Monday, May 21, 2018

Top 10 risk and compliance related news stories and world events that (for better or for worse) shaped the week's agenda, and what is next

Dear members and friends,

Albert Camus believed that retaliation is related to nature and instinct, not to law. Law, by definition, cannot obey the same rules as nature.

Perhaps this is the reason the EU has never officially started a retaliation process against UK after the Brexit, but only speaks about "a mechanism allowing the Union to suspend certain benefits deriving for the UK from participation in the internal market".

Of course, lawyers have their way - Quintus Horatius Flaccus (known in the English-speaking world as Horace) believed that lawyers are persons who hire out their words and anger.

The 18th of May, the European Insurance and Occupational Pensions Authority (EIOPA) has issued an opinion on the solvency position of insurers in light of the withdrawal of the United Kingdom (UK) from the European Union (EU).

According to the opinion, the UK's decision to withdraw from the European Union includes the UK leaving the European single market. The UK will become a third country for the purposes of applying the Solvency II framework after the withdrawal date. Until then the European Union legislative framework will remain in force in the UK.

After the withdrawal date, UK banks and investment firms will lose the MiFID passport to provide derivative services in the European Union. This could have an impact on the abilities of derivatives provided by UK banks and investment firms to transfer risk, after the withdrawal date.

UK insurance and reinsurance undertakings may not be able anymore to provide reinsurance services in some EU 27 Member States after the Withdrawal date unless they take measures to secure market access.

The scope of group supervision under Solvency II, depends in particular on whether the parent undertaking of the insurance group is located in the EU. For insurance, groups with a UK parent undertaking and subsidiaries across other Member States, the scope of group supervision will therefore change after the withdrawal date.

Group internal models can be used to calculate both the Solvency Capital Requirements (SCR) at group level, and the SCR at the level of insurance and reinsurance undertakings in the group. Where an insurance group with a UK parent undertaking applies such an internal model, it *cannot be used anymore* to calculate the SCRs of the insurance and reinsurance undertakings in the group that are located in the EU27 Member States, without re-approval by the national supervisory authority. In the absence of any other approved internal model, the SCR for these undertakings would have to be calculated on the basis of the standard formula.

National supervisory authorities should ensure that the insurance and reinsurance undertakings under their supervision identify, measure, monitor, manage and report the risks arising from the UK becoming a third country and include them in their own risk and solvency assessment.

Read more at Number 5 below. Welcome to the Top 10 list.

Best Regards,

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Number 1 (Page 8)

NIST Updates Risk Management Framework to Incorporate Privacy Considerations

The updated version adds an overarching concern for individuals' privacy, helping to ensure that organizations can better identify and respond to these risks, including those associated with using individuals' personally identifiable information.

The update will interest federal agencies and contractors that do business with them, as it connects the RMF with NIST's well-known Cybersecurity Framework (CSF), highlighting relationships that exist between the two documents.

Number 2 (Page 11)

Why EMU requires more financial integration

Keynote speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the joint conference of the European Commission and European Central Bank, Frankfurt am Main.

"I am pleased to host you today in Frankfurt at the Financial Integration Conference. The 2018 Financial Integration Report is the last issue published under my tenure as ECB Vice-President.

I wish therefore to take this opportunity to reflect on the relevance of financial integration to Economic and Monetary Union (EMU) and provide some suggestions for future directions.

Already at the very early stages of the project, it was clear that financial integration was needed to make the Monetary Union sustainable."

Number 3 (Page 23)

Finding the right measure of consolidation in the banking sector

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Center for Financial Studies, Frankfurt am Main.

"Theory one: the banking sector will continue to "shrink to health", in Germany and in Europe alike.

Theory two: on the heels of this consolidation, mergers and acquisitions will lead to a concentration of the market on a reduced number of institutions. However, mergers should be undertaken with a view to creating institutions that will be stable in the long run. In mathematics, minus times minus equals plus - but it does not follow from this that two weak institutions will necessarily add up to a stable bank."

Number 4 (Page 35)

AuditorSearch

AuditorSearch is a public database of engagement partners and audit firms participating in audits of U.S. public companies.

AuditorSearch SM

Under rules adopted by the PCAOB in December 2015, registered audit firms are required to submit Form AP, Auditor Reporting of Certain Audit Participants, to disclose the names of engagement partners and other accounting firms that participated in audits of public companies.

Number 5 (Page 36)

EIOPA opinion, considering the withdrawal of the UK from the EU

- National supervisory authorities should assess the risks arising for their national markets.
- The Opinion sets out 14 areas where the determination of the solvency position of insurers will change.
- EIOPA will be closely monitoring the risks taking into account their nature, scale and complexity.

Number 6 (Page 38)

An annuity is a very serious business

David Rule, Executive Director of Insurance Supervision of the Bank of England, at Bulk Annuities - The Expanding Market, Westminster and City, London.

"Today I am going to talk about the bulk purchase annuity market, the increasing use by life insurers of illiquid assets – and in particular equity release mortgages – to back these annuities and the significance of the Solvency II matching adjustment."

Number 7 (Page 40)

Cryptocurrencies, digital currencies, and distributed ledger technologies - what are we learning?

Lael Brainard, Member of the Board of Governors of the Federal Reserve System, at the Decoding Digital Currency Conference, sponsored by the Federal Reserve Bank of San Francisco, San Francisco, California.

"We have been keenly evaluating developments in fintech and digital currencies through a multidisciplinary lens, combining information technology and policy analysis to study their potential implications for payments policy, supervision and regulation, financial stability, monetary policy, and the provision of financial services.

This work draws from expertise throughout the Federal Reserve System and benefits from engagement with our colleagues internationally."

Number 8 (Page 43)

Virtual currencies ante portas

Yves Mersch, Member of the Executive Board of the European Central Bank, at the 39th meeting of the Governor's Club of The Central Asia, Black Sea Region and Balkan Countries, Bodrum, Turkey.

"New innovations based on distributed ledger technology (DLT) and blockchain have brought about wide-spread euphoria. Their use to create "cryptocurrencies" or "virtual currencies" (VCs) - to denote their lack of legal recognition - is often touted as something that could fundamentally change the financial sector. The spectacular rise in the market valuation of VCs over the past year suggests that many people shared this belief."

Number 9 (Page 50)

Keynote Address at the New York City Bar Association's 7th Annual White Collar Crime Institute

Steven Peikin, Co-Director, Division of Enforcement

"And the City Bar has been a key forum for education and dialogue about these important issues. I am honored to join today's distinguished group of speakers, panelists, and attendees.

This afternoon, I would like to address a practical topic that I hope will be useful for many in this audience: techniques for productive and effective communication with SEC staff during Wells meetings."

Number 10 (Page 61)

Gremlins on Track for Demonstration Flights in 2019

Airborne launch and recovery of low-cost unmanned aerial systems could enhance combat operations in contested areas, present significant per-mission cost savings

DARPA is progressing toward its plan to demonstrate airborne launch and recovery of multiple unmanned aerial systems (UASs), targeted for late 2019.

Now in its third and final phase, the goal for the Gremlins program is to develop a full-scale technology demonstration featuring the air recovery of multiple low-cost, reusable UASs, or "gremlins."

Safety, reliability, and affordability are the key objectives for the system, which would launch groups of UASs from multiple types of military aircraft while out of range from adversary defenses.

Once gremlins complete their mission, a C-130 transport aircraft would retrieve them in the air and carry them home, where ground crews would prepare them for their next use within 24 hours.

Number I

NIST Updates Risk Management Framework to Incorporate Privacy Considerations

Augmenting its efforts to protect the nation's critical assets from cybersecurity threats as well as protect individuals' privacy, the National Institute of Standards and Technology (NIST) has issued a draft update to its Risk Management Framework (RMF) to help organizations more easily meet these goals.

The RMF update, formally titled Draft NIST Special Publication (SP) 800-37 Revision 2, is a guidance document designed to help organizations assess and manage risks to their information and systems. Previous versions of the RMF were primarily concerned with cybersecurity protections from external threats.

The updated version adds an overarching concern for individuals' privacy, helping to ensure that organizations can better identify and respond to these risks, including those associated with using individuals' personally identifiable information.

The update will interest federal agencies and contractors that do business with them, as it connects the RMF with NIST's well-known Cybersecurity Framework (CSF), highlighting relationships that exist between the two documents.

"Until now, federal agencies had been using the RMF and CSF separately," said NIST's Ron Ross, one of the publication's authors. "The update provides cross-references so that organizations using the RMF can see where and how the CSF aligns with the current steps in the RMF. Conversely, if you're using the CSF, you can bring in the RMF and give your organization a robust methodology to manage security and privacy risks."

