1. ECONOMIC AND MONETARY CHALLENGES IN THE EU AND THE EUROZONE

Growth prospects: how to reinforce investment and growth in the EU?

KEY ISSUES | *Governor Knot opened the Eurofi seminar with a keynote speech on growth prospects in Europe. Below is a summary of this speech, which is reproduced in full further down in this report.*

European Union in a difficult phase

Today, the European Union is going through a difficult phase. Geopolitical tensions at the borders, large migration inflows and threats from terrorism touch upon issues like solidarity and security. And the United Kingdom is even questioning its EU-membership in an upcoming referendum. In the wake of the financial crisis, the contribution that the European Union can make to higher living standards is in doubt. Many EU countries are struggling to find sustainable growth after the crisis. Unemployment is estimated at 9% in the European Union as a whole this year, and even at 10.5% in the euro area. From this perspective the skepticism is understandable. Sustainable economic growth is therefore urgently needed.

The European convergence machine needs fixing

The majority of member states that joined the EU in 2005 and 2007 are doing quite well, even though they started at much lower income levels. Since 1999 their annual per capita GDP grew by 3.4% on average. In stark contrast, the 12 countries that originally joined the monetary union when it was formed in 1999 are now lagging behind. Annual GDP per capita grew by only 0.8% on average in these 12 countries. The hope also that the monetary union would contribute to convergence of living standards did not materialize in this group. Quite the contrary. The countries that entered EMU with a relatively low GDP per capita, such as Greece, Italy, Portugal and Spain, only fell further behind. Their relative GDP per capita decreased from 97% of the EU average in 1999 to 82% in 2015.

It is obvious that the situation needs to improve. European countries need better economic performance, while new member states should ensure that their performance can continue. In other words: the European convergence machine needs fixing.

Explanations for low growth in Europe

Part of the explanation is related to the imbalances that developed before the crisis, such as housing market bubbles, eroded price competitiveness, current account deficits and high public and private debt.

Second, some reasons for low growth may be related to the design flaws in the monetary union, which were exposed during the European sovereign debt crisis. Examples of this are the negligence of imbalances within EMU. It was erroneously thought, for instance, that current account imbalances would be irrelevant in a monetary union.

Another flaw is the lack of compliance with the stability and growth pact. During the period 1999-2014, Luxembourg was the only country of the current 19 euro area Member States that managed to keep its budget deficit below 3% of GDP. Seven countries have failed to achieve this in over half of these 16 years. And out of all 19 euro area countries, only one, Belgium, managed to lower its public debt between 1999 and 2014.

Third and finally, an important part of the growth problem is structural. Many EU countries simply have very low potential growth rates. The European Commission projects potential growth in the euro area at only 1.1% per year. Partly, this very moderate growth potential is the result of structural headwinds, which many developed countries inside and outside the EU are facing. These include ageing populations and a gradual decrease in the growth of labour productivity. Also, some economists fear that new technological innovations will not yield the same productivity gains as past innovations. Yet another part of the explanation for low growth is more >>>

>>> policy-related, as several countries have failed to adapt their economies to the changes in the economic environment in recent decades. While structural convergence was clearly what was needed, structural differences between euro area countries only widened.

The most effective way to raise economic growth are structural reforms

Central banks can buy time, but cannot solve structural problems. Obviously, additional measures are required. Unfortunately, budgetary leeway is limited in most EU countries. Public debt ratios remain high at 94% of GDP on average, and Europe needs to preserve the credibility of its fiscal rules. So the most effective way by far to increase growth are structural reforms. Reforms would have a number of important benefits. First, they would increase the resilience and adaptability of EU member states, especially after crises. The OECD estimates that moving towards best practices in Europe via reforms could raise GDP in member states by 4-7%. Possible measures include product market reform, as well as liberalization of the service sector and of regulated professions.

Another priority should be to stimulate innovation, R&D and the application of ICT (Information and Communication Technologies).

It would also be very helpful to increase the ease of doing business and to improve the investment climate. It should for instance become easier to start a company in Europe, and easier for small firms to grow further.

Finally, the quality of institutions could be improved, leading for instance to higher efficiency of the judiciary system in protecting property rights. One priority in this context is harmonization and modernization of insolvency laws. This would allow Europe to free itself from the millstone of non-performing loans, thereby making room for economic growth.

How to implement reforms: Europe or member states?

Having explored what course of action we should take, we can now ask how these reforms should be implemented. First and foremost, reforms are the responsibility of member states, because they reap most of their benefits and bear most of their political costs.

Still, difficult measures are often only taken once their urgency can no longer be ignored. This is why Europe should also stimulate reforms. Mechanisms like Europe 2020 and the Macroeconomic Imbalances Procedure (MIP) aim to achieve this. Unfortunately, the implementation of policy recommendations remains incomplete so far.

Of the 158 recommendations within the framework of the MIP issued by the European Commission to Member States in 2012-2014, substantial or full progress had only been made for 5%, some progress had been made for 54% and no progress had been made for 41%. Obviously, European coordination may need to become more binding in the future.

Strict compliance with the rules is necessary to reduce existing vulnerabilities more quickly, and to better prevent new ones. That would also reduce the probability of future calls on public risk sharing schemes like the European Stability Mechanism. The shared responsibility for risks should go hand in hand with better control of these risks. ●

Monetary policy: How are monetary developments impacting the financial sector and the economy?

