

# Finance for Europe – Building competitive, resilient and integrated financial markets

A financial services strategy for sustainable growth and competitiveness in 2019–2024

July 2019



## / About AFME

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues.

We represent the leading global and European banks and other significant capital market players.

We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society.

We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

### Focus

on a wide range of market, business and prudential issues

### Expertise

deep policy and technical skills

### Strong relationships

with European and global policy makers

### Breadth

broad global and European membership

### Pan-European

organisation and perspective

### Global reach

via the Global Financial Markets Association (GFMA)



## Executive Summary

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As the European Union gets ready to identify its strategic priorities and to plan its policies for the 2019-2024 legislative term, it is important to reflect on the various forces that are re-shaping many aspects of the economy and the policy landscape. These include an increasingly competitive global economic environment, the growth of disruptive technologies and new business models, as well as the drive to transition to a low-carbon economy. The United Kingdom's prospective withdrawal from the EU will also be a factor in the near-term policy agenda.

In this context, the EU should prioritise a growth strategy that focuses on promoting competitiveness, innovation and deeper integration while transitioning to a greener economy.

A competitive, resilient and well-integrated financial system can play a central role in driving this strategy. AFME believes the EU should establish an ambitious agenda for the financial services sector in 2019-2024, which advances the following objectives.

- Supports European integration and financial stability by providing diversification, shock-absorption and risk sharing channels;
- Promotes the availability of diverse and efficient financing mechanisms for businesses of all sizes, with particular focus on funding for technological innovation and enterprises with high growth potential, through capital market ecosystems;
- Finances the transition to a more sustainable economy and helps to close the yearly investment gap of almost EUR 180 billion to achieve EU climate and energy targets by 2030<sup>1</sup>;
- Provides EU citizens and organisations with a diversity of assets for investment and saving, contributing to wealth creation and the provision of retirement income to address the EU's demographic challenge<sup>2</sup>.

In order to best attract both market liquidity and long-term investment, the EU's financial markets regulatory framework must be continually evaluated as to whether it is sufficiently competitive and at the cutting edge of innovation and connectivity.

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1 European Commission Sustainable Finance Action Plan, March 2018.

2 As stated by Vice-President Dombrovskis in April 2019: "The EU's demographic challenge can be summed up in one simple statistic: today there's one pensioner for every four people of working age. But in 50 years, this ratio will be about one to two." [https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/capital-market-union-keynote-speech-impact-pepp-eu-capital-markets-and-sustainable-pensions-income\\_en](https://ec.europa.eu/commission/commissioners/2014-2019/dombrovskis/announcements/capital-market-union-keynote-speech-impact-pepp-eu-capital-markets-and-sustainable-pensions-income_en)



### Priorities to support sustainable growth and competitiveness

We have identified eight key priorities for a strong EU financial sector agenda to support sustainable growth and competitiveness.

#### 1. Improving efficiency and connectivity in securities markets

Efficient and well-developed securities markets are essential in order to meet the financing and risk management needs of EU citizens, enterprises and public authorities. A central focus of the Capital Markets Union (CMU) project should be to improve the functioning of the EU's market structure following six key attributes identified by AFME.

##### AFME recommendations:

- **Undertake a recalibration of MiFID 2/R** with a view to improving outcomes for end-users and advancing CMU objectives, focusing on the following areas: market structure; transparency and reporting; reference data quality and availability; market data costs; investor protection; issues arising from Brexit;
- **Address impediments to an integrated post trade system** by dismantling the barriers identified by the European Post Trade Forum in 2017, particularly in relation to withholding tax collection and securities laws;
- **Improve the functioning of corporate bond markets** by implementing key recommendations identified by the Commission's Expert Group on Corporate Bonds in 2017.

#### AFME Attributes of an Efficient and Integrated Securities Market Structure

- Operational resilience and efficiency in the service of end-users;
- Strong and well-calibrated levels of investor protection;
- Transparency regimes that support liquidity and market confidence;
- Availability of high-quality data at reasonable costs;
- A high level of conduct, culture and ethics;
- Fair and open access to market infrastructures.

#### 2. Expanding the size and capacity of EU capital markets

A set of initiatives under the CMU project should be aimed at expanding the overall size and capacity of EU capital markets, with a particular focus on improving retail investor participation and the level of financial market integration across the EU.

##### AFME recommendations:

- **Adopt a comprehensive strategy to promote retail investment** in EU capital markets. It is also important to **clarify the scope of the PRIIPs Regulation** to enable the distribution of plain vanilla products to retail investors;
- **Foster better conditions for accessing private and public equity capital** by implementing measures to improve the regulatory environment for IPOs (particularly for SMEs), creating a single market for business angel investors and removing disincentives against equity finance in taxation and other frameworks;
- **Support the development of long-term investment** through the promotion of harmonised tax incentives and structural reform of retirement schemes;
- **Work towards further convergence of national legal frameworks and supervisory practices** by taking incremental steps to address harmful national divergences in securities markets supervision, corporate insolvency regimes and securities laws;
- **Revisit the regulatory treatment of securitisation** by using the CRD6/CRR package and future review of the 2017 Securitisation Regulation as opportunities to re-examine certain provisions to achieve more proportionality and a level playing field with other fixed income instruments.

### 3. Promoting integration in EU financial markets and removing harmful fragmentation

The joint advancement of the Banking and Capital Markets Unions and better regulatory recognition of the EU as a single market are key cross-cutting, complementary and mutually reinforcing priorities to enhance financial stability and cross-border integration. This requires overcoming a deficit of trust that has characterised certain debates among authorities and home/host jurisdictions. Integrated banking and financial markets are crucial for the sound functioning of the Economic and Monetary Union and to promote the internationalisation of the euro. A more comprehensive analysis on these issues, as well as on the implementation of Basel III, is provided in the separate AFME publication on “*The European Banking System: Tackling the Challenges, Realising the Opportunities - Achievements and Next Steps for the New EU Legislative Cycle*” (July 2019).

#### AFME recommendations:

- **Develop an ambitious Capital Markets Union** to enhance the diversity of funding sources, reduce the overreliance on banks, spread risk and help to smooth economic shocks;
- **Complete the Banking Union**, focusing on considering it as a single jurisdiction in terms of prudential requirements, achieving an effective depositor protection, and, in the context of broader considerations, a solution for a European safe asset;
- **Remove the fragmentation in EU financial markets** by addressing supervisory divergences and options/discretions in the regulatory framework which serve to perpetuate fragmentation and inhibit the free flow of capital and liquidity.

### 4. Achieving a sound implementation of Basel III

A well-designed EU implementation of the Basel III final agreement will be an important objective in finalising the post-crisis reform programme. The implementation should be based on a robust and cumulative impact assessment and aimed towards supporting a healthy, competitive and well-regulated banking system.

#### AFME recommendations:

- **Respect the international commitment to avoid significant increases in capital requirements** through a careful assessment of various aspects of the framework against this objective;
- **Preserve the risk sensitivity of the framework**, ensuring that key areas of the package – including the credit risk framework, the new output floor and the operational risk framework and the counterparty risk framework – are evaluated to avoid disproportionate impacts on a number of exposures and to limit the loss of risk sensitivity of the framework;
- **Assess the overall impacts, ensuring global consistency and a level playing field** by continuously monitoring the interaction between the various requirements and their cumulative impact.

### 5. Fostering a culture of integrity and effective conduct regulation

The EU should continue to promote a culture of integrity in the financial system. It is important to focus on effective rules in the fields of financial crime and market abuse, building on the significant work already undertaken in conduct, ethics, fitness and propriety protection of whistleblowers and personal accountability of senior management.

#### AFME recommendations:

- **Improve the tools and frameworks to fight against money laundering**, including transforming the EU Anti-Money Laundering Directive framework into a Regulation as a more harmonised framework would result in administrative efficiencies, cost savings and more effective prevention of crime;
- **Review the Market Abuse Regulation (MAR)** to address challenges to effective monitoring and surveillance of market abuse.
- **Review short selling requirements and guidelines**, to improve aspects of the Short Selling Regulation and ensure a sound application of the exemptions for market making activities.

### 6. Taking sustainable finance to the next level

The EU should continue to build on its global leadership on sustainable finance through the completion of the EU taxonomy to classify environmentally sustainable economic activities, followed by an effort to encourage its adoption by other jurisdictions or international convergence.

#### AFME recommendations:

- **Achieve a practical EU-wide taxonomy**, starting with investment management and investment advice activities, ensuring it is progressive, flexible and proportionate, and promote convergence at global level;
- **Enhance corporate reporting and disclosures** of climate-related information as well as environmental, social and governance (ESG) information more broadly, to end investors to facilitate informed decision making by the users of such information and encourage sustainable investment;
- **Establish a common definition of green securitisation** to facilitate the development of a green securitisation market in Europe.

### 7. Building a competitive Digital Single Market

A comprehensive Digital Single Market strategy is essential to encourage innovation and ensure a level playing field between different market players, while supporting operational resilience and security.

#### AFME recommendations:

- **Develop a pan-European cyber-crisis governance model** between the public and private sector which is consistent with global practices and provides clarity on decision-making in response to a large scale cyber-crisis;
- **Harness the potential of emerging technologies**, focusing on the following areas: reviewing barriers to the adoption of Cloud Computing, addressing considerations on ethics and trust in Artificial Intelligence, and working towards a common digital assets (e.g. cryptoassets) taxonomy;
- **Ensure a level playing field in the Digital Single Market** by fostering a coordinated and pragmatic application of outsourcing guidelines and ensuring that an appropriate regulatory perimeter and requirements are applied equally to all market participants, including Big Tech firms.

### 8. Facilitating global regulatory convergence and cooperation

In the face of emerging fragmentation and challenges to multilateralism, the EU should continue to champion international standards, regulatory dialogue, openness with other countries and supervisory cooperation.

#### AFME recommendations:

- **Lead global efforts to tackle harmful instances of market fragmentation**, including in the work of the FSB, IOSCO and other organisations, and use the forthcoming reviews of key EU legislations – including the CRR/CRD, MiFID/R and third country benchmarks frameworks – to address provisions that could cause unintended fragmentation and frictional costs while encouraging ex-ante and ex-post analysis of effects of reforms.
- **Expand focus on well-functioning equivalence and supervisory cooperation frameworks** in the context of Brexit and other key third country relationships, in support of open, well-regulated cross-border markets, particularly in relation to investment firms, trading venues, market infrastructures and benchmarks.

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## 1. Improving efficiency and connectivity in securities markets

AFME believes the CMU should support six essential attributes of an efficient and well-developed market structure. These attributes can be advanced particularly through a review of MiFID 2/R and addressing long-standing barriers to an integrated post trade system. A fundamental challenge is to ensure that all the elements of the securities market structure are interoperable, can communicate with each other, and can function in a cost-efficient manner, so that EU savers and investors can achieve the benefits of a single market.

### AFME Attributes of an Efficient and Integrated Securities Market Structure

#### Attribute 1

##### Operational resilience and efficiency in the service of end-users

###### Objective

An optimal market structure is designed with primary focus on providing stable and cost-effective channels for the issuance, distribution and trading of securities to the benefit of investors and non-financial companies.

###### Areas for improvement

MiFID 2/R requirements such as the share trading obligation (STO), the double volume caps and tick size regimes have brought major changes to Europe's equities markets. The effects have not always been positive: for example, as currently defined the STO results in detrimental execution and investment performance outcomes for end-investors. The negative impacts could be exacerbated by the possibility of conflicting STOs following Brexit and restricted access to liquidity pools, resulting in investment firms being limited in their ability (in certain circumstances) to deliver the best possible result for customers when executing their orders ("best execution"). In the post trade area, a number of national impediments to market integration and connectivity continue to exist.

#### Attribute 2

##### Strong and well-calibrated levels of investor protection

###### Objective

Investors must be protected from being misled or unfairly treated. Rules should be well calibrated to ensure retail and professional investors, who have very different profiles, receive appropriate information and levels of protection according to their needs.

###### Areas for improvement

A number of areas in MiFID 2/R and other regulations would benefit from a better distinction between professional investors and retail clients. This includes a more tailored regime for eligible counterparties and professional investors in best execution reporting and the communication of cost and charge information.

#### Attribute 3

##### Transparency regimes that support liquidity and market confidence

###### Objective

Transparency, in the form of publication of trade details after a transaction, is important to support price discovery and price formation. However, financial instruments have different characteristics, which must be reflected in the transparency regime. Careful calibration and alignment is necessary to avoid risks to liquidity and higher costs for end-users.