In addition to the RMF-CSF alignment, the update has several important objectives, including:

- Integrating security and privacy into systems development. Building security and privacy into information systems at the initial design stage

is a major concern. The RMF also references NIST systems security engineering guidance at appropriate points, including NIST's SP 800-160 (link is external), which addresses the engineering of trustworthy secure systems.

- Connecting senior leaders to operations. The RMF provides guidance on how an organization's senior leaders can better prepare for RMF execution, as well as how to communicate their protection plans and risk management strategies to system implementers and operators.

- Incorporating supply chain risk management considerations. The RMF addresses growing supply chain concerns in the areas of counterfeit components, tampering, theft, insertion of malicious software and hardware, poor manufacturing and development practices, and other potential harmful activities that can impact an organization's systems and systems components.

- Supporting security and privacy safeguards. The RMF update will provide organizations with a disciplined and structured process to select controls from the newly developed consolidated security and privacy control catalog in NIST's SP 800-53, Revision 5.

Aligning the RMF with other NIST guidance and publications will provide clarity for federal agencies, which are required to implement multiple frameworks. While adhering to the CSF is voluntary for private companies, its use for the federal government is mandatory under Executive Order 13800.

Compliance with the RMF is mandatory for federal agencies in accordance with the Federal Information Security Modernization Act (FISMA (link is external)). The RMF is also required and in widespread use in the Department of Defense and the intelligence community.

"It was imperative for us to figure out how these frameworks fit together," Ross said. "Many agencies are trying to follow both."

Ross added that the privacy-enhanced RMF might be valuable to companies and organizations beyond the federal government, considering how high profile the subject of privacy has become of late.

"Many folks are discovering how vulnerable they are with respect to their personal information and may begin to demand some standard level of protection," he said. "If such a demand occurs, the government will be looking for clearly stated requirements for privacy, privacy safeguards, and

a disciplined and structured process on how those controls could be applied. The timing of this publication could not be any better."

NIST is accepting comments from the public on the draft RMF until June 22, 2018. A final version will be issued in October 2018.

To read more:
https://csrc.nist.gov/publications/detail/sp/800-37/rev-2/draft

Number 2

Why EMU requires more financial integration

Keynote speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the joint conference of the European Commission and European Central Bank, Frankfurt am Main.

I am pleased to host you today in Frankfurt at the Financial Integration Conference. The 2018 Financial Integration Report is the last issue published under my tenure as ECB Vice-President.

I wish therefore to take this opportunity to reflect on the relevance of financial integration to Economic and Monetary Union (EMU) and provide some suggestions for future directions.

Already at the very early stages of the project, it was clear that financial integration was needed to make the Monetary Union sustainable.

The 1970 Werner Report mentioned the complete liberalisation of capital transactions and the full integration of financial markets as one of three necessary conditions for a monetary union.

Along with this, it was understood that the single currency would secure the full benefits of a single market for capital.

During the run-up to the Maastricht Treaty and in the context of the Delors report discussions, it became clear that the dictum "one money one market" also implied addressing possible new concerns about financial stability in Economic and Monetary Union.

In some cases this translated into prescient calls - like that from Alexandre Lamfalussy - for assigning the European Central Bank a role in banking supervision. Eventually however the institutional set-up of Monetary Union left financial stability considerations largely unaddressed.

This approach clearly showed its limits during the financial crisis. The financial fragmentation of EMU during the financial crisis was partly a

result of the initial choices concerning EMU's institutional architecture - to be precise, its minimalist design which left economic and financial policies mostly at national level.

This was maybe due to an overriding faith in the efficiency of financial markets that - even though not shared by all of EMU's founding fathers - prevailed in Maastricht.

It has to be acknowledged, however, that over the following years, financial market integration in EMU and at global level, accelerated at a speed that was hard to grasp in those early days after the creation of Monetary Union.

The introduction of the single currency gave a major impetus to financial integration in the euro area. Financial integration was impressive in terms of quantitative indicators but it was not sustainable - it proved to be shallow and reversible.

In fact, it even contributed to the rapid contagion in the early days of the crisis. We learned the hard way that a single currency requires a financial system that is sustainably integrated and, indeed, as single as possible.

Much has been done to correct the initial design failures of EMU. Along with the introduction of the euro, the EU's Financial Services Action Plan was launched to provide an overall framework for the integration of financial services in Europe.

With the surge of the financial crisis, it also became very clear that macroprudential policy needed to complement both monetary policy and microprudential supervision.

The European Systemic Risk Board (ESRB) and the European Supervisory Authorities were then established at the beginning of this decade.

However, these reforms quickly proved to be insufficient to keep pace with adverse financial sector developments - especially concerning the role of the banking sector in the Monetary Union. In response, the banking union project was launched in the depths of the financial crisis in 2012.

But convergence in regulatory and supervisory standards is not enough to spur the development and integration of capital markets that is needed for growth and private-risk sharing. Therefore, efforts in this direction were also undertaken, with the launch of the capital markets union (CMU) initiative.

In short, the history of EMU is marked by an evolving search for the right institutional embedding of financial markets. And in that search, Europe has to be agile to react to changing circumstances. In doing so it has to find a balance: between markets and regulation, between liability and control, and between the European and national level. However, the crucial question is whether we will achieve a sustainable financial integration that is commensurate with a single currency.

Why financial integration is currently insufficient for EMU

The crisis made it clear that deep financial integration is essential to prevent EMU going into reverse. Financial integration in Europe and in the euro area had been growing steadily before the financial and sovereign debt crisis.

However, the system was not structurally integrated and when the crisis financial erupted integration quickly reversed, exactly when it was most needed.

In response to global and local shocks almost all financial markets became highly fragmented and retrenched inside domestic borders. These developments represented an existential threat to the Monetary Union and the single currency.

That fragmentation has reversed along several dimensions in the last few years. But significant room for further improvements in financial integration remains, for example in the integration of retail banking services and in the financing of the corporate sector.

Financial integration provides risk sharing mechanisms which can reduce the impact of country-specific shocks and contributes to macroeconomic stability.

Internationally diversified portfolios - cross-regional and cross-border asset holdings, including firm ownership claims - are more resilient to global and local shocks and can mitigate the impact of such adverse scenarios.

This is particularly true when integration occurs also in the equity markets as opposed to the current bias towards debt finance intermediated by banks.

For countries in a monetary union, this risk sharing mechanism is particularly important because the single monetary policy is unable to address asymmetric shocks, since other important adjustment

mechanisms, for example related to fiscal policy and exchange rates, are limited.

Therefore more private financial risk sharing can significantly improve the macroeconomic stabilisation of the euro area and thereby the functioning of EMU.

However, bear in mind that in recessionary periods, the power of this risk sharing mechanism is significantly reduced, in particular via the powerful credit channel. Let me point out that this channel accounts for about one-quarter in the United States and around 12% in the euro area, of the overall income smoothing that is achieved in both jurisdictions in normal times.

Perhaps even more important, financial integration is also essential to foster economic growth. Integrated capital markets provide a wider source of financing and lower funding costs for households and firms and ultimately support innovation and the efficient allocation of capital.

A financial system which allocates resources efficiently and is resilient to shocks ultimately supports the transmission of monetary policy and its effect on price stability.

The banking union and the CMU affect different parts of the financial system at different stages of development, but follow similar objectives to achieve a more efficient and stable financial system. They are also complementary projects: work on them should run in parallel and require a solid monetary union.

Completing banking union

The first task ahead is to complete the banking union. Each of its three pillars, notably the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the planned European Deposit Insurance Scheme (EDIS) address the risk of fragmentation.

They are also all necessary to ensure a proper balance between markets and regulations, and liability and control at European and national level.

The SSM ensures that banks are subject to the same set of rules and supervised on the basis of common standards. This reduces the risks of spillovers from bank failures to sovereigns and provides a common framework conducive to further integration in the banking markets, a process which has been lagging.

Since bank failures cannot always be avoided - and indeed this may not be desirable either, as it may undermine market discipline - we need a credible and well-functioning crisis management and resolution mechanism.

This is ensured by the second pillar of the banking union. With the setting-up of the BRRD, the Single Resolution Mechanism and the Single Resolution Fund (SRF), we have made a quantum leap in the institutional organisation of the EMU.

However, the framework is still incomplete. Most notably, it requires a common public backstop to the SRF, which is essential to inspire full confidence in the resolution regime. In addition, it would be desirable to eliminate national divergences in the insolvency and liquidation of credit institutions, and in the implementation of the BRRD through national resolution laws.

Allowing these divergences to persist ultimately implies that the geographical location of a failing bank may still influence the outcome of the resolution, which is inconsistent with the idea at the heart of a banking union.

Finally, in order to complete the banking union, we need a single, fully-fledged EDIS. The EDIS would strengthen depositors' confidence through an equal level of depositor protection across Member States and therefore promote financial integration.