KEY ISSUES | *Many leaders of the industry stressed that lasting ultra-low interest rates were causing negative effects on the economy of the euro area. Indeed banks' profits are significantly reduced due to ultra-ease monetary policy and prudential banking regulations and this leads to a reduction of lending. In other words, in such circumstances, the transmission mechanism – through the banking sector – of the ECB's monetary policy is significantly weakened.*

This low interest rates environment fails to reduce household and corporate sight-deposits

In theory, a decrease in interest rates encourages savers to reduce the amount of their remunerated savings, as their opportunity cost decreases, and it prompts borrowers, on the other hand, to increase their indebtedness, as it reduces their financial burden.

In practice, however, things at the moment are a little more complicated. We are indeed in >>>

>>> an environment of weak economic growth, which makes households feel uncertain about their jobs, and non-financial corporations feel unsure about their ability to sell their products to customers. As a result, the increasing economic uncertainty leads savers to increase their savings, rather than decreasing them, for precautionary purposes, and they invest less in riskier asset classes as they become more risk-adverse. It makes borrowers less reactive to a decline in interest rates, as their commercial prospects are decreasing. When the yields fall or, sometimes even disappear, because of monetary policy, the shift of repressed financial savings to consumption doesn't seem to work in Europe. Indeed, one observes that a significant number of savers are trying to offset lower returns by more savings.

As a consequence, this low-interest-rate environment has translated into higher household- and corporate-sight deposits, as well as a decline of the money multiplier; hence, the monetary policy is not that well transmitted to the real economy.

Low interest rates have a negative impact on retail-deposit banks profitability and a positive effect on specialised financing activities

A representative of the banking industry stressed that low interest rates have a negative impact on retail-deposit banks in particular, because their business consists of maturity transformation between costless short term deposits, and long-term loans. Quite understandably, the interest margin depends on the interest-rate levels of those long-term loans. When interest rates go lower and lower for a prolonged period of time, back-book loans are progressively replaced by lower-yielding loans in the banking book.

Conversely, the same low-interest-rate environment is positive for many specialised financing activities such as factoring, leasing, consumer loans and long-term car rentals, as those businesses usually fund themselves at market rates, without any transformation. For them, then, client and funding rates decline in parallel, and margins remain stable, with a benefit from the demand increase brought by lower rates.

Corporate and institutional banking and market activities are more or less rate-neutral because all loans and deposits are indexed to floating rates in that business.

Clearly, the ongoing decline in interest rates and the significant flattening of the yield curve weigh on the profits of retail deposit banks that traditionally benefit from maturity transformational activities. Even more than the back book maturing and being replaced by lower-yielding loans, the non-maturing back book is also endangered by the renegotiation of rates, because clients are asking for lower rates on their current loans. For commercial reasons, very often in several eurozone countries, banks are obliged to accept, which rapidly reduces the average rate of the loan book.

On the liabilities side, banks can lower interest rates on interest-bearing deposits, but only to a certain extent, because, of course, interest rates generally have a zero floor. As we are already there now, there is not much more to do than what has been done already. The margin pressure from low interest rates, then, forces retail networks to cut costs and to look at how to charge for services. This is a big question and a big problem, especially for pure retail deposit banks, which are clearly the most impacted.

The persisting divergence between the cost of capital and the profitability of EU banks

Another leader of the industry highlighted the persisting divergence between the cost of capital for European banks and their profitability. Indeed, the cost of capital remained at the level of 10% while profitability for the European banking sector as a whole remains quite low, at around 5% approximately. One of the key factors which explains the elevated cost of capital in Europe is that, despite all the efforts undertaken, some buckets of risks that are associated with certain banks and certain countries continue to persist (high level of Non-Performing Loans…). This discrepancy between the cost of capital and profitability in Europe is also triggered by the uncertainty surrounding banking regulations.

The consequences of the decline of the profitability of the banks of the euro area are manifold. The first consequence is that there are much fewer incentives for investors to buy bank shares, which is reflected in the relatively low price-to-book ratios in the banking sector, especially if you take into consideration the regulatory uncertainties such as the gold-plating of the supervisory authorities, which is unpredictable and may create some new surprises, as well as the upcoming Basel IV regulation, which is also frightening for any investor.

The result, then, is that they invest much less in bank shares and require an increase in dividends, since they consider that it is less value-destructive for banks to give back equity rather than trying to invest further in insufficiently profitable banking activities; hence, it is very difficult for banks to further strengthen their equity while the regulator keeps asking for more and is determined to really increase banking capital above current requirements year after year. >>>

>>> There is, then, a Catch 22 situation, which imposes to lend less and to further deleverage, retrench and reduce the size of the bank.

The new regulatory frameworks have also negatively impacted the profitability of EU banks which reduced European banks' lending capacity

Both monetary policy and regulatory policy are weighing on bank profits. Banks are in Europe the indispensable transmission belt of monetary policy: if banks are not profitable, they will not lend more. Clearly, the new Basel 3 regulatory frameworks reduced European banks' lending capacity, and banks were no longer really in a position to fund big corporates according to different leaders of the industry. They were not even able to be market makers in corporate securities; while securitisation has been shown as a solution, you need market makers. Clearly, banks' securities inventories decreased by more than 40% between 2008 and 2015; hence, it was difficult to have a liquid market for those debts.

