of infrastructure projects, the EIB, in partnership with the European Commission, is introducing the project bond initiative which, by providing credit enhancement to project companies, stimulates capital market financing for strategic large-scale infrastructure projects. Thirdly, in view of its experience and track record, the EIB is striving to increase as far as possible the Bank's catalytic role and ability to federate co-financing with other financiers, notably through the Club of Long-Term Investors. ■

Infrastructure - a road to recovery?

Spencer Lake - Co-Head of Global Markets, **HSBC Bank plc**

Infrastructure represents a major opportunity for the European economy with well-documented proposals for new networks for transport, energy and communications that, if delivered, would provide a short-term boost to growth and a longer-term boost to efficiency and competitiveness.

To meet this challenge, EU Member States are developing their plans for infrastructure and taking steps to increase capacity to fund and build designated projects. While this is to be welcomed, we also need to find the right EU dimension, and, more specifically, to decide what should be done at the centre to "industrialise" Europe's market for infrastructure. The recent European Commission Green Paper on Long-Term Investment is an important initiative towards creating a fresh approach and an agreed agenda for the future.

This is particularly important as recent financial regulations have disrupted traditional models of funding with banks deleveraging and focusing more on relatively liquid and observable products. In this new environment, Europe needs to engage with the investor community to increase the levels of assets allocated to alternative investments and towards infrastructure. We calculate that increasing the global percentage of investment allocated to infrastructure by pension funds, insurance funds, mutual funds, sovereign wealth funds and private equity would generate €1.7 trillion of additional capital – enough to meet Europe's needs for transport and energy combined. But it is important also to note that over 80% of pension assets and almost 70% of insurance assets are outside Europe. Other regions have their own demands for infrastructure and proposals to attract new sources of investment. In Europe we need to raise our game to avoid missing out.

The priorities are to maximise efficiency and demonstrate greater deliverability with a better pipeline of projects, to decide what levels of credit enhancement will be needed in order to create a more attractive proposition to a wider pool of investors and to develop more bank / bond hybrid structures to facilitate participation by investors who want to avoid construction risk. Some of this is in the hands of the authorities – for example to open up procurement to bank / bond solutions and to ensure that the related capital charges are not punitive in their impact. The remainder is up to the private sector to deliver more market-based model of finance. In this way, we can put Europe firmly on the road to recovery. ■

Looking forward: insurance role in promoting sustainable growth

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

The financial crisis has shown us that if growth is not sustainable, it brings problems. Speculation, leverage, greed etc. triggered unsustainable growth and led us into today's scenario. If we look back, it was not insurance originated. Looking forward, insurance is committed to being part of the solution. In order to understand how, we need to consider both the nature of the business and its regulatory framework.

Insurance business is about fulfilling promises to policyholders, in many cases long term ones. The promises to be made and how to ensure they are fulfilled is up to the undertaking's own strategy and risk management. Solvency II is soon to become the regulatory framework in Europe. It is a risk based system that incentivises sound risk management both on the asset and liability side, encouraging ALM and fostering firstly consumer protection, but also financial stability.

How do these two elements interact? They do it naturally, as Solvency II encourages the so-called prudent person approach to investments, and incentivises well-diversified portfolios. It will address short-term volatility appropriately by considering the long term reality of the business, thus encouraging insurers to cover long term promises with different long term assets as part of their strategy. And it will do it in a neutral way, by treating all risks according to their risk profile.

A final reflection: let's all avoid shortcuts. Insurance is a business, and decisions should not be driven by regulation, but by strategy and opportunities. Insurers will invest in long term assets they can understand, and where the risk/return ratio and cash flows make sense to them. The good news is that such assets exist and, by purchasing them, insurers will contribute to growth in Europe. ■

Infrastructure investments: long-term investors' role should be strengthened

Jérôme Haegeli - Managing Director, Head of Investment Strategy, **Swiss Reinsurance Company**

The insurance sector, like other long-term investors, exercises a market stabilizing role and provides risk capital to the real economy with a growth-enhancing effect. In today's world, characterized by moderate growth and widespread deleveraging across the banking and public sectors, supporting long-term investment is crucial.
Key, among growth enhancing investments, is infrastructure financing. However, the current market structure and regulatory environment are not fully supportive. Industry reports underline these specific issues: last year the OECD found that the financing of future infrastructure investments is at stake. Moreover, the latest Group of Thirty report on long-term financing and economic growth, pointed out that the demand for long-term financing is outpacing supply.

In order to utilize the full potential of the insurance sector as long-term investors, changes to the market infrastructure and regulatory framework need to be considered. In Europe, for example, the industry is concerned that the calibration of Solvency II standard formula may penalize long-term investments, irrespective of the asset classes' inherent default characteristics. Furthermore, having a common legal framework for infrastructure bonds and loans across European member states would help harmonize the markets and avoid market fragmentation.

Undoubtedly, there are many valid approaches to foster a stronger Europe. With so many challenges, the biggest risk is inaction and not facing up to the economic reality. Without adapting the regulatory framework, it is hard to see how the gap between the demand and supply of long-term financing can be narrowed. Looking ahead, it is therefore essential that regulatory developments do not make long-term investors "short-sighted", but continue to promote their role as contributors to stability and growth. ■

How financial institutions could ensure infrastructure investment needs

Philippe Wahl - Chief Executive Officer, **La Banque Postale**

The effects of the financial crisis and the major regulatory overhaul that has resulted have triggered a profound change in terms of infrastructure financing and, more generally, in the long-term financing of the economy. The role of both historical players in infrastructure funding financing is shrinking. States, constrained by the goals of deficit reduction, are reducing their contribution, while the banking sector, hit by the prudential reforms on capital and liquidity, is taking strong measures of deleveraging.

This has fostered the emergence of new long-term investors, such as insurance companies or funds, which seek to target long-term investments, as well as the opportunity to enhance risk diversification. While this mix of investors has increased the overall capacity of financing, it cannot totally replace the role of banks, whose job is to manage risk over time. Outstanding loans are in fact living risks that require high expertise in risk assessment at the origination, as well as a strong monitoring of risk evolution over time. As a matter of fact, the lack in such monitoring is one of the factors that led to the 2008 credit crisis.

The role of banks and other institutional investors in the long term should therefore be contemplated as complementary and not exclusive, and the regulatory framework should ensure this complementarity. Regulation should also be consistent with the long-term vision necessary for these investors. Volatility induced by certain rules, including accounting standards, is hardly compatible with the particularly long-term duration of these investments. The regulatory environment itself has recently fluctuated widely and should be stabilized to provide a steady framework suitable for such long-term horizon. ■

Take off the brakes of European long term investors' appetite for infrastructure!

Martina Baumgaertel - Head of Group Regulatory Policy, **Allianz SE**

Long term investment is crucial in order to improve and renew European infrastructure. While these investments have to reflect inherent risks properly, doubts are occasioned regarding the risk weights currently foreseen in respective regulation. In particular, we recommend considering more closely level playing field issues regarding capital charges, as they require more analysis and attention.

Finding an adequate result for long term guarantees under Solvency II would also be supportive for long term investments. The low risk segments of investments into stable infrastructure segments or renewable energies require the establishment of separate risk capital classes (debt/equity) in the Solvency II framework. With a risk capital charge of indiscriminately 49%, all investments into these assets are currently classified equally with private equity and hedge funds. As in the case of ordinary equities, 49% might result in misallocation of capital in the case of infrastructure debt.

It is also of utmost importance that long term investments can be adequately reflected in insurance companies' accounts. The newly introduced hold & sell strategy, leading to fair value through Other Comprehensive Income (OCI) with recycling, offers such opportunity, particularly if usable as an option. The accounting policy for equities, however, might still impact negatively on long-term investments in the form of equity, as gains/ losses go either always or never through P&L.

Regarding infrastructure, the following barriers need to be addressed urgently:

Legal certainty is key for long-term investments into infrastructure. Discussions about retroactive changes of compensations for electricity fed into grids or fees for transmission of energy which are led in certain Member States are clearly counterproductive for the objective to attract institutional investors.

The 'unbundling' provisions included in the European Gas and Electricity Directives from 2009 permit investments either in renewable energies or in the network only. This also holds for financial investors which do not reach market dominating positions when investing in these areas. Legal certainty for investors requires amendment of the European legal framework: case-by-case decisions by the Commission are not enough.

The European Commission's intention is very welcome to further investigate the potential of pooled investment vehicles, project bonds and a European public-private partnership framework. Allianz offers expertise to further develop these ideas. ■

Diversifying the financing of EU corporates and SMEs

Progressing non-bank financing of infrastructure, corporates and SMEs in the context of a changing role of banks

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

Given the current constraints on public finances and bank lending, it is critical to explore how non-bank financing of long-term investment in economic growth and employment across Europe can be increased. There are lessons to be learnt from good practice in the US, Canada and Australia where pension funds, insurers and mutual funds are active investors in the economy. New instruments and products will have to be developed to attract further capital market funding for Europe.

There is evidence that actors are starting to pursue innovative initiatives designed to attract and channel pools of fixed income towards long-term investment. These collaborative activities need to ramp up. There should be a greater emphasis on developing innovative EU financial instruments with sufficient capacity to leverage additional private funds. This will necessitate harmonisation of national bankruptcy laws and creating standardised and demand driven risk sharing instruments at the supra-national level.

Policy makers and industry need to explore avenues like a real pan-European municipal bonds market, so as to enable increased retail and institutional investment in infrastructure projects. The EU-EIB project bond initiative could be scaled up, though it must also adopt a more flexible approach to provide assistance for projects which may not have previously met their requirements in terms of issues such as project type or credit issues.

Funding for SMEs is also not working well now in the single market. It could be boosted through new securitisation instruments that could receive a European label and operate across national boundaries not just in one jurisdiction. Europe must be more ambitious and recognise that a key factor in building investor confidence is certainty about transaction flow and outcome. In an environment of unacceptably high unemployment rates, ultimately, Europe must now move beyond rhetoric and begin to take real effective action. ■

Insurance companies develop their investments in enterprises

Denis Duverne - Director and Deputy Chief Executive Officer, **AXA**

Enterprises' access to finance is key for the European economic growth. The financial crisis has significantly changed the regulatory and economic environment. Basel 3 requirements and deleveraging pressure have reduced banking capacity to lend to enterprises. While banking funding depends on maturity transformation and leverage, insurers hold long term and illiquid liabilities. They could play a stronger role to promote access to alternative sources of funding for enterprises on the debt and equity capital markets. They could contribute to significantly increase the financing capacity to cover corporate medium and long-term funding needs. Such evolutions are desirable: insurers would invest in medium-term loans with better yield and portfolio diversification, while enterprises would benefit from a new funding opportunity.