###### Areas for improvement

AFME supports the intent of MiFID 2/R to establish a well-calibrated transparency regime for equity and nonequity instruments. We note that if the transparency regime for bonds, particularly the different classes of bonds is not better designed, it may have inadvertent consequences that could impact the functioning of some less liquid sovereign debt markets. Within equities, we highlight the problematic linkages between the transparency requirements and the excessive breadth of the concept of "traded on a trading venue" in some circumstances. The regime's current fixed reporting hierarchy should be reconsidered as it has led to a number of unforeseen consequences<sup>3</sup>.



### Attribute 4

#### Availability of high-quality data at reasonable costs

##### Objective

Access to data is indispensable for financial market participants to carry out their activities. Concerns about data quality, data availability and high fees can lead to less efficient pricing of securities, more volatile and less liquid markets, and an unlevel playing field among participants.

##### Areas for improvement

Market data costs have increased significantly since MiFID 2/R<sup>4</sup> and data licences are complex for investment firms consuming this primary input. MiFID 2/R requires trading platforms to make pre and post-trade market data available on a “reasonable commercial basis”. Notwithstanding this requirement, consumers of market data report significant price increases, most notably from the primary exchanges that lack the competition which typically drives down prices. Meanwhile, end-users’ ability to access new market data is significantly impaired by the fragmentation of trading venues and data publishers.

### Attribute 5

#### A high level of conduct, culture and ethics

##### Objective

Trust and integrity are fundamental to the smooth functioning of markets and preserving confidence among participants.

##### Areas for improvement

Our recommendations on reviewing MAR will contribute towards this objective. It is important to focus on effective rules in the fields of financial crime and market conduct, building on the significant work already undertaken in conduct, ethics, fitness and propriety protection of whistle-blowers and personal accountability of management and risk takers. This includes improving the effectiveness of tools and frameworks to fight against market abuse, money laundering and financing of terrorism.

### Attribute 6

#### Fair and open access to market infrastructures

##### Objective

Fair and open access to trading and clearing infrastructure as mandated by the existing MiFID2/R rules is vital for maintaining integrated, safe, efficient and continuous markets<sup>5</sup>. Open access leads to lower costs, deeper pools of liquidity, improved service levels, greater capital efficiency and innovation.

##### Areas for improvement

Currently, European CCPs are able to offer privileged access to trading venues within their own corporate group. AFME is anticipating the expected benefits of MiFID 2/R’s open access conditions for CCPs (central counterparties) and trading venues, which should contribute to innovation and competition in the European markets from July 2020 onwards.

#### Reviewing aspects of MiFID 2/R

AFME believes that several provisions of the MiFID2/R<sup>6</sup> regime need recalibration. Our assessment is that MiFID 2/R has been very costly to implement for all segments of the financial sector and remains so on an ongoing basis. The existing framework should be rigorously evaluated and refined in alignment with the objectives of CMU to strengthen the capacity of EU capital markets, reduce fragmentation and improve efficiency.

3 Having a fixed reporting hierarchy within which systematic internaliser status attracts reporting responsibilities, coupled with the decisions by some buy-side firms not to build reporting infrastructure (and therefore only deal with systematic internalisers) has resulted in potentially unforeseen consequences, such as a larger number of firms deciding to be systematic internalisers.

4 AFME notes the findings of the Copenhagen Economics paper “Pricing of Market Data: a report commissioned by the Danish and Swedish Security Dealers Associations”, November 2018. The Report concludes that the combined effect of trading venues having extensive market power in selling their market data, together with MiFID 2/R requiring firms to obtain market data, has had a detrimental effect on investor outcomes.

5 See CPSS-IOSCO “Principles for financial market infrastructures”, April, 2012

6 The Commission is required, after consultation with ESMA, to report to the European Parliament and the Council on more than 20 aspects of MiFID 2/R between 2019 and 2021.

### Recommendations:

- 1 Address inefficiencies in equities trading regulation:** It is important to undertake a robust cost-benefit analysis of provisions including the share trading obligation, the double volume caps and tick size regimes. Authorities should pursue the necessary adjustments, including amending or removing requirements that undermine best execution or lead to sub-optimal outcomes for end-investors.
- 2 Address duplicative trade reporting requirements:** We recommend supplementing the current reporting hierarchy with the ability (not the obligation) for parties to agree who reports a transaction. The MiFID 2/R transparency regime is geared towards providing market transparency on traded instruments in the EEA. The concept of admission to trading extends the requirements to instruments that are not actually traded and, as such, this acts to obscure the pricing signals.
- 3 Tackle the problem of data availability and high market data costs:** Authorities should prioritise a review of the application of the “reasonable commercial basis” requirement to address the problem of high market data costs. AFME is in principle supportive of having a central source of consolidated trading data (a “consolidated tape”) which, in our view, would represent an opportunity to provide greater transparency to market participants, promote integration and facilitate market access.
- 4 Better differentiate between professional and retail clients in key areas:** It is important to review the utility and content of mandatory costs and charges provisions for wholesale clients, as well as reviewing the best execution reporting regime for eligible counterparties and professional end-investors.
- 5 Promote fair and open access to market infrastructure:** It is important to closely evaluate the effectiveness of the open access conditions for CCPs and trading venues as mandated by MiFID2/R that are expected to apply from July 2020.
- 6 Address concerns regarding reference data and “traded on a trading venue”:** To improve reference data quality and availability, we believe ESMA’s databases should be considered a “golden source” which firms could use to ascertain which instruments are “traded on a trading venue”.
- 7 Adjust to Brexit:** It will be necessary to consider MiFID 2/R provisions and calibrations designed for the EU28 following the UK’s departure from the EU. Brexit is likely to result in two distinct MiFID/R regimes interacting with each other: the EU MiFID/R regime and a new UK MiFID/R regime. The implications of this bifurcation will require detailed consideration if it is not to pose a threat to the operational efficiency of the financial market ecosystem.

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Following the application of MiFID 2, we were made aware of substantial increases in the costs of market data, reaching at times up to 400% compared to prices charged prior to 3 January 2018

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**Steven Maijor Chairman of ESMA<sup>7</sup>**

### Addressing impediments to an integrated post trading environment

There is a long history of European initiatives which have aimed to tackle the barriers preventing the creation of a more integrated post trade system<sup>8</sup>. However, with respect to securities clearing, settlement and custody, improvements have been incremental and segmented. National level impediments continue to exist in various areas.

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<sup>7</sup> As stated by Steven Maijor in June 2018: [https://www.esma.europa.eu/sites/default/files/library/esma70-156-427\\_mifid\\_ii\\_implementation\\_-\\_achievements\\_and\\_current\\_priorities\\_steven\\_maijor\\_fese\\_convention\\_2018\\_vienna\\_21\\_june\\_1.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-156-427_mifid_ii_implementation_-_achievements_and_current_priorities_steven_maijor_fese_convention_2018_vienna_21_june_1.pdf)

<sup>8</sup> Some of the most notable initiatives were the two Giovannini reports of 2001 and 2003, the EMIR and CSDR frameworks, and the launch in 2015 of the TARGET2-Securities (T2S) settlement platform.

## 1. Improving efficiency and connectivity in securities markets

In 2018 AFME published the White Paper “A Roadmap for Integrated, Safe and Efficient Post Trade Services in Europe”, where we set out our vision of a future post trade system. Our vision is for:

- A truly integrated, harmonised, low-risk and low-cost post trading system in Europe;
- Post trade infrastructures and service providers that compete in a harmonised and standardised operational, legal and regulatory environment, offering innovative and low-cost services to all users on a non-discriminatory basis.

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The estimated cost of inefficient withholding tax collection procedures is roughly EUR 8.4bn per year, which is transferred to end investors.

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**CEPS analysis<sup>10</sup>**

Recommendation:

- **Dismantle the barriers identified by the European Post Trade Forum (EPTF):** It is critical to work towards addressing the barriers identified by the EPTF in 2017<sup>9</sup>, which AFME has discussed in detail in the aforementioned White Paper. We urge EU authorities to endorse a strategy to this effect, including responsibilities and timelines, and implement it accordingly. Particular focus should be given to withholding tax issues (see the box below) and removing inconsistencies and uncertainties in securities laws (see our comments under section 2).

### Withholding tax regulations – A deterrent to cross-border investment

Inefficient withholding tax collection procedures, including the lack of a relief-at-source system, continue to be a prominent impediment to cross-border integration in EU securities markets. The actions<sup>11</sup> proposed by the EPTF will significantly increase the attractiveness of national capital markets for cross-border investments. We have unfortunately seen no evidence that the non-binding code, which called for voluntary commitments by Member States to improve the efficiency of current withholding tax procedures (in particular for refunds of withholding tax), has been acted upon.

### Implementing measures to improve the functioning of corporate bond markets

Corporate bond markets are a core pillar of a successful CMU. Strong corporate bond markets give businesses access to more diverse sources of funding and offer Europeans more investment opportunities.

The report of the Commission’s Expert Group on Corporate Bonds<sup>12</sup> put forward 22 recommendations based on analysis from the Expert Group, which was tasked with assessing how corporate bond markets can be improved to enhance their efficiency and resilience. These recommendations address the functioning of markets from the perspective of issuers, investors and intermediaries.

Recommendation:

- **Implement the Expert Group’s recommendations:** AFME supports a holistic implementation of the Expert Group recommendations. Individual recommendations solely implemented are unlikely to be as impactful in improving efficiency in the corporate bond market.

9 See “European Post Trade Forum Report”, May 2017.

10 See CEPS “Europe’s Untapped Capital Market: rethinking financial integration after the crisis”, February 2016.

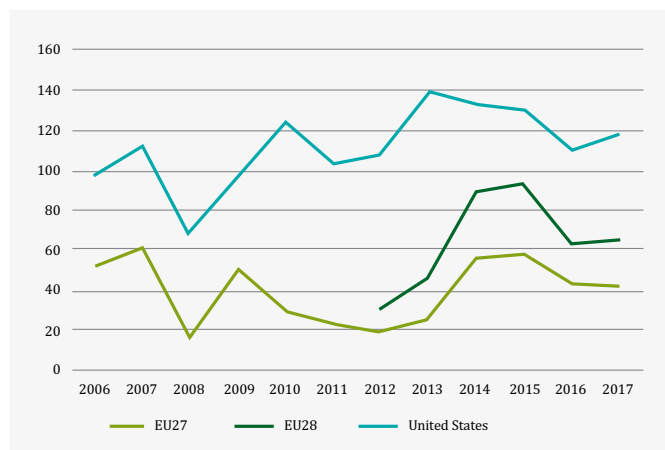
11 Policy actions should focus on: electronic processing and standardisation of formats, recognition of power of attorney and self-declaration of residence, together with a memorandum of understanding among national fiscal agencies for data sharing on fiscal residence and tax reporting with a common identification system. These actions should ultimately create conditions for relief-at-source as the default procedure.

12 See “Report from the Commission Expert Group on Corporate Bonds, November 2017.

## 2. Expanding the size and capacity of EU capital markets

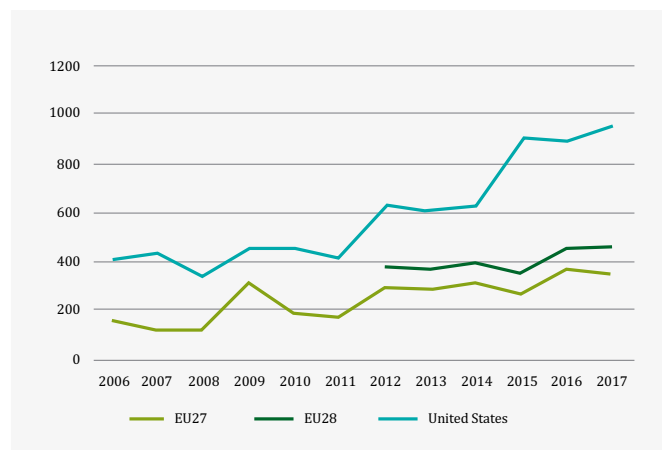
It is crucial to enhance the capacity, size, liquidity, interconnectivity and depth of the EU’s capital markets. Capital markets in the EU remain fragmented and under-sized<sup>13</sup>. In some Member States, instruments other than bank credit represent a very small share of funding to the economy<sup>14</sup>. Enhancing the demand for, and availability of, pre and post-IPO equity risk capital is particularly important. This form of financing is better suited to the delayed profitability associated with innovative projects or nascent technologies<sup>15</sup>, which are key to promoting economic growth and job creation.