Market makers would however be substituted by the ECB, which will buy some of those bonds via its quantitative-easing policy, as it does already for sovereign bonds. For large corporates, a solution has been found: they issue bonds in the market, which are then bought from Institutional Investors by the ECB, so large corporates are going to be funded by the ECB. The latter becomes a lender of first resort, which will allow central banks to avoid being the lender of last resort.

A greater concern comes, however, from SMEs because their financing relies almost exclusively on banks. They do not have easy access to financial markets. These loans are further at stake because of the very significant capital requirement increases that will be induced by the introduction of Basel IV, which is currently under discussion. In that context, in order to preserve the financing of SMEs, we may see, according to a leader of the industry, a new step in quantitative easing in the future, with the ECB purchasing loans to SMEs. That may be the solution for the future.

Nonetheless, if the measures envisaged by the Basel Committee, notably to tighten the risk weighting process, were all decided by the end of 2016, European banks would see their capital requirements jump, on average, from 12% to 15% (or even 16%). The return on equity achieved in 2015 would fall to around 3%. This would not allow a large number of banks to cover their costs and thus to carry out their intermediation role. ●

Integration and disintegration: what trends in the EU and potential impacts for the EU financial sector?

KEY ISSUES | *The objective of this session was to discuss fragmentation trends in the EU, their potential impact of on the EU single financial market, the EU financial industry and the funding of the EU economy and also to define the priority actions that should be implemented to minimize the impact of such fragmentation on the financial system and the EU economies.*

Fragmentation Risks

A 'perfect storm' of challenges now existed, including the situation of Greece, the suspension of Schengen and control-free borders, the high level of unemployment and public indebtedness in some Member States, and the Brexit referendum on 23 June. This posed dangers to Europe's main achievements: the single market, the single currency and the single border. The European Union itself might not be close to disintegration, but a huge amount of fragmentation had already been witnessed. Although the European Commission and the other European institutions were in the process of tackling these problems, the vast number of legacy problems inherited from financial crisis complicated matters.

The EU had been proving itself to possess sufficient capacity, flexibility and political wisdom to deal with the challenges it faced, as could be seen from the example of the UK settlement. However, in coming years, questions of integration would need to be addressed, and this meant not just having multiple speeds, but also multiple directions of travel, with some countries opting for less integration and some opting for more.

Impacts of Fragmentation

Fragmentation was distinct from disintegration: the former might be a temporary consequence of the need to address certain problems where appropriate means to do so did not exist at European level. However, >>>

>>> these kinds of solutions would not provide a stable long-term solution to the problems that Europe faced, and would likely introduce more segmentation if they were to become the default approach. Whether the United Kingdom voted to remain within the European Union or leave it, the likely closeness of the vote should act as a 'wake-up call' to Europe, demonstrating that the union that had existed between the 12 pre 1994 member states could not be replicated with 28.

The United Kingdom not voting to leave the European Union would not necessarily resolve the issue on a permanent basis; another referendum could always be held in some years' time. However, if Britain decided to leave, it was not clear whether or not Europe and Britain would be able to amicably conduct negotiations to reduce the impact of Brexit, and what impact this would have on integration within the rest of the EU. A confrontational outcome and no further integration would drive risk premiums up. To mitigate risks, EU member states would also need to stop using the EU as a 'scapegoat' when things went wrong.

Necessary Priority Actions

Deepening the Monetary Union without undermining the single market

The work carried out by the European Council suggested that deeper monetary union might be necessary, such as via banking union; however, if this were to take place, Europe would need to be careful not to introduce any kind of discrimination against those who were not in the euro and who were not part of banking union. The 19 member states that had joined the euro had done for differing reasons, and this would need to be borne in mind.

Combining fiscal discipline with growth-enhancing measures is also important. According to a Panellist, the EU was in the process of finding a way to combine the need for discipline with growth-enhancing measures. The flexibility debate was complex and difficult, but the European Commission was moving in the right direction.

Europe should be more present in the monitoring and in the accompaniment of national structural measures

Given the persistent low growth environment specific emphasis, priority should be given to the implementation of structural reforms which have been the main way forward to boost potential output and productivity growth and to reduce unemployment. It was specified that the EU needed to address the problem of achieving stronger convergence in its structural reforms or economic policy with a stronger enforcement mechanism that contained an element of incentive, which could combine with this new, synchronised fiscal stimulus.

Completing the Banking Union

The Single Supervisory Mechanism and the Single Resolution Mechanism had been very important, but the third pillar on banking union, the European Deposit Insurance Scheme, was extremely difficult for the partner institution to work with. The envisioned end point was a fully mutualised Eurozone fund, which was a goal that remained controversial. Unless progress was made in improving the adequacy of the prudential standards with which bank exposures to sovereigns were treated, and a common view was reached, a political consensus emerging around mutualising debt was difficult to envision.

A speaker stressed that there were a number of important issues with which Europe would soon need to deal, including risk-weighted asset homogenisation, TLAC and MREL, and how global standards could be contributed to and implemented at European level. While doing all of this work, the need to have a proper balance between stability and sustainability of measures would need to be borne in mind; Europe was presently moving in this direction. TLAC and MREL would be approached in an intelligent way, and the European Union, in general, could learn from its mistakes, as had been seen recently in relation to the minimum distributable amount and the Pillar 2 issues recently in SREP. The speaker remained relatively confident that – despite the size of the challenges that the EU currently faced – the resilience, flexibility and internal intelligence that existed within Europe would prevail, taking into account Europe's particular political rhythm and dynamic.

