The Italian financial community's priorities in the European agenda of 2020-2021

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Banche Assicurazioni Finanza

Italian Banking Insurance and Finance Federation

This note was prepared by the Italian Banking Insurance and Finance Federation (FeBAF) and its members to undertake a joint dialogue with Italian MEPs.

The Italian Banking Insurance and Finance Federation (FeBAF) was established in 2008 by the Italian Banking Association (ABI) and the Italian Insurance Association (ANIA). The Federation, which acts as a forum for the investment and financial industry, currently comprises thirteen associations operating on the financial markets: ABI, ANIA, AIFI, and ADEPP, AIPB, ANFIR, ASSOFIDUCIARIA, ASSOFIN, ASSOGESTIONI, ASSOIMMOBILIARE, ASSOPREVIDENZA, ASSORETI, ASSOSIM.

The Federation, which has offices in Rome and Brussels:

- is open to collaboration with other business associations;
- promotes the role of the banking, insurance and financial industry in harmony with Italy's general interests;
- represents the positions of member associations on economic and social policies in relations with political and monetary authorities and trade associations and towards public opinion;
- protects business logic and spreads a culture of competitiveness, by promoting transparency and service to consumers and savers in the banking, insurance and financial industries.

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Introduction

The pandemic is hitting hard. The ECB estimates that the proportion of enterprises that might have to tackle a liquidity crisis due to Covid would be, without support policies, 26% in Spain, 22% in Germany, 21% in France and 16% in Italy; conversely, with short-term active support policies - the ones initially rolled out on a variety of fronts by Governments with the contribution of the European Union - the proportion would decrease to 13% in Spain, 18% in Germany, 6% in France and 9% in Italy (with almost one Italian enterprise in ten unable to survive). We cannot afford this. Likewise, the EU cannot afford a 3% decline in its potential "Output" - the highest level of production sustained over the long term.

Still, the EU did respond to the first major healthcare and economic crisis in its history. Immediately after the first wave hit, it did so by sharing a number of measures and emergency funds and it is doing it again now during the present new pandemic shock which is not sparing anyone – be it in terms of human life, society and the economy.

The agreements sealed by the Government in Brussels over the last few months to provide substantial financing for national restart plans alongside the new exceptional ECB support measures and the lifting of stringent budgetary constraints are an opportunity to be seized with the utmost coordination and practicality. These unprecedented measures boost the genuine European unitary spirit and prove that also the economies of individual Countries are now inextricably interconnected by highly integrated production processes in such a way that the weakness of one automatically impacts the other.

The financial sector in Europe, and in particular in Italy, has been called upon to undertake an unprecedented titanic commitment to help households and enterprises, the national healthcare system, the Civil Defense system and communities. This commitment has enabled to keep alive, amid the hardships of all, our economic and social fabric. While many things did fall through the cracks, the Country is hanging in, despite a thousand difficulties. Unlike during the international crisis of twelve years ago, this time round the financial sector was not a part of the problem; rather, it is key for the solution, especially in Italy. The proper, indispensable support having been ensured during the first phase, the challenge now is to calibrate the methods and timing of actions so as to seize recovery opportunities and avoid unproductive welfare dependency.

This said, just why is our document on the "priorities" for the economic and financial agenda that we submit every year in autumn to Italian EU MPs so important this year?

Because the unbreakable bond between the financial sector and the real economy has never been so clear as in this long-drawn-out emergency. Banks, insurers, funds and companies that contribute to the functioning of markets are the transmission belt of economic and monetary policies that must be able to operate without uncertainty. And never as this year the "priorities" identified by the Banking Insurance and Finance Federation (FeBAF) and its 13 members are proposed for the benefit of the real economy and the overall resilience of Europe rather than as mere requests to defend specific interests. These priorities are an all-encompassing, well-structured proposal made by an important sector and aiming for a public-private partnership that combines, at multiple levels, the principles of subsidiarity that are inherent in the EU and its Member States.

We want to confidently look at the Next Generation EU as a project – so much so that we do not want to play it down by over-simplistically calling it Recovery Fund. It is not just about "recovery". Indeed, it is meant to lay the groundwork for the EU of the future; likewise, it is not just a "fund", as its instruments are more structured and complex, even though this financing is crucial, and Italy will receive substantial resources.