Ultimately, a fully-fledged EDIS would be strengthened by the pooling of resources, thus building confidence in the single currency, throughout the Monetary Union.

The finalisation of the banking union through its third pillar would require an adequately sized fund, built and financed by banks by raising ex-ante contributions, accompanied by a public backstop as recommended by the ECB opinion on EDIS.

The calibration of these contributions should help to minimise the risk of some banking systems subsidising other banking systems in the event of a crisis.

A recently published ECB Occasional Paper simulating severe banking crises, demonstrates precisely that, with proper bank risk-based contributions, an almost negligible cross-border subsidisation occurs.

For this reason, a crucial element of a fully-fledged EDIS would consist of risk-adjusted contributions to the fund based on bank-specific strengths and weaknesses benchmarked at the banking union level.

Progress is also needed in the framework for macroprudential regulation. I regard this as a precondition for safeguarding financial stability in an integrated market and therefore protecting the Single Market.

The CRR/CRD IV, the ESRB and the SSM Regulations already define the key elements of the macroprudential framework, but as the framework is tested and more experience is gained the rules will need to be steadily revised.

Authorities with a mandate in this area must have well-defined roles and responsibilities, including a distinct set of instruments.

Current overlaps between instruments should be eliminated, and more flexibility in the macroprudential policy framework should be maintained, so that authorities can implement those measures in a consistent and timely manner, which would require significant changes to Article 458 of the CRR.

A more integrated financial market will support the emergence of new types of risk and also require extending the toolkit with new instruments.

For the banking sector, this includes complementing the toolkit with borrower-based instruments (such as limits on loan-to-value, or loan-to-income ratios) as well as sectoral buffers and a time-varying leverage ratio add-on so that all aspects of systemic risks can be addressed in the banking union.

Finally, the mandatory reciprocity framework needs to be expanded so as to ensure the effective mitigation of cross-border spillover effects and regulatory arbitrage across jurisdictions in the EU.

The significant progress we have made with our banking union needs to be recognised also from the international regulatory framework perspective.

A case in point is the G-SIB framework, which currently penalises cross-border transactions within the banking union by attaching a higher systemic risk score to banks with more transactions of that kind.

This goes against the very rationale of the banking union, as it reduces the incentives for cross-border transactions and risk diversification, thus making banks more vulnerable to local shocks.

At the same time, we also need to remove the remaining obstacles to further integration within our banking union. Such obstacles are often due to regulatory fragmentation and ring-fencing of national markets.

For example, a number of national options and discretions, such as diverging large exposure rules, are hindering the free flow of liquidity and capital in the banking union and should be harmonised further.

Turning to other parts of the financial system, we can expect that the CMU will provide further impetus to the growth of market-based finance and may present new challenges to financial stability.

Additional steps should be taken to strengthen the ability of European regulators and supervisors to address systemic risks stemming from the non-banking part of the financial sector.

This could be achieved by expanding the mandate of relevant authorities and, in the medium run, by creating a single supervisor for the capital markets.

Adequate macroprudential instruments need to be envisaged as well, including instruments targeted at market-based finance. Macroprudential tools for this area either still need to be provided to authorities or need to be further clarified in respect of their application.

For Securities Financing Transactions (SFT) and derivative markets, macroprudential margins and haircuts have been identified as potentially powerful tools for reducing the excessive build-up of leverage and procyclicality in these markets.

For alternative investment funds, the existing macroprudential leverage limit needs to be operationalised. The forthcoming review of the Alternative Investment Fund Managers Directive provides an opportunity to resolve any issues that may hinder the future implementation of this leverage limit.

Moreover, as the ESRB recently recommended, for the investment fund sector, the role of authorities when using their powers to suspend redemptions needs to be further specified in law.

In addition, European Securities and Markets Authority should have a general facilitation, advisory and coordination role in relation to the National Competent Authorities' powers to suspend redemptions in situations where there are cross-border financial stability implications.

The need for a European safe asset

The stability and integration of financial markets in the Monetary Union is also closely related to the creation of a euro area-wide safe asset, for a number of reasons.

First, it could help reduce the excessive home bias in banks' sovereign exposures, which exacerbates the feedback loop between banks and sovereigns.

Reforms to the resolution regime (i.e. BRRD) have tackled the issue from one direction, from banks to the sovereign. However, at present, there is no clear solution for tackling it in the other direction, from the sovereign to the banks.

The creation of a euro area-wide safe asset, composed of a pool of sovereign bonds, would lead to a reduction in the home bias of banks' portfolios by facilitating de-risking and diversification.

Second, a euro area safe asset would be crucial for the financial integration and the capital markets union.

In fact, it is necessary for the creation of an integrated, deep and liquid European bond market as a central piece of CMU. A single term structure of risk-free interest rates could serve as a euro area pricing benchmark for the valuation of bonds, equities and other assets. The safe asset could also be used as collateral, for example for repo and derivatives transactions across the euro area.

In principle, several options are available for creating a safe asset. Some options are not politically viable, while others may not be economically sound.

I am not referring to the type of eurobonds that would replace national sovereign debt as a joint liability of Member States, as these would require a deep political union.

Various proposals have been put forward, but I will concentrate on just two: a variant of the European safe bonds (ESBies) or sovereign bond-backed securities (SBBS) and the e-bonds as proposed in the Monti Report.

The current proposal of the SBBSs refers to a tranched, synthetic bond backed by national sovereign bonds. The senior tranche would have very low risk levels, presumably below German debt, as a result of the

diversification gains based on historical correlations and of the protection granted by lower-grade tranches.

Market practitioners and rating agencies have been skeptical about the instrument. Their main concern is a perceived lack of diversification to ensure that the senior tranche can be indeed as safe as claimed because correlations among several countries' debt could increase in a stressful situation (as occurred during the financial crisis).

Also, it may be difficult to sell the junior tranche at coupons that do not fatally compromise the overall economics of the synthetic security issuance.

Indeed, if the junior tranche had to be placed at a relatively high coupon, then the senior tranche would need to offer a lower coupon than Bunds, a doubtful selling prospect. This would likely render the economics of the SBBS as unviable, which would be very unfortunate.

These obstacles could be overcome if, for instance, a small first loss tranche were to be covered by public guarantee, jointly provided by member states. Such contingent liability could be limited to a reasonable level. The success of the synthetic European Bonds would have significant benefits for financial integration and for the banking and capital markets unions.

Alternatively, a European entity could issue e-bonds as a pure securitisation of sizable amounts of national sovereign bonds but with a preferred creditor status over national sovereign bonds.

Such a structure would be less efficient and could increase the cost of issuing the non-preferential part of national debt that is not included in the securitisation. However, this could even act as a disciplining device and would not necessarily imply an increase in the costs of the total debt issuance.

The amounts achieved could nevertheless be considerable. For instance, according to a recent working paper of the Peterson Institute, in order to have an expected five-year loss rate of 0.5% or lower, the European entity could securitise 50% of a country's debt or 25% of its GDP.

Capital Markets Union, financial integration and economic growth

A European safe asset is crucial for the CMU project which in turn important for economic growth. A big and liquid market, both of debt and equity, would spur innovation and enable the development of an efficient venture capital market.

This relates to the importance of boosting the euro area's capacity to engage in activities conducive to innovation and productivity growth. In the years since the Great Recession, the pace of productivity growth in Europe has been persistently slow. In fact, European productivity growth had already started to stagnate during the mid-1990s.

While some economists have argued that this is all part of a global secular decline in growth, driven by factors such as an ageing population and growth convergence across emerging markets, others believe that scientific progress will keep pushing the technological frontier forward.

In any case, it is vital that we have financing mechanisms in place in Europe that can support science and technology's contribution to economic growth. One powerful way in which policy can assist this process is by stimulating the emergence of deep and integrated European capital markets. Capital markets, after all, play an important role in sharing economic risks and in smoothing consumption.

But even more fundamentally, they contribute greatly to innovation and growth. Evidence increasingly suggests that while both banks and markets are important for the financing of economic growth, non-bank financial intermediation provides a relatively more powerful contribution to innovation and productivity-enhancing activities in modern sophisticated economies, also in the euro area.

Importantly, complementarities between banks and markets increase, as the economy develops, and so deep capital markets will end up complementing banks as sources of financing. While the European Commission's current CMU initiative is an important step in the right direction, a much more ambitious agenda for bolstering capital markets in Europe is needed in the future.

Developing well-functioning capital markets which support economic growth across Europe requires a comprehensive approach. To that end, Europe needs to boost the supply of equity finance.

Policies which stimulate individual ownership of traded shares, such as reducing the tax advantage of debt over equity or enhancing financial literacy, can have a material effect on public equity markets in Europe.