Developing contractual arrangements

Given the diversity that existed within the European Union, contractual arrangements were very important, but had not been used sufficiently. These had been used within Schengen, but a lot more of those contractual arrangements could be created; these helped differentiate those who wanted to sign up from those who did not. There were many areas of the European Union; those who had a common currency had entirely different integration needs, and members of the Union differed on whether they regarded themselves as members of a free-trade arrangement or members of a capital market. People's views on what kind of arrangement they were in needed to be more clearly spelled out, because both the speed and direction of travel were now visibly different.

Being more ambitious regarding the Capital Makers Union

One Panel member felt that while Europe had been overly ambitious regarding some issues, such as mutualisation of debt, it was not ambitious >>>

>>> enough about capital market union, concerning itself solely with eliminating internal barriers. Global capital markets were much more powerful, and needed to be harnessed; to drive this work forward, a European equivalent of the SEC would need to be made responsible for it. Another Panel member added that new European regulation had to be designed to produce more integration, rather than a loose framework that created more diversity. To promote further European integration, the narrative would need to be changed, and there would need to be clear leadership that emphasised the positive aspects of the European Union and the institution's achievements.

Political Approaches

Jacques Delors had referred to a two speed Europe; however, 'two speeds' implied a joint destination, and this was proving not to be the case. The European Union might want to consider offering two, or possibly three, different models of integration, with the goal of producing a higher degree of diversity and political legitimacy without jeopardising the advantages of the internal market, with monetary union and a completed banking union at its core. All EU member states would hopefully be able to unite around the goal of retaining the existence of an internal market within a customs union, with free movement of persons, although the exact form that this would take could be debated. For the financial services industry, this meant having a robust framework for the 28 member states that allowed some states to become more deeply integrated than others.

2017 would be a critical year for the European Union. If the UK's referendum were to be won by the 'Remain' campaign, and strong pro-European majorities were elected in EU member states that were holding elections in the near future, the European Union would be well placed to implement bolder and more ambitious measures. A critical decision would eventually need to be taken by EU member states, probably during 2017, as to whether common tools that entailed some element of risk sharing should be introduced within the European Union, and for these to be implemented, the right political conditions would first need to be created. ●

EMU: what priorities and ambitions for deepening the EMU?

KEY ISSUES | *The objective of the session was to define the priority actions for making the euro viable and avoiding a situation where the risk of an exit country becomes real.*

This plenary session was devoted to discussing the conditions required to improve the economic governance of the euro area. Speakers were also invited to discuss how to encourage Member States to meet their fiscal and structural commitments.

The process of convergence needs to be restored

Monetary Union without a sufficient degree of convergence of economic policies is unlikely to be durable and could, in fact, be damaging to the European Community. According to a public decision maker, the question is how to re-launch that economic convergence, with both political steer and concrete support. According to him, the Five Presidents' Report provides good guidance. The first question is not one of revolutionary new steps, but of showing that what we have already agreed is working. 'Deepening by doing' - as the Five Presidents' Report describes the first stage - means fully implementing decisions taken. Advancing further within the existing legislative framework and streamlining its application where necessary. Only consistent implementation of the decisions already taken can provide us with the necessary credibility to advance toward Stage 2 as proposed in the Five Presidents' Report where more far-reaching measures would be agreed upon to complete the EMU's economic and institutional architecture. This speaker explained that there are a number of issues which can be implemented at this stage and which do not need any institutional changes or treaty changes.

First, we need to set clear common reform priorities. This is why individual euro area member states recommendations includes a clear set of joint priorities on enhancing productivity, adjusting labour markets, addressing fiscal situations and talking about the financial sector and >>>

>>> working out non-performing loans. The Eurogroup is benchmarking the implementation of those priorities across member states and the EU Commission is supporting strongly this approach;

Secondly, we need the engagement of all stakeholders within member states. At the beginning, the European Semester co-ordination mechanism was perceived in Member States as some department in a finance ministry sending some papers to Brussels and nothing more. Of course, this approach does not really work so what we need is that the European Semester and our common decision making priorities to become part of the national political debate. That means strongly engaging with member states and not only with governments but with social partners and other stakeholders.

A member of the Ecofin Council stressed that we can perform much better is the area of country-specific policy recommendations to identify the main economic challenges for each EU Member State. If we are really committed to these recommendations, the EU's budget should support the respective member states to implement these recommendations. National projects which profit from financing by the European funds should be designed to implement the country-specific recommendations. The Commission needs to make this a precondition for the financing of national projects. An approach of this kind, which is based on the synergy effects between the implementation of the country-specific recommendations and the use of EU funds, would have a positive effect on the public image of the EU as an agent for active change - rather than an obstructionist. An integrated policy approach consisting of European money and structural policies would in addition facilitate clear communication of existing and future political priorities.

A "full coordination" institution in the euro area is required

A public decision maker explained why a "full coordination" of fiscal and structural policies was necessary and made the economic case for a stronger governance of the euro area. According to him, clearly monetary policy cannot be a substitute for economic policy coordination or the lack of reforms. And the absence of coordination has a genuine economic cost. Several studies pointed to a significant cost of non-coordination, in the order of 2 to 5%¨of GDP since the crisis.