This poses two challenges in one, with both having to be addressed simultaneously.
Indeed, on the one hand, as a Country, we will have to be able to plan and spend, select few core priorities and skillfully and resolutely pursue them. Being aware that "there's no free lunch", we will have to carefully select, implement and report on projects. Our Federation can rely on a wealth of competences and a broad variety of experts from diverse backgrounds and as such is willing to offer its contribution to the Government and European institutions.

On the other hand, the complexity of European *governance* requires that the mechanism that has identified and guided European funds be first approved by the 27 national MPs and subsequently by European institutions. As always, time is not an independent variable: while the surgery may be successful - as we do hope it will be - in the meantime the patient "dies". Therefore, it will be essential to immediately introduce reforms and tools for the benefit of the economy at a national level alongside the resources that will – when they will – come from the European Union.

Never had we lived a pandemic before. So, when it came, Covid-19 managed to disrupt our habits, our lifestyles, our "normality" in just a few months. Historically, though, many major catastrophes and “black swans” eventually paved the way for radical changes for the better. The legacy of lockdown measures is a set of behaviors that are already becoming new lifestyles: from *smart working* to the *e-commerce* hype. The way we work, consume and move has changed. The financial world interprets our changing needs and trends to provide quick, adequate responses and propose avenues to the future.

A review of the European regulatory framework is needed in order for us to be able to help, protect and finance enterprises and entrepreneurship, households and new welfare needs aiming for sustainability, innovation and the integration of capital markets. The regulatory architecture conceived before the pandemic must factor in the latter, starting from the prudential criteria for banking and insurance which - for now - penalize the investments in the real economy and infrastructures. That is to say the two drivers of a long-lasting recovery for Italy as a protagonist of a competitive Europe in the new world balance. It would be paradoxical and self-damaging especially for the other geographies in the world that adopt very different criteria, but which are fully entitled to operate, as they do, in our continent.

In the pages that follow, we will explain our proposals in detail.

Luigi Abete – President, FeBAF

Executive Summary

The EU is strongly committed to adopt a variety of instruments aiming firstly to address the pandemic emergency and subsequently to restart the economy. The second, broader epidemic wave raises a number of questions on the choices to be made in view of the economic and social strength of European countries.

After the first phase of urgent regulatory actions, action is now needed to prevent the pro-cyclical, adverse and unintended effects deriving from the application of the existing regulatory framework. To this end, it would be important to temporarily suspend or re-modulate a targeted number of regulatory constraints of the financial regulatory framework. Indeed, one should be mindful that many of the new rules approved in the wake of the previous financial crisis resulted from a different economic background and were conceived to tackle an ordinary crisis rather than such a vast crisis as the one triggered by the pandemic.

It should be noted that many of the rules written for banking, financial or insurance players ultimately could impact enterprises and households and, as a result, employment and the overall social strength of the Country.

The priorities

1. Modify existing rules on NPLs, AMC and State aids

In order to enable banks to use all available resources to finance the real economy during an economic shock triggered by an exogenous factor, targeted rules on NPLs should be modified, even on a temporary basis. In this way, while the regulatory framework would remain unaltered, it would be made temporarily more flexible as to tackle the effects of the pandemic. To this end, we propose:

- a temporary adjustment in the application of the *"definition of default"* and some of its technical aspects, mainly for the benefit of enterprises;
- temporary adjustments to the "*calendar provisioning*" - the prudential framework for mandatory provisioning of NPLs under the European Regulation and ECB expectations and supervisory practices;

- in view of future NPL disposals, an extension of the time window for the application of the adjusted calculation of the effects coming from NPLs' massive disposals (art. 500 CRR);
- the development of domestic *Asset Management Companies (AMCs)* as part of a Europe-wide network
- the organic review of the 2013 DG COMP Communication on state aids so as to avoid *burden sharing* in case of NPL disposal;

2. Solvency II

As a number of criticalities have emerged in these early years of application of the new regime, it is necessary to pay the utmost attention to the planned review process, the second phase of which is currently underway.