At the same time, because stock markets often penalise companies which undertake radical, but uncertain, innovative activities, the contribution of private equity - particularly in the form of early-stage venture capital finance - is indispensable, as a critical mass of angel investors who can provide financing for medium-size projects is also needed.

Only with a deep, liquid market is it possible to launch IPOs of successful projects that can offset the losses with projects that fail.

Harmonising insolvency rules across jurisdictions would be a major step towards supporting capital markets.

This is critical for mobilising finance through capital markets, as it would create incentives and favourable conditions for institutional investors to overcome the home bias in their investment strategies.

This is especially true for pension investment, as large private pension funds tend to be a complement to deep capital markets. We need to establish a harmonised regulatory environment for new types of finance, such as crowd funding.

The emergence of increasingly complex financial products needs to be accompanied by adequate consumer protection of financial investment, in order to safeguard financial stability and ensure the protection of individual investors.

The second component of a comprehensive approach entails policies that will stimulate entrepreneurship. High-tech entrepreneurial firms that aspire to go public should be supported and facilitated by stock exchanges specialising in IPOs for young innovative companies.

A reduction in the wedge between corporate income taxes and personal income taxes has already been shown to have a strong positive effect on high-tech investment in a European context.

Last but not least, the efficient application of R&D tax incentives and increased public funding of private research universities, whose labs often make key scientific and technological breakthroughs, are other important avenues for stimulating innovation and the commercialisation of science.

Conclusion

Let me conclude. So far, measures adopted in the context of the CMU initiative, albeit positive and helpful, are not yet commensurate with the ambition of the project.

With CMU, we should aim to reach a situation where both issuers and investors enjoy the same basic legal rights concerning capital markets activity regardless of the EU country where they are located.

The CMU project involves all EU member states but it is particularly important for the euro area member countries. It is a big waste to have taken the huge step to adopt a single currency and continue to forgo the benefits that could be reaped by creating a true banking and capital markets union. I believe that euro area countries should forge ahead in enhanced co-operation in order to achieve CMU more rapidly.

We should however, be well aware that CMU requires a European safe asset, the harmonisation of taxes on financial products, a convergence of company law, including on bankruptcy, the creation of a single rule book of regulation for markets activity and ultimately a European Single Securities Market Supervisor.

The other big condition is a rock solid monetary union so that assets' risks and returns are not significantly influenced by redenomination risk but exclusively by their idiosyncratic features.

A heavy toll, I know, but I will believe that the CMU project is possible when I see authorities start making inroads in some of those difficult issues.

Thank you for your attention.

Number 3

Finding the right measure of consolidation in the banking sector

Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Center for Financial Studies, Frankfurt am Main.

1. Introduction

Mr Issing, Ladies and gentlemen

It is a great honour and pleasure to be here at the CFS this evening. It was here that I delivered my first speech to the public in 2011 - and today marks my last official speech as a member of the Bundesbank's Executive Board. In a sense, I have therefore come full circle.

As has the topic as well: this evening, I will be talking about consolidation in the banking sector. "Old hat", some of you will be thinking, "how fitting for a farewell speech". You are possibly not completely off the mark, but old hats can be in vogue as well - especially if they are as relevant to the future as consolidation in the banking sector.

There are two good reasons why I have chosen this topic. The first of these is: M&A is what characterised my career as a banker - it has thus always been one of my most important topics. The second reason is: consolidation will help to shape the banking sector of the future.

Let me begin with this statement: we must think the debate on consolidation further; we must think it a new.

I would like to posit four theories.

Theory one: the banking sector will continue to "shrink to health", in Germany and in Europe alike.

Theory two: on the heels of this consolidation, mergers and acquisitions will lead to a concentration of the market on a reduced number of institutions. However, mergers should be undertaken with a view to creating institutions that will be stable in the long run. In mathematics, minus times minus equals plus - but it does not follow from this that two weak institutions will necessarily add up to a stable bank.

Theory three: if the underlying economic conditions are good and if the euro area and the banking union offer the requisite environment, there will be more mergers and acquisitions going forward - initially within the German market, and, later, across borders in the euro area.

And, finally, theory number four: those who think of consolidation and structural change only in linear terms and who are fixated on exploiting economies of scale overlook the future of financial intermediation. "Shrinking to health" and innovation have to be thought across the established limits of the banking industry - along new, digitalised value chains. And this does not necessarily lead us to a concentration of today's banking business in the hands of a small group of large banks.

2. Why are we talking about consolidation?

Let me begin with a question: why is there so much talk of consolidation in the banking sector? And why am I also talking today, in my farewell speech, about a topic as "old hat" as consolidation? There are four reasons for this.

First, because the financial sector, especially the banking sector and large banks in particular, dominated large segments of the economy in the 20 years prior to the financial crisis. A case in point is shown by the highly educated engineers, physicists and economists who developed complex financial products and risk management models - instead of building bridges or developing medical devices.

These, but also many other bright university graduates, were sucked in by the financial sector because they could measure themselves against the best and could earn a lot of money - however, only thanks to a financial bubble. Although this bubble burst in 2008, overcapacity in the financial sector did not automatically go away, but has had to, and still has to, be gradually shrunk in a process that has been going on for years - much as it also took years to build up.

Second, in the past few years, we have been repeatedly found ourselves debating the topic of "overbanking" - the European economy's overdependence on the banking sector, the bloatedness of the banking sector, its political influence, the size of its payrolls, the number of institutions. That, too, is a reason why I am talking about consolidation this evening. The extent quickly becomes clear if we look at the size of the banking sector relative to GDP: in Germany, for instance, it rose from less than 190% in 1993 to 360% in 2008, the year the financial crisis broke out.

But there's another, third reason: the banking sector is currently in the throes of fundamental transition. Because more and more financial services are being offered outside the traditional banking sector, fintechs and "shadow banks" are putting pressure on the banking sector to consolidate.

And, finally, there is a fourth driver of the debate on consolidation: the poor profitability of European and, not least, also German institutions. The earnings of

German credit institutions have been falling for more than 15 years - by around 30% since 1999. The persistently low interest rates have significantly exacerbated this situation. And the fact that interest rates are expected to remain low for the foreseeable future means that the outlook for profitability here and in wide swathes of Europe will be more on the gloomy side.

Germany is particularly affected by the low level of interest rates because most German institutions have business models which are highly dependent on interest rates. The recent low-interest-rate survey conducted by the Bundesbank and BaFin has shown that small and medium-sized German credit institutions are expecting a 9% drop in their profits from 2016 to 2021; this represents a whopping 16% decline in the return on assets over the same period.

One major cause is growing competition in the low-interest-rate environment. Over 70% of institutions are expecting intensified competition from other banks and savings banks. And as many as 85% are expecting increasing competition from fintechs.

I am therefore not truly surprised that M&A has been a topic in the European and the German banking sectors since 2008. Indeed, many market observers are probably surprised at how slowly consolidation is progressing.

But where are we now in this process? Since 2008, we have seen a moderate, continuous process of downsizing in Europe: the ratio of banks' assets to GDP was, at the end of 2016, well below its 2008 levels. More precisely, it dropped from 350% to around 260%. Measured in terms of the enormous rise prior to the financial crisis, it is quite conceivable that the downsizing process will continue further, although it has stalled somewhat of late.

Another measure of consolidation in the banking sector is the number of branches and employees per capita of the population. From 2008 to 2016, the average number of inhabitants served by a branch rose by nearly one-third; over the same period, the average number of inhabitants per bank employee rose by one-quarter. And the number of institutions in the euro area has also already dropped considerably, by nearly 30%: from 6,062 in 2008 to 4,385 at the end of 2016.

There is little doubt that this process will continue. How far this process will go, however, nobody can say - though there has been no shortage of attempts to predict the number of German or European institutions in 2050.

And thus, my first hypothesis was that, in the years to come, we will likewise see a moderate shrinkage of bank balance sheets and transaction volumes in the euro area - albeit, of course, with a certain variation from one country to the next. The number of employees and branches per capita, too, will continue to decline.

These trends will be driven further by the digitalisation of financial services. And the number of institutions itself will keep falling. One of the reasons, to which I will come in a second, is mergers. The other is that there will be market exits

which, I hope, will be carried off without any political intervention and in an orderly fashion under the resolution regime.

There is little doubt that this downsizing process is "shrinking to health" - difficult as the repercussions will be for institutions and their employees. Out of cost-efficiency considerations, if nothing else, overcapacity which is no longer needed has to be either downsized or deployed to other profitable purposes. And, from a macroeconomic perspective, it is particularly necessary to want a financial sector that is not inflated but efficient.

3. The role of mergers & acquisitions

What is more doubtful, however, is the weight that each of these three different consolidation approaches will have. What share will the shrinking of existing institutions have? How many of them will exit the market? How many of them will merge with other institutions?