To take the debate forward, he proposed to make three principled choices: first: making parallel progress on both domestic reforms and European coordination. This is the cornerstone of any French German agreement: to be fair, the French call for Germany to support coordination, and the German doubt about French reforms, have been and are still well-founded. This requires overcoming distrust between countries and putting both aspects under the same umbrella, namely a common institution.

Moreover, it must be recognized that institutions with a mandate are superior to rules without institutions. To bolster policy consistency and coordination, the rules of the Growth and Stability Pact should be supported by strong institutions with discretionary powers. This is why there is room for an intermediate level of integration. The speaker called it "full coordination of national policies", a presently missing link between integration, as we have for monetary policy decision-making, and rule-based surveillance, such as it is currently the case for national fiscal policies in Europe and which is clearly lacking teeth. The highest level of policy integration would logically involve building a genuine fiscal union, as well as completing the Single Market; but that would surely require more ex ante convergence and resolution of legacies from the past. In addition to the completion of banking union, the most urgently needed part of EMU reform is to set up a strong institution to fully coordinate national fiscal and structural policies.

This approach would help to make the Euro area more than the sum of its parts. Jean Monnet famously declared that "nothing is possible without men, but nothing lasts without institutions." The mandate of this decision-making institution must be to achieve the strongest, sustainable and balanced growth, through a decisive progress in terms of national macroeconomic policy coordination. To that effect this public decision maker shared with the audience some thoughts regarding the tasks a Finance Minister of the Euro area would have.

The tasks for a Euro Area Finance Minister

First, the Minister would be in charge of preparing the euro area-wide collective strategy to fulfil its sustainable growth mandate. It would be essential for the euro area to collectively agree on overall economic policy objectives, and on the division of tasks through the setting of individual performance targets for Member States. Nobody seriously contests that a collective strategy adding more structural reforms in some countries including France, and more fiscal expansion in others including Germany would make for a better policy mix for sustainable growth and employment in Europe.

Second, the Finance Minister would be responsible for supervising the implementation of the collective strategy, using adequate instruments to provide symmetric incentives. Third, the Finance Minister would be responsible for implementing centralized crisis management. A Finance Minister for >>>

>>> the euro area would naturally be in charge of overseeing European Stability Mechanism operations.

Last, while moving towards further integration, the Minister could be given the authority for managing a euro area Convergence Fund, evolving towards a Euro budget. We are touching here on the issue of a common fiscal capacity, promoted recently by Pier Carlo Padoan. As successfully done in the past, it could be built in three stages. In the first stage, Member States would be free to join. In a second stage, this budget could become a stabilisation instrument, centralising a well-defined set of policy instruments, such as a European layer of unemployment insurance. The third and final stage of fiscal integration would only be achieved if agreement can be found both on financing (direct revenue-raising capacity and common debt issuance) and on the desirable level of business cycle synchronization. This perspective would be a powerful incentive for national discipline and commitment as shown during the march to the Euro.

Further integration and democratic accountability should progress together. These institutional changes require a new Treaty. In such a context, a legitimacy-enhancing appointment process is required. In addition this euro area Finance Minister would need to be backed by a genuine Treasury administration. Last, a stronger democratic control over euro area affairs would be required. To this end, it would be appropriate to consider institutionalising a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments would also need to be enhanced, through an inter-institutional agreement, or by creating dedicated commissions.

A member of the Ecofin Council stated that the first priority for Euro area Member States would be to implement their domestic homework in terms of fiscal and structural policies which is essential for economic growth and financial stability. But this is not enough. He supported fiscal integration but the priority in this respect is to agree on its content. He stressed that Fiscal sustainability and macro economic stabilisation are not mutually exclusive but rather complementary objectives to stabilise a prosperous economic environment. More is needed to protect EU economies in cases where national fiscal stabilisers are not enough to cope with asymmetric shocks, and also when the monetary policy is limited. This is particularly important when countries are making efforts to reach their fiscal targets and therefore do not have much room to use national fiscal policies for stabilisation. This is why some were advocating a fiscal capacity and a common unemployment insurance scheme. This tool would be something quite visible and understandable for others. However this tool cannot resolve all the problems. He stressed that the key priority was the homework which must be done at a national level.

Another speaker of the public authorities agreed on the fact that deepening the EMU is a necessary objective, which will become credible once a broad consensus among Member States on a way forward has been built. This the reason why the economic case to explain the need for a Euro Finance Minister has to be clearly established. He also stated that the EU Commission was currently in a broad process of consultation in the first half of this year, running events and gathering views from member states and from stakeholders in all member states. Then the Commission will summarise the feedback getting from the member states through an expert group with a view to preparing a Commission-wide paper in spring 2017 outlining the steps for Stage 2 on completing the European economic and monetary union. ●

Ageing population: key challenges posed for the financial sector

KEY ISSUES | *This plenary session was devoted to discussing the economic challenges and the impacts on existing pension systems posed by the ageing population. The session also addressed the contribution of the financial industry to these issues.*

The character of the problem

Significant changes in the age structure projected in the EU

In order to understand the nature of the problem, it was important to define what an 'ageing population' was. Here the source was low fertility rates, the retirement of the baby boom, and improvements in life expectancy. The other impact had been that the low fertility rate in most OECD countries was quite below the substation rate, meaning there would continue to be a reduction in the population. >>>

>>> The primary factor, though, was improved life expectancy. On an individual level, people would spend longer in retirement than previously, but the number of years saving for retirement was not increasing.