### 2.1: Equity issuance by Non-Financial Corporates (€bn)



Source: Dealogic

### 2.2: Bond issuance by Non-Financial Corporates (€bn)



Source: Dealogic

It is also important to avoid implementing policies detrimental to CMU objectives. AFME reiterates its concerns regarding proposals to introduce a European tax on financial transactions (FTT). Not only would an FTT make financing more expensive for European corporates due to increased transaction costs and reduced market liquidity, it would have a direct negative impact on end-users who would ultimately bear its burden. A new tax on equity instruments would be a negative signal at a time when the EU should be creating incentives to promote equity finance.

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Roughly 70% of funding for EU non-financial counterparties (NFCs) has been in the form of lending with the remaining 30% from market finance. In the US this is reversed and around 70% of finance for NFCs has come from capital markets instruments and the remainder has been lending.

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#### AFME analysis<sup>16</sup>

13 See AFME “Capital Markets Union – Measuring progress and planning for success”, September 2018. AFME’s CMU Key Performance Indicators (KPIs) show encouraging trends in, for example, the availability in pre-IPO risk capital for SMEs, the amount of household retail investment on market instruments, and the labelling of sustainable instruments.

14 For a full analysis of capital markets in the CEE region, see AFME and New Financial “The Benefits of Capital Markets to High Potential EU Economies”, November 2016. Deeper capital markets in Central and Eastern Europe could unlock more than €200 billion in long-term capital, deliver more than €40 billion a year in extra funding for companies and boost growth across the region. We support the work undertaken by the Commission under the Vienna Initiative on bank finance and encourage the continuation of this agenda focusing on equities markets in the CEE region.

15 See AFME “The Shortage of Risk Capital for Europe’s High Growth Businesses”, March 2017.

16 AFME “Capital Markets Union – Measuring progress and planning for success”, September 2018.



### Mobilising retail investment

Encouraging more retail investor participation in EU capital markets is one of the keys to unlocking the true potential of CMU and delivering direct value to citizens and the economy. The relationship between the availability of deep savings in capital markets instruments and the capacity of companies to raise finance in markets is strong. There is a symbiosis between investing in instruments that generate returns for households and funding the investments in innovation and technology that generate real economic value for future generations.

Recommendations:

- 1 Establish a comprehensive EU retail investment strategy:** Such a strategy should consider a variety of actions focusing on the availability of appropriate products for retail investors and incentives to invest in them. Consideration could be given to the following: roll-out of auto-enrolment pension schemes; exploring the concept of an EU Investment Savings Account so that retail investors can invest in shares and bonds in a tax efficient way; and measures to enable retail participation in a broader range of products, such as loan fund products. The strategy should be supported by Member States and seek to include commitments to facilitate national level measures – such as favourable tax treatments – that would promote a greater access to retail products.
- 2 Clarify the scope of PRIIPs to enable the distribution of plain vanilla bonds:** Uncertainty about the scope of the PRIIPs Regulation, and concerns about its requirements, have had a serious impact on the provision of plain vanilla financial products to retail clients, such as straight bonds issued by investment grade corporates. This is due to the requirement for a key information document to be published, and then maintained, by the relevant issuer during the life of the instrument, even though these products are neither “structured” or otherwise “complex”. We support the call from the European Supervisory Authorities in July 2018 for the scope of the PRIIPs Regulation to be clarified and we recommend a review of the Regulation to be commenced as soon as practicable.

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The average EU household accumulates savings at a higher rate than in other jurisdictions (net savings rate of c. 6%, compared with 3.3% in the US, and 2.6% in Japan), but invests 35% of those savings in conservative instruments like cash or deposits, while in the US households allocate only 15% in such instruments.

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**AFME analysis<sup>17</sup>**

<sup>17</sup> See AFME “Capital Markets Union – Measuring progress and planning for success”, September 2018, p. 14.

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If the EU's market capitalisation-to-GDP ratio were to increase to 100% (from 78% today), this would imply that more than € 3.6 trillion in additional equity capital could be deployed in European companies.

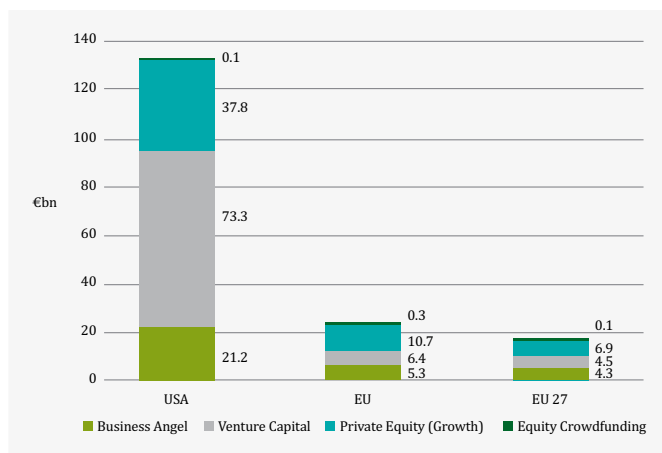
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**AFME analysis<sup>19</sup>**

### Fostering better conditions for accessing public and private equity capital

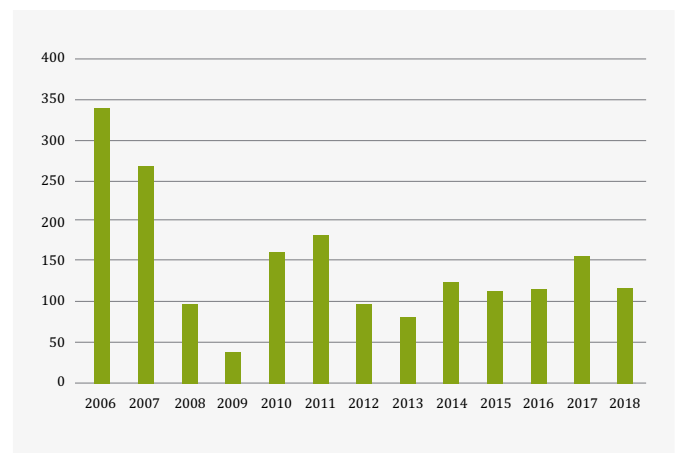
The EU needs more equity capital to generate economic growth and employment<sup>18</sup>. Equity risk capital is particularly suitable for early-stage enterprises with a limited or no track record but above average growth prospects. Established companies also benefit from equity capital for example to expand into new markets or build new production sites, or to start a completely new business with uncertain outcomes.

#### 2.3: Pre-IPO risk capital investment in the US and Europe by asset classes (2017, €bn)



Source: InvestEurope, EBAN, TAB, NVCA, and University of New Hampshire

#### 2.4: Number of IPOs on Jr markets in the EU



Source: Dealogic

Changes to regulation are needed to encourage companies to seek equity risk capital and to incentivise institutional investors and high net-worth individuals to invest, in particular, in unlisted SMEs and venture capital funds.

Recommendations on the IPO regulatory environment (particularly for SMEs):

- 1 **Harmonise relevant regulatory standards:** such as the liability regime across the EU for the marketing offerings of issuers and investment banks, and the rules governing the ability of issuers to incorporate information into a prospectus by reference.
- 2 **Improve the efficiency of the IPO process in the EU:** by creating a central EU filing system for offering documentation to facilitate the flow of information about companies to potential investors and other participants, and permitting issuers to submit prospectuses to competent authorities online.
- 3 **Harmonise (and reduce) the free float requirements across European exchanges:** to allow comparison between venues based on the availability of investors/liquidity rather than regulatory differences.

18 See AFME-BCG "Bridging the Growth Gap", February 2015. The report identified the fragmented nature of European capital markets and the lack of equity finance as key elements holding back economic growth.

19 We believe that there is a large pool of potential equity capital that is currently untapped. The scale of this foregone funding opportunity can be derived by comparing European and US markets. In 2018, the US equity market's capitalisation represented 149% of GDP, whereas Europe's was just 78%. If Europe's market capitalisation-to-GDP ratio was to increase to 100%, this would imply that more than € 3.6 trillion in additional equity capital could be deployed in European companies, improving the balance between debt and equity funding.

## 2. Expanding the size and capacity of EU capital markets

Recommendations on the pre-IPO environment:

- 1 **Improve the environment for business angel investment:** create a passport regime for business angel investors, as well encouraging Member States to review relevant tax and fiscal frameworks.
- 2 **Create a category of sophisticated investors:** to incentivise high net worth individuals to invest directly in venture capital funds. We would suggest amending MiFID 2/R to ensure that “sophisticated” investors are recognised as a specific investor category.

### Supporting the development of long-term investment

Long-term investors are indispensable to the creation of an ecosystem that fosters the development of innovative companies. Because of the duration of their liabilities, pension funds are perfect candidates to bolster the investment in equity across Europe. While the creation of the Pan-European Personal Pension product was a step in the right direction, the EU should promote further development of pension funds aside from traditional national retirement schemes.

Recommendation:

- **Promote harmonised tax incentives:** workers willing to save for retirement should benefit from attractive tax conditions across the EU.

### Converging legal frameworks and supervisory practices

Undue national barriers and legal frameworks inhibit cross-border investment and the overall integration and development of EU capital markets. Progress in these areas has been slow and patchy in part due to the complex and divergent nature of national frameworks. Further targeted convergence of securities markets supervisory frameworks and practices will also be important, building on, and complementing, the steps taken in the recently completed review of the functioning of the European Supervisory Authorities (ESAs).

Recommendations:

- 1 **Advance supervisory convergence in securities markets:** Targeted efforts should continue towards refining and improving the consistency and coherence of approaches across the EU supervisory authorities. A more inclusive and transparent approach to supervisory convergence, including mechanisms for consultation with market participants, would also help to ensure that harmonisation of supervisory practices is better understood and undue outcomes are minimised. Where the increased convergence powers of the ESAs warrant further enhancements, a targeted review should also be considered as a second step.
- 2 **Continue working towards high quality and more harmonised insolvency frameworks:** Better functioning and more harmonised insolvency regimes across the EU have the potential to facilitate more predictable and orderly outcomes for corporate restructurings, reduce borrowing costs for issuers, attract investors and better safeguard their investments, and, overall, facilitate cross-border trade and investment. Following the recent Directive on preventive restructuring frameworks and “second chance”, work will need to continue in this area as national regimes and judicial environments remain widely divergent. It is also important to promote the availability of out-of-court workout solutions. The Accelerated Extrajudicial Collateral Enforcement (AECE) proposal tabled by the Commission in 2018 should be taken forward subject to further consideration and amendment.
- 3 **Remove inconsistencies and uncertainties in securities laws:** Supporting targeted solutions in the domain of securities laws materially increases the credibility of the CMU projects. Such solutions include: clear rules for acquisition and disposition of securities, consistent legal concept for good faith acquisition, extension of the insolvency regulation regarding close-out netting rules and conflict of law rules that include securities.

## Improving the regulatory treatment of securitisation

The new framework for simple, transparent and standardised (STS) securitisation<sup>20</sup> rightly constituted one of the building blocks of the CMU. Following its enactment in December 2017, policymakers must continue working towards creating an environment which supports a high quality and dynamic European securitisation market.

The new framework was off to a slow start in early 2019 as much of the underlying technical framework was incomplete at the time. March 2019 brought the first STS transactions to the market and market soundings suggest that more STS supply is expected in the second half of 2019. However, placed issuance levels remain low as shown in figure 2.5 below<sup>21</sup>.

