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Sustainable Architecture for Finance in Europe (https://safe-frankfurt.de/)

SAFE Finance Blog

The SAFE Regulatory Radar in November

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German proposal for a common European deposit insurance, new rules for investment firms and covered bonds, and new EU legal framework on Sustainable Finance: a selection of financial regulatory developments from this month

At the end of each month, the SAFE Regulatory Radar highlights a selection of important news and developments on financial regulation at national and EU level.

Banking Union: German proposal for a common European deposit insurance

German Finance Minister Olaf Scholz has set out his ideas for completing the Banking Union in an opinion piece published on 6 November in the Financial Times (https://www.ft.com/content/82624c98-ff14-11e9-a530-16c6c29e70ca), based on a "non-paper (http://prod-upp-image-read.ft.com/b750c7e4-ffba-11e9-b7bc-f3fa4e77dd47)" of the Federal Ministry of Finance. He aims to put an end to Germany's opposition to the European deposit insurance scheme (EDIS (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/european-deposit-insurance-scheme_en)) and to move forward with the Banking Union. Scholz does not claim to replace national systems, but rather advocates for a new European deposit re-insurance system which would complement national arrangements.

Scholz's proposal consists of four main elements. First, he suggests a common insolvency and resolution mechanism for all banks, irrespective of their size and system relevance. He argues that Europe should follow the example of the Federal Deposit Insurance Corporation (FDIC (https://www.fdic.gov/)), which oversees all banks in the US banking system and not only a subsample of significant ones. Second, the position paper states that the risks which currently exist must be further reduced to achieve the goal of a stable banking sector. One of the prerequisites for this is the reduction of non-performing loans. Also, the authors write that the financial and sovereign debt crisis has demonstrated that sovereign bonds are not a risk-free investment. Therefore, risk-adjustments should be reflected in the regulatory treatment of sovereign bonds. Third, a European deposit insurance mechanism should be part of the enhanced architecture of the European Banking Union.

According to Scholz's proposal, EDIS (European deposit insurance scheme) would stabilize the financial system as a whole by counteracting bank runs due to depositors' lack of confidence in the performance of the national systems. The different performance of national deposit guarantee schemes (DGS (https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en)) could be offset by a European re-insurance system. So in addition to the national DGS (deposit guarantee schemes) funds, a European Deposit Insurance Fund managed by the Single Resolution Board (SRB (https://europa.eu/european-union/about-eu/agencies/srb_en)) with national chambers could be set up, which could provide liquidity to the national DGS (deposit guarantee schemes) through repayable loans if required. It remains to be ensured that the national DGS (deposit guarantee schemes)'s target level and the contributions from institutions develop in line with the volume of deposits to counteract exponential acquisition of deposits at the expense of other banking sectors.

To ensure that even national DGS (deposit guarantee schemes) in member states with small banking sectors (and thus limited ability to repay liquidity loans) can draw sufficient funding, a reinsurance model could be conceivable in the steady-state of the Banking Union (i.e., as a second step, after all other elements of the Banking Union have been implemented). In addition to providing liquidity, the model would also include a limited loss-carryover component. In this way, more money could be made available to the national DGS (deposit guarantee schemes) than a variant that provides full repayment of the loan, the position paper argues.

Last but not least, tax law continues to be one of the key areas associated with distortions of competition within the EU. For this reason, uniform taxation of banks within the EU is essential, Scholz's proposal stresses. Progress in the Banking Union should not encourage the development of distortive tax regimes, in particular, those aimed at profit shifting.

While there is already a Commission proposal on (https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en)EDIS (https://ec.europa.eu/info/publications/commission-proposal-european-deposit-insurance-scheme-edis_en) (European deposit insurance scheme), which has been discussed thoroughly, more technical work is needed on crisis management and government bond regulation, the paper says. In December 2019, expert groups should develop in-depth analysis with proposals for both regulatory mechanisms and crisis management, as well as for the creation of a single market for banking services, including specific mechanisms for banks. Also, expert groups should come up with proposals for calibration models for the appropriate regulation of government bonds. Based on these analyses, the European Commission should then submit regulatory proposals. In the case of banking insolvency law, the Commission should shortly submit a regulatory proposal that can be discussed in the Council. The Commission could also submit a new proposal for a European deposit re-insurance model.