This ageing affects the solvency of DB and DC funded pensions

The impact of population ageing and the micro and macro impacts differed depending on whether the subject was defined benefit (DB) pay-as-you-go pensions, DB funded pensions or defined contribution (DC) funded pensions. In DB systems the question was whether there would be enough money. If the ratio of people paying into the system moved to 4:1 to 2:1, then there would not be sufficient money, as pension benefits were paid with current contributions. In DC systems, the macro aspect was more important, as people would live longer and accumulate the same amount or less to finance longer in retirement.

The fiscal and economic challenges will be substantial in many Euro area countries

Ageing would mean that more people would withdraw from the labour force. Employment in the working population might decline, and pension expenditure was expected to remain the same until 2060. However, pension expenditure was only one element, alongside healthcare and long-term care, which was expected to grow by 2% by 2060. The current migrant crisis had benefits in the medium term, helping economies address severe ageing problems, but it also posed a challenged to EU governance. There was agreement about the need for people to work longer, to provide the income for later security, but that security needed protection in the present as well.

Demographic trends would impact the creditworthiness of sovereigns. Simulations showed that the US would reach sub-investment grade by 2050, the UK, France and Germany would be at BBB during most of the period. Since the simulations a number of countries had taken steps to address demographic change, by reforming their social security systems and reducing their budget deficits. However, real and nominal growth prospects had been lowered, as inflation had been all but absent. Median net general government debt in the advanced-market economies would be 134% of GDP by 2050, up from 52% currently.

The Regulatory Challenge and the political responses

Across Europe, questions needed to be asked as to whether entities were sufficiently solvent and able to deliver on promises. In that respect there was also pressure from the low-interest environment which diminished returns. If the situation remained unchanged, benefits would need to be reduced and people would need to work longer. There were two political responses: the populist, where politicians sought refuge in Pillar I, and the reformist, where better collaboration between the three pillars was sought. It was important for pension providers to be able to deal with consistent regulators and rules.

Public Awareness and Understanding of the Problem

Public Awareness

There was general agreement that people needed to work longer. Some people, however, lacked the proper understanding of changes being made in their own interests. Many of people's beliefs about economics were untrue. Even when people understood, it did not mean that everybody acted appropriately. Similar to climate change or other hugely long-term challenges, there was a perception gap between long-term realities and short-term actions. Even if a person had the best intentions and started saving with a promise to save for the next 35 years, there might be incidents such as divorce, children or tragic events which caused the promise to be broken and the money to be taken out.

It was suggested that, while perhaps awareness was there on a conceptual level, it was not clear how many were fully aware of their own pension situation. Research had shown that most people thought the chance of their being unable to reach their pension without disability or a period of unemployment was smaller than 10%, when in reality it was 25%. In summary, understanding the problem was easy: people needed to work longer. The implementation, however, was less easy, and this was where the problem lay.

Government Awareness

The awareness was already present at a government level, as shown by the number of reforms which had passed in the last few years, such as automatic linking of benefits or retirement to life expectancy, or automatic stabilisers within the system. Three EU member states now had automatic balancing systems, eight had links between benefits and life expectancy, and seven had links between retirement age and life expectancy. As a result of this, predictions made only three years previously had proved pessimistic. Estimates suggested recent reforms in Italy would increase GDP by 2.5% and employment by 2.2% by 2030. >>>

>>> EU mechanisms had been introduced help governments to maintain awareness and to provide incentives for affecting those reforms, and the OECD message had always been to diversify sources in order to finance retirement. Private systems should be complementary to their public counterparts. In most countries, the solutions being pursued were to promote more and more DC schemes. The key thing was that benefits would be determined by the assets accumulated.

Addressing the Problems of Awareness and Understanding

Everybody recognised that life expectancy was increasing, but did they understand that they needed to save more? The savings opportunities and returns at present were not very exciting, owing to monetary and growth policies. One dimension so-far unmentioned was the rise in inequality. When these very complex issues were considered, a response had to be articulated that addressed the inequality aspect of recent trends. It was important to recognise that large parts of the European population would never be able to save for their pensions. It was important to help people to budget and allow them to save more.

With changes in the law in the UK, employers could no longer set a retirement age in pension schemes, so good pensions were needed to encourage employees to retire. Auto-enrolment had been introduced, which had been a very important first step.

The Solutions

Delaying Retirement and Greater Contributions

Although it had been said that people could not contribute more and contributing more led to lower returns, it seemed that lower returns resulted from higher life expectancy and lower growth. The only way to achieve what somebody who retired in the 1970s did was to contribute more and for longer. Many countries, such as Sweden, had done this by linking statutory age of retirement to improvements in mortality and life expectancy. This was fine, but care needed to be taken, as not everybody reaching retirement age had the same life expectancy. Many countries were linking statutory age of retirement to improvements in mortality and life expectancy, but care needed to be taken around socio-economic factors. The other suggestion was that the ratio of years contributing to years in retirement was important.

Increasing Participation

Increasing participation rates could address not only the ageing problem, but the growth problem more broadly. Improving participation rates of ages 55 to 64 could increase GDP by 3%, and, by improving participation rates of ages 65 to 75, the projected dependency ratio in 2060 fell from 2:1 to 3:1.

Increasing Productivity

In principle, you can borrow more, earn more or spend less to tackle such challenges. Borrowing more is, for the moment, out of the question, because debt is already very high, so we are left with either earning more or spending less. There, one can see that there is potential for spending less or at least spending better – there is potential for efficiency that could be tackled. Health costs can be reduced by 25% efficiency savings.

