EUROPEAN CENTRAL BANK

ECB contribution to the European Commission's consultation on Capital Markets Union mid-term review 2017

General remarks

The ECB has been a strong supporter of the capital markets union (CMU) project since its inception.[1] A well-functioning, diversified and deeply integrated euro area/European Union capital market is very important for the European Central Bank (ECB). First, CMU would play a key role in diversifying the funding sources of European non-financial corporations, thereby enhancing the smooth transmission of monetary policy. Second, CMU actions focused on increasing cross-border equity financing and cross-ownership of assets within the euro area/EU could represent an important risk sharing mechanism and smooth consumption growth.[2] Foreign direct investment (FDI), foreign equity and longer-maturity debt in general would lead to a more resilient form of financial integration.[3]

The European Commission's Action Plan on CMU[4] is a step in the right direction. The ECB supports many of the initiatives which have been undertaken by the Commission, such as its proposal on simple, transparent and standardised (STS) securitisation, its actions to foster further integration in financial market infrastructures and its efforts to reduce the debt-equity bias in tax systems. Looking ahead, CMU will require considerable ambition, also on the part of the Member States, which must be prepared to address legislative and other barriers to the cross-border flow of capital. Establishing the right conditions for a true single market in this area, i.e. a situation where all market participants with the same relevant characteristics face a single set of rules, have equal access to markets and are treated equally when they are active in this market, requires a longer-term vision and sustained effort beyond the envisaged duration of the Action Plan. All stakeholders should thus step up efforts towards achieving CMU.

As will be explained in detail under section A, further action is needed to foster robust cross-border capital flows and sound financial integration. Importantly, further action is needed regarding the harmonisation of insolvency frameworks, taxation and company law to remove cross-border barriers to financial integration. Moreover, debt recovery procedures should become faster and less

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[1] See Building a Capital Markets Union – Eurosystem contribution to the European Commission's Green Paper, 21 May 2015.

[2] See Obstfeld, M., "Risk-Taking, Global Diversification, and Growth", *The American Economic Review* Vol. 84, No 5, 1994, pp. 1310-1329.

[3] See, e.g., Special Feature A of the ECB's report Financial integration in Europe 2016.

[4] See Action Plan on Building a Capital Markets Union, 30 September 2015.

expensive. To that aim, out of court settlement regimes harmonised at EU level could be encouraged. Additional action to promote a deeper and more liquid European capital market will also allow new funding instruments, such as for long-term infrastructure investment, to be offered. Moreover, it will offer additional opportunities for the investment of Europe's savings, such as sizeable opportunities for increasing the cross-border investments of pension funds and other retirement savings, especially in equity.

Furthermore, measures focusing on improving access to market-based financing must be complemented by other policy measures targeted at firms which depend on bank funding. Bank finance appears to be more important at earlier stages of development, when it supports capital accumulation, while market finance is more important at later stages of development because it stimulates innovation and technological change. Deep and liquid capital markets help to lower bank lending conditions for firms, as banks have to compete with capital market financing conditions, currently in particular for high-quality borrowers.

The banking union supports and complements the CMU. Banks remain an important actor within CMU. They are active in capital markets as service providers, investors and issuers. In this regard banks and capital markets complement rather than substitute one another. An increasingly integrated banking market should also support the integration of capital markets in the EU because more banks would be in a position to offer their products and capital market services on a cross border basis. In the longer term – as CMU progresses – cross-border banks would have a stronger incentive than domestic banks to develop and offer products that exploit scale effects and cross-border risk sharing, and hence contribute to a further integration of capital markets. In this regard, further regulatory and supervisory convergence propelled by the banking union should make cross-border mergers and cross-border activities easier and safer and hence also support CMU. Furthermore, the banking union aims to make the banking system more resilient and thus also supports the smooth functioning of capital markets. As a bank supervisor, the ECB plays a crucial role in ensuring the health of the banking system by enforcing strong and harmonised supervisory standards. A healthier banking system in turn both lends more and attracts more investor financing.

The CMU project should not lead to a weakening of prudential standards. There need not be any trade-off between supporting the financial sector, in the context of CMU, and appropriate supervision. The very significant gains achieved post-crisis in introducing legislation that strengthens the banking sector and reduces both the probability of public support and the amount of such support need to be preserved and moreover strengthened. While largely completed, the banking regulatory agenda still requires finalisation.[5]

[5] In March 2016, the ECB issued an Opinion (CON/2016/26) in relation to amending the third pillar of the banking union: the European Deposit Insurance Scheme. In the Opinion the ECB said that it fully

An increased non-bank financial sector should be accompanied by an expansion of the prudential framework for non-bank financial institutions to adequately address systemic risks. The regulatory agenda for the non-bank financial sector is still developing, and the supervisory framework is highly fragmented. A coherent and well-policed regulatory perimeter is needed between banks and non-banks that are engaged in bank-like activities (e.g. including investment firms) to underpin this architecture and to avoid regulatory arbitrage which would be detrimental to financial stability or the safety and soundness of credit institutions. As risks may legitimately shift towards the non-bank sector, heightened vigilance is required. For example, large investment firms with substantial cross-border links pose risks that need to be addressed at the European level. The CMU Action Plan already recognises the need to monitor and mitigate "financial stability risks emerging in capital markets" and aims to address it via the review of the EU macroprudential framework. In this context, it would be important to acknowledge that macroprudential authorities should have adequate tools to address systemic risks in the non-bank sector. The CMU work should strive to provide the legal basis for such macroprudential tools.