More involvement of the insurance sector will first depend on an effective cooperation and a fair split of risks and rewards between the banking and insurance sectors. Insurance companies will not substitute themselves to banks which have a fundamental role on the retail market of small enterprises short term and working capital funding needs. Banks will continue to play a major contribution in the small credit risk analysis. However, they can make easier insurance investments in SMEs by homogeneising and securitising individual loans. It will provide for the use of insurance statistical risk underwriting tools. This being said, insurance funds will be more oriented towards the funding of large and medium enterprises than small enterprises.

Provision of long term funding to enterprises is also subject to the removal of regulatory impediments. Current Solvency I and local insurance regulations like the asset admissibility constraints in some European jurisdictions (such as France, Spain or Italy) can significantly reduce the lending capacity to Enterprises. Further inconsistent regulatory and liquidity constraints across the European jurisdictions create geographical distortions. Liquidity constraints in UCITs and other regulated funds prevent from doing large amount of loans.

Solvency II's current regulatory capital charges deter insurance companies from holding corporate stocks and long-term bonds. They are penalizing investments which have a maturity longer than one year. They may be dissuasive for equity and medium or long-term debt with a maturity higher than 7 years. Moreover, regulatory capital charges are very heavy for non-investment grade or non-rated companies. Finally, unfavourable capital charges for securitized products penalize the economics of the transactions.

Enterprises debt and equity market making need to be strengthened. Insufficient liquidity, limited transactions, lack of regular quotation and standards may hinder their development. Finally, tax treatment of insurance long-term loans revenues to enterprises could be better harmonised (e.g. removal of withholding tax in some jurisdictions) or reviewed with specific incentives. ■

Time to take a proactive approach to reviving business lending

Roberto Nicastro - General Manager, **UniCredit**

Past failures in the global credit markets necessitate several regulatory changes. But Europe's business activity is stagnating. Regrettably, available financing to SMEs and large corporations is being limited. To start with, financial institutions are facing new challenges to fund in the wholesale markets, while stricter capital and liquidity requirements are imposed. It is increasingly hard to reconcile Basel III's capital requirements with the high cost of capital to European banks. While credit demand, especially for long-term financing, has been undercut by recession, there has been an uptick in demand from riskier borrowers. And SMEs face growing difficulties in furnishing lenders with adequate business projections.

The relief offered to SMEs by CRD IV, through lower risk-weighting for SME loans, is welcome. Yet, additional solutions are available to revive lending, with many of them depending on the banks as the main loan suppliers to SMEs. Government-sponsored risk-sharing or credit guarantee programs that foster trust in the functioning of the economy remain the chief instruments to promote lending to SMEs. In addition, it can also be useful to harmonize regulations that encourage cross-border SME networks and to incentivize training to upgrade financial and managerial competences.

Market-based instruments should also be considered and promoted, for instance the PCS initiative to standardize asset-backed securities, including SMEs loans, could prove to be an important platform, provided that a proper harmonization of rules that define adequate investment criteria for investors takes place at EU level. In any case,

the persistence of substantial credit spread differences within the eurozone remains a cardinal obstacle – especially for SMEs in so-called "peripheral" countries. Therefore, financial microeconomic intervention can help only in parallel with a secure, sound progress both in the EU's competitiveness and in the eurozone convergence. ■

Channelling vital financing to SMEs

Antonio J. Zoido - Chairman and Chief Executive Officer, **BME**

The deleveraging of financial institutions puts at risk the volume of financing available, in particular for SMEs. Also the latest surveys on SMEs' access to funding confirms that the number of companies forced to pay higher interest rates on credit has grown in the countries hardest hit by the financial crisis. Indeed, concerns about the lack of credit for this type of enterprise are at the heart of the global debate.

Therefore new funding methods that complement traditional bank credit must be promoted to finance SMEs.

Regulated markets stand out as offering one of the most compelling alternatives to achieve this objective but a range of incentives, as well as more flexible regulation, are needed to procure an initial positive impact and what could result in a culture change.

Alternative investment markets for growth companies, being shares market or fixed income may require tax and other incentives to attract investors.

Both types of markets are important for the purpose of boosting and improving funding of small and medium size companies.

Therefore, it is counterproductive to set obstacles to these funding mechanisms by creating new taxes, or restrictions on trades, which could impact negatively on the cost of capital, precisely at a time when capital is most needed by companies to finance themselves.

The Financial Transaction Tax (FTT) being contemplated in Europe is one of those obstacles. Trading volumes and market liquidity would be hurt if this tax was introduced. It would also be difficult to generalize its implementation across the board. The final outcome could be an increase in the cost of capital. The cost savings for issuers and investors that MiFID was intended to bring about to stimulate competition, would be offset by higher transaction costs implicit in the proposed FTT. ■

The role of government in developing corporate bond markets for SMEs

Per Callesen - Governor, **Danmarks Nationalbank**

While European corporates on aggregate have used debt capital markets more intensely in the aftermath of the crisis, developments diverge widely between countries, and most definitely between firms of different sizes.

Moving towards more differentiated and direct funding intermediation is generally sensible. Increased use of bond market funding for larger firms and growth in securitisation of SME bank credit have the potential to play parts in a longer term adjustment of the corporate funding markets, taking due account of lessons from the past.

National authorities will play a role in such process. Governments will need to set up an enabling legal environment for bond issuance and securitisation, where this does not exist. Supervisors will need to promote dialogue among market participants on how to secure efficient issuance procedures, and promote confidence by strictly monitoring developments. But for sustainability and soundness, funding products have to be market based.

It has been argued that limited state guarantees are necessary to establish the required track-record of such products. However, products including some form of state guarantee are fundamentally different from products without it. Guarantees would not remove real barriers to market developments, only the incentives

to find market based solutions. And guarantees would distort competition, as well as create contingent liabilities for the states.

Wider use of debt markets may help improve credit conditions for firms, especially small and medium sized ones. But at best, this will happen over time, and is unlikely to be a short term panacea. ■

Diversifying the financing of EU corporates and SMEs

Re-inventing the IPO landscape can enable future jobs growth in Europe

Deirdre Somers - Chief Executive, **Irish Stock Exchange**

Through the Financial Services Action Plan, Europe has spent 10 years integrating its financial markets with the objectives of achieving greater levels of efficiency, scale and competitiveness, with some success. However, equity markets don't exist for the sake of their own sake, or for the sake of the intermediaries within them. They exist to provide companies with access to capital and investors with valuable investment opportunities. So, when judged against this purpose, how well has Europe done?

MiFID sought to create greater transparency and competition among trading venues. The drive for scale, efficiency and competition benefited large globalised trading venues, investment banks and brokers. Larger players have become more dominant, capturing more of the market value chain. This has led to the erosion of the business case for smaller trading venues, brokers and niche players – those that typically serviced the non-blue chip element of the EU market.

90% of the trading in the EU is produced by less than 10% of its listed companies (Ref: FESE). That 10% deliver the product for liquid, low latency, co-located, institutionally dominated, dark and light pools anticipated by MiFID. For 90% of EU companies, MiFID has produced no discernible benefit but has seriously undermined the incentives and business model of the ecosystem that traditionally supported them. The quest for scale has left 90% of EU companies behind. Fewer market participants want to bring them to market, broker them, analyse them, roadshow them. Certainly, the large investment banks are not supporting these companies.

Mid-sized companies are facing an increasingly stark funding landscape – made worse by the tightening of bank finance. Many are opting to sell, rather than grow – primarily outside Europe. A stark example of what this means comes from Ireland. Ireland has, per capita, one of the highest rates of business start-ups in Europe, yet trade sale is the chosen exit route for over 90% of our high potential companies. Sadly, I don't believe Ireland is unusual.

Why do mid-sized companies apparently no longer find the prospect of an IPO a compelling prospect – despite a challenging funding environment? If EU markets fail to deliver, there will be an inevitable migration of ownership of European companies to US and Asia. Does Europe believe that a shrinking pool of public companies is impact-free for Europe as an economic block?

The mid-market is the economic engine of Europe, producing over 70% of GDP and employment. Without a dynamic mid-market and an active pipeline refreshing that market, the future is bleak. It is time to act. ■

Ways envisaged to ease SMEs' access to long-term finance

Benoît de Juvigny - Secretary General, **Autorité des marchés financiers (AMF)**

Public authorities (including national and European regulators) and market participants both share responsibility for enhancing the long-term financing of the European economy, re-establishing confidence and enhancing Europe's overall attractiveness as the venue for investment.

Accordingly, it will be necessary to address interconnected factors, such as the capacity of financial institution to overcome the constraints on long-term finance imposed by Basel III, the effectiveness of financial markets, the possibility that an excessive part of the financial market is dedicated to the funding of the public sector, the role of public policies in catalysing long-term saving and financing and the difficulties that SMEs face in trying to gain access to finance.

On that last crucial subject, further steps could be considered, including developing venture capital, new securitisation instruments for SMEs, loan funds, dedicated markets for SMEs with the broadest possible range of investors and specific accounting rules for listed SMEs (such as IFRS for SMEs).

SME bond markets could become an alternative to bank lending, and they could not only help attract new investors (both institutional and retail), but also help develop new SME securitisation instruments such as labels for high-quality, transparent and standardised securitisations. Other non-traditional sources of finance, such as crowdfunding, could also be explored.

In the short term, proposals presented under MIFID II allowing operators of multilateral trading platforms to be registered under the label "SME growth market" and the proportionate regime for SMEs should help reduce the costs and burdens of raising capital for SMEs.

Nevertheless, in France we have called for a broader definition of listed SMEs on the one hand, principally a larger market capitalisation value, and on the other hand lighter regimes than those foreseen by the transparency and prospectus Directives for both medium and SMEs. ■

SME Financing Needs

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

In Europe, small and medium-sized enterprises (SMEs) have typically met their funding needs through bank loans, bank overdraft facilities and trade credit. However, constraints on banks, resulting from the interaction between the broader macro-economic environment and new regulatory capital rules, have reduced the availability of credit. One alternative source of funding discussed among public policy officials – most recently in the European Commission's Green Paper on Long-Term Financing of the European Economy – is the use of asset-backed securitisation (ABS).

Historically, ABS backed by SME loans have comprised a small fraction of structured finance issuance in Europe. Key factors often cited for the limited use of securitisation include a lack of standardisation of loans and overall cost relative to other funding sources. The collateral performance of European SME ABS is linked to the health of the local economy. Consequently, delinquency rates in countries with stronger credit profiles (such as Germany and the Netherlands) have remained low in contrast to those countries that are undergoing more extreme economic stress.