Then there is the better option, which is to earn more. Earning more with a lower population is more difficult and requires much more productivity. Improving productivity requires open markets within and outside the European Union. Entry costs and tax distortions which might create segmented markets would need to be removed. At the same time the quality of capital and labour needed to be improved, so more research and development was needed in innovation and more and better skills.

This was feasible, because, if one looked at the gap between the current situation and the best performing countries, it could be calculated that GDP could increase by around 11% in 20 years in the EU, though it varied from country to country. Additionally, if the reforms were implemented jointly by several or all member states, the dividend could increase to 12%. As a result, budget positions would improve, and so would employment. Once there was some sort of mechanism to remind governments of these benefits and entice them to make the reforms necessary to reach those dividends and communicate that information to the public. It was also important to create opportunities for older people to work on a part-time basis. This would require certain tax incentives and societal levies, to not disincentivise people working 10 to 15 hours from topping up their pensions.

Public/Private Co-operation

Pillar I would provide only a basic level of financial support for elderly people, and would need to be supported out of general taxation. Pillar II would need to be strengthened with more auto-enrolment, with a move to DC rather than DB pensions. This pillar was a combination of public requirements managed in a private fashion. Pillar III would then serve as more of a top-up to safeguard the standards of living for those who could not afford it. >>>

>>> In terms of auto-enrolment, the next step within Pillar II schemes would be auto-escalation. Employees received a 3% wage increase, 1% of which went into their pension. This could be done without legislation, and it was important that employers started to think about it.

Decumulation

Decumulation would also be more and more important. The insurance world could not provide the guarantees needed, so co-operation was needed. Following recent changes, the UK was a test-bed for examination of the different options. Mistakes would be made, but could be learnt from.

Other solutions

Other solutions included moves to transfer risk to the individual, with capital backed savings, so that people would contribute more. Financial markets had a very important role, because of the need for drawdown programmes and annuity markets, and insurance companies and pension funds both needed financial instruments to hedge longevity risk. ●

Retirement products: what products for answering retirement needs in the EU?

KEY ISSUES | *This session focused on the role that EU institutions can play beyond domestic arrangements, in providing appropriate products / vehicles for answering retirement savings needs and the related EU regulatory frameworks (e.g. Pan-European Pension Product) that may be needed.*

Speakers were also invited to discuss the role that financial players can play to develop EU products in order to encourage and support citizens to save for their retirement.

The roles of public, occupational and personal pension vehicles in each of the 28 Member States diverge significantly. The need for EU products to answer retirement needs was obvious when considering the immense demographic challenges in Europe, current economic uncertainties, and low interest rates. Those factors aggravated conditions for retirement provisions of European citizens, which was a concern to European policy makers. The industry had to adapt.

The Current State of Pensions

The issue was of how to achieve adequate pensions for citizens. Within the pensions framework, the first pillar desperately needed reform. The inevitably unpopular reality was that if a more sustainable first pillar were to be attained with public finances, they would need to lower first pillar pensions. The retirement age also needed to move up. With the ageing population came growth in interest in pensions and retirement, which increased the difficulty of making adjustments to pensions.

The second pillar had various issues, not least that very few countries had it; there were therefore few employers ensuring that their employees had pensions. Additional considerations were made regarding changes in the labour market's behaviour. Historically, employees would have worked under one employer for their entire lives. That was no longer the case, and the current system was not optimised for the new trend towards many short and small contributions to pension pots.

The third pillar was completely insufficient, fragmented due notably to varying approaches to pension provisions, tax differences and in most cases did not give consumers value for money.

To make the pension gap sustainable they needed more second and third pillar solutions. Although there had been steps towards reforming the sustainability of first pillar regimes, the same was not true for the second and third pillars, and awareness of the problems of future retirement pension revenues was gathering pace. Therefore incentives for good second and third pillar pension provision were essential. Europe could help with all three pillars, in rulemaking, implementation, and reform. >>>

>>> Fear was thought to be at the heart of discussions on all three pillars. People wanted to save, but were unsure. That was in part due to awareness of the low interest rate environment, but also because of lingering distrust in the financial services sector. The widespread fear was thought to be driving customers' decision making; although that was disputable.

However, it was noted that fear was a positive force if acted upon. The industry had an opportunity to attempt to push the energy and awareness behind the fear towards positive outcomes, and to aid their customers in their long term plans. Another asset to consider was that recent studies had indicated that employees trusted their employers. Therefore early engagement with employers was one route of action to consider.

Insurers had the potential to strengthen confidence in the industry through two routes. First was through transparency. The second was through provision of evidence that they would remain solvent in the long term. Insurance could offer guarantees, and that was a route to restoring confidence that was simple from a consumer's perspective. Movements towards transparency and education for citizens were strongly supported.

The Relationship between Citizens and Pensions

The widespread European perspective was that people believed that the Government had a responsibility to take care of them. As such, a reasonable measure was to increase financial education and citizens' understanding that, where possible, they had to take care of themselves. Although it was accepted that there were challenges to individuals being able to do so: some people had insufficient income; the first pillar was insufficient to provide adequate pension income for a good lifestyle; and in countries with a large ageing population, it was not easy to declare that there was no money left and people had to take responsibility for themselves.