A strengthening of the single market supervision at EU level is needed. Although the establishment of the European Securities and Markets Authority (ESMA) has been a major step towards fostering convergence of national supervisory practices, the supervision of securities markets remains at the national level, which fragments the application of EU legislation. ESMA could play a much larger role in ensuring consistent transposition and effective enforcement of rules agreed at EU level and provide a locus for single decision making on these issues. In the longer term, CMU will require the implementation and enforcement of rules to be strengthened, and will warrant an appropriate supervisory architecture, leading ultimately to a single European capital markets supervisor. The ECB will provide detailed reflections on the future supervisory architecture in its reply to the Commission Consultation on the review of the European system of financial supervision.

New perspectives have emerged since 2015 when CMU was designed. While the situation in terms of overcoming financial fragmentation and constrained access to finance has clearly improved recently, it has also become even more evident that more integrated capital markets can deliver more private risk sharing across countries and reduce the diverging effects caused by asymmetric shocks. This is especially relevant for the euro area. Furthermore, the departure of the United Kingdom from the European Union will change the economic, institutional and political landscape in Europe. The imperative for building a true CMU is becoming even stronger, as the remaining Member States should have an increased interest in further developing and integrating capital markets within the EU27.

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shared the Commission's view that further enhancement of depositor protection was needed in order to underpin the financial stability, thus contributing to the deepening of Economic and Monetary Union.

The following section contains detailed proposals from the ECB perspective for additional action to increase the ambition of the CMU project.

A. Additional action to complete the capital markets union

The ECB's contribution to a well-functioning capital markets union is primarily to ensure a strong and resilient banking sector in the euro area. Creating the right framework conditions in the banking union will enables further financial integration and development of CMU. Nonetheless, the ECB recognises the need to pursue additional policy measures in the remaining five policy areas.

1. Financing for innovation, start-ups and non-listed companies

EU regime for start-ups

The market for start-up financing is currently fragmented and still functioning below its potential. While venture capital is necessary for firms seeking rapid scaling up, seed capital is required to enable businesses to move from ideas to prototypes. Entrepreneurs are relying on own, family and friends' funds and, more recently, on crowdfunding platforms. The exponential growth of such platforms in the past years shows that the market has been severely underserved. There is, however, scope for public intervention, to help the market towards sustainable development.

Improving and diversifying start-ups' access to financing sources increases the chances of developing well-capitalised and successful small and medium-sized enterprises (SMEs). In turn, this creates broad-based economic growth, with positive financial stability spillovers. Moreover, encouraging start-ups' early use of more diverse funding sources and making them less reliant on bank financing also benefits the monetary policy transmission mechanism. The ECB supported measures to diversify SMEs' funding sources beyond bank financing and towards more capital market solutions as a means to ensure a better transmission of its monetary policy when the bank lending channel became impaired during the financial crisis.

The proliferation of platforms offering debt, equity or other forms of financing fragments the market. On the one hand, such fragmentation is often across national borders, reflecting local laws governing contractual arrangements and financing. This often reflects inefficiencies due to national differences in taxation and capital-raising. On the other hand, the fragmentation also reflects different business models and financing forms offered to entrepreneurs and investors. This can create issues for both investors and entrepreneurs, if risks are not well understood. Start-up equity and debt financing at early stages are highly risky, and both start-ups and investors need to understand the consequences. A lack of any form of standardisation of financing documentation and a general dearth of educational material both for entrepreneurs and investors hamper investor confidence and may lead to suboptimal investments and capital-raising.

Policy action could take the form of creating a supportive EU regime both for start-ups and investors in start-ups, an EU wide public portal connecting entrepreneurs and investors, and standardisation of the most common forms of equity and debt financing. An EU-wide start-up regime would be particularly useful. Such a regime should ideally include simplified, expedited and standardised registration procedures, reduced tax rates for start-ups meeting specific criteria, and a more favourable regime for investors investing in such start-ups. An EU-wide portal, supported via public funding, could allow start-ups to advertise their financing needs and business plans on a centralised platform, in addition to private platforms; adequately drafted business plans are key to drawing investor interest. Standardised equity and debt financing contracts, developed in consultation with the peer-to-peer (P2P) industry, would also help steer the market towards transparent and common contracts, and thus increase both entrepreneur and investor confidence in accessing/providing finance. The experience with rental and mortgage contracts in various Member States clearly shows that standardisation of key contractual terms reduces transaction costs and significantly reduces abuse.

Channelling a larger amount of pension savings into non-traded equity could also increase the funding options of young growth firms. Whereas traded equity is barely limited in pension regulations, some EU countries still have relatively low limits on non-traded equity. It may be worthwhile reviewing particularly restrictive limits and studying the extent to which pension investments in seed, start-up or venture capital financing can be incentivised.

Fintech

The high growth pace of fintech (financial technology) marketplace lending creates both opportunities and challenges. The development of fintech activities such as P2P lending via numerous marketplace investment platforms targeting the provision of funds both to start-ups and more established SMEs represents a desirable new credit provision channel. Available data, while scarce, suggest that such activity has expanded very significantly over the past few years, supported both by tightening bank lending standards since the financial crisis and by a search for yield among retail investors. Fintech benefits small companies by allowing them to raise capital more cheaply, in the form of both debt and equity, while offering retail investors direct access to an asset class to which they would otherwise not have direct access. Such Fintech activities should be supported. By bypassing the traditional banking lending channel, P2P offers a sometimes cheaper alternative and is, in some cases, the only funding alternative to bank lending. As such, it achieves a desirable outcome. Yet, P2P requires adequate regulation to prevent risks to financial stability, establish consumer confidence in the sector, and prevent the potential abuse that often comes with innovative products not yet subject to regulation. It is not yet clear to what extent existing regulation appropriately captures risks in fintech activities

such as P2P, given the very high business model heterogeneity.[6] The financial stability implications of P2P activity need to be appropriately considered, and take into account the extent to which P2P performs bank-like services. Risks could arise if P2P gains a significant market share of the banking sector's consumer and business financing, while not being subject to equivalent or similar oversight. Consequently, there is a need to understand the various fintech business models and the extent to which the risks to consumers and to financial stability are adequately captured. This would inform an assessment of the extent to which current regulation is adequate or requires modifications, or fintech-specific frameworks need to be developed. Given the large variety of fintech activities, different regulatory responses are likely to be needed. Depending on the nature of the fintech activity, the regulatory response may need to encompass prudential, consumer protection and other regulation. It must also be ensured that regulation does not hamper the development of fintech activities. In particular, the regulatory response at national levels has been so far highly heterogeneous, which hampers cross-border investment and expansion.