European structured finance spreads are contracting, indicating a growing level of demand from investors in this market. Recent

measures, such as the European Central Bank's ABS Loan-level Initiative, have endeavoured to facilitate SMEs' access to this market by increasing transparency on the underlying loans. Looking ahead, in addition to data transparency, some factors that could increase the use of asset-backed securitisation for SME loans and thus avail new sources of financing to SMEs include objective loan-selection criteria, strong and stable transaction counterparties such as servicers, simple transaction documents and definitions, and governance under an established legal framework. ■

Providing incentives for funding to European SMEs

Isabelle Vaillant - Director, Regulation Department, **European Banking Authority (EBA)**

SMEs are often referred to as the 'backbone' of the European economy because of the fundamental role they play in providing employment and sustaining economic growth. However, SMEs tend to face structural financing obstacles, as they are largely dependent on bank financing whereas larger companies have more diversified funding sources, due to their access to capital markets. These financial constraints can be an obstacle to the recovery of the European economy and have triggered several calls for policy intervention, also in the area of banking regulation. As a consequence, in the recently approved CRD4/CRR, capital requirements are lowered for loans to SMEs.

The rationale of this capital discount is to neutralise the general increase of capital requirements in the new regulation and facilitate lending to SMEs. Nevertheless, recent experience shows that capital based measures, even if more specifically targeted only to new lending, may not achieve this. Firstly, lending decisions are not only based on the capital cost – this is only a single input in a complex assessment and banks will not necessarily pass on the capital relief to the SMEs. Secondly, in the current environment, loan demand for new credit from SMEs may remain limited. For this reason, this measure should be accompanied by other non-prudential measures.

The development of the corporate debt market could mitigate the effect of financial crises, as alternative sources of finance will be available for companies when banks are in a constrained position. Additionally, promoting the use of ratings across SMEs in the EU could also have a beneficial effect on SME direct access to finance and could help encourage securitisation in Europe.

Traditionally, SMEs have preferred debt over equity due to transparency and fiscal reasons. However, in the current economic environment, where companies have entered the crisis highly leveraged, additional debt may be more of a burden than a stimulus for growth. Consequently, we see a lot of merit in promoting angel investing, venture capital and private equity and encouraging the development of a European SME stock market as a supplement to existing bank financing. ■

Basel III and the financing of corporate and SMEs

Jordi Gual - Chief Economist, **La Caixa**

Basel III and its transposition into European Directives have multiple implications for bank lending. In particular, new liquidity requirements are based on ratios that tend to favour holdings of debt securities over loans, and that penalize credits with longer maturities. Increased capital requirements also raise the cost of credit, especially for uncollateralized loans, which consume more capital. Indeed, in this new environment, banks will have an incentive to move into the business of intermediating the debt issuance of large corporates and to securitize the SME loan portfolio.

The new rules are especially damaging for SMEs. The higher cost and the higher collateral requirements will make access to credit more difficult and expensive. In addition, the shortening of maturities will aggravate the SMEs already high dependence on short-term funding. Finally, for banks that use IRB models, the regulatory distinction between SMEs and corporates and their different treatment does not provide incentives for SMEs growth that may lead to a change in regulatory category.

There is no doubt that the development of complementary sources to bank funding for SMEs is desirable, but penalizing bank funding is not the best way to promote it. It is more constructive to improve capital market infrastructure, adapted to SMEs needs, and to remove administrative burdens on alternative forms of financing.

Whatever the regulatory changes, fundamental economic principles show that relationship banking will remain key for SME funding. Banks provide SMEs with critical information needs, mentoring and a dedicated service that helps them realize their full business potential. Relationship banking also allows for the collection of soft information on SMEs that can be used to build qualitative ratings, an essential element to facilitate the growth of alternative sources of funding. The incentives of institutions engaged in relationship banking to generate this kind of information need to be preserved.

In sum, in a future where securitization and non-bank channels are bound to gain importance, the role of relationship banking will still be very important. Regulatory reforms that penalize bank lending or discourage relationship banking may, in fact, jeopardize the ultimate goals of policy makers that attempt to promote non-bank financing. ■

Liquidity preservation through carefully calibrated MiFID 2/MiFIR provisions

Sally Dewar - Managing Director, International Regulatory Risk, **JPMorgan Chase & Co**

The final outcome of the ongoing negotiations on MiFID 2/MiFIR will have a direct bearing on the safety and efficiency of European capital markets, the scope of investor choice and protection, the ability of sovereigns and corporates to raise funds and, ultimately, on future growth of our region's economy. As the file moves through the legislative process, it is important to carefully calibrate new rules – including market structure design, the use of house capital by investment firms and trade transparency provisions – in order to avoid a wide variety of unintended consequences negatively impacting the efficiency of EU capital markets.

For example, the creation of the organised trading facility (OTF) for equity and non-equity instruments correctly recognizes a broker's important role of expediting and matching investors' trades in circumstances where they do not wish to face market risk. The usability of an OTF, however, largely depends on allowing appropriate discretion over investor access and the matching of orders. The lifting, by client consent, of a proposed ban on OTF operators using their own capital for the facilitation of investor-initiated trades is equally important, particularly in low-liquidity fixed income markets where contemporaneous, equal and opposing trades are rare. An access prohibition to investment firms' own risk books will result in either poorer quality trade execution or inability to transact at all.

Investors would also be negatively impacted by the deletion or further restriction of the Reference Price Waiver (RPW), the use of which allows investors to avoid paying a risk premium to market intermediaries when transacting larger orders incrementally. Restricting the RPW would force investors to pay fees and rents to the market for services which they do not require, and without material compensation in price formation. ■

The proposed OTF category puts investor key issues at risk

Hans-Ole Jochumsen - President, **Nasdaq OMX Nordic**

One of the greatest tasks of exchanges is to support economic growth through the enablement of job creation. Transparency, liquidity and price formation are all key issues for investors in this process and regulatory changes must aim at supporting this. The level of the fragmentation and lack of transparency in Europe's equity trading is already a concern, and the new proposed OTF category would add to the problem.

Contrary to regulated markets and MTFs, the proposed OTF allows operators to execute orders on a discretionary basis. As a consequence, all investors and brokers will not be treated equally. Smaller local investors and brokers are at risk of being disadvantaged. OTFs provide an opportunity for large global players to focus investment capital to the top-tier stocks, which will further amplify the liquidity gap to the smaller shares. Hence, OTFs will come at the cost of lower activity in local markets where the SMEs raise capital and start growing.

OTFs for equities will result in reduced liquidity, poor price formation and restricted trading opportunities that will be damaging for European investors and companies. The market structure should instead be organised to provide for a capital market where companies can access finance and create growth and jobs in these times when the recovery of the European economy is the prime goal.

In order to maintain a high level of innovation, better market data quality and a competitive pricing of market data services, transparency is of utmost importance. Does this mean a consolidated tape with only one provider should be established? No. To enable post-trade consolidation, the most efficient measure is to improve the quality of the input data. It is therefore important to maintain the services of market data providers as privately run services subject to competition. ■

Recovery and Resolution regime for CSDs

Marc Antoine Autheman - Chairman, **Euroclear SA/NV**

Central securities depositories (CSDs) are legitimate candidates for an R&R regime, as their failure could threaten financial stability. The primary driver of any R&R regime for CSDs should be service continuity to ensure performance of their 'core' functions (DVP settlement, including for the operation of monetary policy, certainty of asset holdings, the operation of CSD links, etc.). Given their status as critical market infrastructure, there should be a clear distinction between Recovery plans (which will be drawn up by the CSDs) and Resolution plans, which are the responsibility of the competent authorities.

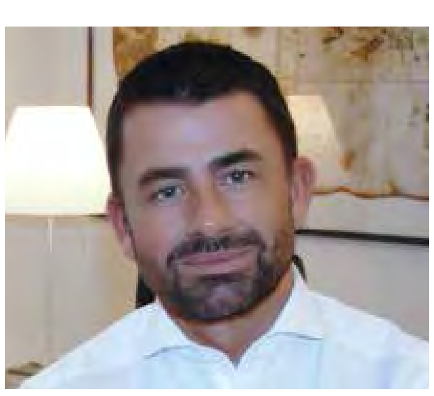
R&R regimes for FMIs should not treat CSDs the same way as CCPs, nor should they copy R&R arrangements for banks. CSDs do not centralise risk, nor do they mutualise risk; they act to remove risk from the market through DVP settlement and related services. If a CSD settles in central bank money, it only faces operational risk. Where CSDs do take credit or liquidity risk, those risks are very tightly controlled at all times and are currently mitigated (e.g. by collateralising intra-day exposures) in line with the CPSS/IOSCO Principles for FMIs, and will be subject to the future CSD Regulation.

A CSD should be able to demonstrate that it has options in its Recovery Plan to manage different circumstances, such as "rapid" in case of a loss requiring some form of "immediate" recapitalisation, or "long-term" in case of a wider and slower-evolving P&L issue (such as longer-term structural business changes).

Any R&R regime implemented for CSDs, therefore, needs to be flexible and proportionate in its application. Moreover, any R&R regime for a market infrastructure should avoid "discouraging" users to use it due to the modalities of its R&R regime that may create a moral hazard for its users, such as, for example, a very tight loss-sharing mechanism. ■

The structure defined in the MiFID review is likely to fall short of fostering more safety, resilience and efficiency

Mark MacGann - Senior Vice-President, Head of Government Affairs and Public Advocacy – Member of the European Management Committee, **NYSE Euronext**



While the MiFID review intends to address some of the factors behind the global financial crisis by bringing more safety and resilience to the system, it is paradoxical to note that some of its provisions are actually defeating this purpose. For instance, MiFIR contains provisions which require "two way" open access between CCPs and trading venues in respect of all financial instruments. This means that CCPs must provide access to all trading venues, and trading venues must provide access to all CCPs. These provisions could have far-reaching consequences for the effectiveness of Europe's core market infrastructure in managing systemic risk and providing liquid and transparent trading venues which meet the needs of customers in the real economy. Incredibly, an analysis of the provisions' implications for market liquidity, market risk and the efficient use of infrastructures is completely absent from the proposals tabled by the European Commission.

Moreover, one of the main priorities in respect of fostering more safety and resilience in the European market structure has been ignored: the Commission proposals on the MiFID review fail to address the loopholes that have allowed OTC trading in cash equities to thrive under MiFID I rules. The new framework proposed by the Commission does not introduce any legally binding definition of OTC for cash equities, nor does it strengthen the existing multilateral categories.

Instead, the Commission proposes the creation of a new trading platform, the organised trading facility (OTF). However, the proposals to allow OTF operators to exercise discretion over the order matching process are in fundamental contradiction with the categorization of the venue as multilateral by the Commission. Through its inconsistency with the principles of pre-trade transparency, it will raise the prospect of sub-optimal investor protection, price formation and – in relation to the G20 derivatives trading mandate – clearing arrangements. Clearly, in respect of the latter point, it would be highly regrettable if any new trading category were to undermine the advances introduced by EMIR in respect of derivatives clearing.