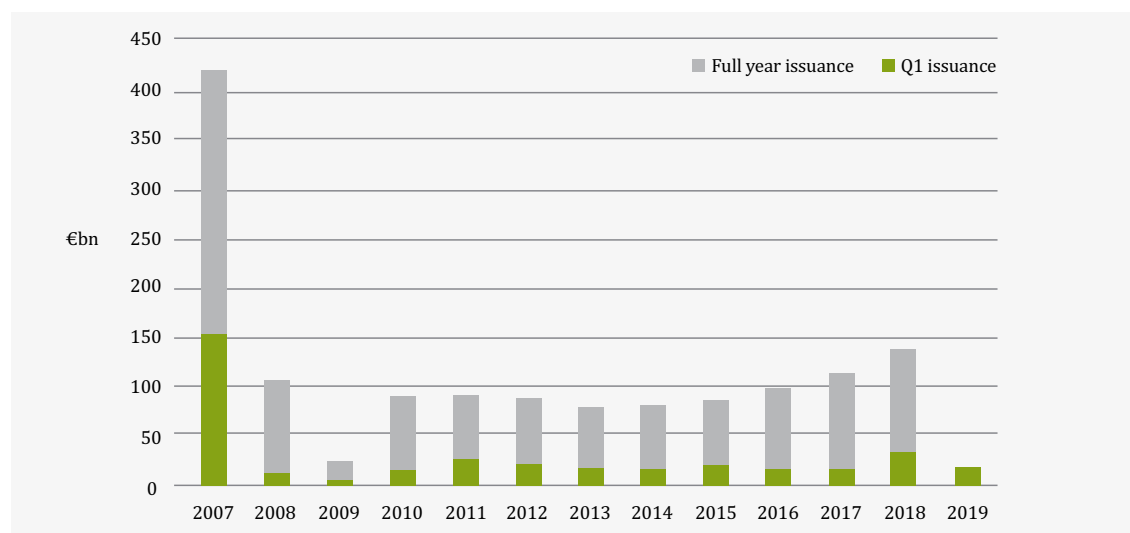
AFME believes that an overly conservative and burdensome regulatory treatment, together with other factors, have discouraged a recovery of the European securitisation market. Some of the harsh calibrations do not reflect the strong historic credit and price performance of European securitisations. Capital requirements for transactions meeting the “best in class” STS criteria remain significantly higher than those for other high-quality fixed income investments. Concerns remain that the new framework introduces additional regulatory and operational constraints for market participants<sup>22</sup>.

Authorities should closely monitor the performance of the new STS framework and utilise upcoming legislative reviews to re-evaluate and fine-tune regulations impacting on securitisation, to ensure this mechanism remains safe but also viable and attractive for EU issuers and investors.

Recommendations:

- 1 **Revisit the treatment of securitisation in key legislations:** The CRD6/CRR3 package and future review of the STS framework are opportunities to re-examine the treatment of securitisation to achieve a more proportionate framework.
- 2 **Adopt measures to promote green securitisation:** Please refer to our recommendations under section 6.

### 2.5: European securitisation placed issuance (€bn)



Source: AFME and SIFMA

20 For an explanation of what securitisation is, see AFME’s Infographic “Securitisation: an essential tool to fund economic growth” available at <https://www.afme.eu/en/reports/publications/european-securitisation-an-essential-tool-to-fund-economic-growth/>

21 Over a decade on from the financial crisis, issuance in Europe is still at a fraction of the level it once was, having dropped from €819 billion in 2008 to just €269 billion in 2018 – of which only half was actually placed with investors with the remaining part being retained by originators and used to support repo funding from central banks.

22 These demands include meeting 100+ criteria for a securitisation to qualify as STS and a heavily burdensome disclosure framework notably for private transactions, with limited benefits in terms of cost, capital and liquidity treatment for banks. Meanwhile, non-STS securitisations, a crucial mechanism in tackling the problem of non-performing loans in Europe, are subject to an increasingly challenging and costly regulatory environment.



## 3. Promoting integration in EU financial markets and removing harmful fragmentation

Over the last decade, the European banking system has been subject to profound changes. It is now a safer system, better able to contribute to sustainable growth<sup>23</sup>.

Despite this progress, important challenges remain. Banks' ability to fund growth would be significantly improved by the creation of a functioning single integrated European market. The reality is, however, still distant from this key objective. Even in the Banking Union, national "fences" to protect local shareholders, creditors and taxpayers continue to be maintained, resulting in a deep fragmentation of the market along national lines. The costs of fragmentation and national ring-fencing are difficult to overstate and are summarised below.

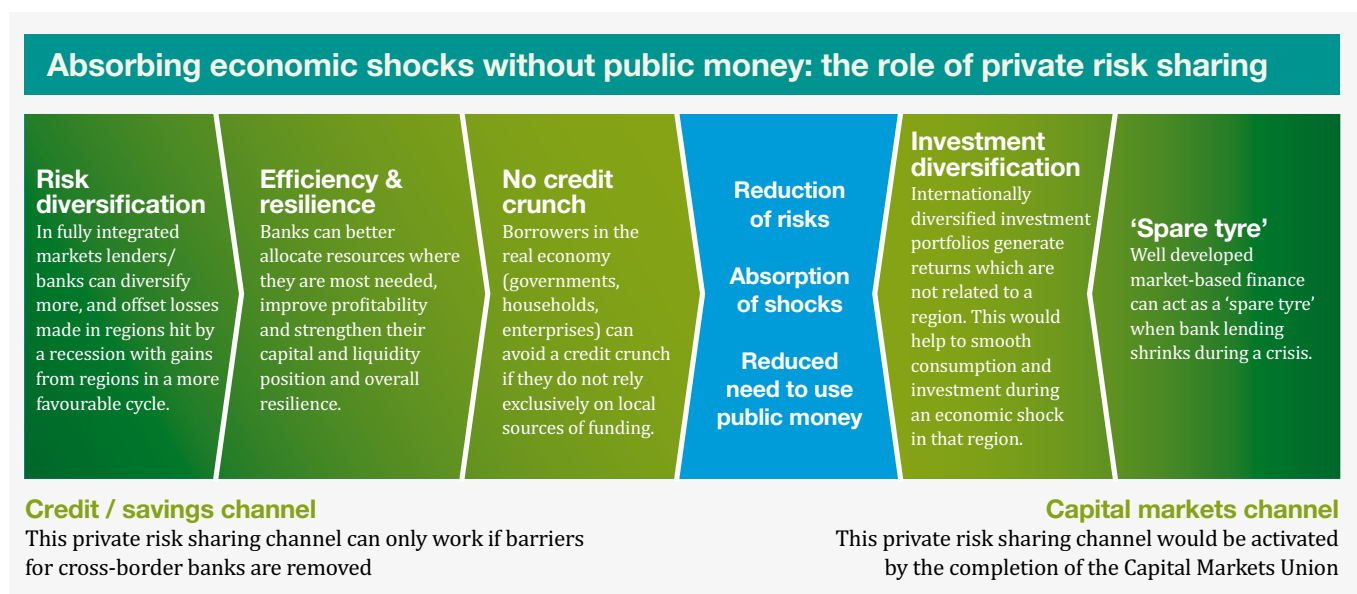
The costs of ring-fencing	
<p><b>Fragility and lower resilience</b></p> <p>Ring-fencing makes a crisis more likely if (even within a single banking group) capital and liquidity cannot flow where they are most needed. The system (and individual banks within it) becomes more fragile as entities of a cross-border banking group are unable to support each other in difficult times. The ability to only count on local resources, rather than those of the broader group, means that ring-fencing might also result in lower, and not higher, protection for local stakeholders.</p>	<p><b>Amplification of crises</b></p> <p>Ring-fencing amplifies the negative effects and the costs of any crisis by limiting banks' ability to diversify risk across several jurisdictions thereby magnifying the impacts of a local downturn (asymmetric shock).</p> <p>These effects are compounded if - when local banks are experiencing a crisis - cross-border credit flows cannot step in and compensate for the reduced access to credit at local level.</p>
<p><b>Drag on consolidation and profitability</b></p> <p>A requirement to hold excess amounts of local capital and liquidity leads to inefficiencies and a heavy drag on banks' ability to achieve adequate profitability as the cost for such resources will be higher. As a result, necessary (given the persisting excess capacity in the European banking sector) cross-border consolidation becomes impossible. An excessive number of locally-focussed banks will also be unable to mobilise the resources needed to innovate and be competitive and profitable in the context of increasing digitalisation of the business.</p>	<p><b>Higher costs for the economy</b></p> <p>The inability to count on a large integrated domestic market, the resulting lack of economies of scale, as well as the higher cost of capital and liquidity caused by fragmentation results in many cases in higher costs for financial services users.</p>

### The need for an integrated and functioning single market for banks

To enable banks to play their role fully in funding growth in Europe and to ensure an adequate diversification of funding sources and of risks, it is essential that an integrated and functioning single market for banks, together with an ambitious CMU, are achieved. In recent years banks have stopped developing plans for building cross-border operations. In many cases, they have instead been retrenching into national markets, as the business case for cross-border banking has weakened, partly as a result of the many national barriers.

As a result, Europe has remained vulnerable to local/asymmetric economic shocks. In fact, achieving deep integration in credit and financial markets would be the most effective way to absorb such shocks, and therefore prevent and reduce risks. This is what is called "private" risk sharing, where risks can be shared (and through such sharing, reduced) without the need for any public money. Its functioning is summarised in the graph overleaf.

<sup>23</sup> A more comprehensive analysis on these issues, as well as on the implementation of Basel III, is provided in the separate AFME publication on "The European Banking System: Tackling the Challenges, Realising the Opportunities - Achievements and Next Steps for the New EU Legislative Cycle" (July 2019)



As explained in more detail in our separate AFME publication on “*The European Banking System: Tackling the Challenges, Realising the Opportunities - Achievements and Next Steps for the New EU Legislative Cycle*” the comparison with other integrated areas (e.g. the United States) shows that in the EU an unnecessarily high proportion of economic shocks are not smoothed or absorbed via risk sharing channels (the fragmentation in credit markets, as highlighted by the ECB, actually contributes to the amplification of shocks, as cross-border activities tend to experience a reduction when such shocks happen, instead of representing a way to absorb them). It also shows that private risk sharing channels – which do not involve fiscal transfers or central pooling of national resources – would go a long way in absorbing shocks, in making the system more resilient and in removing fragmentation.

Fragmentation is also an important contributing factor to banks’ continuing low level of profitability which in turn restricts their capacity to support lending and growth. If banks can achieve sound returns on equity at least equal to their cost of capital and sustainably profitable business models, they can retain more capital, further reducing their risk of failure and making the entire system more stable as a result.

### Completing the Banking Union: a key priority for the next EU legislature

In this context, the completion of the Banking Union remains a key priority, for a more stable EMU and to establish an integrated, competitive banking system in Europe. The change represented by the successful establishment of the Single Supervisory Mechanism and of the Single Resolution Board, in addition to a very detailed single rulebook, need to be acknowledged and further progress achieved in the form of effective risk sharing mechanisms, which play a fundamental role, as explained above.

However, the Banking Union is still not complete. Capital and liquidity cannot flow freely within European banking groups; and agreement has yet to be reached on its third pillar, aimed at providing an effective deposit insurance across the Banking Union.

Achieving substantial risk reduction in the system is understandably considered a necessary precondition for any progress on the above-mentioned missing elements; and it is fair to say that a lot of risk reduction has already been achieved. It should be stressed, however, that the contraposition between risk reduction and risk sharing is not justified. In fact, achieving effective risk reduction depends to a very large extent on the existence of risk sharing mechanisms. For instance, any potential risk at national level deriving from the removal of national ring-fencing would be largely offset by the fact that the EU and the Banking Union would be more able to absorb negative cycles and to fund growth.

### 3. Promoting integration in EU financial markets and removing harmful fragmentation

These considerations should encourage the EU legislators to regard the removal of the intense fragmentation in the EU, and the completion of the Banking Union, as an objective of the utmost importance and urgency. Results need to be achieved both in terms of greater public risk sharing and, importantly, of effective private risk sharing – e.g. waivers for capital and liquidity requirements for cross-border groups, more favourable treatment of intragroup transactions, progress on CMU and removal of obstacles to cross-border consolidation. These will at the same time represent a reduction of key risks of such a scale able to put the EU banking system on a solid and stable foundation and the EU economy on a path to stronger growth.

#### Banking Union and Capital Markets Union: two mutually reinforcing projects

The Banking Union and Capital Markets Union projects are intrinsically linked and mutually reinforcing. A fully functional and integrated Banking Union, can help to achieve a more integrated capital market in the EU<sup>24</sup>.

The creation of a fully integrated Capital Markets Union in Europe would provide European corporates and governments greater access to finance and European investors a broader range of investment opportunities. As explained above, this would also provide a powerful shock-absorbing mechanism.

Capital markets, particularly in the form of public and private equity capital, tend to provide better funding sources for higher risk investments – for example innovative start-ups or frontier technologies. Meanwhile, bank loans tend to be more appropriate for funding medium-to-low-level risks, consolidated industries and more traditional investments. Both funding channels are necessary to support the diversity of Europe’s financing needs.

Recommendations:

- 1 Develop an ambitious Capital Markets Union:** The CMU is key for increasing the diversity of funding sources and reducing the overreliance on banks. A more diversified financial system would provide support in periods of expansion, as well as during an economic turmoil when banks’ ability to lend is constrained.
- 2 Complete the Banking Union:** The completion of the Banking Union remains a key priority in order to achieve a stronger monetary union. This includes considering the Banking Union as a single jurisdiction in terms of prudential requirements, achieving an effective depositor protection, and, in the context of broader considerations, a solution for a European safe asset.
- 3 Remove the fragmentation in EU financial markets:** Cross-border banks need to be able to manage their capital and liquidity at a consolidated level and to achieve diversification and economies of scale. This will also help with addressing their lack of profitability and excess capacity. Together with CMU this is a powerful way to share risks and to absorb economic shocks.