EU regime for private placement

European private placement (PP) markets have grown considerably over the past few years, offering a viable alternative to bank credit. Private placement plays a key role for firms moving from bank funding to capital market funding in a cost-conscious manner. The use of private placement debt has increased considerably over the past few years, as European companies have sought to replace more expensive and less readily available bank credit with capital market placed products. The increase has also been driven considerably by numerous industry efforts since 2012 to standardise documentation in two of the three main private placement jurisdictions, France and the United Kingdom, and also to offer an alternative to the US private placement market which attracted most of the issuance of European companies during the crisis. In parallel to industry-led standardisation initiatives, governments in France, Italy and the United Kingdom have made supportive changes to the tax regimes for privately placed debt. Despite the improvements, the private placement market remains fragmented, with several models dominating the market: the Schuldschein, governed by German civil law, is predominantly used in the German market, although non-German issuers have used the format in recent years owing to its well-established status; the French and, more recently, UK private placement markets have grown around standardised documentation developed by industry bodies, the French Euro Private Placement Working Group and the Loan Market Association. Important product differences exist between the nationally focused private placements: Schuldschein instruments are typically used by larger SMEs with investment grade, while Euro PP and UK PP issuance size are typically smaller and a wider range of credits apply. No standardised documentation is

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[6] For example, in some P2P business models investors invest directly in a project, either by buying a security or an instrument, or by acquiring a beneficial interest in it. In other cases, the platform establishes a company, special purpose vehicle or a collective investment scheme which issues a security to an investor, so that the investor is exposed indirectly to the project. See also ESMA's Opinion on investment-based crowdfunding, December 2014.

required for Schuldschein issuance, while Euro and UK PP issuance is increasingly being governed by standardisation developed by industry bodies. German banks and insurers investing in Schuldschein instruments are, moreover, subject to due diligence and credit analysis requirements.

More ambitious steps could be undertaken regarding the development of debt private placement regimes, which is aimed at supporting access to markets for medium and large SMEs. While the growth of the private placement market is very positive, there appears to be no convergence as regards the issuance documentation or as regards the terms of debt issued in the national private placement markets. An EU regime for private placement, built around the best practices in the market, could support EU-wide standardisation and at the same time create the conditions for sustainable future development by imposing minimal due diligence requirements. It would not need to replace existing national regimes but rather introduce certain standardisation and other prudential requirements. The case for a unified regulatory framework is, moreover, supported by the still nascent nature of the private placement markets in most of the jurisdictions in the EU and the fact that many EU countries do not yet have a national regime. Such a framework would also be beneficial from a prudential perspective, to ensure that investments are made by investors best placed to withstand any associated risks.

2. Making it easier for companies to enter and raise capital on public markets

International Securities Identification Number and Legal Entity Identifier

Mandatory use of the International Securities Identification Number (ISIN) and Legal Entity Identifier (LEI) in the EU, and globally, will increase transparency in the capital market, foster its integration and enhance efficiency and consumer protection. Financial market stakeholders need easy and reliable tools to uniquely identify financial assets, transactions, issuers, guarantors and counterparties as well as their key features. This is particularly important for data management, which serves as a backbone for operational activities for market participants and supervisors or for provision of (statistical) information to the public.

The current situation is very costly for market participants. The many different proprietary identifiers and local identifiers cause difficulties as they are incomplete, overlapping, and insufficiently accurate and do not guarantee a level playing field. While the drawbacks of the current situation are known and undisputed, there is no change in the markets owing to the fact that unique identifiers are a public good which need to be introduced and maintained by legislation. A mandatory requirement to use the LEI should be extended to all financial instruments. In addition to securities, the LEI and/or ISIN should be used for investment funds, financial derivatives and loans.

The need for easy and reliable tools to uniquely identify financial assets, transactions, issuers, guarantors and counterparties applies not only to private stakeholders but also to public authorities and in particular to the European System of Central banks (ESCB). The compilation, processing and dissemination of data on securities and their issuers is regularly performed by the ECB and national central banks in order to provide both micro-data and aggregated statistics for the purposes of monetary policy, fiscal policy, market operations, risk management, macroprudential stability and supervision. ESCB data management is severely hampered by the fact that the ISIN and LEI are not universally used, as well as by the lack of authoritative sources for links between the two. Furthermore, the general lack of machine-readable reference information at the source and the manual work implied impact on the quality of the data received by the ESCB, implies additional management costs for its cleaning and may result in errors affecting all ESCB business areas.

Substantial progress has been recently achieved by the EU Prospectus Regulation. The final compromise text includes the key points raised in the ECB's Opinion, namely (i) the mandatory use of the ISIN and LEI in prospectuses, and (ii) the need to present the information contained in the prospectuses in a machine-readable manner, which will be achieved through the draft regulatory technical standards specifying the data necessary for the classification of prospectuses and practical arrangements to ensure the machine-readability of such data, including the ISIN of the securities and the LEI of the issuers, offerors and guarantors.[7] This represents a major step towards the standardisation and digitalisation of financial data and a modern industrial 4.0 data management within the EU. It also offers a standard which could be adopted by financial markets globally. It will also complement the current regulatory use of the LEI and ISIN in the EU, mainly in the areas of data reporting for OTC derivatives, banks' capital requirements and the Markets in Financial Instruments Directive (MIFID) II.