My personal take on this - which dovetails with the second hypothesis I mentioned at the beginning of my speech - is that an increase in M&A activity, and thus a higher level of market concentration, can make sense from both an economic and a commercial perspective; that said, long-term success will be reserved for initiatives which ultimately bring forth a stable credit institution running a sustainable business model.

Why am I making this point so emphatically? Because M&A has a mixed track record in the banking sector, if you measure it in terms of profitability, stability, market power and customer satisfaction.

Some see bank mergers as a kind of magic formula for driving consolidation forward. They're so optimistic because of the economies of scale which typically arise when identical activities are combined and the synergy effects which can be harnessed when complementary operations are fused. And it does indeed appear that mergers unleash positive effects in reality, not just in theory - a meta study conducted last year by the ECB concluded that M&A tends to generate positive economies of scale, even if they would not appear to be overwhelmingly large.

However, increased M&A activity can also be problematic, because this form of consolidation drives even more market share into the hands of a small number of market participants.

And large institutions are, first, not just particularly susceptible to poor governance; they can, second, also present a risk to financial stability - I'm talking about the too-big-to-fail problem here. The bigger banks become, the more closely they need to be supervised and the better the resolution options need to be formulated.

Third, concentration in the market can lead to an agglomeration of market power, and thus to a lower quality of services and higher prices. The ECB's paper

discovered that the market power of credit institutions in the euro area has increased since the financial crisis.

Overall, according to the ECB's meta study, it cannot be concluded beyond doubt which empirical factor has more of a bearing - the positive efficiency gains, or the problems which the heightened concentration causes for customers and financial stability.

So there is conclusive evidence, it would seem, that M&A is not a magic bullet. Any merger or acquisition has a certain likelihood of failing. Only well-thought-out M&A transactions stand a genuine chance of success. It's quality that counts, not quantity.

Now some of you might be thinking that's all very well - but what are the hallmarks of a well-thought-out and successful merger? Those of you who've just pulled out your pen and paper will be in for a disappointment because there is no ready-made solution.

That said, I would nonetheless like to share with you four minimum conditions which I consider to be important for mergers and acquisitions in the banking sector:

The first applies to any strategy, but it is particularly relevant to M&A: an M&A transaction is more likely to succeed if it is planned, purposeful, and done out of conviction rather than compulsion.

Second, M&A transactions in the banking sector need to be examined analytically in order to quantify as accurately as possible whether and to what extent economies of scale and synergy effects can indeed be harnessed. Complementary mergers in which business operations and/or regions fit together perfectly can fall flat, but they can also be blessed with success if they are based on detailed analysis upfront.

Third, they are far-sighted - that is to say, they consider which problems might arise and look at how other mergers panned out.

Fourth, they are creative - in other words, they look beyond the confines of existing business operations. In a market gripped by structural change, this calls for a great deal of creativity - imaginative solutions which think outside the limitations of the banking sector of old. Dovetailing complementary business operations, which I mentioned just now, can also be a successful approach across traditional sector boundaries.

4. The future of M&A in Germany and Europe

The question now is this: how many successful and well-thought-out mergers are we likely to see in Germany and Europe?

That is what my third hypothesis is all about. Given good economic conditions and a reformed banking union, there may well be more M&A activity in future - both within the German market initially and later across national borders in the euro area.

That's because institutions will gradually emerge from crisis mode and the period of regulatory reform over the past ten years in which they had better things to do, to put it crudely, than simulate strategic M&A options. This creates huge potential.

The more accommodative the current economic environment is and the more regulatory uncertainty recedes, the greater that potential will be. Basel III was concluded at the end of last year, and the plan now is to implement it in full in the EU, the USA and the other member states.

Implementation of these final, major reform elements introduced in response to the financial crisis will push back regulatory uncertainty once and for all. That is why it is so important for the Bundesbank, and for me personally as well, that we now set about preparing implementation in the EU, even if the European elections will soon be upon us, so that we can swiftly wrap up the process once the elections are over.

In my view, this gradual reduction of economic and regulation uncertainty opens up a window of opportunity, above all in Germany, for more mergers and acquisitions. At this point, let me remind you of one of the most fascinating findings from the latest low-interest-rate survey: nearly 50% of small and medium-sized German credit institutions can see a prospect of mergers and acquisitions over the medium term.

But that will call for creative and unconventional solutions within the German banking sector as we know it - solutions that are needed not just by private institutions but by their public-sector counterparts as well. The latter have a public mandate, making them an important pillar of the German economy. And they should stay that way - which is also why this pillar needs to be refreshed.

Specifically, the Landesbanken spring to mind here. Something like two months ago, the first sale of a Landesbank to private investors was set in motion, bringing a long and arduous journey to a close. This transaction is a novelty for the German banking sector.

It was a forced sale, admittedly, but it shows that a transaction like this is doable - yes, it is possible to sell a Landesbank to private investors, and even at a price that many had considered impossible beforehand. With a little luck, this story will be a prelude for bigger solutions in the Landesbank sector. The market environment, in any case, is still exceptionally favourable.

As a banking supervisor I will always take a neutral stance when it comes to structural policy. Industrial policy is out of bounds for central banks, and rightly so - even if that's a view not everyone would agree with. That said, I would like to

take this opportunity to encourage banks and savings banks to explore fresh and creative avenues - before problems force them to do so.

But we also need to take a look beyond the German horizon. Because in a currency and banking union, one could be forgiven for wondering whether we need more cross-border mergers in the euro area.

The management of the SSM took quite a clear line on this topic in a recent speech. Cross-border mergers and acquisitions within the SSM are rare, it was said, and the degree of concentration across the SSM banking sector, and particularly in a number of member states, is too low. According to the ECB, this is due not least to the political and supervisory obstacles that still persist in the euro area.

Even if there is some evidence to suggest that cross-border mergers and acquisitions tend to be more successful and have less of a negative impact on competition, I currently see national mergers as a more promising avenue for tapping synergy gains. In my view, only once these synergies have been harnessed will institutions think more along European and cross-border dimensions.

For now, cross-border mergers in the euro area will probably be few and far between. That's because mergers and acquisitions across national borders are exceptionally complex transactions on account of the cultural and lingual barriers they need to transcend.

A lack of clarity surrounding the future regulatory framework for a cross-border project makes it more difficult still to gauge whether the complexity of governance across cultural areas is something that can be organised while still making a profit.

5. Conditions and limits to European mergers and acquisitions

Additional reforms are necessary before any further progress can be made here. I don't just mean the completion of the banking union, but it is especially necessary. We have an opportunity - and also an obligation, in my view - to establish the banking union on a firmer foundation. This is why the EU must succeed in reducing the excessive risks still latent on many banks' balance sheets.

We can do this first by scaling back existing non-performing loans and preventing the build-up of new ones. I firmly believe that in this matter there are no alternatives to the ECB guidelines. The foundation of the banking union can then be fortified by putting an end to the preferential treatment of sovereign bonds, third by building up loss-absorbing capital, TLAC and MREL, and fourth by harmonising insolvency regimes.

As a second step further down the line, we should then discuss how we can create a strong European reinsurance system for deposit protection that intervenes

when national schemes are unable to cope - but only then. If we manage to do this, we will make the banking union more stable and more credible.

There is, of course, a "but" to all this, because I can see the danger that, as supervisors, we might go too far. I see the danger of overestimating the opportunities of M&A strategies and underestimating their risks. We cannot expect scale and synergy effects to simply materialise across cultural areas, nor can we act as though the banking union is already completely supranational today - in many places there will also be national security hurdles over the coming years. And that is as it should be.

My concern is that European mergers and acquisitions may be misused for political interests. Here I am referring to potential attempts to create European champions that could then supposedly take on large competitors from other parts of the world. I consider this type of thinking questionable. We must not now make the error of replacing the misguided ideology of national champions with a no less misleading ideology of European champions. This will not lead to growth and more jobs, but it may result in ossified structures and risks to financial stability.

Ladies and gentlemen, consolidation is essential and fundamentally good for the banking sector, but neither national nor cross-border mergers and acquisitions should be seen as a means of escaping the digital revolution and structural change.

6. What will the digital revolution mean for the future of financial intermediation?

The last part of my speech today will address these fundamental changes. That isn't to say that too little is spoken about digitalisation - one would be hard pressed to find a business section of a newspaper or a conference programme today that doesn't mention it. We do have a tendency, however, to overstate short-term trends - just think of Bitcoin and fintech start-ups - while we underestimate and think too little about long-term trends.

Who among you has a clear idea of how digitalisation will alter banking and the banking sector's structure in the medium and long term?