Since publication of the proposals, some stakeholders have called for the introduction of the possibility for the OTF operator to engage in proprietary trading as the platform operator. Given the Commission's stated objective of introducing a multilateral category (already undermined by its discretionary nature as outlined above), a combination of proprietary trading and the operation of a multilateral OTF are clearly contradictory. This is because the provision of proprietary flow by the operator of a multilateral OTF would give rise to important conflicts of interests, since the interests of own account traders and multilateral venue operators are intrinsically contradictory. It is essential for investor protection that its operators be subject to a watertight prohibition from dealing on own account on the platform.

Overall, the proposed framework introduced by the MiFID review is likely to fall short of achieving its objectives of fostering more safety, resilience, and efficiency in EU capital markets. ■

Do bilateral margins provide an adequate incentive for CCP clearing?

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

The main objective of bilateral margins is to protect non-CCP cleared transactions from market and counterparty credit risk. The fact that a transaction is not cleared through a CCP is not necessarily due to the lack of standardisation incentives.

The characteristics of certain OTC derivatives and their liquidity may make them ineligible for CCP clearing. Even in a situation where the incentives are perfectly structured, bilateral transactions will still exist and the risks arising from them need to be adequately covered.

The question that we need to answer is how to structure the bilateral margins requirements to ensure that the risks arising from non-CCP cleared transactions are adequately covered. In meeting this objective, we are already likely to provide incentives to clear via a CCP.

This is due to the fact that, if risks from bilateral transactions are fully covered, margins exchanged in the bilateral context are expected to be higher than in a CCP environment, where market participants can benefit from netting effects and a better risk management framework. The incentives are therefore naturally set if bilateral margins will ensure the full coverage of the risks faced by counterparties entering into non-CCP cleared OTC derivatives.

The second question is how to introduce these bilateral margin requirements. It is clear that the introduction should be gradual to avoid major market disruptions. The practice of bilateral margins, in particular for initial margins, is largely new. Its broad application, which is necessary to fully cover the risks arising from bilaterally executed OTC derivatives, might have significant impacts on collateral availability and eventually on market liquidity. Therefore, an appropriate phase-in period should be considered. ■

Recovery and Resolution of CCPs and CSDs

Kay Swinburne - MEP, Coordinator of the Committee on Economic and Monetary Affairs, Rapporteur on Recovery and Resolution of non-bank financial Institutions, **European Parliament**

International thinking on how to recover and resolve market infrastructure, including CCPs and CSDs, needs to focus very clearly on operational continuity. When an individual bank fails, while it can sometimes lead to contagion across the market, transactions across the system can continue through other market participants stepping in or with government support, to take the place of the failed institution.

This is not the case with market infrastructure. Should either a CCP or CSD become insolvent and cease to function, then potentially millions of transactions can no longer clear and settle. The post-trade activities of the financial markets may be less conspicuous than that of traders, but they remain critical to a well functioning market and involve systemically vital institutions.

The global commitment to achieve mandatory central clearing of derivatives where possible has led to an intense debate about the level of risk concentration in CCPs. As a much higher percentage of derivative trades by value and volume are centrally cleared, together with the race for market share, the issue of recovery and resolution plans for CCPs has moved up the regulatory agenda.

Analogously, the need to maximise collateral efficiency and the central role some CSDs are looking to play in the area of collateral management introduces new risks. The repo markets and securities lending is also set to increase with the implementation of EMIR as highly liquid assets become sought after for margin in the central clearing process.

The new risks associated with market infrastructure playing this type of role are yet to be fully explored, yet it is clear that both markets and regulators need to work together to ensure that the opportunities the market is looking to exploit are met with proper supervision and regulation, ensuring that their primary purpose as market infrastructure is not put in operational danger along the way. ■

CCPs: the need for recovery arrangements in case of extreme situations

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

EMIR has ensured that Central Counterparties (CCPs) in Europe will have substantial margins, default funds with a CCP contribution and separate CCP capital to absorb any losses, which will be sufficient to cover the default of its largest two clearing members. These standards build upon, and in many cases exceed, industry best practice that allow CCPs to perform with distinction during a financial crisis far more demanding than any stress test.

However, it is the right time to consider what happens if in an extreme situation, multiple concurrent defaults occur in conjunction with market price dislocations which exceed the embedded parameters in CCPs stress tests, leading to losses in excess of the full range of default protections held by CCPs. If those circumstances arise, it is right to question whether the financial sector itself would be failing and what intervention may be being taken by authorities to avoid a collapse of the financial system as a whole. However, it is also right to firstly consider the inherent and longstanding role of the CCP itself and how it may manage the process in order to contain and extinguish the problem and remain operational to keep markets open.

A CCP, as the buyer to every seller and the seller to every buyer, operates a balanced book. Following a default, a CCP will have an imbalanced book and must bring itself back into equilibrium. The need for recovery arrangements assumes the exhaustion of the conservatively set and embedded protections available to the clearing house including initial margin, guarantee fund contribution and mutualised fund contributions. Recovery can be achieved by a variety of means: cash injections, haircuts on positive variation margin or in extremis cancelling of the problematic contracts.

Views on the most effective and equitable approach vary, and achieving a consensus is complex but an important path. We need to start by recognising that there are no simplistic solutions to a systemic failure in the financial system. This process of recovery, if agreed in advance and executed well, should mean that resolution is unnecessary.

However, we must ensure that any solutions are realistic and likely to work in the most challenging financial conditions. Given that CCPs globally rely on the same group of substantial clearing members for their financial strength, it is difficult to imagine a crisis arising which is not multi-jurisdictional and systemic in nature. In those circumstances it will not only be the viability of clearing houses which will be in question, but that of the integrated global financial system. The steps taken in recovery must dovetail with steps the public authorities may need to take in order to maintain economic stability for the benefit of society as a whole. ■

The spectre of a liquidity crisis looms over OTC derivatives reform

Peter J. Axilrod - Managing Director, **The Depository Trust & Clearing Corporation (DTCC)**

As recent financial shocks have demonstrated, funding issues can often transform market stress into full-blown crises. Even when a financial institution is technically solvent in the sense of assets exceeding liabilities, shortage of liquidity alone can lead to the institution not being able to meet its funding needs or satisfy large margin calls on open derivatives positions.

Due to the global nature of financial markets, any localized shortage carries with it the possibility of a chain reaction of cross border failures, which are often impossible to address once the market stress event has occurred, except through extraordinary measures such as direct infusions of central bank liquidity acting as the lender of last resort.

This makes it imperative for policy makers to be aware of both (a) the potential for sharp increases in the amount of liquidity that might be required by major financial institutions due to increased collateral and mark-to-market payments, and (b) the unencumbered collateral that would be available to such institutions to secure the borrowing of the related cash or collateral.

Much has been said about the need for a very good central database of derivatives transactions that would permit cross-border stress tests to be performed on behalf of policy makers, so that they will have a better idea of when large market player positions could create the potential for sharp increases in liquidity needs extending across borders. What has been less discussed is that there is also a need for policy makers to better understand the availability of collateral to secure this additional liquidity. The way collateral is held today - central securities depositories, custodian and omnibus accounts - means that policy makers would not easily obtain a clear picture of the availability of collateral, namely who ultimately owns what, and what is already encumbered and what is available to be pledged.

Any perceived or real gap between an institution's funding needs and the availability of collateral to fund those needs can create uncertainty in the markets, unleash a concatenation of events, often causing irreparable damage to the institutions in question and difficulties for supervisory authorities who do not have the tools to monitor this link between funding needs and available collateral.

Global trade repositories for derivatives have a role to play in these plans, as they can identify potentially large margin calls under market stress conditions that could be difficult for firms to satisfy. They can also provide the tools to track related potential "payment failures" across jurisdictions (which may not be visible to individual national or regional authorities).

Furthermore, they can ensure that both the public and relevant authorities have an accurate understanding, at all times, of both the size of the market as a whole, and, in the case of relevant authorities, the positions of particular market participants.

Repositories for collateral information, indicating not only what collateral is held to secure which obligations, but unencumbered sources of additional collateral, could be invaluable to understanding systemic liquidity risk during extreme market stress. Despite the potential magnitude of the problem, collateral reporting requirements have so far lagged behind trade reporting. With the exception of ESMA, which has included some collateral information amid its reporting requirements, it remains a widely unaddressed issue. Adding essential collateral information to OTC derivatives trade reporting would be a good first step towards not only improving the transparency of OTC derivatives trades, but also preserving the very stability of our financial system. ■

Collateral re-use should be possible with appropriate transparency and legal certainty

Florence Fontan - Head of Public Affairs, **BNP Paribas Securities Services**

Collateral re-use is currently under public authorities' scrutiny as a potential source of systemic risk. Various initiatives both at international level or European level (IOSCO initiatives on repos and securities lending activities, ESMA guidelines on UCITs and ETFs…) are debating this subject in various ways. There is in particular a temptation to prohibit re-use of collateral received in order to avoid systemic risk. The main concern: if collateral can't be retrieved at one point of the chain, the entire chain of operations could be put into danger creating significant domino effect.

Re-use of collateral is not source of systemic risk if the appropriate legal environment is in place and this is achievable in Europe. First, where close out netting is recognized, the exposure of each party to the other is limited to a net amount, reducing systemic risk to that net amount. Further, enforcement by close out netting alleviates the necessity to mobilize collateral, providing rapidity and certainty. This framework exists in Europe since the Collateral Directive. Second, all parties to the transaction should have legal certainty in respect of the collateral and appropriate accounting should be implemented. Therefore a financial institution should only be able to re-use collateral where it has received title in the collateral prior to the reuse. As the new owner of securities the collateral receiver should be able to dispose of them. Finally, parties should have full transparency. So no re-use should take place without the prior consent of the parties. Europe could fully enforced those simple rules by amending the collateral directive and defining legal certainty for securities and collateral. This framework would also provide Europe with a competitive edge avoiding scarcity of collateral while maintaining its shift to a secured financial environment. ■

Recovery and resolution of market infrastructures – the way forward in Europe

Emil Paulis - Director, Financial Markets, DG Internal Market and Services, **European Commission**

The European Commission consulted on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks between 5 October and 28 December 2012. The consultation followed the adoption on 6 June 2012 of a Commission proposal for a EU framework in this area for banks and investment firms. Consistent with international work, notably CPSS-IOSCO initiatives[1], it examined if and how the failure of non-bank financial institutions, e.g. CCPs, CSDs and systemic insurance companies, should be subject to specific steps to ensure orderly recovery and resolution where necessary.