Capital Markets Union: a harmonized framework for investment firms and covered bonds in the EU

On 8 November 2019, the Council of the EU adopted a legislative package that leads to further development of the Capital Markets Union. In particular, the recent legal acts establish a new prudential framework for investment firms and a harmonized framework for covered bonds. The documents were signed on 27 November 2019 and will come into force on the twentieth day following that of its publication in the Official Journal of the European Union.

One of the reforms concerns an updated regime for investment firms under the Markets in Financial Instruments Directive (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065) (MiFID II). Until now, all legal persons providing investment services have been subjected to the same requirements as banks. Based on of the agreements of the Investment Firms Regulation (https://data.consilium.europa.eu/doc/document/PE-80-2019-INIT/en/pdf) (IFR) and the Investment Firms Directive (https://data.consilium.europa.eu/doc/document/PE-79-2019-INIT/en/pdf) (IFD), investment firms will be subject to the differentiated regimes according to their size, nature, and complexity. The largest firms (class 1) that provide bank-like services, such as dealing on their own account or underwriting financial instruments, would be requested to apply the Capital Requirements Regulation (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575) (CRR) and the Capital Requirements Directive (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013L0036) (CRD4) and supervised as credit institutions. All other investment firms (classes 2 and 3) will enjoy a new supervisory regime with limited requirements and will be not subject to CRR (Capital Requirements Regulation)/CRD4 (Capital Requirements Directive). For the classification of investment firms, the new laws introduce “K-factors” that cover risks to customers, risks to market access or liquidity and risks to the firm itself. The new regime aims to make the rules for investment firms more proportionate regarding their type and more appropriate to the level of risk which they take. It is expected to be applicable from 2021.

Another set of rules establishes harmonized product requirements and supervision of covered bonds. Covered bonds are a key instrument of long-term finance in many EU member states but the European cover bonds market remains fragmented. The new framework consists of the EU Regulation (https://data.consilium.europa.eu/doc/document/PE-86-2019-INIT/en/pdf)and Directive (https://data.consilium.europa.eu/doc/document/PE-85-2019-INIT/en/pdf)as regards exposures in the form of covered bonds which aim to reinforce investor protection and to ensure a stable funding source for credit institutions. The new legislation introduces a common definition of covered bonds as a debt obligation issued by a credit institution and secured by a cover pool of assets that covered bond investors have direct recourse to as preferred creditors. It also defines the structural characteristics of the instrument as well as tasks and responsibilities for the supervision. The package contains rules of using the

‘European Covered Bonds (https://www.coveredbondlabel.com/)’ label which would help investors to assess the quality of the covered bonds. After the implementation period, both the regulation and the directive will be fully effective around mid-2022.

Sustainable Finance: new EU legal framework

On 24 October 2019, the Council of the EU published legislative acts contributing to Sustainable Finance. The package is a part of the Capital Markets Union and aims to promote Green Finance and to bring it in line with the objectives of the Paris agreement on climate change.

The regulation on disclosures relating to sustainable investments and sustainability risks in the financial services sector (Disclosure Regulation (https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf)) concerns transparency obligations for sustainable investments. Under the new law, the institutional investors have to disclose information on the procedures they use to integrate environmental, social, and governance (ESG) risks into their investment process, and which impact those risks may have on the profitability. Institutional investors that pursue a ‘green’ investment strategy are required to explain how this strategy is implemented and which impact sustainability has on their portfolios and products.

The Low Carbon Benchmarks Regulatio (https://data.consilium.europa.eu/doc/document/PE-90-2019-INIT/en/pdf)n creates new categories of benchmarks. A climate benchmark is an investment benchmark (index) that incorporates the objectives related to greenhouse gas emission reductions and the transition to a low-carbon economy. Under the new law, the administrators of climate benchmarks have to explain their methodology concerning the ESG (environmental, social, and governance) of low-carbon factors in their index.

The first type of benchmarks, the EU climate transition benchmarks, aims to lower the carbon footprint of a standard investment portfolio and foresees much diversification while the second type, EU Paris-aligned benchmarks, are designed for highly ambitious climate-related investment strategies and impose stricter minimum requirements.

The Disclosure Regulation will be applicable in 15 months after its publication in the Official Journal of the EU which is expected at the end of the year. The Low Carbon Benchmarks Regulation will enter into force on the day after its official publication.

Another key EU regulation, the Taxonomy Regulation (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52018PC0353), was not adopted at the first reading and is awaiting for the following negotiations. Once agreed and finalized, it is expected that a unified green classification framework will come into force at the end of 2022.

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