Luckily, when we consider this, we don't have to start from scratch. We have been working on this for quite a long time on the Basel Committee's Task Force on Financial Technology. An initial result of this has been the development of five scenarios of how digitalisation could change the banking sector, and I'd like to share these five visions of the future with you now.

Let's start with the least disruptive scenario: the "better" bank. In this scenario, institutions that are already established on the market are successfully modernising and becoming digitalised. They continue to maintain good customer relations and carry out banking services themselves. Though established institutions are under considerable pressure to reduce their costs and to

modernise extensively, they also have in-depth knowledge of the market, a broad customer base and high capacity for investment. This suggests that established banks are able to reinvent themselves piece by piece during their day-to-day operations and ultimately hold their own in the market.

Scenario two concerning the "new" bank tells a different story. In this scenario, established banks founder due to their structures, which have evolved over many years and turn out to be legacy risks. New banks - small start-ups or those founded by tech giants - then take over their business. Free of legacy risk and designed specifically for a digital and interconnected world, these new banks can offer their services more cheaply and are more attractive to customers - they are quick, innovative and state-of-the-art.

But the sector could change even more radically, as scenario three - the "fragmented" bank - shows. In this scenario, banking business becomes fragmented and the value chain is broken up. Universal banks are history, regardless of whether they are "old" or "new". Instead, a large number of specialised providers emerge, offering individual financial services. From the customer's perspective, this fragmentation wouldn't necessarily be a disadvantage and it wouldn't be visible at all if the providers offered their services on joint platforms - dubbed the platform economy.

Scenario four is similar: the "invisible" bank. As in scenario two, established institutions in this case are unable to keep pace with the new competitors when it comes to customer relationships. Nevertheless, they don't disappear from the market, but maintain a background role as a service provider. In this role, they carry out the tasks that are only possible with a banking licence or that require specialist knowledge - risk management, lending or deposit business, for example. We can already witness this type of cooperation today when tech companies present themselves to customers as service providers, while the settlement side of transactions is carried out by established financial institutions. Payments and credit platforms are two such cases in point.

This leaves us with scenario five: disintermediation. In this scenario, established banks are no longer relevant market participants and nor are they replaced by new banks, because the intermediary role of traditional credit institutions is simply no longer needed. Here, innovative technologies take on the task of connecting end customers with each other directly. This may sound rather far-fetched at first, but we are seeing at least some attempts in this direction already: for example, lending via P2P platforms or business financing via crowdfunding.

Ladies and gentlemen, these are five scenarios, five visions of the future of how digitalisation could change the banking sector, though there are of course others. Personally, I believe we will see a mix of these scenarios as the banking sector evolves.

On the one hand, customer needs will be key to developments - consider, for example, the smartphone generation, many of whom have never set foot in a bank

branch. In the second stage, how financial service providers respond to these needs will be crucial. Joint ventures and M&As may play an important role here by speeding up the change processes. Small fintechs that do not have any legacy risks are by their very nature more agile and can more easily develop innovative products and business models. Established banks have a solid customer base and strong marketing channels, which means they can bring promising concepts to the wider market within a short time frame. In many cases, although not all, it would appear that the secret is in the mix.

And that's why my fourth theory was that the process of designing structural change in general, and M&As in particular, cannot be linear. Instead, it must be dynamic. Whilst placing hope in scale effects, we must not forget one thing: the most important factor in the success of a market economy is its growth dynamic, which, unlike in a planned economy, is the result of many decentralised decisions by a variety of market players. This system gives rise to high levels of innovation and efficiency.

By the same token, clever M&A strategies also permit and seek out creative ways to break up enterprises - by which I mean selling off certain portfolios or business units. They are not limited to one sector, they take a service-based approach, and they follow the new, digital value chain.

And we must even go one step further. If digitalisation reaches all corners of the economy - think of "Industry 4.0" -; if today's forms of economic cooperation undergo a complete change because the technological revolution also facilitates revolutionary cooperation forms, which financial services will still actually be in demand at that point? What form can they be offered in? How could they be linked to other services?

To put it another way: if the economic structures change as the world becomes increasingly digitalised, how will the demands placed on the banking and financial industry and its structure change? What will the enterprises of the future want from the financial sector? Does the digital revolution of economic structures also mean a revolution for the financial market?

Although questions like these are still faint whispers from the future, we can already hear them today, and they are becoming ever louder. This is clear from cases such as the music streaming provider Spotify going public, for example.

In doing so, the company that revolutionised the music industry through its streaming services is flying the flag for a revolution in the financial industry, too. The IPO took place with minimal assistance from investment banks and the issue price was not set in advance, but instead was determined through a free market process.

Spotify's IPO was not, in itself, by any means a revolution in the financial world. But it was the first step along the way. And it won't be the last - of that I am sure.

7. Conclusion

Ladies and gentlemen, during my time as a member of the Bundesbank's Executive Board, I devoted a great deal of energy to guiding the banking sector through its recovery process. When I gave my first speech at the CFS in 2011, I talked about financial stability.

I discussed what challenges the German banking system was facing and how financial stability could be ensured. Although we have made considerable headway over the last few years, we are still a long way from our destination.

With this in mind, my first theory this evening was that contraction and consolidation will help assist the recovery of the sector in the future, too.

In my second theory, I outlined the role I expect mergers and acquisitions to play going forward. In Germany and Europe, I expect to see a concentration of the market on a smaller number of larger institutions. This will depend on well-thought-out strategies and will separate the wheat from the chaff.

I am certain that - as I mentioned in my third theory - we will see more of this type of merger if we create positive economic conditions, including a stable banking union in a stable euro area.

Under these conditions, I assume that, in future, we will see more M&A activity within Germany to begin with, and then across borders within the euro area, too. Despite this, the stability of the bank market hinges on it remaining fragmented in many areas - in terms of size and business models, to be clear.

And, finally, theory number four: I hope that, in future, we will spend less and less time discussing consolidation within the old conceptual confines.

In a digitalised economy, not only will the ways in which financial services are provided be radically overhauled; there will also be a structural change in the demand for services. We have no idea what financial services will actually still be in demand at that point, or by whom.

Banks and savings banks therefore cannot simply carry on as before. If they want to remain a meaningful part of the financial services industry in the future, they must run their established business more efficiently and more innovatively and, at the same time, ask themselves how heavily they want to rely on the established banking structures making a recovery.

While these mammoth tasks are being performed, supervisors must not work against the institutions, but must support them.

Even if we are first and foremost responsible for financial stability, it is just as important not to curtail economic growth disproportionately. It was always my aim to find this balance and encourage dialogue about it.

On that note, I now look forward to a lively debate with you.

Thank you very much for listening.

Number 4

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https://pcaobus.org/Standards/Documents/2017-02-16-Form-AP-Staff-Guidance.pdf

Number 5

EIOPA opinion, considering the withdrawal of the UK from the EU

- National supervisory authorities should assess the risks arising for their national markets.
- The Opinion sets out 14 areas where the determination of the solvency position of insurers will change.
- EIOPA will be closely monitoring the risks taking into account their nature, scale and complexity.

The European Insurance and Occupational Pensions Authority (EIOPA) has issued an Opinion on the solvency position of insurers in light of the withdrawal of the United Kingdom (UK) from the European Union (EU).

The objective of this Opinion is to call upon national supervisory authorities to ensure that all risks to the solvency position of insurers arising from the *UK becoming a third country* are properly addressed.

National supervisory authorities should ensure that the insurance and reinsurance undertakings under their supervision identify, measure, monitor, manage and report the risks arising from the UK becoming a third country and include them in their own risk and solvency assessment.

Furthermore, national supervisory authorities should assess the risks affecting their national markets and, where necessary, take preventive supervisory actions.

The withdrawal of the UK from the EU might have an impact on the solvency position of insurers. Technical provisions, own funds and capital requirements of insurance and reinsurance undertakings in Member States other than the UK can change when the UK becomes a third country due to changed regulatory requirements.

In particular, Solvency II and other financial regulation distinguish between activities in and outside of the EU.
The Opinion sets out 14 areas where the determination of the solvency position of insurers will change.

The areas include the risk-mitigating impact of derivatives, the recognition of ratings from UK rating agencies and the regulatory treatment of credit risk exposures situated in the UK.

Not all of the changes may affect each insurance company.

Together with national supervisory authorities, EIOPA will monitor the risks to the solvency position of insurance and reinsurance undertakings.

The monitoring will be proportionate to the nature, scale and complexity of the risks.

National supervisory authorities should provide to EIOPA the necessary information for this monitoring within the current European framework for supervisory cooperation.

Gabriel Bernardino, Chairman of EIOPA, said: "In their risk management, insurers should in particular prepare for the scenario that the UK becomes a third country and leaves the internal market. It is important that national supervisory authorities monitor and assess the risks to their national markets and take timely and effective supervisory actions."