Digitalisation of securities data will complement the progress achieved on the ISIN and LEI. Further to the features described above, the Prospectus Regulation hints that each prospectus will contain not only the ISIN and LEI as machine readable information but also the main features of the securities. This should be implemented by standardising key data attributes on securities at source, through validation by the competent authority and by making the related database available to the public in a format that is machine readable free of charge. The digitalisation of securities would serve stakeholders such as financial market infrastructure providers (e.g. central securities depositories and securities clearing and settlement systems), commercial data providers, asset managers, and supervisors and other authorities by reducing the costs of

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7 See the final compromise text of 16 December 2016 on the Regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading (15574/16) and the Opinion of the European Central Bank of 17 March 2016 on a proposal for a regulation of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading (CON/2016/15).

retrieving, compiling and using data as well as guaranteeing their accurateness, completeness and timeliness.

Review of the market abuse regime

It will be important to review the market abuse regime,[8] which places a large burden on issuers listed on SME growth markets. Especially matters that relate to the widening of scope of issuers' duties under the Market Abuse Regulation[9], such as providing insider lists and notifying managers' transactions, to include companies listed on multilateral trading facilities should be analysed and addressed. The ECB therefore strongly supports an assessment by the European Commission of the implementation of the rules under MiFID II on investment research in relation to SMEs.

Bringing pension investments to bear

Pension systems offer large potential for multiplying demand for equity investments, given that the share of their funds invested in equity is still relatively low overall and taking into account the need to significantly increase the funding of pension schemes as demographic developments challenge pay-as-you-go components.

As regulatory limits on (both domestic and non-domestic EU) traded equity investments for occupational or personal pension schemes tend not to be binding in most EU Member States, providing incentives for equity investments in early stages of accumulation and particularly reforms closing overall funding gaps could significantly boost capital market development and risk sharing in Europe. In this context the ECB supports the Commission's initiative to consider the development of a potential European personal pension within CMU. Moreover, the ECB welcomes recent consultation by the European Insurance and Occupational Pensions Authority (EIOPA) on a potential European occupational pension and looks forward to its results. But in order to move sizeable amounts of funds towards cross-border equity investments (and thereby also manage the viability of pension schemes in a low-yield environment) countries with particularly low equity shares may consider setting distinct incentives for more equity investments.

3. Investing for long-term infrastructure and sustainable investment

Investment-friendly environment

Achieving an increase in long-term and sustainable investment requires a structured framework for creating an investment-friendly environment. Despite

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[8] See Opinion of the European Central Bank of 12 October 2016 on a proposal for a directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC (CON/2016/49).

[9] Regulation (EU) No 596/2014 on market abuse.

some recent positive signs of recovery, years of weak investment growth in the euro area has slowed down capital accumulation, including on R&D and equipment, which has weighed on potential and productivity growth since the crisis. ECB analyses show that, beyond macroeconomic and financial conditions, several regulatory and institutional factors continue to be a drag on business investment.[10]

The CMU agenda should therefore be seen together with strengthened work under the third pillar of the European investment plan. The third pillar has an important role in supporting reforms needed to increase competition, reduce administrative burdens and promote business-friendly investment regulations. The work under this pillar is essential to ensuring that the CMU succeeds in its intent and delivers tangible long-term results. This is even more important after taking into account that only about 60% of the EU's 2015 country-specific recommendations (CSRs) related to investment bottlenecks have seen at least some progress. Looking at the 2016 CSRs, the implementation record for CSRs related to the business environment is even lower than the overall CSR implementation level for 2016 CSRs: Not a single business-related CSR has been fully addressed or seen substantial progress.

In line with the December conclusions of the ECOFIN Council, action is needed at Member State and EU level to unlock the full potential of the opportunities provided by CMU.[11] While each Member State should focus on the most pressing areas which hold back private investment, there appears to be an urgent need across many countries to improve business conditions, in particular bottlenecks and inefficiencies in the regulatory environment and debt workout mechanisms, as also stressed by the ECOFIN conclusions. Policies enhancing the regulatory environment, improving competition in product markets, favouring labour flexibility and supporting debt deleveraging and credit growth are critical to providing a long-term boost to business investment across EU countries.

Solvency II review

Further changes in Solvency IImight be necessary to promote CMU in the insurance sector. A lot of work has been done by the Commission and EIOPA to promote infrastructure investments by insurers. The calibration of risk charges for infrastructure corporates is currently under review by the Commission, based on technical advice from EIOPA, which also took into account the adequacy of the proposals from a prudential standpoint. Overall, these initiatives go in the right direction to foster infrastructure investments by insurers. The Commission identified unrated bonds and loans as well as unlisted equity as additional areas in which prudential requirements for insurers could be a barrier to investments. EIOPA is also asked to suggest certain qualifying criteria which would allow the identification of unrated bonds and loans that could be assigned a better credit

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[10] See "Business investment developments in the euro area since the crisis", Economic Bulletin, Issue 7, ECB, Frankfurt am Main, 2016.

[11] See Conclusions on tackling bottlenecks to investment identified under the Third Pillar of the Investment Plan, ECOFIN Council, 6 December 2016.

quality step and thus a lower capital charge. Clear and conclusive criteria could give incentives to insurers to invest more in SMEs, thereby further strengthening CMU. If appropriate, a set of qualifying criteria could also promote investments in unlisted equity.