The main criticality is the fact that some Solvency II rules expose insurers to excessive asset volatility and are inconsistent with the industry business model, to the point of penalizing those very long-term products and investments that should be the distinctive element of their financial strategy.

To this end, we propose to:

- modify the *Volatility Adjustment*, aimed to dampen the impacts of financial markets artificial volatility as, in the most critical times, it failed to work properly. These modifications of the mechanism should factor in the long time-horizon of the insurance business that is capable of withstanding and reabsorbing extreme volatility episodes in the mid-term;
- improve the calibration of capital requirements for equity and bond investors, which are still too high – especially for long durations – to allow for a greater exposure of insurers to these financial instruments;
- correct some criticalities in the interest rate risk proposal as the latter does not take account of the peculiar features of the insurance business and, more broadly, the efficient functioning of financial markets.

3. Management of failing LSIs and harmonization of bank insolvency regimes

The introduction of a specific procedure for LSIs that do not meet the "public interest" criteria under the BRRD appears crucial as this would preserve the residual value of the institutions and hence it would maximize the interests of creditors.

Besides, the banking insolvency regime should be harmonized at EU level.

4. The IFRS 17 accounting standard

In view of the future approval of the new international accounting standard on insurance contracts (IFRS 17) and given that, based on its current wording, some of its parts are inapplicable, we request that this principle be modified so as to solve the criticality relating to the requirement of annual cohorts.

It is crucial to find a European solution that provides for an exception to the application of the requirement that the contracts in respect of segregated funds be aggregated in annual cohorts in that such requirement is not consistent with the structural characteristics of the underlying business.

5. Capital Markets Union

The actions proposed by the Commission in the Action Plan appear to be in line with the needs of the banks operating in capital markets as issuers and intermediaries and of insurers, in particular by strengthening the role of long-term investors and recognizing the role that private integrative pension schemes can play in addressing the challenges of population aging. The Actions proposed should be swiftly implemented, in line with the original goals.

6. Basel 3: finalizing post-crisis reform

In view of the future transposition of the standards in the EU regulation, we highlight the need to implement such international standards *cum grano salis*, so as to take account of the specificities of the European economy and of a growth-oriented regulatory framework. The impact analyses made prior to the pandemic should be made anew.

7. Sustainable Finance

The rules currently under discussion should encourage players to strengthen their contribution towards a sustainable economic and social development. To this end, it is fundamental to ensure consistency between the regulations being implemented (Transparency Regulation – SFDR - and Taxonomy Regulation in the first place) and the modifications to the existing regulations (MiFID and UCITS) in view of promoting transparency and unlocking investment opportunities for retail investors.

It is equally important that the new regulations prioritize the establishment of a solid information chain that starts from the issuers and reaches out to final investors and that rests on shared standards and identified relevant indicators, in agreement with the principle of proportionality and adequate application timing. It would be useful to establish an information "HUB" available to investors.

Banks and insurers should be required to disclose information on the sustainability of their portfolios or **assets** only if they have sufficient reliable information.

8. The digital challenge

We are in favor of the Commission's proposal to equip the Union with a specific regulatory framework for "*crypto-assets*". Certainty of the law, protection of consumers and investors and financial stability have to be guaranteed.

Having regard to the payments' strategy, we appreciate the Commission's willingness to evaluate in depth the market situation before adopting any initiatives that would be binding for players.

We deem essential to ensure an adequate European framework that is in favor of innovation and enables consumers, enterprises and new market players to benefit from the opportunities offered by digitalization, eliminating any regulatory obstacles that curb innovation and facilitating access to and use of data as well as supporting greater use of new technologies. The clearer and more detailed the definitions in the rules, the easier for innovation to move in a new playing field.

9. MIFID

While awaiting the comprehensive MiFID review, a new category, i.e. the "expert" client, should be considered and evaluated according to specified parameters, including portfolio size; besides, the category of non-complex financial products should be broadened and the quality and availability of reference data for professional investors should be improved.

10. Trust-like institutions

Hopefully, Community law will adopt clear and homogeneous regulations to govern trust-like institutions.