The opinion:
https://eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-18-2018_opinion_on_solvency_and_Brexit.pdf

Number 6

An annuity is a very serious business

David Rule, Executive Director of Insurance Supervision of the Bank of England, at Bulk Annuities - The Expanding Market, Westminster and City, London.

Today I am going to talk about the bulk purchase annuity market, the increasing use by life insurers of illiquid assets – and in particular equity release mortgages – to back these annuities and the significance of the Solvency II matching adjustment.

First, though, I want to reflect briefly on the UK life insurance sector as a whole.

Standing here in 2018 it is a very different market to the one I might have been describing just 20 years ago.

The big change is that most new life and pension products do not guarantee returns.

The great majority of savings products are unit linked. And individual pensioners are increasingly choosing draw down products rather than annuities.

In both cases, investment risks lie with the policyholders.

Other things being equal, that should mean a less risky life insurance sector and fewer sleepless nights for a prudential supervisor like me.

The other side of the current life insurance market though is managing the legacy of past promises.

Two trends are clear here: first, a very active market in transfers of books of annuities and closed life books between firms, with insurers specialising in particular niches; second, transfers of annuities to life insurers from corporate, defined benefit pension schemes – the bulk purchase annuity market that is the subject of this conference.

Risks for insurers in the bulk purchase annuity market

The bulk purchase market has grown over recent years from a flow of around £5bn in 2010 to over £10bn in each of the past four years.

With the funding position of many defined benefit schemes improving and company boards still keen to shed pension risks, commentators expect the market to expand further. Transfers in excess of £15bn are predicted this year.

The number of life insurers active in this market has increased, with most of them seeing it as a priority for future growth.

Our sense is that the market has become more competitive. This is good news for UK companies seeking to shed pension risks.

For the insurers, finer margins make it more important that they understand the risks on deals and get the pricing right.

A concern is that firms might relax risk management standards or take short cuts in order to win deals and meet new business targets.

I want to highlight three areas of risk: data due diligence; longevity and its reinsurance; and asset selection, rating and valuation.

I will touch briefly on the first two before spending more time on the third.

On data due diligence, it seems obvious to say that insurers should not enter into bulk purchase transactions without understanding in some depth the nature of the annuity liabilities they are taking on.

But this is an area where we see firms taking different approaches and willing to price with different levels of risks.

One particular aspect is whether insurers have a full picture of their potential obligations to pensioner spouses and dependents.

Insurers need to be clear about their appetite in relation to data risks. Most of the longevity risk on new transactions is currently being reinsured, often outside of the UK.

To read more:
https://www.bis.org/review/r180511d.pdf

Number 7

Cryptocurrencies, digital currencies, and distributed ledger technologies - what are we learning?

Lael Brainard, Member of the Board of Governors of the Federal Reserve System, at the Decoding Digital Currency Conference, sponsored by the Federal Reserve Bank of San Francisco, San Francisco, California.

It is a pleasure to be here today. What better place to discuss digital currencies than in San Francisco, home to so many technology innovators working on new ways to disrupt various aspects of our daily lives?

Because of the transformative potential of digital currency and distributed ledger technologies, the Federal Reserve is actively monitoring digital innovations in the financial system.

We have been keenly evaluating developments in fintech and digital currencies through a multidisciplinary lens, combining information technology and policy analysis to study their potential implications for payments policy, supervision and regulation, financial stability, monetary policy, and the provision of financial services.

This work draws from expertise throughout the Federal Reserve System and benefits from engagement with our colleagues internationally.

Cryptocurrencies

The past decade has seen a wave of important new developments in digital technologies for payments, clearing, and settlement.

Cryptocurrencies represent the leading edge of this digital wave. And it was the advent a decade ago of Bitcoin, the first cryptocurrency, that first gave shape to the vision of a decentralized digital currency.

At the heart of any cryptocurrency is the creation of a new type of asset--the unit of the cryptocurrency itself--that is distinct from any traditional form

of money used in routine transactions, such as U.S. currency or checking accounts in commercial banks.

A typical cryptocurrency would not be a liability of any individual or institution. There is no trusted institution standing behind it. This is in stark contrast to U.S. currency and reserve balances, which are liabilities of the Federal Reserve Banks, and deposit accounts, which are liabilities of a bank or another regulated depository institution backed by federal insurance up to a specific level.

And while a typical cryptocurrency may be used in payments, it is not legal tender, in contrast to U.S. currency.

A typical cryptocurrency relies on the use of distributed ledger technology, which provides a new way to keep ownership records and transfer ownership from one user to another, often with little to no information about the identity of the owner.

For instance, Bitcoin relies on the blockchain, which is run by anonymous computers all over the world linked together through a ledger of anonymized transactions.

Digital currencies use automation via computer processing power, networking via the internet, and cryptography to transfer value from one person to another.

What is innovative is that the computer code behind these transactions uses automated checks and balances to validate the sender and receiver, and whether there is enough value in the sender's account to make the payment.

Traditionally, this validation would be done by banks and payment networks. Instead, with a cryptocurrency, this validation could be done by anyone with enough computing power and resources to participate.

Importantly, this technology is not owned or managed by any entity--regulated or not--that would be responsible for its maintenance, security, and reliability.

Rather, its maintenance, security, and reliability are handled by a decentralized developer community, which often lacks strong governance.

This combination of a new asset, which is not a liability of any individual or institution, and a new recordkeeping and transfer technology, which is not maintained by any single individual or institution, illustrates the powerful capabilities of today's technologies.

But there are also serious challenges. For instance, cryptocurrencies have exhibited periods of extreme volatility. If you purchased Bitcoin in December 2017 at a value of over $19,000, your electronic claims would be worth close to half that today.

Indeed, Bitcoin's value has been known to fluctuate by one-quarter in one day alone. Such extreme fluctuations limit an asset's ability to fulfill two of the classic functions of money: to act as a stable store of value that people can hold and use predictably in the future, and to serve as a meaningful unit of account that can be used to assign a comparable value of goods and services.

To read more:
https://www.bis.org/review/r180516d.pdf

Number 8

Virtual currencies ante portas

Yves Mersch, Member of the Executive Board of the European Central Bank, at the 39th meeting of the Governor's Club of The Central Asia, Black Sea Region and Balkan Countries, Bodrum, Turkey.

New innovations based on distributed ledger technology (DLT) and blockchain have brought about wide-spread euphoria. Their use to create "cryptocurrencies" or "virtual currencies" (VCs) - to denote their lack of legal recognition - is often touted as something that could fundamentally change the financial sector.

The spectacular rise in the market valuation of VCs over the past year suggests that many people shared this belief.

In the course of 2017 the global VC pool both deepened, from USD 30 billion to USD 400 billion, and widened, with the proliferation of "initial coin offerings" or "ICOs" - virtual fundraising facilities for start-up investors.

But in my view, the subsequent market plunge rather points to a fading fad. From December to February the price of bitcoin, the top dog among VCs, fell from almost USD 20,000 to below USD 7,000.

Don't get me wrong: I am an ardent believer in progress through innovation. Technological progress can provide us with significant efficiency gains and increases in general welfare. Perhaps DLT and blockchain can do just that2

But I am very sceptical towards the use of these technologies to create currency. Although they combine decentralised payments and label them as currency, VCs are still not legitimised by any authority.

Moreover, VCs rely on financial intermediation via exchanges and wallet providers to re-enter the real economy.

Any fiat money requires trust to gain and maintain the acceptance of those who use it. Indeed, history has shown that confidence in public money is best provided by a trusted issuing authority, that is, an independent central bank issuing safe and stable liabilities that people can access and hold.

Trust in a central bank, in turn, is created and sustained via legal safeguards, a clear price stability mandate and a sufficient degree of democratic accountability. In contrast, nobody is liable for VCs, nor are they backed by any trustworthy authority. Under these circumstances, it may well be that VCs will fail, as so many other earlier forms of money did.

There are, at present, more than 1,500 VCs in circulation, with dozens of new schemes being launched monthly. The total value outstanding has fluctuated sharply, largely because of speculative activity, and most have failed to attract users. Yet authorities need to be aware of the potential risks they pose for the economy.

Are VCs the latest incarnation of money? The answer for now, and indeed for the foreseeable future, is no.

What is money?

Economists identify money as a verifiable asset that serves as a medium of exchange, a unit of account and a store of value. How well do VCs carry out those functions?

First, VCs' performance as a medium of exchange is weak - to say the least. Some have attained patchy acceptance - the largest at present, bitcoin, is accepted by some retail outlets. But on a global scale these outlets remain small in number, and hardly any actual transactions take place.

On a daily basis, there are around 200,000 bitcoin transactions globally, compared with 330 million retail payments in the euro area.