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<sup>24</sup> See AFME “Creating an Integrated Financing Union for the EU – The important role of Banking and Capital Markets Unions”, May 2019.

## 4. Achieving a sound implementation of Basel III

Ten years on from the financial crisis, a significant, multi-year regulatory reform programme has been put in place, leading to a financial system that is both more resilient and better able to contribute to sustainable growth. The framework is now in place to ensure stronger, safer banks, and to bring an end to “too big to fail”. Through the efforts of supervisors, policy makers and the industry, banks are now considerably better capitalised, with higher levels of liquidity than a decade ago and the overall financial system is far more resilient to potential shocks.

The December 2017 BCBS agreement complemented the initial set of Basel III reforms announced in 2010, thus finalising the post-crisis prudential framework for banks. The EU is likely to present legislative proposals aimed at implementing the agreement during the first half of 2020. Correctly assessing the impact of the reforms will be necessary, to avoid unintended effects, unnecessary overlaps and inconsistencies with previous and ongoing reforms. A recent industry study undertaken by the Global Association of Risk Professionals shows that the likely increase in CET1 capital could reach almost 300 billion euros. This clearly represents a departure from the Basel Committee’s stated aim (and the ECOFIN commitment) not to significantly increase capital requirements. Furthermore, the impact of the reforms is geographically concentrated as the aggregate RWA increase amounts to around 28.4% for European banks<sup>25</sup>.

The table below provides some additional considerations on specific areas:

### Credit risk

Under the Basel III final agreement, the risk weightings for real estate exposure have been changed, and reliance on external credit ratings has been constrained. Moreover, advanced IRB approaches have been removed for exposures to large corporates and financial institutions, while all IRB approaches have been removed for equity exposures. AFME notes that the changes adopted represent a significant overhaul of IRB approaches and the overall impact of these will be particularly felt in Europe, where corporates mostly rely on bank lending to source funding. Financing will become more expensive for EU corporates also because the vast majority of them are unrated, which implies higher risk weights. There will also be significant operational challenges linked to changes and decommissioning of internal models. Other issues are the proposed use of the origination value for the calculation of LTVs (loan-to-value) for property exposures, which fails to reflect fluctuations in property markets, and equity investments, which will be heavily penalised, thus hindering the advancement of the CMU agenda in Europe. Furthermore, the lack of a granular risk-sensitive approach in the revised Basel III framework for Specialised Lending (both under the standardised and advanced approaches), will negatively impact financing of projects linked to critical aspects of the real economy and the climate transition such as infrastructure, aircraft and shipping, and exporting and importing among many other areas.

### Output Floor

Under the December 2017 agreement, the output floor sets a floor to total RWAs calculated under internal models at 72.5% of those calculated under standardised approaches. The output floor will represent a binding constraint for many banks in Europe, especially larger ones which currently use internal models to calculate a substantial proportion of their capital requirements. To avoid unwarranted impacts on certain business lines and knock-on impacts on corporate financing and the real economy, it is essential that the floor is calculated and applied at the highest consolidation level. Furthermore, attention needs to be paid to the EU specificities already built into the credit risk Standardised Approaches (e.g. the SME supporting factor or trade finance) and going forward to the impacts on Specialised Lending and Corporates RWAs. Although the output floor is to be phased in over the period to [2027] it is likely that the market will require much earlier adoption.

### Operational Risk

The Basel Committee decided to rule out use of internal modelling and developed a new Standardised Measurement Approach (SMA) for the purposes of calculating Operational Risk capital requirements. The approach strongly penalises size and past loss experience and considers neither changes to business models nor forward-looking risk mitigation techniques such as insurance, thus misrepresenting the potential future operational risk.

<sup>25</sup> Source: EBA Basel III monitoring exercise – March 2019. The 28.4% increase in the EU compares with 8% for North America.



### Counterparty credit risk

Revisions to the Credit Valuation Adjustment (CVA) framework, issued by the Basel Committee, removes banks' ability to use internal models. However, certain fundamental aspects of CVA have to be reconsidered to avoid disproportionate effects for corporates and other clients. A better recognition of hedging transactions and a closer alignment with accounting practices would improve the calibration of the framework, and the introduction of the Standardised Approach for Counterparty Credit Risk (SA-CCR) and its use in the calculation of the output floor will have further increase costs of banks' derivatives exposures to corporates and other clients.

### Minimum Securities financing transactions (SFTs) haircuts regime

SFTs (including repurchase agreements or "repos" and securities lending) play a crucial role in capital markets. For instance, securities lending is an essential way for pension and other funds to earn low risk additional returns on assets that they hold. It is also a necessity for functioning secondary markets, making securities otherwise held for long term investment available for trading and short selling, enhancing market liquidity, price discovery and reducing costs of intermediation. It is vitally important that the SFT minimum haircuts regime is not applied to these transactions in a way that would stop banks from borrowing securities and intermediating in this market. Therefore, these transactions should be scoped out of the minimum haircut requirements, particularly when the counterparties are already regulated mutual and pension funds.

### Recommendations:

- 1 Respect the international commitment to avoid significant increases in capital requirements:** In light of the already very significant increases in capital requirements resulting from the post-crisis reforms, it is important that the EU implementation of the Basel agreement does not result in additional capital requirements.
- 2 Preserve the risk sensitivity of the framework, avoiding disproportionate impacts:** Key aspects of the package – including the credit risk framework, the new output floor, the operational risk framework and the counterparty credit risk framework – need careful consideration to avoid disproportionate impacts on a number of exposures and to limit the loss of risk sensitivity of the framework.
- 3 Assess the overall impacts, ensuring global consistency and a level playing field:** It is important that the interaction between the various requirements and their cumulative impact is continuously monitored in order to identify and remove unintended effects.

## 5. Promoting a culture of integrity and effective conduct regulation

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Continued focus on promoting a culture of integrity in the financial services sector is key to restoring the public's trust. AFME welcomes a number of significant initiatives undertaken in the past policy cycle in the fields of conduct, ethics, fitness and propriety, protection of whistleblowers and personal accountability of senior management, which will contribute to strengthening conduct standards across Europe.

The EU should continue to pursue work on conduct regulation related to fighting financial crime and market abuse. This includes increased personal accountability, implementing a review of the Market Abuse Regulation and prioritising reforms in the field of anti-money laundering (AML), with a view to improving the quality of data flow between the financial services industry and its supervisors and effectively fighting against financial crime and market abuse.

### Strengthening the anti-money laundering framework

The EU should continue to focus on improving the tools and frameworks to fight against money laundering across Europe.

Recommendations:

- 1 Strengthen personal accountability for managers and risk takers in financial services:** Build on the ECB's fitness and propriety requirements with a view to raising standards of personal conduct across the industry in the EU.
- 2 Transform the EU Anti-Money Laundering Directive framework into a Regulation:** A more harmonised framework would result in administrative efficiencies, cost savings and more effective prevention of crime.
- 3 Promote greater collaboration between financial institutions and law enforcement agencies:** This would entail, for example, a regime encouraging the disclosure of information by financial institutions to Finance Intelligence Units and vice-versa, as well as from FIUs to supervisors. Data protection concerns would, of course, need to be considered carefully, as well as protection of the industry disclosers from litigation.
- 4 Encourage the development of utilities for Know Your Customer (KYC) purposes:** This would allow companies acting on behalf of financial institutions to collect KYC information from clients. KYC and digital ID standards vary across the EU and this should not be the case. Overcoming these challenges could greatly improve the efficiency of the KYC process and, in turn, assist the fight against money laundering and financing of terrorism. We would also support EU-wide digital ID and KYC standards to this effect.

### Reviewing the Market Abuse Regulation

We believe the Market Abuse Regulation (MAR) should be reviewed in the next legislative term. This is because the scale and intricacy of the regulation<sup>26</sup> presents challenges to effective monitoring and surveillance, which risk undermining its overall aims. The level of monitoring demanded generates very high volumes of data, which can make it hard to spot cases of market abuse amongst all the ‘noise’. We have also observed differences in the application of MAR across Member States<sup>27</sup> which merit consideration.

Recommendation:

- **Undertake a review of MAR:** Thorough industry review and feedback on the existing Regulation and guidelines so that the regime functions more efficiently and as intended.

### Reviewing short selling requirements and guidelines

Following the technical advice provided by ESMA on the evaluation of the Short Selling Regulation (SSR) in December 2017, we believe a review of this legislation and accompanying guidelines should be considered to address certain inefficiencies. A review of the SSR should seek to support an appropriate recognition of the nature of “market making activities” and improve other aspects of the Regulation<sup>28</sup>.

Recommendation:

- **Undertake a review of the SSR and associated guidelines:** Thorough industry review and feedback on the existing Regulation and guidelines so that the regime functions more efficiently and as intended.

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26 MAR has a very broad scope, covering a wide range of different products and asset classes. It covers specific issues, such as rules on disclosure e.g. of inside information to potential investors as part of ‘market soundings’, in highly granular detail.

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27 For example some, but not all EU regulators and supervisors, see market abuse as a financial crime that should be reported to Financial Intelligence Units as well as to National Competent Authorities. This results in duplicative reporting which is neither helpful to the authorities nor an efficient use of banks’ resources.

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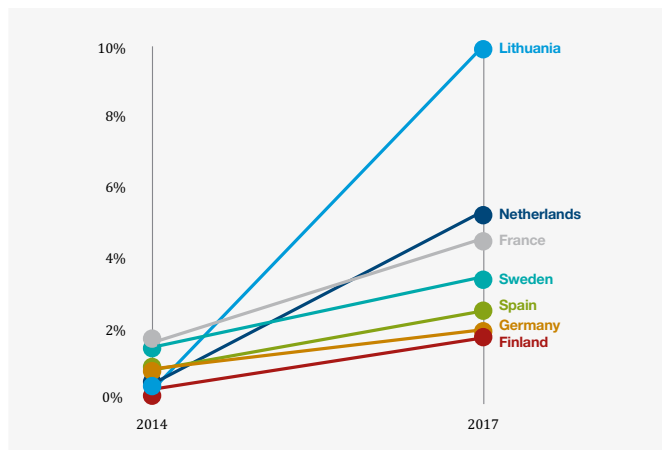
28 See AFME-ISDA response to ESMA’s call for evidence on the evaluation of the Regulation (EU) 236/2012 of the European Parliament and the Council on Short Selling and certain aspects of Credit Default Swaps, December 2017.

## 6. Taking sustainable finance to the next level

AFME strongly welcomes the political consensus in the EU on promoting sustainable finance. The EU has made a very promising start in becoming a global leader in driving sustainable finance, issuing a significantly higher percentage of sustainable assets compared to other jurisdictions<sup>29</sup>.

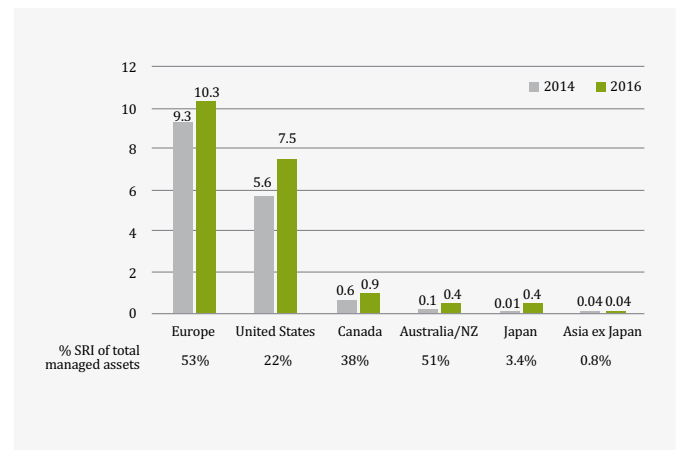
Priorities for the next legislative term should include the completion of an EU-wide taxonomy for the classification of environmentally sustainable activities and the promotion of this agenda at the global level.

### 6.1: Sustainable bond issuance as % of total bond issuance: selected countries



Source: CBI, Dealogic, ECB, SIFMA, ECBC and AFME

### 6.2: Sustainable assets under management (€ trillion)



Source: Global Sustainable Investment Alliance

## Achieving a practical EU-wide taxonomy

The EU taxonomy for the classification of environmentally sustainable activities is a pivotal initiative. It is critical that the taxonomy is effective in delivering its core objective to provide clarity on which activities can be considered environmentally “sustainable”. The key to success will be achieving the right balance in providing clarity and meaningful guidance to the market, while avoiding undue rigidity and prescriptiveness.