4. Fostering retail investment and innovation

Distributed ledger technologies

The Eurosystem has the statutory task of promoting the smooth operation of payment and settlement systems.[12] **The Eurosystem also fulfils carries out its tasks by acting as a catalyst for change and fostering the harmonisation of market standards, as well as by encouraging the removal of barriers to financial market integration.** The impact of technological innovation as applied to financial markets (fintech) is, therefore, relevant for central banks, which need to ensure that innovation can be an enabler of safer, faster, and cheaper domestic and cross-border financial transactions, while at the same time avoiding a situation where the adoption of innovation based on diverging standards in different national markets constitutes a barrier to integration.

Among recent fintech innovations, distributed ledger technologies (DLTs) have attracted much interest from the financial industry as well as from public authorities in their different capacities as regulators, catalysts and supervisors. The potential adoption of DLTs by market participants would entail the need to (1) bring various aspects of technological innovation within the current legal framework, reconciling them with the basic principles of contract, property and securities law; (2) explore the legal nature of virtual currencies and digital financial assets in general, and the finality of book-entries and their updates in a distributed ledger; (3) foster the definition of interoperability standards among novel market infrastructures and with incumbents, across geographies and asset classes; and (4) understand the implications of technological innovation for incumbent institutions, for the overall architecture of financial markets as we know them today, and for financial supervision and oversight.

The ECB suggests that the current efforts towards the development of harmonised and principle-based regulation and legislation across Member States be reinforced. This would ensure that market participants developing new services and technologies are not limited by different national legislations and by the risk of unexpected regulatory changes. Regulation should be designed to be long-lasting, to the extent possible, and constant interaction with developers of new services should be promoted to avoid a situation where changes in regulation warranted by specific innovations are overlooked until the latter are ready for adoption by market participants.

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[12] Article 127(2) of the Treaty on the Functioning of the European Union and Articles 3 and 22 of the Statute of the European System of Central Banks and of the European Central Bank

5. Strengthening banking capacity to support the wider economy

Non-performing loans

Measures undertaken in the context of establishing CMU could contribute to strengthening the banking union by helping to tackle the problem of non-performing loans (NPLs). In particular, initiatives aiming at developing a secondary market for NPLs, and reforming insolvency frameworks and judicial systems, which are mentioned in the Commission consultation document, should be pursued. NPLs remain a key ECB priority, since they raise both macroprudential and microprudential concerns. High NPL ratios are not the only cause of low bank profitability in certain EU jurisdictions, but there is some evidence that the resolution of NPLs could significantly increase returns on bank equity in several countries.[13] Moreover, NPLs weigh on bank funding and lending, given both the investors' and the banks' uncertainty as to the recovery values and the need for further provisioning. In tandem, NPLs are also symptomatic of a debt overhang among households and firms, with negative consequences for the real economy. NPL resolution would significantly strengthen the banking sector and improve its capacity to support the wider economy. ECB Banking Supervision has in March 2017 published guidance to banks that makes it clear that high levels of NPLs should be addressed by the relevant banks as a matter of priority.

Supervisory action alone is not sufficient to resolve the NPL problem, and macroprudential, legal and economic measures must complement microprudential steps. Without structural reforms, the disposal of NPLs could be costly, as losses are realised in the process. In order to adequately address the NPL problems facing euro area banks, there is a need for comprehensive national and EU strategies, consisting of structural and regulatory reform, judicial and policy action, in order to address this problem in a decisive manner, and to prevent a build-up of NPLs in the future:

i) debt recovery procedures should become faster and less expensive, as the cost of enforcing claims and liquidating collateral weighs directly on the value of NPLs;

ii) at national level, reforms to legal, judicial and/or extra-judicial frameworks to create a more favourable environment for NPL workouts are necessary;

iii) NPLs should be made more transparent and easier to price for investors by removing existing information asymmetries.

Given the scale of the current challenge, the necessary pace of NPL resolution will not, however, be achieved without well-targeted forms of public intervention. In jurisdictions with systemic NPL problems, AMCs can provide a "bridge", spanning the period of time during which market prices for non-

[13] See speech by Vítor Constâncio, Resolving Europe's NPL burden: challenges and benefits, Brussels, 3 February 2017.

performing assets and underlying collateral are particularly low, or where they may become lower before, ultimately, recovering. More specifically, AMCs can help to swiftly remove a significant share of NPLs from bank balance sheets, thus reducing asset quality uncertainty and lowering the funding costs for banks. Crucially, that uncertainty, and its' alleviation, may not just impact banks that participate in the transfer of assets to an AMC, but all banks in a given sector. As part of a broad strategy to NPL resolution, the European Commission announced at the recent ECOFIN that it will develop a blueprint for national AMCs in Europe that can provide a workable way forward for Member States. This European blueprint should clarify what is possible within a flexible approach to the existent regulation and encourage countries to adopt all necessary measures in a well-defined time frame. As part of the broader resolution strategy, two more instruments which could facilitate sales of NPLs should be considered. Clearinghouses could be established to reduce the information asymmetry and securitisation schemes could be developed to complement outright NPL sales.

Insolvency frameworks and hierarchy of creditor claims

The ECB welcomes the European Commission's proposal on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures. While the proposals only apply to future debt restructuring and do not benefit the current NPL stock, this is an important step towards building a minimum common standard across the EU, in particular for the purposes of pre-insolvency restructuring.

The European Commission's proposal should be followed by further action to harmonise national insolvency regimes, even though this would be more difficult and wider-ranging. The European Commission's proposal does not attempt to harmonise core aspects of insolvency such as rules on conditions for opening insolvency proceedings, a common definition of insolvency, ranking of claims and avoidance actions in general. While the ECB fully understands the challenges linked to harmonisation in the area of insolvency law due to far-reaching changes that may be needed with respect to commercial law, civil law and company law, it nevertheless considers that further work needs to be undertaken to lay common ground for further substantive harmonisation of insolvency laws.