Personal pension products were one way for individuals to look after themselves, but the question of how to motivate people to use them remained. The EIOPA had made commendable efforts towards solving the problem of motivation and had suggested that if they wanted people to buy personal pension products, then there had to be guarantees of their reasonableness offered. PEPPs were a viable starting solution, but not a final cure. In order to really motivate people to take care of themselves they had to develop a portfolio of pilot products that met certain investment rules and were properly supervised, and then introduce them on a level playing field.

Furthermore, encouraging people to save was not the final answer. Instead they needed to change the dynamics of the market by engaging people, giving them advice, and encouraging them to think long term. Those that planned for the long term also became more confident in their financial futures because they were more engaged. Therefore early engagement was essential.

Development of Long Term Investment

There was widespread agreement that the industry needed to do more in considering how to bring long termism back into the pension regime. They needed to build on what had already been done. Pensions were fit candidates for long term investment, but work needed to be done in collaboration with companies to refocus the long term approach. Both society and individual savers had much to benefit from that refocus because they were currently missing out on long term gains, which negatively impacted both innovation and wealth.

The immense demographic challenge had been considered, but the challenge should have been systematically linked with the challenge of investment within the European economy. The need for long term investment was substantial, and was a particular issue in Europe.

An additional point to consider was that pension funds were not the only way of channelling long term savings towards retirement or otherwise long term investment. There were many products available that offered similar outcomes, and thus there was scepticism on the need to generalise the pension fund or create a pan European one. The current expectation upon the European Union was for them to analyse the characteristics of long term investment and design a new regime dedicated to long term saving and investment.

Whilst it was possible to build products that would provide value for money for customers whilst allowing more long term investment in infrastructures, a warning was given: customers had to understand that they could not have all of the benefits they wanted. People had a preference for liquidity and were understandably risk averse, but businesses were advised not to try to offer long term guarantees in conjunction with short term liquidity. The economic reality was that it was too costly to do so. However, there was room to do better than they currently did.

The best service that the financial services industry could offer was to provide a money-collection product that would maintain a reasonable level of volatility, whilst protecting consumers from hyper-volatility. >>>

The Beginning of PEPP

EU institutions were advancing and preparing regulation for the PEPP. Work had been developed on the PEPP because the industry believed that Europe could add value. Regarding PEPP and the three pillars, work needed to be done on the second and third pillars to improve both efficiency and overall value for money. In many countries the products used for private pension provision were not true retirement saving products; that was problematic because pension investments differed greatly from short term investments. In order for the PEPP to realise its potential, it had to be a true retirement product. More generally it had to be digitalised, simple, economic, and high quality.

Actions were advocated for a second regime that would come from a European perspective and work alongside different national regimes. The regime required a degree of simplicity and was thought to be possible in a more cost efficient and transparent way.
The building of a pan European product was an acknowledged possibility. The industry knew the characteristics that it needed. There was also potential for the introduction of a default product, in the interests of simplicity, alongside the choice from more flexible products.

The challenge of digitalisation also bore relevance in regard to the upcoming PEPP. Discussions on 21st century regulation needed to take place because that was where opportunities were. Europe had the potential to provide pensions in a modern and digitised format, and with greater transparency than previous products.

There were also savings to be made from encouraging individuals to engage digitally. It was further considered that if customers were spoken to in one consistent and transparent language across the industry, it would empower individuals and allow the PEPP much wider acceptance.

There were understandable obstacles to the success of the PEPP; political willingness was one. They were currently in the last hours of being able to make political decisions on the sustainability of the second and third pillars in Europe. In 15 20 years' time the ageing population would make pension discussions and reforms significantly more difficult.

A further obstacle to the PEPP was the lack of interest towards it. Banking and pension management were not considered exciting activities. In order to gather interest PEPP had to be simple, transparent, and standardised; and people needed to be educated on how to manage their pensions.

Establishing cross border pensions was a further difficulty. Insurance firms cooperated at the international level, but solutions were mostly national, which was potentially problematic. Further, when looking at new solutions, they had to consider the distribution costs.

A final obstacle was that DC still had scope for improvement with regards to long term investment potential, and portfolio diversification.

The FCA's post implementation analysis of the Retail Distribution Review would be a good framework for the EU to look at how they compartmentalised the earning and savings habits of individuals across the EU, which would greatly inform the debate on the applicability and usage of the PEPP.

Future Thoughts

It was clear that the EU had a role to play in ensuring retirement provision and pension coverage for EU citizens. It was recommended that the industry worked to clear existing obstacles and incentivise long term savings for the benefit of European citizens.

Further steps had already been taken. Eventually the work that had been done needed to give rise to pilot products. That had been suggested to the European Commission, and was pending a response; further help on that front was openly invited.

The ageing society had proved to be a substantial concern. Calls were made for more debate and analysis on how to adapt to the new demographic.

An amount of future thought was geared towards helping citizens. Citizens had to understand that they were personally responsible for their pensions. However, the industry also needed to develop a consistently simple framework for customers that was digitally accessible and kept costs down.

Further digitalisation was encouraged. The benefits to the industry were as yet untapped.

The future of the economy would largely depend on the ability to fill the investment gap. That was the highest priority. Meanwhile, all diagnoses indicated that long term investment was hampered by a series of regulations that had been implemented. It was advised that they looked seriously at the business model of long term investors, and that they took the necessary initiatives without delay. ●