There is broad agreement that specific measures should be defined for the recovery and resolution of financial markets infrastructures (FMIs), i.e. CCPs and CSDs, as they are central to the financial system and often non-substitutable. Recovery and resolution measures should ensure the continuity of essential services provided by FMIs. This is key to safeguard financial stability as is robust recovery planning under the oversight of supervisors. There is also broad understanding that any framework should be adapted to the features of each type of FMI. The recovery and resolution framework for CSDs should thus differ from that for CCPs, given the differences in, for example, risk profile. Due to the strong interlinks between FMIs, frameworks should be coordinated and effective in order to mitigate spill-over effects. There is also a need for effective cross-border cooperation between authorities.

A recovery and resolution regime for FMIs complements EMIR[2] and the proposed CSD Regulation (CSDR). The implementation of the clearing obligation for OTC derivatives will heighten the systemic angle of CCPs. Robust risk management rules for CCPs were introduced by EMIR and its delegated acts, but a recovery and resolution regime must complement these preventive measures in the event that, despite their robustness, they would prove insufficient to prevent a CCP bankruptcy.

The Commission is continuing its preparations of a legislative initiative on the recovery and resolution of non-banks, with a particular focus on CCPs, with the aim of adopting a proposal before the end of 2013. ■

1. See Consultative Report on the recovery and resolution of financial markets infrastructures, July 2012: http://www.bis.org/publ/cpss103.htm
2. Regulation on OTC Derivatives, Central Counterparties and Trade Repositories

Collateral fragmentation

Emil Paulis - Director, Financial Markets, DG Internal Market and Services, **European Commission**

The observed move towards more secured funding along with tougher collateralisation requirements as part of the G20 reforms are having a profound effect on the EU's financial markets. Collateral has become essential for market participants to obtain access to liquidity which results in an increasing demand for securities collateral in the EU. While demand has been increasing, a fall in the re-use rate of assets can be observed. Market participants have been more inclined to hoard high quality collateral and are less willing to allow others the right of re-use.

This potential scarcity of high quality collateral is driving the need to use securities as efficiently as possible. This activates the development of new business models that can offer clients access to the needed high quality liquid assets. Through collateral mining, transformation, optimisation, re-use, and upgrades, collateral management is moving from the back to the front office. It is not just needed to cater for posting collateral against OTC derivatives, but also to generate cost savings and to manage funding needs to exploit opportunities.

The EU cannot afford post-trade fragmentation. Market participants need to be able to easily and efficiently access collateral regardless of their location. The Commission has analysed the need for post-trade harmonisation to facilitate the movement of collateral safely and efficiently, preventing that collateral scarcity become a drag and a danger to the real economy. This will require providing certainty of "who owns what" across the EU. To do this, key legal and operational barriers to the way that securities are held, traded, and lent need to be broken down. Methods for providing collateral should be harmonised to give certainty to both collateral takers and providers. ■

Collateral scarcity - a central bank perspective

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

Article 18,1 of the Statute of the ESCB requires all credit operations of the Eurosystem to be based on adequate collateral. Consequently, all Eurosystem liquidity-providing operations are based on underlying assets. With the aim of protecting the Eurosystem from incurring losses in its monetary policy operations and of ensuring the equal treatment of counterparties, as well as of enhancing operational efficiency and transparency, underlying assets have to fulfil certain criteria in order to be eligible for Eurosystem monetary policy operations.

Given the different purposes of a central bank framework compared to other regulatory or CCP frameworks, the respective collateral eligibility requirements have differences as well and cannot be harmonised. In order to understand the complexity and reduce the uncertainty, transparency on the differences of collateral eligibility requirements across various frameworks is needed.

Given the upward trend of collateral demand in general and the concerns of collateral shortages by some euro area banks in particular, the Eurosystem concentrates on making the supply of collateral more flexible.

Two aspects are being considered in this respect. Firstly, the definition of broad eligibility criteria, taking into account national differences and allowing the use of a widely accepted range of (new) collateral. Secondly, the efficient processing of existing collateral. Concerning the latter, the Eurosystem already announced some important enhancements. The abolishment of the repatriation requirement and the integration of tri-party collateral management services within the collateral framework as of 2014 will provide a valuable contribution to this effect. ■

The big C challenge - all parts of it

David Wright - Secretary General, **International Organization of Securities Commissions (IOSCO)**

2013 is a vital, shaping year for global regulatory reform. Progress has been made in many areas, but it is now imperative that there is real intellectual convergence and buy-in on the key policies - resolution, OTC derivatives, bank capital requirements, the shadow banking nexus and the forgotten fifth column - namely changing financial industry behaviour, strengthening corporate governance and ensuring global regulators have effective deterrence and sanctions regimes.

The current plan is to complete the shadow banking and OTC derivative pieces by September 2013 in time for the G20. Much work remains to be finished. Data availability is still partial; trade repositories just beginning; data formats require attention; data aggregation must be facilitated; and the macroeconomic work to judge the overall economic impacts in these complex markets is only just beginning.

Concerning OTC derivatives, there are many industry sirens blazing that the regulatory sum of multiple and additional collateral requirements, writ large, will do serious economic damage. These include increasing collateral required for access to Central Bank liquidity, additional collateral for initial and variation margin to encourage migration to central clearing and platform trading, collateral for repo haircuts, for clearing margin and for the new Basel capital requirements which have ratcheted up bank capital five times.

Many industry voices argue that this collateral bill is beyond the capacity of the current financial system to provide it. In short, demand for collateral will way exceed supply. The argument made by industry is that, as a result, future credit supply will be severely constrained. The answer to this is that the calibration of this complex issue - in fact the accumulation of several complex issues - as stated above is now under intense economic assessment by the global regulators. QIS continue to be worked through and phasing-in procedures are being considered.

Of course, there will be impacts. They must be manageable and proportionate to the real risks. Policies must be implemented consistently across all major markets and in the G20. Cross-border conflicts of law must be removed, or at least strictly minimized. Regulators must fully understand the interconnectivity economics at play, the contagion channels, the distribution of collateral, velocity changes, the pro-cyclicality effects as well as the new emerging markets for collateral, such as innovative collateral management business lines.

But the increased costs of adjustment must be judged ultimately against the benefits - i.e. a safer, sounder and more rational global financial system, whereby huge derivative exposures are netted and contained in sound clearing systems, bank capital elevated to sensible levels and long daisy chains of callable collateral made safer. If global regulators succeed and system risk is reduced, then these long term benefits must be factored in.

The IMF have measured these benefits and academics have calculated the costs of financial crises. Let us continuously bear in mind the broader societal costs of this crisis: upwards of a 10% loss of global GDP and rising, social distress in many economies, quantum leaps in unemployment in many parts of the world and rapid increases in government debt levels. When we judge the final proposals we must take into account the totality of the economic and social costs and benefits, not just selective parts that suit one side of the argument or the other. ■

The Optimization Imperative – How can clients meet sharply higher demands for collateral?

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

Collateral requirements are expected to rise dramatically with ongoing regulatory reform efforts focused on increased oversight and reducing systemic risk in the global financial system. Estimates vary widely, but even conservative figures amount to US$2trn, which will create a substantial market challenge, magnified by a focus on premium collateral.

With high quality assets in scarce supply, it is a critical task of ours to help clients optimize their available inventory, particularly when multiple internal business lines compete for the same pool of assets. Optimization allows our clients put the "right" piece of collateral in the "right" spot, recalling and reusing it as circumstances change. It reduces operational and counterparty risk and helps retain highly ranked assets for reinvestment or other business imperatives.

Collateral optimization is cost-effective, as it maximizes the efficiency of market participants' inventory in meeting their obligations. However, gaining a clear view of assets held and/or available can be a challenge given a complex web of counterparty, clearing broker and custodial relationships.

The right collateral agent can provide a clear, central view of a client's entire inventory and continuously identify the best mix of assets to meet obligations. Optimization is driven by rigorous testing against pre-defined standards and a strong algorithm that factors in the asset mix, cost of funding and obligations.

Time-tested transformation strategies (e.g. upgrade trades, securities lending, margin financing, secured credit) contribute to helping all market players obtain the right asset to secure an obligation. However, transformation should be employed sparingly to maximize efficiency and minimize expenses.

Existing collateral optimization solutions, provided by custodian banks and ICSDs, seek to navigate the complex regulatory environment and help market participants use their assets most efficiently.

It is important that the evolving legislative framework takes into consideration the complex chain of intermediation required to ensure that collateral assets are mobilized and optimized when and where they are needed. ■

New tools for a new world

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

It has been estimated that - depending on market stress scenarios - between \$1.6 and \$30 trillion in additional collateral may be needed globally as a result of new and proposed regulations for OTC and cleared derivatives transactions. With the global supply of eligible collateral estimated at \$75 trillion, market participants are thinking about both the cost of and access to sufficient collateral.

How do market participants determine the proper level of collateral needed to operate in a sustainable manner in a sustainable market going forward? Efficiencies are a must. The right level and type of collateral must be available for the right kinds of activities.Potential sources of needed collateral are as diverse as the make-up of a market participant's portfolio, including its own investments (including otherwise ineligible assets, which may be "transformed" into eligible assets), committed credit and funds that may provide access to liquidity. Over time, we can expect more sources to emerge as new means of access are developed. Less obvious options include prioritizing activities in the portfolio management process that require collateral, deprioritizing activities that produce the least value, and changing asset allocations and haircuts with a bias towards assets that are more likely to be eligible and liquid for use as collateral.

Another key consideration is the development of a standardized indicator of the market level of liquidity. In this way, it would be possible to calibrate current and projected collateral to relevant activities requiring it, including (but not limited to) derivatives. A liquidity indicator combined with other tools could assist with planning the quantity and source of liquidity to meet cost and risk management objectives. A new generation of tools can facilitate the future growth of capital markets. ■

ESMA's guidelines and the use of collateral

Wim Hautekiet - Executive Vice President and Chief Executive Officer, **The Bank of New York Mellon SA/NV**

In December 2012, ESMA published "Guidelines on ETFs and other UCITS issues", and in March 2013 it published a Questions and Answers document. We believe that these documents show some confusion with relation to efficient portfolio management (EPM) techniques and the use of collateral.

The confusion arises from the fact that collateral can flow in two directions, depending on the EPM transaction, and that collateral arrangements may differ. In the event of a securities loan, or of a repo or reverse repo, legal title to collateral may move to the counterparty or away from the counterparty to the UCITS. Collateral arrangements may, or may not, involve title transfer arrangements. In some cases, third-party agents – such as custodians – may hold the collateral, and may, for cash collateral, provide collateral re-investment services. Non-cash collateral delivered to UCITS is not re-used.

ESMA's Guidelines focus on who can hold collateral, without regard to the direction in which title transfers, or to the nature of the transaction. ESMA's Q&A permits "tri-partite agreements", but only where there is "no title transfer". When there is transfer of title, the Q&A specifies that a custodian other than a depositary must hold the collateral under a sub-custodian arrangement.