The Commission's proposal on the preventive restructuring framework could be complemented by an EU regime for out-of-court restructurings for SMEs. While various insolvency reforms undertaken at the national level have been aimed at facilitating court-led proceedings, such court-led procedures often remain highly complex and costly owing to time needed for enforcement and the resources involved, thereby reducing recovery values. Particularly in the case of NPLs, any delays in the judicial proceedings significantly affect recovery values and reduce offer prices, leading to situations of high bid-ask spreads and a general lack of NPL sales. Costly judicial proceedings may not be feasible for smaller SMEs, with low levels of capital and a lack of financial resources to

undertake restructurings via court-based proceedings. The Commission's proposal, while offering an alternative to normal insolvency proceedings, still relies on court systems. A complementary course of action would be to encourage out-of-court settlements. Out-of-court workouts are typically faster and more flexible, provide more confidentiality and, considering the overall costs that regular procedures entail, may also be less expensive. In Member States with overburdened and understaffed judicial systems, out-of-court restructuring would provide a valuable alternative. An EU-wide harmonised regime governing the framework for such out-of-court workouts could increase transparency and would create a level playing field. In comparison with national insolvency regimes, which are well established and often straddle commercial, civil and company law, out-of-court workout regimes are newer and therefore, more amenable to harmonisation. A harmonised EU approach in this area could at a minimum establish non-binding guidelines for out-of-court restructuring or, even more effectively, create formal out-of-court regimes. Such a regime could be targeted towards SMEs and preserve the national insolvency regimes as backstop. A number of European countries have introduced a version of such regimes since the crisis[14]. Fiscal and other legislative actions could be used to incentivise their use,[15] considering the large direct and in particular indirect savings that could be achieved by facilitating faster workouts.

Another element that would promote further harmonisation of insolvency regimes is the introduction of a general depositor preference rule in the Bank Recovery and Resolution Directive, which would enhance banks' resolvability by clarifying the hierarchy of creditor claims and facilitating the allocation of losses. The ECB calls for the introduction of such a rule, based on a tiered approach, in the EU.[16] A harmonised depositor preference rule would help to create a level playing field for banks' debt issuance and enhance the robustness of the resolution framework for banks, which benefits the overall stability of the financial system and, in turn, strengthens banks' capacity to support the wider economy.

Options and national discretions

An increasingly integrated banking market – and thus a strong banking union - should also support the integration of capital markets in the EU. Options and

[14] In 2012 Portugal adopted a formal out-of-court restructuring regime targeted at SMEs, through mediation by a government agency. The regime features a creditor standstill and requires tax and social security authorities to participate in the negotiations. In 2013, Spain introduced a regime, reformed in 2015, under which the Chamber of Commerce or a mediator appointed by the registrar or a notary takes the lead in negotiating a settlement. Albania (2013), Austria (2013), Latvia (2010), Portugal (2011), Romania (2012), Serbia (2010) and Slovenia (2014) adopted non-binding guidelines for out-of-court debt restructuring for all business entities (including SMEs) in line with the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL International) Global Principles for Multi-creditor Workouts. Iceland (2010) supervised the adoption by individual commercial banks of out-of-court restructuring guidelines. See Bergthaler, W., Kang, K., Liu, Y, and Monaghan, D. "Tackling Small and Medium Sized Enterprise Problem Loans in Europe", *IMF Discussion Note*, March 2015

[15] See Garrido, J. M., Out-of-Court debt restructuring, World Bank study, 2012.

[16] See Opinion of the European Central Bank of 8 March 2017 on a proposal for a directive of the European Parliament and of the Council on amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (CON/2017/6).

national discretions in prudential banking regulation prevent the achievement of a ‘Single Rulebook’ at EU level. Thus they hamper access to bank lending for companies which cannot directly tap capital markets. Options and national discretions therefore add an additional layer of complexity and costs for credit institutions, while allowing opportunities for regulatory arbitrage. Options for Member States also create obstacles to the efficient operation of the Single Supervisory Mechanism (SSM) since this requires the supervisor to take into account different regulations and practices in the participating Member States. In 2016 the ECB Banking Supervision project on the harmonisation of Options and national discretions was completed: more than 130 supervisory options and discretions were harmonised. However, a significant number of Member State options remain. Unwarranted options and national discretions should be harmonised to facilitate more efficient and consistent supervision of banks in all euro area countries, and the current review of the Capital Requirements Directive/Capital Requirements Regulation offers an opportunity to reduce the number of options and national discretions.

Macroprudential framework

The ECB strongly supports expanding the macroprudential framework beyond banking to address risks arising from the continuously growing non-bank sector. The significant growth of the asset management sector and the growing relevance of market-based financing increase the likelihood of systemic risks originating from, or being amplified by, areas beyond the banking sector, and makes it all the more important to create a framework for these areas. The insurance sector could also be a source of, or amplify, systemic risk.

It is important that macroprudential authorities which have a mandate for the non-banking sector also have the tools to address such new systemic risks to anticipate a potential future crisis.[17] However, the ECB notes that the CMU mid-term review does not include any indication of how this can be achieved, although the case for an enhanced toolkit and integrated supervision at the European level is strong for those segments of the capital market where integration is very advanced and the emergence of cross-border risks is likely. It is particularly important for pan-European entities and activities, such as securities markets and insurance, to ensure equal enforcement across the EU. This would entail changes in the competences of ESMA (or the designated EU single market supervisor) and EIOPA.

Specific tools are required, for example, for derivatives and securities financing transaction (SFT) markets, as well as for the asset management sector. [18] For derivatives and SFT markets, macroprudential margins and haircuts could be used to prevent the build-up of system-wide leverage via derivatives and SFTs and to further limit the procyclicality of margining and

[17] See ECB contribution to the European Commission’s consultation on the review of the EU macroprudential policy framework.