### Recommendations:

- 1 **Adopt a progressive, proportional and flexible approach:** A successful taxonomy should evolve and adapt over time, acknowledging that most economic activities, companies and industries are at different stages of their transition journey towards low-carbon standards. It should provide flexibility in encouraging the evolution of new sustainable products. It is important to focus on “green” criteria but be flexible to encourage companies to transition to more sustainable business models incorporating criteria for environmentally sustainable economic activities and practices, taking into account activities and practices that are on their pathway towards low-carbon standards.
- 2 **Recognise sustainable practices and not only economic activities:** Of companies in sectors that cannot be classified as environmentally sustainable, to encourage and support companies establishing those practices.
- 3 **Incorporate diverse investment strategies:** That contribute positively to environmental objectives into the definition of sustainable investment, and not only direct capital allocation to sustainable activities.
- 4 **Facilitate the availability of reliable data:** Conclusions about whether financial products qualify as environmentally sustainable investments can only be reached using the information from the issuing investee companies, based on the assessment of their sustainable economic activities and/or practices.

<sup>29</sup> See AFME “Capital Markets Union – Measuring progress and planning for success”, September 2018, pps 21-24.

- 5 Promote the EU taxonomy as a global reference point:** A successful EU-wide taxonomy could become a key reference point and standard for other jurisdictions. AFME believes that the main objectives of the EU should be built around promoting the global adoption of the taxonomy framework and positioning this agenda within the work of global bodies such as the IOSCO and the FSB.

### Enhancing corporate reporting and disclosures of ESG related information

Appropriate reporting and disclosures are essential to provide potential investors with a clearer picture of the climate-related risks and opportunities facing companies. AFME supports the development of better voluntary disclosures, focused on materiality, to improve investment and lending decision-making through the Non-Financial Reporting Directive, the industry-led Financial Stability Board (FSB) Task Force on Climate-related Disclosures (TCFD) work as well as additional existing national, EU-based and international frameworks.

Additionally, improving the flow and clarity of ESG (Environmental, Social and Governance) information is key for market participants' understanding of sustainable investment decisions. Embedding ESG risks and factors into capital markets should be done in a progressive and sequential way, first by recognising the existence of actual practices in relation to the integration of ESG risk factors applied by financial advisers, asset managers and institutional investors, and then by clarifying regulators' expectations.

Recommendations:

- 1 Align the EU disclosure frameworks with the TCFD's recommendations:** We strongly support the alignment of EU disclosure frameworks with the TCFD's recommendations that have been applied globally as the main benchmark standard on climate related reporting.
- 2 Include a broad definition of ESG principles for the purpose of MiFID 2/R:** A flexible framework for integrating ESG considerations in MiFID 2/R would help account for ESG preferences in the context of the regulation's suitability requirements and provide clients with products that could better address their needs. However, we believe that the definition of ESG principles for the purpose of MiFID 2/R needs to be wider than the EU taxonomy allowing the capture of a broader and more nuanced set of client preferences around sustainability and responsible business practices.

### Promoting the development of green securitisation

We believe that greater and more diversified European issuance of sustainable finance instruments could be achieved by further developing the green securitisation market. Green securitisations could be one of the most effective potential means to harness small scale developments like residential rooftop solar energy and small SME loans for energy storage projects<sup>30</sup>.

In 2019 AFME will continue to work towards a set of principles for the development of a green securitisation market in Europe, which will provide further analysis on measures conducive to this objective.

Recommendation:

- Develop a definition of green securitisation:** Identifying what constitutes "green securitisation" will be key to development of this market, its scope and role. AFME looks forward to contributing to setting out the main attributes of such a definition.

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<sup>30</sup> The OECD estimates that annual issuance of green asset-backed securities could reach between US\$280-380 billion (or between 44-52% of annual issuance) by 2035 for renewable energy, energy efficiency and low-emission vehicles financing alone (in a 2 degrees scenario). See OECD "A quantitative framework for analysing potential bond contributions in a low-carbon transition", 2016. <http://www.oecd.org/cgfi/quantitative-framework-bond-contributions-in-a-low-carbon-transition.pdf>



## 7. Developing a competitive Digital Single Market

Financial technology (FinTech<sup>31</sup>) is transforming capital markets by introducing new platforms and services, increasing competition and lowering costs for businesses and investors. Success will depend on the ability to achieve the long-term benefits from new technologies by prioritising investment, collaborating where possible, building a culture of innovation and developing the skills needed; all while managing the potential risks this may introduce for operational resilience and cybersecurity.

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Out of 33 global FinTech unicorns in January 2019, only 7 were in Europe (1 in the EU27; 6 in the UK).<sup>32</sup>

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Four technologies have the potential to transform banks and the industry: Data & Analytics, Cloud Computing, Artificial Intelligence (AI) and Distributed Ledger Technology (DLT).

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**AFME-PwC analysis<sup>33</sup>**

A strong digitalisation agenda is essential for the EU to remain competitive and at the forefront of innovation globally. Digitalisation could be an enabler for European integration and the CMU by reducing barriers to cross-border business and transactions costs.

### Developing a pan-European cyber-crisis governance model

Financial Services providers and infrastructures are often cited as a prime target for cyber-attacks because of their pivotal role in the economy. In an increasingly complex, interconnected and fast evolving landscape, cyber-policies need to keep in mind the global picture and remain pragmatic, so that firms can dedicate scarce resources where it matters and respond to time critical attacks as a coordinated network.

We welcome the recent EU-level work undertaken on the Cybersecurity Act<sup>34</sup> and the ECB's TIBER-EU framework<sup>35</sup>. We also welcome the joint advice of the ESAs on "The costs and benefits of developing a coherent cyber resilience testing framework for significant market participants and infrastructures within the whole EU financial sector", published in April 2019.

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31 AFME considers FinTech to encompass a broad number of actors and participants. Some are small innovative companies, others are large incumbent financial firms looking to acquire or work with startups to drive innovation, others are even existing technology companies providing new financially focused tools. AFME's preferred definition of FinTech therefore is: "Innovative computer programs and other technology used to support or enable banking and financial services".

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32 <https://www.cbinsights.com/research-unicorn-companies>

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33 AFME-PwC "Technology and Innovation in Europe's Capital Markets", September, 2018.

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34 AFME welcomes the adoption Cybersecurity Act and Package in December 2018 as an important step towards improving the safety, security and resilience of the Digital Single Market. Specifically, AFME welcomes the permanent mandate given to the European Network Information Security Association (ENISA) and its role to support, with Member States and other EU Institutions, the development of a 'blueprint' for European operational cooperation and crisis management in the event of a large-scale Cyber-crisis. This will be an important initiative to provide clear understanding and expected actions, roles and responsibilities for all pan-European actors involved.

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35 AFME welcomes the framework issued by the European Central Bank for Threat Intelligence-Based Ethical Red Teaming (TIBER-EU) which aims to standardise and harmonise the way entities perform intelligence-led red-team tests. We believe the framework will help financial institutions discover vulnerabilities in their cyber defences and look forward to continuing to work with the ECB as it evolves.

Recommendation:

- **Develop a European cyber-crisis governance model:** Such a model should be consistent with global practices and balance national versus cross-jurisdictional needs. Existing frameworks should be used, where possible, to promote consistency and build on existing shared understanding and requirements. The model should provide greater clarity on how decision-making would be managed, as well as specific roles and responsibilities, to ensure an effective and timely response to a cyber-crisis.

### Harnessing the potential of emerging technologies

New technologies can offer solutions in several capital market segments and functions, such as equity issuance, corporate governance, asset management, investment intermediation, product distribution and post trade market infrastructure including securities custody services.

Recommendations:

- 1 **Review barriers to the adoption of cloud computing:** AFME believes that cloud computing is a foundational technology for EU competitiveness. We welcome that the EBA final guidelines have sought to mitigate the risks associated with the use of cloud service providers by financial institutions, such as concentration or third-party risks. However, we believe they are likely to pose barriers for the industry to fully benefit from cloud computing and may limit adoption across the EU as intended<sup>36</sup>. We believe further discussions are needed to address elements of the recommendations and provide clarity of interpretation for the industry. The guidelines should also be considered alongside other existing regulations, such as the GDPR, which may support increased cloud adoption as procedures continue to mature. We also encourage engagement by the EBA with its non-EU peers to monitor and share evolving practices.
- 2 **Address considerations on ethics and trust in Artificial Intelligence<sup>37</sup>:** AI capabilities are not new to financial services and firms have mature codes of conduct and controls in place to manage their responsibility to protect and treat clients fairly. However, we have identified elements unique to AI as a technology that merit further consideration. We group these into two themes: data input and design (e.g. AI acting on data set bias); and understanding and control (e.g. a lack of transparency of AI related decisions). Following the presentation of the Commission's Coordinated Plan on Artificial Intelligence in December 2018, AFME looks forward to continuing to work with European authorities and supporting the development of an ethics and trust framework that is appropriate for financial services.
- 3 **Work towards a digital assets (e.g. cryptoassets) taxonomy<sup>38</sup>:** Digital assets (e.g. cryptoassets) and tokenisation in general, can bring benefits to market participants. But it is key that authorities effectively identify, assess and address risks arising from this emerging activity in a coordinated fashion, including potential risks to consumer protection and market integrity. This assessment will also be key for fostering a more efficient and sustainable tokenisation scheme across Europe in the long-term. AFME believes that a globally consistent taxonomy is required to develop a common framework for analysis and a harmonised regulatory framework for the treatment of cryptoassets<sup>39</sup>. We also believe that it is urgent to undertake a deep analysis of the applicability of EU existing regulations, and their potential limitations, in regard to the treatment of cryptoassets<sup>40</sup>.

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36 See "AFME comments on the EBA final recommendations for the use of cloud service providers by financial institutions", March 2018.

37 See AFME White Paper "Considerations on the Ethical Use of Artificial Intelligence in Capital Markets", November 2018.

38 See "AFME response to the FCA Consultation Paper on Guidance on Crypto Assets", April 2019.

39 AFME believes the dematerialisation of financial assets (i.e. the digital representation and issuance of financial assets), such as fiat money or tradeable securities, goes beyond the scope of cryptoassets. For instance, dematerialisation encompasses tokens which are asset-backed and issued by central authorities (e.g. central bank digital currencies) or other assets that do not necessarily use cryptography and are not tokenised (i.e. off-chain digital representations of assets, such as the Certificateless Registry for Electronic Share Transfer (CREST) for equities). It is therefore AFME's view that any guidance on crypto assets should fit within the broad scope of guidance on all "digital assets".

40 For instance, regulations which are applicable to wholesale capital markets firms such as the Settlement Finality Directive (SFD), Central Securities Depository Regulation (CSDR), European Market Infrastructure Regulation (EMIR) and the General Data Protection Regulation (GDPR) should be factored into this analysis.

## Ensuring a level playing field in the Digital Single Market

The benefits of new technologies can often be realised through new business models offered by both incumbent institutions and new entrants to the market. Competition among diverse service providers should be strongly supported, but it is equally important to ensure a level playing field among all players, not least to maintain robust regulatory and consumer protection standards.

AFME welcomes the recent attention by global authorities to the interaction and competition between incumbent financial services institutions – including banks – and new entrants into the financial services space, including FinTech firms and large, established technology companies (“BigTech”)<sup>41</sup>.

Recommendations:

- 1 Encourage a coordinated and pragmatic approach to outsourcing arrangements:** AFME notes the publication of EBA’s final report on Guidelines on Outsourcing Arrangements in February 2019. We welcome that the final Guidelines have sought to reduce the burden in respect of arrangements that are not assessed to be part of a critical or important function. However, there remain areas where limited change has been made (e.g. access and audit rights, sub-outsourcing) from the draft version. AFME encourages both European and national authorities to foster a coordinated and pragmatic application of the guidelines across the EU.
- 2 Ensure a level playing field among diverse participants:** AFME recommends that EU authorities monitor and carefully analyse the impact of heightened competition from new market entrants (such as BigTech firms), with a view to assessing potential effects in areas such as financial stability, cyber security and resilience, data sharing and protection, consumer protection and lending standards. A regulatory level playing field among all service providers should be an objective of the Digital Single Market, ensuring that an appropriate regulatory perimeter and requirements are applied equally to all market participants. AFME also believes that a focus on ensuring a level-playing field should consider how existing legislation, such as laws on copyrighting, may need to adapt to become more compatible, and supportive, of digital innovation in the EU.