The Guidelines prohibit the re-use, re-investment or pledging of non-cash collateral without regard as to whether legal title has transferred, and if so, in which direction. The Guidelines should recognise that there may be legitimate and important reasons for the onward use of collateral delivered by a UCITS to a counterparty, including, for example, collateral transformation services.

ESMA has made no explicit linkage between these collateral discussions and shadow banking. We welcome this, and hope it reflects where shadow banking-related concerns arise, and where they do not. ■

Mitigating the risks of securities lending and repo activities in asset management

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

Securities lending and repo activities are part of the efficient portfolio management (EPM) techniques that Member States may permit UCITS to use under the UCITS Directive. Although the UCITS framework already has a number of safeguards on the use of these techniques, ESMA saw merit in building on this foundation by developing guidelines for UCITS in this area. These safeguards are especially important as UCITS funds are developed for the retail investor.

The first priority to consider in mitigating the risks raised by the use of EPM techniques is disclosure. It is important that investors are aware of the potential additional risks to which they may be exposed through this activity. The guidelines require UCITS to provide a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the UCITS performance.

Disclosure on its own is not sufficient as a risk mitigation mechanism. In particular, safeguards are needed to ensure that UCITS that make use of EPM techniques remain liquid investments. For this reason, the guidelines oblige UCITS to ensure, for example, that they are able to recall any security that has been lent out.

Moreover, ESMA saw merit in limiting the counterparty risk arising from EPM techniques to 10% of the assets of the UCITS per counterparty. Any collateral received by the UCITS in the context of EPM techniques should comply with strict quantitative and qualitative criteria set out in the guidelines.

Also, ESMA addressed the specific issue of revenues arising from securities lending activity. The guidelines provide that all the revenues arising from EPM techniques, net of direct and indirect operational costs, should be returned to the UCITS.

To conclude, the ESMA guidelines on securities lending and repo activities are important to maintain and strengthen the protection of investors in UCITS funds. ■

Systemic risks and investment funds

Thierry Darmon - Deputy Head of Euro Fixed Income, **Amundi**

Most FSB's provisions in respect to shadow banking are welcome. Nevertheless it is worth remembering that the main sources of systemic risk are leveraging and globalization, neither of which are characteristics of the European fund industry. The distinction introduced by FSB between the CNAV and VNAV for example was necessary. In this area of money market funds, the European Systemic Risk Board recently published new recommendations, including the need for provisions to cope with the risk of a run. This risk is not the same for retail investors as for institutional or corporate investors. Temporary suspension of redemptions proposed by ESRB may make sense for the second category of investors who have day-to-day knowledge of the market. However, such a provision could in fact be counterproductive in the case of retail investors and provoke unexpected reactions. Here, the new provision of the Irish regulator to replace the fair treatment of a fund's shareholders across the different classes by a fair treatment of shareholders class by class could be an appropriate response to prevent massive runs.

Excluding CNAVs from retail MMF could also be wise in order to avoid any misunderstanding, but not for Corporate investors who may need them for practical reasons.

The present level of short term rates entails such low levels of performance for MMF that any buffer provision or tightening of criteria in the choice of assets as proposed by ESRB may lead to zero if not negative performance. Of course, the new FTT applied to these funds would lead to their immediate death in the FTT zone with a dramatic effect on the money market and on the short financing of Banks and Corporates. In France, for example, MMF represents 44% of negotiable certificates of deposits and 35% of financial commercial papers. More widely, such a tax applied to mutual funds would be passed onto investors and would not achieve its previous goal of "punishing" financial actors and speculators for their responsibility in the last crisis. ■

MMF: preserving financial stability and investor benefits

Joanna Cound - Managing Director, Government Affairs & Public Policy, **BlackRock**

European MMF provide a valuable service to European investors and issuers. Investors value MMF for their credit diversification and because they are bankruptcy remote; MMF provide a relatively stable source of cross-border funding for European banks. Regulators have concluded that MMF did not cause the financial crisis, but they are concerned over the role MMF played in transmitting 'runs' as MMF investors 'ran' on the bank credit held in MMF portfolios during the 2008 financial crisis.

BlackRock urges policy-makers to adopt the following as the only combination of measures that will stop 'a run' and preserve investor benefits: tighter asset standards, greater transparency, mandatory liquidity buffers, and, in stressed markets, redemption gates and liquidity fees.

These measures meet the FSB's requirement that risk mitigants be "functionally equivalent in effect to the capital, liquidity and other prudential requirements that protect banks against a run on their deposits". Banks use access to central bank liquidity, deposit insurance and suspension of convertibility to prevent bank runs and capital to address idiosyncratic issues. As for all investment funds, MMF do not have access to the first two mechanisms. Redemption gates and liquidity fees are, however, the securities markets equivalent of 'bank holidays'. A liquidity fee acts as a powerful circuit breaker - it provides strong incentives to stay invested whilst giving all MMF investors access to their cash.

Other measures will not be as effective: capital reserves are not designed to prevent 'runs'; equally, a conversion from constant value to variable MMF will not protect MMF from 'runs'; both measures will shrink the product and hence a valuable alternative source of bank funding. ■

Trends in asset management

Emil Paulis - Director, Financial Markets, DG Internal Market and Services, **European Commission**

The UCITS V proposal aims to align the tasks and liability of the fund depositary. This is essential because the responsibility for losses is not uniform and clear throughout all EU jurisdictions. Another issue introduced by the European Parliament is whether the CRD IV rules on bonus caps should apply to UCITS managers as well.

UCITS VI is a follow up to the shadow banking green paper. UCITS VI covers exchange traded funds, total return swaps, securities lending, repos and a variety of transactions where fund managers expose fund (and thus investor) assets to counterparty risk. UCITS VI aims to limit and mitigate those risks. UCITS VI will also examine whether the time is ripe to introduce the depositary passport and whether harmonisation of the depositary's duties progressed enough to warrant a passport.

Money Market Funds (MMF) are the most liquid category of UCITS funds and MMF individually are among the biggest funds (one fund = up to 50 billion). Precisely because they promise liquidity, stability and a competitive yield, they are more prone to investor runs when one of these elements appears at peril. Following on from the recommendations by IOSCO, the FSB and the ESRB, we are conducting our own impact assessment on the available policy options. Whatever we will propose will reflect accepted international standards and aim to ensure that European MMFs remain competitive internationally.

Stakeholders believe that long term investment funds (LTIFs) specialising in providing equity and loan finance for large projects have a crucial role to play in Europe. They advocate a "third fund passport" that exists alongside the UCITS and the AIFMD schemes. LTIFs should be managed by either UCITS or AIF managers. ■

UCITS: efficient portfolio management and investor protection

Philip Warland - Head of Public Policy, **Fidelity Worldwide Investment**

The use of securities lending and repo techniques in UCITS are valid and valuable techniques for managing risk and increasing income. But they introduce additional operational and counterparty risks. As such they raise investor protection issues.

These techniques require first-class collateral management systems and fit-for-purpose counterparty assessment processes. Moreover, since UCITS are a retail investment product that can be offered on an execution-only basis, it is prudent to ensure that any securities lending or repo transaction contract specifically bars the re-use of any assets provided by the UCITS. This is not because of the concerns, which some have, about the creation of credit in a "shadow-banking" context, but simply to protect the UCITS investor from assets being irrecoverable somewhere along the lending chain.

It is worth noting that the requirement for cash or near cash collateral for derivative transactions in the future is likely to force UCITS to turn to collateral management techniques, where the fund's assets are replaced by cash through a third-party. Again, careful attention will have to be paid to counterparty management. It is ironic that legislation to improve the safety of derivative transactions is likely to lead to increased risk for funds and a concentration of risk in CCPs.

It is very important to ensure that the principles governing these techniques are the same in all parts of the financial markets. But it may be legitimate, in the context of UCITS, to have these principles set out more prescriptively. ■

What's really crucial to improving the global consistency of financial regulations: Extra-territoriality and the treatment of margin

Alex Wilmot-Sitwell - President Europe & Emerging Markets, **Bank of America Merrill Lynch**

While all areas of global financial regulation require harmonisation, we feel the following two are particularly crucial:

1. Consistency of territorial scope of provisions, necessitating a global framework of principles and a standardised approach to implementation and extra-territorial application.

Having a global model for the extra-territorial application of financial regulation is in the best interests of all parties operating and regulating Global Markets. We believe that the core principles of a workable territorial scope model would be, firstly, that entities should be subject to the local regulation only. Clients should be subject to one set of regulations, irrespective of the entity they face within their home jurisdiction. (For example a UK insurance company facing a UK High Street Bank, or facing a US Bank branch or subsidiary in the UK.) A model where local establishments of overseas firms are operating under their home jurisdictions will not work, as clients will not want to be subject to two sets of complicated regulations.

Secondly, for the purpose of extra-territorial application, branches and affiliates should be evaluated on the same basis within the same jurisdiction to ensure a level playing field, so there should not be differences, for example, for a UK client facing a US branch or a US affiliate. Thirdly, equivalence determinations between differing regimes should be to a commonly agreed standard. Detailed equivalence assessments conducted separately by the US and Europe will use large amounts of precious regulatory resources at a time when those resources are most needed to agree and implement regulation. Agreeing a high level matrix as to how regulatory regimes evaluate each other will also increase transparency and increase the likelihood of a common, un-contentious outcome.

Lastly, where local regulation is in the process of being finalised, the determinations of equivalence from foreign regulators should take this into account and disregard minor timing differentials. There is little point in wasting time and resources on an evaluation in a regulatory environment that is pending change. During this period, there should be a "presumption of equivalence" in effect, as long as this is not abused. This will have the effect of harmonising timing of implementation and levelling the playing field for global firms. If actual timing conversion cannot be achieved between regulatory regimes, it makes sense to smooth over differences which are temporal in nature.

2. Globally agreed provisions for the treatment of margin on un-cleared OTC derivatives trades, and the models used to calculate those margin requirements.

While the output from BCBS/IOSCO in their consultation on the treatment of un-cleared margin is a very positive step towards global harmonisation, from our perspective there should be further global consistency in a number of key areas: exemption of FX products, usable collateral, the application of Initial Margin to inter-affiliate trades and the use of risk based models for the calculation of initial margin.

We strongly believe that FX products should be outside the scope of margin requirements due to the highly liquid and low risk nature of the products. Existing market infrastructures for settlement must be taken into account rather than displaced. Having inconsistent approaches in this most global of markets will cause dislocation of business and have a direct impact on liquidity for buy side and "real money" firms.

Usable collateral has to be extended beyond government bonds and cash. The proposals of the IOSCO paper are well founded to address the very binary issue of the large amount of collateral that will be required, especially during the initial phases of mandatory clearing determinations, and the availability of that collateral. We must avoid a situation where regional regulators allow different collateral to be used, further complicating an already complicated daily process.