[18] See ECB contribution to the European Commission’s consultation on the review of the EU macroprudential policy framework.

haircut-setting practices.[19] Systemic risks can build up in derivative and SFT markets, irrespective of whether these transactions are cleared or not, and authorities will need to have tailored instruments to address such risks. For the asset management sector macroprudential tools existing in current legislation, such as the macroprudential leverage limit, could be used to address excessive leverage of alternative investment funds and should be made operational.[20] In addition, a framework for applying existing tools to address liquidity risks from a systemic perspective should be developed and complemented by further macroprudential tools as appropriate.

Mergers and acquisitions

Further regulatory convergence is likely to make make cross-border mergers easier, and cross-border banks could support integration and "agglomeration" i.e. the creation of scale effects in capital markets. Cross-border banks are more likely to lift cross-border efficiency potential and have better distribution capabilities. Furthermore, mergers and acquisitions could be an effective means to address the issue of overcapacity in the banking sector. Indicators of market concentration, branch network density and cost-efficiency suggest some overcapacity in parts of the European banking sector, especially in countries with more fragmented banking systems. While low market concentration in some cases is a reflection of structural features of the banking sector (e.g. the important role of savings or cooperative banks), it could also hinder the recovery of profitability given still subdued demand for credit. Overcapacity in some national banking sectors, combined with the greater intensity of competition from non-banks, further squeezes net interest margins. Against this background, there is some scope for efficiency gains from consolidation without reinforcing the "too-big-to-fail" problem.

The banking union, including single supervision and resolution mechanisms, provides ideal conditions for banks to capitalise on new cross-border M&A opportunities. Cross-border bank consolidation has remained limited to date. Efforts could be increased to foster cross-border consolidation among SSM countries. Ultimately, the euro area economy needs banks that are large and efficient enough to operate and diversify risks on a cross-border basis within a single European market, but small enough to be resolved with the resources of the Single Resolution Fund. This would help reap the full benefits of the banking union and improve the trade-off between financial stability and economic efficiency. While consolidation should follow market-led initiatives, European policymakers should work towards creating the institutional conditions for more robust financial integration. Targeted financial sector policies could include removing options and national discretions in European banking regulation, allowing the euro area to be considered as a single jurisdiction for calculating the Basel capital surcharges for systemic institutions, harmonising taxation and insolvency laws and consumer protection, streamlining supervisory merger

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[19] See, e.g., Special Feature A of the ECB's Financial Stability Review., May 2016

[20] See, e.g., Special Feature A of the ECB's Financial Stability Review, November 2016

review procedures and coordinating them with competition reviews, and addressing legacy non-performing loan problems.

EU covered bond framework

While EU covered bond markets are well functioning, with many long-established national legal frameworks for covered bonds, they remain highly fragmented along national lines. Consequently, the ECB favours a high-quality and transparent EU covered bond market, and sees potential for harmonisation of some standards and practices across the EU. Reduced market fragmentation (i.e. increased market integration) to this end would improve market liquidity and increase the resilience of the market (in the face of future crises). In addition, improved liquidity and reduced transaction costs (for investors) would improve pricing overall and further increase the attractiveness of covered bonds as a funding source. Such an approach should be sufficiently cautious and should avoid market distortions in a segment that proved to be relatively resilient throughout the financial crisis and for which a certain level of harmonisation across the specific national legal frameworks already exists.

The ECB welcomes the EBA recommendations to the European Commission[21] to further harmonise national EU covered bond frameworks as a tool to achieve these two objectives. The three-stage approach proposed by the EBA recommendations is consistent with the ECB's view that a comprehensive covered bond legal framework at EU level is achievable over a medium to long-term horizon, following a harmonisation and convergence process.[22]

The proposed further harmonisation of several essential features of the national covered bond frameworks represents a significant step forward in increasing comparability between the national frameworks. These features are: the definition of core concepts such as the dual recourse, the segregation of cover assets, the coverage requirement and the special supervision. Moreover, the ECB also welcomes the proposed enhancements to the definition of those covered bonds that receive a preferential capital treatment. The newly proposed minimum coverage requirement in particular represents a highly desirable improvement. As a common measurement of overcollateralisation, it would allow supervisors and investors to compare covered bonds more easily across Member States and issuers. It should also ensure that all covered bonds eligible for the preferential capital treatment provide investors with an additional layer of safety.

The rapid development of innovative covered bond structures, whose features are not yet fully understood by all stakeholders, requires careful assessment, to ensure a sustainable market development. Over the past few years new covered bond structures in which the scheduled maturity of the outstanding

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21 See EBA Report on Covered Bonds – Recommendations on harmonisation of covered bond frameworks in the EU, 20 December 2016.

22 See Covered bonds in the European Union – ECB contribution to the European Commission's public consultation, 29 January 2016.

bonds can be extended by the issuer have been increasingly used. While these structures present certain advantages to the issuers compared with the traditional bullet structures, and are generally positively assessed by investors as an additional protection against a default of the issuer, the specific risks posed by them have not been sufficiently assessed by the prudential supervisors.

STS securitisation framework

The proposed securitisation regulation and STS securitisation framework, due to be finalised soon, are highly important CMU achievements. A careful balance needs to be achieved to ensure that the proposed STS securitisation framework can be successfully adopted by the markets, while preserving the prudential nature of the framework. In its opinion[23], the ECB has put forward a number of measures that aim, on one hand, to make the securitisation framework more usable, and on the other hand, to increase the prudential nature of the framework. Debate over increasing the retention rate for securitisations from the current 5% level, which has emerged as a central point during the trilogue discussions, should also consider the very significant progress achieved since the crisis on a number of measures complementary to the retention rate, such as transparency, through the introduction of loan-level data in the Eurosystem collateral framework and, more recently, through the requirements of Article 8b of the Credit Rating Agencies (CRA) Regulation. Moreover, the STS framework, through its criteria, further enhances the governance of a major part of the European securitisation markets. Any changes to the retention rate should be assessed carefully, given the close interaction between the retention rate and both the significant risk transfer and accounting deconsolidation, which are key advantages of securitisation over other forms of asset-based funding. Particularly at the current juncture, where credit institutions' capacity to lend to the real economy is constrained and economic growth remains subdued, securitisation can act as a fresh source of funding and free up capital for lending.