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<sup>41</sup> This interest is reflected in the Financial Stability Board (FSB) report “FinTech and market structure in financial services: Market developments and potential implications”, February 2019.

## 8. Facilitating global cooperation and regulatory convergence

In the preceding sections, we have highlighted areas where intra-EU barriers and regulatory inconsistencies detract from the development of a full single market. As markets are globally interconnected, these concerns apply also to fragmentation and barriers between the EU and other jurisdictions. The inconsistent implementation of internationally agreed standards, fragmented regional regulations and divergent supervisory practices, where unjustified<sup>42</sup>, can undermine the effectiveness of global standards and create vulnerabilities, as well as significantly increasing compliance costs and the possibility of regulatory arbitrage.

In their response to the global financial crisis a decade ago, G20 leaders acknowledged the risk of fragmentation, protectionism and regulatory arbitrage and committed to mitigating these risks<sup>43</sup>. As the global regulatory community and the financial services industry continue the implementation and supervision of a new set of reforms, it is all the more important to recall the G20 commitments<sup>44</sup>.

### Mitigating unintended fragmentation and frictional costs

Financial markets are experiencing increasing levels of fragmentation, resulting from excessive and unjustified regulatory and supervisory divergence. The following are examples of areas where regulatory inconsistencies and regional deviations can have harmful impacts:

- Divergent cybersecurity frameworks, as discussed in section 3;
- Ringfencing requirements, understood as application of regional regulations at legal entity level, preventing banks from deploying capital and liquidity across borders;
- Resolution planning: including the fragmented implementation of internal minimum total loss-absorbing capacity (TLAC) requirements, where many jurisdictions including the EU have not introduced the global standard calibration, which results in unnecessary trapped capital;
- Regional regulations with extraterritorial effects, such as the EU Benchmarks Regulation where the application and fulfilment of the third country regime is challenging.

In this environment, the EU should continue to champion international standards, regulatory dialogue and supervisory cooperation.

// Differences in rule-making could lead to cross-border regulatory arbitrage and a potential build-up of risks in parts of the global financial system that go beyond those addressed by individual national authorities. Fragmentation of institutions' operations across borders may prevent capital and liquidity from being channelled to those entities in need of additional resources during periods of stress.

// **Financial Stability Board<sup>45</sup>**

42 AFME believes that consistency of implementation is or should be outcomes based. Deviations might be justifiable based on genuine differences in markets/structures

43 G20 Leaders Communiqué, 2009, stated: "We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage," <http://www.g20.utoronto.ca/2009/2009communiqué0925.html>.

44 G20 Leaders Declaration, 6 September 2013, stated that '*jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes*'.

45 FSB "Report on Market Fragmentation", June 2019. The FSB also notes that there are a variety of reasons for market fragmentation, not all of which are undesirable or attributable to the effects of regulation and supervision.

### Recommendations:

- 1 Lead global efforts to review market fragmentation:** As the negative effects of market fragmentation become increasingly evident, the EU would be well placed to be at the forefront of efforts to improve regulatory and supervisory cooperation and address barriers that undermine financial markets and the effectiveness of regulations. AFME and our sister organisations<sup>46</sup> encourage the EU to reflect upon the conclusions of the recent FSB<sup>47</sup> and IOSCO<sup>48</sup> reports on market fragmentation and how it can continue to lead on mitigating fragmentation within the EU and internationally.
- 2 Review EU legislation:** We believe that forthcoming EU legislative packages and reviews of legislation offer opportunities to consider regulatory frameworks with the aim of addressing, or mitigating the effects of, requirements that create unintended consequences in the financing of the economy, or instances of fragmentation, which undermine market liquidity and global markets. The CRD6/CRR3 package, as well as potential reviews of MiFID 2/R and the Benchmarks Regulation should be considered in this context. It is vital to ensure that the EU remains open and closely connected to global capital markets and that the level playing field is ensured. It is important that EU headquartered firms are able to diversify risks, by accessing liquidity and seizing opportunities both in the EU and at global level. Also, financial firms headquartered outside the EU provide a significant contribution to financing the European economy and they represent an important share of European capital markets activity.

### The importance of regulatory consistency in the FX market

The Foreign Exchange (FX) market is the world's largest financial market. An effective exchange of currencies underpins the global financial system.

Globally coordinated regulation benefits both regulators and market participants alike. However, many regional regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market. Whilst the 2009 G20 Pittsburgh Agreement promoted a harmonised approach, in reality the regulatory implementation of the G20 Agreement has not been fully harmonised across the main FX trading centres.

Examples of inconsistent regulations are found in the following areas:

- Trade reporting, where an eligible trade executed between the US and the EU could be reported up to 12 times across these jurisdictions, with the information requiring tailoring for each report due to the specific reporting obligations;
- Capital requirements, where the implementation of the global standards may include jurisdictional deviations which may lead to increased costs and further fragmentation of liquidity offerings.

We therefore strongly support future regulatory considerations that promote further harmonisation across jurisdictions and remove any barriers to participants accessing the global FX markets, whilst allowing supervisors the best opportunity to oversee trading practices and market transparency.

### Supporting open, well-regulated cross-border markets

The EU has a track record of facilitating cross-border financial flows and promoting open capital markets at a global level. For EU capital markets to thrive, it is vital to maintain and continue to develop open capital markets that are able to provide access to global capital pools and funding opportunities, while ensuring market integrity and fairness of treatment between EU firms and third country entities.

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46 The Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington, which are brought together under the umbrella of the Global Financial Markets Association (GFMA).

47 See FSB "Report on Market Fragmentation", June 2019.

48 See IOSCO "Market Fragmentation and Cross-border Regulation", June 2019.



## 8. Facilitating global cooperation and regulatory convergence

A number of equivalence decisions are likely to be considered or reviewed in the coming years in areas potentially including investment firms, trading venues (equities and derivatives), central clearing counterparties (CCPs), central securities depositories (CSDs) and benchmarks. We also note that the recently adopted EU legislations on market infrastructures (“EMIR 2.2”) and on prudential requirements for investment firms (“IFR/IFD”) introduce several important provisions relating to equivalence and the supervision of third country entities, as well as processes for annually scrutinising equivalence decisions<sup>49</sup>.

The context of increasing global fragmentation outlined above and the UK’s pending withdrawal from the EU add particular relevance to this objective in the next EU legislative cycle.

Recommendations:

- 1 Expand focus on a well-functioning equivalence regime:** It is important that the EU maintains a well-functioning equivalence regime and a strong emphasis on promoting global regulatory cooperation and international standards. Equivalence decisions by the Commission should be proportionate and outcomes-based, favouring regulatory dialogue, international supervisory cooperation and deference. Equivalence assessments should be detailed and granular in relation to activities from third countries that are likely to be of systemic importance to the Union.
- 2 Facilitate cooperation with key third countries:** The EU should continue to support – and where possible expand and deepen – its financial markets regulatory dialogue with key third countries. The formalisation of frameworks for supervisory cooperation with key jurisdictions should continue to be pursued with a view to facilitating the exchange of information, regulatory consistency, supervisory convergence and dialogue that contributes to building trust and ensuring an effective oversight of financial markets. In light of the close interconnectedness between the EU and UK markets, it will be particularly important to engage in effective and close cooperation with the UK on financial services, while retaining autonomy over decision-making on both sides.

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A well-developed CMU is important from the perspective of global capital markets and increases further the EU’s attractiveness as a destination for foreign investments. This complements the EU agenda for free and fair trade. The EU’s equivalence regime offers access for third country operators to EU markets in certain areas, subject to equivalent regulatory and supervisory standards in the third country concerned.

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**European Commission**<sup>50</sup>

49 For example, the IFR/IFD legislation requires the Commission to present a delegated act to specify the circumstances under which the scale and scope of the services provided, and activities performed by third-country firms in the EU are likely to be of systemic importance for the EU; it also requires the Commission to report annually to the European Parliament and the Council on the equivalence decisions taken or withdrawn in the reporting year.

50 European Commission “Capital Markets Union: progress on building a Single Market for capital for a strong Economic and Monetary Union”, March 2019.

### Glossary

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#### Approved Publication Arrangements (APAs)

Under the MiFID 2/R framework, a market infrastructure authorised to provide the service of publishing trade reports on behalf of investment firms.

#### Artificial intelligence (AI)

Umbrella term for a number of algorithms and technologies that allow machines to simulate human intelligence by learning (the acquisition of information and rules for using the information), reasoning (using the rules to reach approximate or definite conclusions) and self-correction.

#### Bail-in

Bail-in is a resolution tool which provides the authorities with the power to apply a mandatory write down or conversion of debt to equity, enabling the bank to be recapitalised and stabilised quickly and be restructured in an orderly manner.

#### Basel III

Basel III is a set of international banking regulations developed to promote stability in the international financial system, designed to reduce damage to the economy by banks taking on excess risk. The regulation introduces new capital and liquidity standards to strengthen the regulation, supervision, and risk management of the whole of the banking and finance sector.

#### Benchmark

A benchmark is a standard against which the performance of a financial instrument or market can be measured.

#### Benchmarks Regulation or BMR

The Benchmarks Regulation introduces a regime for benchmark administrators that ensures the accuracy, transparency and integrity of benchmarks, aiming at improved governance, quality of data and investor protection.

#### Best Execution

The responsibility placed on brokers to provide the most advantageous or best price order execution for customers.

#### Big Tech

The major multinational online services or computer companies (such as Apple, Google, Amazon and Facebook). Big Techs have the potential to expand their business models to include the provision of financial services.

#### Bond

A formal contract to repay borrowed money with interest at fixed intervals.

#### Broker

An individual or firm that charges a fee or commission for executing buy and sell orders submitted by an investor.

#### Business Angel

Wealthy individuals who invest in a start-up company using their own funds.

#### Central Counterparty Clearing House (CCP)

An organisation that helps facilitate trading in European derivatives and equities markets. These clearing houses are often operated by the major banks with the prime responsibility of providing efficiency and stability to the financial markets that they operate in. There are two main processes that are carried out by CCPs: clearing and settlement of market transactions. Clearing relates to identifying the obligations of both parties on either side of a transaction. Settlement occurs when the final transfer of securities and funds occur.

#### Central Securities Depository (CSD)

An organisation that holds securities (either certificated or uncertificated) to enable book entry transfer of them. In general, each country will have only one CSD, although there are some that split equities, fixed income and funds into separate CSDs.

#### CET1

Common Equity Tier 1, or CET1 in regulatory jargon - the highest quality capital.

#### Close-out netting

Method of finalising payments that is designed to reduce the credit risk arising from the default of one or more parties to the transaction.

#### Cloud computing

The practice of using a network of remote servers hosted on the Internet to store, manage, and process data, rather than a local server or a personal computer. Cloud Computing is considered in three models:

- Private Cloud: Applications are run on virtual infrastructure at the bank's designated facilities, or those hosted and managed by a third-party provider. Physical infrastructure costs remain with the bank.
- Public Cloud: Applications are hosted on a Cloud provider's infrastructure in their data centres, typically via a pay-as-you-go model.
- Hybrid Cloud: A mix of both private and public Cloud approaches are adopted.

#### Collateral

A form of security held by the lender in case the borrower fails to pay back the loan. For example, if you get a mortgage, your collateral would be your house.

#### Consolidated Tape Provider

A person authorised under MiFID 2/R (Article 4(1)(53) of MiFID 2) to provide the service of collecting trade reports for specific financial instruments (both for equity and non-equity products) from regulated markets, MTFs, OTFs and APAs and consolidating them into a continuous electronic live data stream providing price and volume data per financial instrument. A consolidated tape provider authorised under this regime has yet to emerge.

#### Corporate bond

A bond issued by a corporation in order to raise financing for a variety of reasons such as for ongoing operations, M&A, or to expand business. The term is usually applied to longer-term debt instruments, with maturity of at least one year.

#### Cost and charges disclosure

Financial institutions' issuance of information related to the costs and charges associated with the manufacturing and managing of the financial instruments.

#### Credit Risk

The possibility of a loss resulting from a borrower's failure to repay a loan or meet contractual obligations.

#### CRR/CRD

The Capital Requirements Regulation and Directive, setting out the capital requirements for banks and investment firms as part of the Banking Union's single rulebook and implementing the Basel III agreement.