Without a consistent approach to the territorial scope and harmonisation of the impact of regulation, we are likely to see further fragmentation of the market due to the necessity for locally regulated booking entities. This will have an inevitable impact on liquidity for the buy side, and the inefficient use of capital in these entities will push up costs to end users. In addition, regulatory oversight will be increasingly contentious and will require significantly greater resources to deal with effective double regulation. Without consistency in margin rules,

we are likely to see regulatory arbitrage amongst global firms who seek to align themselves to jurisdictions with more relaxed, or no, margin requirements.

In Europe and the United States the hard work has been done over the last twenty four months in designing and delivering new regulatory proposals. Now we must take the final step to ensure that this regulation is adapted for the global and interconnected markets it seeks to regulate, without which we may not be as effective as intended. ■

Lessons learnt from drafting technical standards on EMIR

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

ESMA faced a challenging timetable for the delivery of its draft technical standards under EMIR. A short summary of the key milestones is set out below:

- 21/09/2010 the Commission adopted the proposal;
- 9/02/2012 a political agreement was reached;
- 27/07/2012 EMIR was published in the Official Journal;
- 27/09/2012 ESMA submitted all the draft technical standards, bar two, to the Commission, having consulted twice from February to March and from June to August.

To draw a parallel with the US, the Dodd Frank Act was passed on 21 July 2010 and most, but not all, of the CFTC rules were released in 2012 while many of the SEC rules have yet to be developed.

ESMA is fully committed to the fulfilment of the G20 mandate and began developing its draft technical standards during the negotiation of the Commission proposal, managing to deliver its standards on time, after proper consultation. Therefore, the first lesson learnt is that fixed deadlines for the delivery of the technical standards may not work, given that the length of a negotiation process cannot be forecast. This lesson is reflected in the most recent Commission proposals.

The second lesson relates to the need for consistency with international standards, but also the recognition that in most cases these international standards are not specific enough, and when transforming them into detailed rules, these might differ. These differences may leave room for regulatory arbitrage that will need to be addressed with other tools, e.g. equivalence assessments.

Finally, the last lesson is to consult at an early stage on the cost-benefit analysis to ensure that stakeholders provide the relevant data needed for this analysis. General requests for evidence and data to justify responses to the consultation do not generate the necessary inputs. ■

Improving the global consistency of financial regulations

Steve Hottiger - Managing Director, Head Group Governmental Affairs, **UBS AG**

One of the lessons of the financial crisis is certainly that more effective regulation, as well as enhanced supervision, is necessary. The financial industry is supportive of this process and ready to contribute. Regulation must, however, be consistent and internationally coordinated in order to ensure a level playing field, avoid regulatory arbitrage and facilitate cross-border market access.

In the immediate aftermath of the crisis, consensus on and coordination of global regulatory reforms under the aegis of the G20 were promising. A number of important initiatives emerged, such as Basel III or the OTC market reforms. A few years later, we are now in the middle of the implementation process and the global consensus has been fading. A prominent example is the prevalent delay and exemptions in the implementation of Basel III.

Several initiatives to improve global consistency currently under way are positive. The FSB is for example monitoring the implementation of regulatory requirements across its members and undertaking peer reviews. These should be further enhanced. The FSB also set up a complaint handling process regarding compensation practices, which could possibly be extended to other areas.

However, more is needed to further improve global consistency. The G20 and FSB could, for example, take measures to encourage member countries to further align national regulations with global standards. Consistency could also be promoted by either improving current cooperation processes among jurisdictions or by further developing the global institutional framework. Another important step would be giving the recommendations made by global standard setting bodies legal force and enhancing the enforcement tools at a global level. ■

The growth of "localisation"

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

"Localisation" – in both major and emerging economies – is a growing source of inconsistency in implementing internationally-agreed regulatory standards. It is not new – some countries have always imposed local requirements and required or encouraged foreign banks to operate locally as subsidiaries rather than branches. But the extent of localisation is increasing, even while the G20 promotes greater international cooperation.

The financial crisis has reinforced localisation. First, it has weakened confidence in both parent banks and home country authorities, leading some host country authorities to heighten their geographic ring-fencing, through subsidiarisation and by imposing local requirements to "protect" the local financial system.

Second, as financial stability and systemic risk have become increasingly important at global and national level, host country authorities have been developing their own versions of capital surcharges, resolution planning and more intensive supervision of banks of local systemic importance.

In turn, the tougher treatment of locally-headquartered SIFIs has increased pressure for similar requirements on foreign-owned domestic SIFIs, as with recent US proposals requiring foreign banking organisations with a significant US presence to create an intermediate holding company and to hold stronger capital and liquidity positions in the US.

Local regulators are also scrutinising foreign banks' intra-group transactions and their outsourcing of operations and processes, to ensure that they can assume control in the event of crisis and access local systems and operational data.

The impact on banks is significant – increasing localisation increases costs and reduces the potential efficiencies and economies of scale of operating an international banking group. ■

Improving global consistency of financial regulations

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

International consistency in financial regulation and its implementation is a sine qua non in a globalized world. This is the foundation of a level playing field across countries, and without this there could well be a race to the bottom spurred by regulatory arbitrage and excessive risk taking. Achieving consistency, however, requires a strong will to act by all parties: supra national bodies, financial institutions and markets.

Consistency of rulemaking and implementation starts with open, consultative and participatory discussions when financial regulations are being designed. As jurisdictions have to work within their various legal frameworks and market structures, the potential for difference of definition, interpretation and implementation will always exist. Still, all stakeholders have to rise above narrow institutional and national interests and commit to subscribing to a global perspective so that the scope for divergence can be reduced. Supra-national and regional bodies play an important role in these discussions both by providing the forum and by bringing this global perspective to the table.

Well-designed assessment programs with transparent processes and outcomes support consistency. Much work is already undertaken by a range of international bodies: the IMF and the World Bank carry out assessments of sectorial standards in financial regulation, the Basel Committee for Banking Supervision is undertaking a thorough assessment of implementation of the revisions to its capital accord, and the Financial Stability Board is conducting peer reviews.

Regular monitoring by such independent third parties and peers is important to promote consistency in outcomes. It is important that these be well coordinated and avoid overlaps as they are costly and resource intensive. It is also important that mechanisms for following up on the findings of these reviews be strengthened so that the desired consistency in outcomes can be achieved. ■

New standards must ensure global consistency

Michael Bodson - President and Chief Executive Officer,
The Depository Trust and Clearing Corporation (DTCC)

With new financial supervisory regimes coming online across the globe, it is essential that there is regulatory consistency and coordination across jurisdictions if greater market efficiency and stability is to be achieved. In a modern financial system defined by financial markets and entities that are increasingly interconnected, regulatory divergence or duplication has the potential to increase opportunities for regulatory arbitrage, threaten market efficiency and stability and undermine efforts to prevent the next financial crisis.

The measured approach adopted by global regulators in considering the cross-border application of their respective regimes reflects the difficulty of regulating global markets from a local jurisdiction – and it is the scope of new policies that lies at the heart of the issue. Overly extraterritorial rules not only ignore the opportunity to achieve regulatory goals through policies of equivalence and mutual recognition, but also increase the potential for duplicative or conflicting regulatory policies. This could lead to increased compliance costs that reduce market liquidity and subject market participants to operational and legal risks tied to conflicting local and third-country policies. The combination of these and other factors will inevitably lead to regulatory arbitrage that tilts the playing field in favour of certain jurisdictions over others. At the same time, during periods of market stress or crisis, the lack of a consistent regulatory approach and information sharing will inevitably lead to more localized and therefore less internationally coordinated regulatory responses. Compounding this problem is the continued absence of an international standard-setting body with a strong enforcement mandate, which could undermine efforts to level the regulatory landscape. For example, despite international standards developed by groups like CPSS-IOSCO, the lack of effective enforcement measures subjects them to a broad interpretation in terms of both content and timing of implementation.

Ultimately, the absence of a consistent regulatory environment may impede the development of efficient markets where multijurisdictional regulatory requirements can be satisfied with single solutions. This could reduce costs to the participant, and thus the end investor, as well as weaken regulatory responsiveness at times when it is most needed. In our efforts to address the lessons of the past, we must ensure that globally consistent regulation is developed in order to promote a level playing field where competitive, innovative and stable markets can grow and thrive. ■

Towards a strengthened mandate for international organizations

Tim Ryan - Managing Director, Global Head of Regulatory Policy & Strategy, **JPMorgan Chase & Co**

Global consistency in financial regulation is important to ensure elimination of regulatory arbitrage and reduction of systemic financial risk transfers to jurisdictions less able to manage them. Global consistency becomes even more important when it involves cross-border activity, as legal certainty and a level playing field are of paramount importance to conducting such business.

Mutual recognition principles and equivalence of outcomes are superior to an issue-by-issue based equivalence approach, which is complicated, overly burdensome, lacks transparency and tends to accentuate differences between national approaches and thus increases the risk of an unlevel playing field. Current difficulties in the acceptance of mutual recognition and principle-based equivalence pose challenges to which solutions should be pursued. These challenges arise from a lack of confidence in the abilities of foreign regulators or where nations seek competitive advantages – actions, when looked at in isolation, are seen as necessary to protect and advance national interests. It is critical in this context that the EU and the US take the lead in developing a model of mutual trust, recognition and the establishment of a cross-border relationship framed by a focus on principles and outcomes.

From this base, a more global framework might credibly develop and would be welcomed. We should strengthen the mandate of international organisations like IOSCO or the FSB and ensure improved decision making within them. Global organisations also need a bigger footprint within countries, so that the fundamental importance of global consistency is regularly reinforced – to each nation's regulators and policymakers as well as their voting public.

But we need to recognise that even strengthened international organisations will continue to have limited tools to ensure compliance and remain dependent on sovereign nations coming to agreement. Hence, over the longer term, it is worth considering whether the legal framework for each country's financial regulators should be amended to ensure they support the recommendations of international bodies, and in the event of disregard, the use of WTO style penalties. In addition, the inclusion of financial services in an EU-US FTA could complement ongoing technical work between experts within IOSCO or the Financial Markets Regulatory Dialogue. ■

We need to re-affirm global consistency of financial regulation

John Siena
Assistant General Counsel, Director of EMEA External and Regulatory Affairs, **BNY Mellon**

Since the financial crisis began, it is clear that progress in a broad array of reform measures is needed to restore confidence in the stability and resilience of the global financial system. Both between the EU and the US, and within the EU, key divergences remain in respect of Basel 3, derivatives regulation, accounting standards, and the toxic combination of extraterritoriality and re-nationalisation of resolution measures – at the expense of cross-border cooperation and mutual recognition.