Efforts to preserve the prudential nature of the securitisation framework could instead focus on safeguarding key progress already achieved in areas such as transparency. For example, the Article 8b requirements, with respect to the mandatory disclosure of loan-level data for European securitisations, should be preserved in the new legislation. A well-designed securitisation framework, with well-designed retention risk requirements, would ensure a successful adoption of the STS framework and would contribute to the recovery of credit flows in the EU.

The further revision of capital charges for STS securitisations in Solvency II is necessary to ensure the successful adoption of an STS securitisation framework in the EU. Insurance companies represent key investors in the securitisation markets; as such measures to incentivise, in a prudent manner,

[23] See Opinion of the European Central Bank of 11 March 2016 on (a) a proposal for a regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation; and (b) a proposal for a regulation amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CON/2016/11).

their continued involvement in securitisation markets are urgently needed. The calibration of Type 1 transactions, as defined in the Commission's Solvency II Delegated Regulation adopted in the October 2014 framework, would benefit from increased risk sensitivity in a number of directions, as recommended by the ECB and the Bank of England.[24] An updated calibration should also consider the difference in risk profile and tolerance between insurance companies and banks, the capacity of the STS criteria to capture a lower risk profile in securitisations and that calibration should not incentivise insurance companies to seek investments in the assets in question in an unsecuritised, rather than a more liquid securitised, format.

6. Facilitating cross-border investment

Financial market infrastructures

Fostering further integration in financial market infrastructures will be a key element in establishing CMU. The focus should be on greater harmonisation of rules concerning securities, collateral, and message and data standardisation. It would help to remove the remaining barriers preventing cross-border access and ensure a level playing field for investors and issuers of financial instruments in the EU.

TARGET2-Securities (T2S) facilitates integration in securities market infrastructures but more action is needed to remove remaining barriers. The ECB launched TARGET2-Securities (T2S)[25] on 22 June 2015, creating a single platform for securities settlement in Europe. T2S facilitates post-trading integration by offering core, neutral and borderless pan-European securities settlement in central bank money so that central securities depositories can provide their customers with harmonised and commoditised delivery-versus-payment settlement services in an integrated technical environment (covering both domestic and cross-border business). However, while T2S will facilitate the removal of certain barriers in T2S markets, its potential can only be fully exploited if the remaining barriers (including those identified by the Giovannini Report[26]) in the field of market infrastructures are addressed.

The ECB strongly supports the actions undertaken and planned by the European Commission in this area as already reflected in the CMU mid-term review:

i) The first action relates to the legislative proposal regarding securities ownership rules. The ECB welcomes the objective of addressing the challenges regarding the uncertainty, i.e. in relation to costs and risks, over which law applies in chain securities transactions across borders. In

[24] *An EU framework for simple, transparent and standardised securitisation*, Joint response from the Bank of England and the European Central Bank to the Consultation Document of the European Commission, 27 March 2015.

[25] See the ECB's website for information on TARGET2-Securities.

[26] See the Second Report on EU Clearing and Settlement Arrangements of the Giovannini Group, April 2003.

this regard, the introduction of a single conflict of laws rule for the holding and transfer of intermediated securities or the provision of proprietary interests therein would be desirable. This would require going further than the sectoral legislation (such as the Settlement Finality Directive and the Financial Collateral Directive) and introducing a general rule applicable to all securities held with an intermediary. If the link to the location of the securities account is to be maintained, the connecting factor should sufficiently describe how the applicable law is determined, as the securities account does not physically exist and its "location" would need to be determined with reference to specific factors. Furthermore, in the longer term a comprehensive reform of substantive securities law should be considered.

ii) The second action relates to the work undertaken jointly by the European Commission services and Member States to agree on a code of conduct regarding the procedures for relief at source from securities withholding taxes. As already identified by the Commission-sponsored initiatives, i.e. the Giovannini Report, the Clearing and Settlement Fiscal Compliance expert group (FISCO)[27] and the Tax Barrier Advisory Group (T-BAG),[28] as well as the ECB's T2S Advisory Group,[29] non-harmonised and burdensome withholding tax procedures constitute a barrier for the securities industry and for investors. They penalise cross-border investment, disrupt financial processes such as clearing and settlement, increase the cost of cross-border trading and are ultimately incompatible with a single European securities market

The ECB will continue to support, and further contribute to, the work of the European Post-Trade Forum (EPTF).[30] As stated in the CMU mid-term review, the EPTF is currently reviewing the progress made in removing the remaining Giovannini barriers to post-trade, including the reassessment of their context and relevance taking into account recent legislation and developments in financial markets, e.g. the Central Securities Depositories Regulation and T2S. The ESCB as well as the Advisory Group on Market Infrastructures for Securities and Collateral (AMI SeCo)[31] await with interest the announced public consultation on the EPTF report.

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[27] See Clearing and settlement: Commission expert group examines EU fiscal compliance barriers to cross border securities trading, European Commission press release, 19 April 2016

[28] See the European Commission's website for information on the Tax barriers business advisory group.

[29] See the ECB's website for information on the T2S Advisory Group.

[30] See the European Commission's website for information on the EPTF.

[31] See the ECB's website for information on the governance of market infrastructure and payments.