#### Crypto assets

A digital asset designed to work as a medium of exchange that uses strong cryptography to secure financial transactions, control the creation of additional units, and verify the transfer of assets. Cryptocurrencies are one type of crypto asset (e.g. Bitcoin, Ethereum, etc.)

#### Derivative

A security the price of which is dependent upon (or derived from) one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.

**Digital Asset**

A digital representation of a financial asset (such as fiat money or tradeable securities).

**Distributed Ledger Technology (DLT)**

A consensus of replicated, shared, and synchronised digital data geographically spread across multiple sites, countries, or institutions. There is no central administrator or centralised data storage. One form of distributed ledger design is the blockchain system.

**Double Volume Cap Mechanism**

A mechanism introduced in MiFID 2/R aiming to limit the trading under the reference price waiver (Article 4(1)(a) of MiFIR) and the negotiated transaction waiver for liquid instruments (Article 4(1)(b)(i) of MiFIR) in an equity instrument.

**EMIR**

The European market infrastructure regulation (EMIR) lays down rules on OTC derivatives, central counterparties and trade repositories.

**End user**

The ultimate consumer of a financial service – typically governments and other public entities, companies and investors of all sizes and types. See also: Retail Investor.

**Equity**

Ownership in any asset after all debts associated with that asset are paid off. For example, a car or house with no outstanding debt is considered the owner's equity because he or she can readily sell the item for cash. Stocks are equity because they represent ownership in a company.

**Equivalence**

Assessment by the European Commission of whether a country's regulatory, supervisory and enforcement regime is equivalent to the related EU framework. Once a market is deemed equivalent, services, products or activities can be provided or carried out in the EU. In some cases, equivalence may be required for EU participants to carry out certain activities in the third country.

**ESG Criteria**

Environmental, Social and Governance standards for a company's operations that socially conscious investors use to screen potential investments. Environmental criteria consider how a company performs as a steward of nature. Social criteria examine how it manages relationships with employees, suppliers, customers, and the communities where it operates. Governance deals with a company's leadership, executive pay, audits, internal controls, and shareholder rights.

**Execution**

The completion of a buy or sell order for a security. The execution of an order happens when it is completely filled, not when it is placed by the investor. When the investor places the trade, it goes to a broker, who then determines the best way for it to be executed.

**Feedback Loop**

The feedback loop between governments' debt risk and bank risk, can be summarised as follows: governments are exposed to banks' risk if they need to bail-out failing banks, in the event that effective alternative ways to 'resolve' that bank are not available. At the same time, banks are exposed to sovereign risk: if the creditworthiness of sovereign debt is reduced, the market value of banks' holdings of domestic sovereign debt is also reduced, with possible impacts on the solvency of the bank. Also, if distressed banks cut back on lending, the negative impact on the economy could lead to a reduction in tax revenues, contributing further to the sovereign-bank loop.

**Financial market infrastructure**

Refers to institutions responsible for providing clearing, settlement and recording of monetary and other financial transactions.

**Free Float**

Method by which the market capitalisation of an index's underlying companies is calculated by taking the equity's price and multiplying it by the number of shares readily available in the market.

**Illiquid**

Describes a security or other asset that cannot easily be sold or exchanged for cash without a substantial loss in value.

**Initial Public Offering (IPO)**

The process for making shares of a private company available to the public for the first time to raise capital.

**Issuance**

The sale of new securities to raise funds. The price at which the securities are sold is the issue price, and the entity that sells them (and in the case of bonds is responsible for meeting interest and principal payments) is the issuer.

**Issuer**

A legal entity that develops, registers and sells securities for the purpose of financing its operations. Issuers may be domestic or foreign governments, corporations or investment trusts. Issuers are legally responsible for the obligations of the issue and for reporting financial conditions, material developments and any other operational activities as required by the regulations of their jurisdictions. The most common types of securities issued are common and preferred stocks, bonds, promissory notes, debentures and derivatives.

**Know Your Client (KYC)**

The due diligence that financial institutions and other regulated companies must perform to understand their clients' background, risk tolerance, investment knowledge, financial position, source of funds and risk of being involved in activities of money laundering or terrorism financing.

**LCR**

The Liquidity Coverage Ratio (LCR) requires banks to hold enough high-quality liquid resources to withstand estimated cash outflows over a 30-day stress period, therefore aiming to promote short-term resiliency. The LCR is calculated as the ratio between stock of High-Quality Liquid Assets (HQLA) and net cash outflows over a 30-day stress scenario. Such a ratio needs to be greater than 100%.

**Leverage Ratio**

The leverage ratio is the ratio between Tier 1 capital and on and off-balance sheet assets.

**Liquidity**

The degree to which an asset or security can be bought or sold in the market without affecting its price. Liquidity is characterised by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

**Listing**

In corporate finance, a listing refers to the company's shares being on the list (or board) of stocks that are officially traded on a stock exchange. Some stock exchanges allow shares of a foreign company to be listed and may allow dual listing, subject to conditions.

**Market Abuse Regulation (MAR)**

EU regulation which prohibits abusive behaviour in the markets, including insider trading and market manipulation. It increases the means for regulators to fight against market abuse and provides for greater cooperation in international investigations.

**Market Capitalisation**

The total market value of a company's outstanding shares. It is calculated by multiplying a company's shares outstanding by the current market price of one share.

**Market making**

A market maker or liquidity provider is a firm that stands ready to buy and sell financial instruments on a regular basis. Market makers do this by quoting buy and sell prices, as well as providing on-request quotes, to ensure a two-way market.

### **MiFID 2/R**

EU Regulation setting the basic legal framework for trading in financial markets in the EU, aimed at achieving a robust regulatory framework for better transparency and investor protection. MiFID 2/R defines the European financial market structure for equities, bonds, foreign exchange instruments, commodities and derivatives.

### **Money Laundering**

The process of making money generated by a criminal activity, such as drug trafficking or terrorist funding, appear to have come from a legitimate source. The money from the criminal activity is considered dirty, and the process “launders” it to make it look clean.

### **MREL**

The “minimum requirement for own funds and eligible liabilities” is a requirement for banks to hold a minimum amount of loss-absorbing equity or debt (i.e. instruments which can be converted to shares or be written off when the bank gets into difficulties) and facilitate the resolution plan, ensuring that losses are absorbed by shareholders and creditors of the bank and not taxpayers. This is in addition to minimum capital requirements and, where appropriate, ensures that banks have enough debt that can be bailed in to enable them to be recapitalised.

### **Multilateral Trading Facility (MTF)**

A multilateral system, operated by an investment firm or a market operator, and which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract. MTFs are alternatives to traditional stock exchanges (or “Regulated Markets”).

### **Net Stable Funding Ratio**

The Net Stable Funding Ratio (NSFR) limits over-reliance on short-term wholesale funding, encourages better assessment of funding risk across all on and off-balance sheet items, and promotes funding stability. It is therefore a more long-term, structural requirement which not only focuses on a subset of liquid assets, but on the entire interaction between assets and liabilities in the balance sheet. The NSFR is a ratio between stable funding available from a bank’s liabilities and capital, and stable funding that is required for a bank’s assets. This ratio is required to be above 100%.

### **Operational Risk**

The risk of loss resulting from inadequate or failed internal processes, such as employee errors and system failures, from outsourcing or from external events.

### **Organised Trading Facility (OTF)**

A multilateral system, which is not a regulated market or MTF and in which multiple third party buying and selling interests in bonds, structured finance product, emissions allowances or derivatives are able to interact in the system in a way which results in a contract.

### **Output Floor**

One of the key components of the Basel agreements, which sets a standardised approach to the calculation of minimum capital requirements for internationally active banks

### **Outsourcing Arrangements**

An arrangement, of any form, between an institution, a payment institution or an electronic money institution and a service provider by which that service provider (including another group company) performs a process, a service or an activity that would otherwise be undertaken by the institution, the payment institution or the electronic money institution itself.

### **PRIIPs**

Packaged Retail Investment and Insurance Products offered by banks to retail investors/consumers. As these financial products may sometimes be affected by excessive complexity and lack of transparency, the EU has adopted a regulation on PRIIPs, which obliges those who produce or sell investment products to provide investors with key information documents (KIDs).

### **Private Equity**

Equity which is not listed on a regulated exchange.

### **Professional Investor**

Banks, financial institutions and other large corporations with access to complex and higher-risk investments as well as some high net worth individuals. See also: Retail Investor.

### **Prospectus**

Document containing detailed information in order to inform the market of an issue of securities or of a takeover bid.

### **Regulated Market**

A multilateral system that is operated or managed by a market operator and that brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments within the system.

### **Retail Investor**

Individual investors that invest their own money, including through the use of an intermediary like a bank. MiFID 2/R distinguishes between retail and professional clients where retail clients enjoy higher consumer protection compared to professional clients and retail clients do not have access to all types of financial products. See also: Professional Investor.

### **Risk**

Risk is the chance that an investment’s actual return will be different than expected. This includes the possibility of losing some or all the original investment.

### **Risk-weighted assets**

Risk-weighted assets (RWAs) are computed by adjusting each asset or asset class for risk to determine a bank’s real exposure to potential losses. Regulators then use the risk weighted total to calculate how much loss-absorbing capital a bank needs. The risk weighting varies according to each asset’s inherent potential for default and what the likely losses would be in case of default – for instance, a loan secured by property is given a lower risk weight.

### **Safe asset**

A safe asset is a liquid asset that credibly stores value, in particular during systemic crises. They play a central role and the demand for such assets is high. Savers need a vehicle to store their wealth; financial institutions use them to have liquid assets and comply with liquidity requirements and more generally to post collateral in many financial operations. Sovereign debt securities can play this role, as long as public finances are considered sound by the markets.

### **Securitisation**

The process of pooling together a large number of loans (such as mortgages, auto loans or SME loans) held on the balance sheet of a bank or other financial institution and selling them to a newly created and legally separate entity. This entity finances the purchase of the loans by issuing bonds to investors. The loans generate cashflows (for example, monthly mortgage payments from homeowners), which are used to repay the investors. In this way, loans which would otherwise be illiquid can be converted into more liquid and tradeable securities.

### **Security**

An instrument representing ownership (stocks), a debt agreement (bonds) or the rights to ownership (derivatives).

### **Settlement**

Settlement is the process in which securities, or interests in securities, are delivered, usually against payment, to fulfil contractual obligations.

### **Share Trading Obligation (STO)**

Under the MiFID 2/R framework, the share trading obligation requires investment firms to ensure the trades they undertake in shares admitted to trading on a regulated market or traded on a trading venue take place on:

- (i) a regulated market or multilateral trading facility;
- (ii) a systematic internaliser (“SI”); or
- (iii) a third country trading venue assessed as equivalent.

**Short Selling**

The practice of investors borrowing stocks that they do not own with a view to selling them in the hope that they can buy them back at a lower price and profit from the difference.

**Short Selling Regulation (SSR)**

EU regulation designed to tackle the risks carried by short selling practices by introducing restrictions and increasing transparency on short selling transactions.

**Sustainable Bond**

Loans used to finance projects that bring clear sustainable benefits such as environmental, social and economic benefits.

**Systematic Internaliser (SI)**

An investment firm which, on an organised, frequent systematic and substantial basis deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system

**Systemic Risk**

The risk of an adverse change in the financial system as a whole, which would affect all markets and asset classes.

**Tick size**

The minimum price movement of a trading instrument. The price movements of different trading instruments vary, with their tick sizes representing the minimum amount they can move up or down on an exchange.

**Total Loss Absorbency Capacity (TLAC)**

An international standard, finalised by the Financial Stability Board in November 2015, intended to ensure that global systemically important banks (G-Sibs) have enough equity and bail-in debt to pass losses to investors and minimise the risk of a government bailout.

**Trade**

In financial markets, trading is the buying and selling of securities.

**Trading Venue**

There are four types of venue where trading of financial instruments may take place:

- Regulated Markets (RMs);
- Multilateral Trading Facilities (MTFs);
- Organised Trading Facilities (OTFs);
- Systematic Internalisers (SIs).

**Underwriting**

The process by which investment bankers raise capital from investors on behalf of corporations and governments that are issuing securities by agreeing to purchase securities from issuers, and then distributing them to investors through a syndication process.

**Unicorn**

A privately held start-up company valued at over \$1 billion.

**Venture Capital**

Funds provided by investors to start-up firms and small businesses with perceived long-term growth potential. It is a very important source of funding for start-ups and is usually a high risk for the investor but can potentially provide above-average returns.

**Withholding Tax**

A tax levied on income (interest and dividends) from securities owned by a non-resident.

## Disclaimer

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