In the US, the Fed has made proposals to ring-fence capital and liquidity of "foreign banking organisations"; the EU, meanwhile, plans to implement unrealistic "equivalency" requirements on foreign jurisdictions and service providers, to apply strict remuneration restrictions extra-territorially, and to allow a sub-set of member states to impose a punitive extra-territorial tax on financial transactions.

Both the EU and US derivatives market reform measures raise liquidity and market access concerns.

Leaving such approaches aside, we need to find ways of achieving comfort through effective cross-border resolution mechanisms and more pragmatic equivalency (or, as known in the US, "substituted compliance") measures.

Another threat comes from legislation or regulation with unintended side-effects. Efforts to regulate or restrict shadow banking - however laudable in some respects - may inhibit liquidity in securities markets, or may limit the availability of collateral, as may the investor protection-inspired efforts of AIFMD and UCITS.

It is vital that we intensify our efforts to providing for safe, resilient and sensibly transparent global capital flows. The urge to trap capital and liquidity locally is an understandable – and very human – impulse in the face of difficult political and fiscal conditions.

However, this impulse must be resisted if developed economies are to put themselves on a path of sustainable growth. ■

Reducing the impact of extraterritoriality and differing regulatory requirements

Fabian Vandenreydt - Head of Markets Management & Core Business Development,
Society for Worldwide Interbank Financial Telecommunication (SWIFT)

The volume of output from financial market regulators shows no sign of relenting – and the ongoing legislative focus on the financial sector suggests that even more national and regional laws will soon be in place, requiring yet more detailed rules. Whilst both lawmakers and legislators largely subscribe to common objectives, significant differences arise in both the underlying legislation and in the implementation of detailed implementation rules. Further complicating matters is the regulatory or legislative overlap that arises from the extraterritorial impact of such measures.

Whilst regulatory bodies clearly have been making real efforts to cooperate more on some areas of regulation, e.g. on the clearing and reporting of OTC Derivatives, differences do still emerge, and this is partly (but not wholly) due to the independent legislative processes at national or regional level, in the case of the EU. For financial firms – and clients of financial firms – that operate across national boundaries and regions, regulatory differences and extraterritorial issues present a heightened compliance challenge. Whilst realistically such issues are not going to disappear entirely any time soon, there are ways in which some of the effects can be limited and the impacts mitigated. Firstly, greater coordination between regulatory bodies is highly desirable.

Secondly, the involvement of supra-national bodies, such as the FSB (active for example in the recent Legal Entity Identification initiative) and IOSCO (active on many fronts including the recent principles for the supervision of financial market infrastructures), in drawing up effective blue-prints for the development of consistent regulation at the supra-national level can be helpful, and indeed we have seen a marked increase in such activities over the past few months.

Thirdly, recognition by supra-national regulatory bodies of standardised industry tools as enablers for regulatory compliance would greatly help the financial industry comply at the operational level across markets. From SWIFT's perspective, messaging and reference data standards are amongst the areas that are important, and we would look to see further efforts to more tightly coordinate the use and adoption of open international messaging and data standards by regulators globally.

Such an approach would help eliminate some of the frictions arising from varying and or overlapping regulatory requirements, lessen the operational overheads for the financial industry and reduce the costs passed on to the real economy. ■

Financial services regulation: The importance of global consistency and convergence

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

The financial crisis has called for a global response and the G20 agreed on a number of commitments to repair the main problems exposed by the crisis: stronger capital for banks; appropriate resolution tools; new regulation of derivatives; stricter framework for the remuneration of financial market players; increased supervision and reduced reliance on credit rating agencies; more transparency in the markets; and a global governance that would ensure that the agreed reforms are effectively implemented around the globe in a consistent manner.

Regulatory divergence is dangerous. It invites actors to take advantage of the differences, through arbitrage. It increases the uncertainty, and the costs associated to regulation. It reduces the ability of supervisors to cooperate. For these reasons, jurisdictions have kept working closely together to ensure that global rules are implemented. Progress is being made on Basel III, and there is the expectation that also the US would implement the agreement in time for an entry into force by the beginning of 2014.

Intense discussions are taking place on derivatives. It appeared that it is easier to agree on the principles of reform, than to ensure that the details of the implemented rules are perfectly consistent. Crucially, we must put in place mechanisms that ensure that the various regulations work together, providing clarity as to which set of rules would apply to which cases, and providing the framework for supervisors to work together and exchange the necessary information to prevent the build-up of systemic risks.

It would be particularly damaging if the US authorities started a trend of regulation based on an approach that does not recognise the capital and liquidity requirements imposed in other jurisdictions on the basis of global standards, and did not rely on the supervisory activity there. It would be a great concern if duplicative rules were imposed in isolation as it would start a process of costly replication worldwide, leading to capital and regulatory fragmentation.

Regulatory fragmentation is dangerous globally precisely because it fragments the financial system, reducing its ability to finance trade and the economy and creating the opportunity for regulatory arbitrage. Regulatory fragmentation would be even more disastrous within Europe. It would increase the costs for cross-border financial activities. It would increase uncertainty for investors. And it would not incentivize authorities to cooperate.

This is the reason why the Commission is engaged in building the Single Rulebook. Banks will have similar rules applying across Europe, thereby reducing costs, increasing efficiency and improving the allocation of capital. Investors would have a clearer view of the rules that apply. There would be a level playing field between banks. The independent European authorities would ensure that rules adhere to the highest international standards. And national authorities would have a common framework and strong incentives for their cooperation.

Common rules are only one aspect. There must also be a common supervisory approach. This is why the Single Supervisory Mechanism, entrusting the ECB with strong supervisory powers, is so important for the euro area. This is why in the negotiations on the Single Supervisory Mechanism it was agreed to give the power to EBA to define a supervisory handbook which would apply to the entire EU.

The single rulebook and the handbook will also facilitate cooperation between supervisors. And the new rules provide a balanced framework that allows national authorities to take the measures that are appropriate to tackle the risks that are present at national level, while allowing an EU framework to ensure that these measures do not entail negative consequences for the internal market. As is well known, the Commission has some reservation on the shape of the final rules as the European framework is insufficiently designed.

The European financial system is too integrated to allow for a dispersed approach to financial stability problems. Financial reforms have therefore been put forward with the objective of introducing throughout the EU uniform measures necessary to ensure that the financial institutions are sound and well managed. Key to this respect is the role of the European Supervisory Authorities.

For instance, when coordinating the bank recapitalisation exercise in 2012, the EBA has taken great care to avoid that the capital strengthening process would translate into deleveraging. Figures show that banks have mostly raised fresh capital, and that deleveraging was relatively modest. On the other hand, it is also clear that the role of the banks is evolving as they are reducing their overall exposure, down from the high levels of leverage in the run-up to the crisis. Less leveraged banks, also thanks to stricter prudential rules, would be safer actors, thus improving financial stability. As a consequence, they may reduce their direct involvement in some areas, notably on long term investments.

Banks will, of course, not disappear from the intermediation chain in Europe. Their credit risk assessment skills and local knowledge of and relationships with enterprises mean they will continue to and need to be important players. But against the background of developments since the crisis in the banking sector, there are new needs and opportunities for other intermediaries to complement the role of banks by channelling financing to long-term investments in a more balanced way. This evolving role of the banks opens up opportunities for other intermediaries, like institutional investors, and for market based financing.

The Commission has issued a Green Paper on the Long-Term Financing of the European Economy whose purpose is precisely to start a debate on how to ensure that these opportunities are taken up. The Green Paper raises 30 questions, and will launch a three-month debate which will hopefully lead to a number of ideas on how to improve the ability of the financial system to channel financing to long term needs – like infrastructure and productive investments.

All interested parties and institutions should contribute to this debate, including the institutions that are part of the European System of Financial Supervision, the ESAs and the ESRB. ■

The challenge of regulatory consistency - Thinking globally when acting locally

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

Consistency in global regulation is important because it improves the interoperability of our capital markets. By supporting freer flow of capital across borders, consistency supports deeper capital markets and economic growth. Working toward consistency now is particularly important in the context of driving sustainable economic recovery.

Consistency, in this context, should not be understood as having identical rules which apply regardless of national circumstances. The consistency we should be aiming for is consistency of regulatory outcomes based on commonly agreed and sufficiently granular standards. That is, achieving the same regulatory outcomes, with jurisdictions using different rules to get to those outcomes.

The challenge for policy makers and regulators in working toward consistency is to reconcile the need to develop global solutions for global problems with domestic regulatory objectives and domestic sovereignty – the challenge of thinking globally while acting locally. This challenge has been amplified in recent years by the extra territorial application of regulation by some jurisdictions, differences in timing in introducing new regulation and the absence of an international regulatory framework for addressing these issues.

IOSCO has a leadership role to play in helping policy makers and regulators meet these challenges. This role has two dimensions. The first is to develop authoritative guidance and standards – a global rule book – which is sufficiently clear about its objectives, sufficiently granular to be useful and delivered in a timely way. This will provide a basis for understanding and aligning the outcomes we want to see.

The second is to develop guidance on how domestic regulatory regimes should knit together where there are differences in national rules. IOSCO will shortly start work to develop a tool box of measures currently used to address these differences – tools which will include mutual recognition and substituted compliance. This work will aim to develop a shared understanding and a common language of how we approach these issues. IOSCO will then work towards developing guidance on how those tools should be used and the role IOSCO might play in how the tools are used. ■

OECD Principles for long term investment financing by institutional investors

André Laboul - Head of Financial Affairs Division, **Organisation for Economic Co-operation and Development (OECD)** & Secretary-General, **International Organisation of Pension Supervisors (IOPS)**

Traditional sources of long term investment financing are all facing challenges – including fiscal constraints on government spending, or the weak economic outlook not proving conducive to corporate investment. Financing from the banks has clearly been constrained since the financial crisis. Dysfunctional money markets and risk mispricing are adding further pressures.

In addition to fixing these blockages, it is important to also consider new sources of investment financing going forward. With their huge assets, institutional investors are frequently cited as just such a source. Yet, currently less than 1% of pension fund assets are allocated directly to infrastructure projects, and many obstacles to increase such allocations remain.

These include the lack of appropriate financing vehicles and of investment and risk management expertise, regulatory disincentives, lack of data on infrastructure and of investment benchmark, and challenges particular to green infrastructure.

The G20 Finance Ministers and Central Bank Governors recently recognized that "long-term financing for investment, including infrastructure, is a key contributor to economic growth and job creation in all countries". They welcomed a diagnostic report which finds inter alia that there is scope for some sources of long-term financing, including local currency bond markets, domestic capital markets, and institutional investors to play a larger role for investment in infrastructure.

Concerning the latter, they are looking forward to the OECD report on the "High Level Principles of Long-Term Investment Financing by Institutional Investors" by the Leaders' Summit in September in St Petersburg. These Principles will be developed by the new OECD Task Force on Institutional Investors and Long-Term Financing. ■