Bitcoin is far inferior to existing payment options. Transactions generally require confirmation from six miners, which can take an hour, or potentially much longer due to network congestion.

Bitcoin payments are also expensive: the cost varies over time, but reached €25 in December 2017. And even if recent claims put the price at between €1 and €30 and the processing time at under ten minutes, this compares poorly to 0.2 euro cents and a maximum of ten seconds for transactions on the forthcoming TARGET Instant Payment Settlement (TIPS) service.

The second function of money is acting as a unit of account, without which buyers and sellers would not be able to measure the value of a particular good or service.

VCs fail this test - none of them are generally accepted as a unit of account. In part this is due to the lack of widespread recognition. VCs are not legal tender and are not backed by a central bank. Moreover, their prices are too volatile to establish a reference value.

But the lack of acceptance as a unit of account is also down to the third function of money - being a store of value.

VCs exhibit wild fluctuations in value. For instance, the average volatility of the top ten VCs by market capitalisation was more than 25 times higher than that of the US equities market. Such fluctuations mean that businesses setting prices in VCs could find themselves with a large and detrimental gap between their actual price and their optimal price.

Similarly, households cannot rely on VCs as a stable store of value to optimise their spending over time by saving.

VCs have neither intrinsic value, such as the commodity content of gold coins, nor extrinsic value, such as the value assigned to traditional fiat currencies by the trusted public issuing authority.

It is very clear that VCs currently do not fulfil the three basic functions of money: they are inefficient media of exchange, poor stores of value and are not used as units of account.

It is these failures that make the label "currency" a misnomer.

Potential impact of virtual currencies

Yet even if VCs are not money, public authorities should still be aware of the potential risks they pose for financial stability - although currently these markets are too small to be of systemic importance.

VCs are inherently risky compared to conventional financial assets. They are excessively volatile and illiquid due to the fragmented nature of unregulated exchanges and their high ownership concentration: 96% of current bitcoin holdings are estimated to be held by 2.5% of users.

This facilitates price manipulation and other misconduct and is further compounded by operational and technical weaknesses of the underlying technology.

Yet, VCs do not appear to pose material financial stability risks. One reason is that they are small compared to the financial system as a whole. The market capitalisation of VCs was USD 432 billion in early 2018, about 1.5% of the market capitalisation of the S&P500.

But the significant rise in the market valuation of VCs we saw prior to December 2017 calls for caution. If, in the future, such a boom led to a large enough VC market, it could become a factor that affects financial stability in the event of a crash. Such risks could intensify via several channels.

Wealth effects could disrupt financial stability not only through consumer spending but also through collateral valuation. If VCs were indeed used as collateral for loans, a fall in the value of such collateral could lead to margin calls and increased defaults, with knock-on effects on borrowing and economic activity.

The effects of a crash could be further magnified if VC investors were highly leveraged.

Not only would investors lack equity to absorb losses, but losses would also spread to creditors. Moreover, the use of derivative contracts could spread the losses more broadly across the economy by allowing other market participants to hold leveraged positions against VCs.

A crash could affect the stability of the wider financial system if big banks were to hold huge unhedged exposures to VCs. Similarly, the widespread use of VCs for payment or settlement could affect economic transactions on a large scale and disrupt the financial system.

Amid such potential risks, resolute ring-fencing measures may be needed to safeguard the integrity of financial sector services, protect investors and consumers, and prevent negative spill-overs to the real economy.

The four broad areas that require particular attention are:

(i) VCs themselves;
(ii) the facilitators - VC exchanges, wallet-providers and brokers;
(iii) financial market infrastructures (FMIs); and
(iv) the banking sector.

Regulating virtual currencies

VCs cannot be directly regulated or overseen in the absence of a centralised governance and legal framework. In fact, most VCs are "mined" peripherally by a computer programme explicitly to prevent any one legal

entity being in control. Several countries have banned VCs outright or ring-fenced them from the financial sector, notably China, where VCs were very active and computing capacity was concentrated.

In most countries regulatory action has focused on issuing warnings. In the United States for instance, the Securities and Exchange Commission (SEC) outlined more than 30 questions that had to be answered before it would give the green light to mutual funds and exchange-traded funds (ETFs) that invest in VCs.

Some countries have adopted "regulatory sandboxes", granting fintechs active in VCs temporary, conditional exceptions to regulatory requirements.

Although such sandboxes may be useful to try and test regulation, they clearly risk incentivising regulatory arbitrage. We ultimately need global answers in the absence of a defined jurisdiction for VC issuance.

At their meeting this year in Buenos Aires, the G20 finance ministers and central bank governors acknowledged that technological innovation, including DLT and blockchain, had the potential to improve the efficiency and inclusiveness of the financial system.

They warned, however, of the risks stemming from VCs regarding consumer and investor protection, market integrity, tax evasion, money laundering and terrorist financing, not least because VCs lack the key attributes of sovereign currencies.

Ministers and governors therefore committed to extending global standards for combating money laundering and terrorist financing to VCs, and called on international standard-setters to monitor VCs closely - and assess multilateral responses where needed.

Restraining the facilitators

Let me turn to the facilitators of VCs. We need to hold VC exchanges to the same rigorous standards as the rest of the financial system.

For this purpose, the 5th Anti-Money Laundering Directive will bring VC exchanges and wallet-providers within the scope of anti-money laundering (AML) and combating the financing of terrorism (CFT).

But we need a broader perspective on regulation. Possible regulatory action to extend licensing and supervision rules to VC facilitators could be explored.

Protecting financial market infrastructures

Third, I would like to cover financial market infrastructure services.

One of the key questions is whether VCs could become a settlement asset in payment and settlement services or be used in the clearing domain. Existing standards for FMIs refer to the usage of "a settlement asset with little or no credit and liquidity risk"8

While this appears to exclude settlement involving VCs, such standards do not systematically apply to all FMIs.

The situation is similar in the field of securities settlement. Could VCs be used as an asset for settling securities transactions or constitute a security per se? The answer hinges on whether they could be legally characterised as a "financial instrument" under the applicable regulation. And this depends on whether crypto-assets allow the identification of an issuer who can be held liable.

The use of VCs at central counterparties (CCPs) should also be monitored. Here too, standards require CCPs to accept highly liquid collateral with minimal credit and market risk. While it is doubtful that a VC would meet such a requirement, clear guidelines ex ante would be helpful.

In my view, there's a need to examine whether any VC activity carried out by FMIs should have to be ring-fenced. The enforcement of segregated accounts and liabilities could be discussed.

FMIs play an important role in financial markets, and any liquidity support offered by central banks should be to mitigate shocks emanating from the real economy, not from gambling in risky assets.

Regulating banks

Finally, we need to look at the banking sector. Due to the high volatility of VCs it might seem appropriate to require any VC trading to be backed by adequate levels of capital, and segregated from other trading and investment activities.

Given the risks posed by leverage, banks should not accept VCs as collateral, or should only accept them with haircuts that appropriately reflect past volatility and liquidity, as well as market and operational risks. Likewise, limits on leverage could be examined.

Conclusion

Let me conclude.

Do VCs herald a new world of money? No, virtual currencies are a misnomer in the first place. They are not money, nor will they become money in the foreseeable future.

They lack the official recognition and backing of a public authority. Their market share is still small, the amount of money at risk in financial market infrastructures is insignificant and their ties to the real economy are still limited.

But this can change. Authorities should therefore pay close attention to mitigating the potential risks that could stem from a growing VC market. We have to be mindful not to have the complex and interlinked financial system contaminated by immature technologies or shallow business models. Interfaces and gatekeepers require particular scrutiny.

Likewise, we should not succumb to the temptation to sacrifice the achievement of a level playing field for innovative advances that are aimed at regulatory arbitrage.

But I don't want to sound too negative. It is not unknown for new innovations to bring about euphoria, which in turn fuels bubbles that eventually burst. Still, just because the initial euphoria subsequently fades, does not mean that the innovation itself is without virtue.

These virtual currencies are clearly not suitable for use as money, but the underlying technology may, in time, become useful and widespread. And although we at the ECB don't intend to introduce a central bank digital currency for the foreseeable future, we are actively experimenting with the technologies. We will be able to cater for changing needs in trusted and stable central bank liabilities that are accessible to the citizens, if and when this becomes necessary.

Number 9

Keynote Address at the New York City Bar Association's 7th Annual White Collar Crime Institute

Steven Peikin, Co-Director, Division of Enforcement

Good afternoon and thank you for that overly-generous introduction. Before I begin, let me give the required disclaimer that the views I express today are my own and do not necessarily represent the views of the Commission or its staff.

Introduction

I'm delighted to be here today among so many friends and colleagues, and I extend my thanks to the New York City Bar for hosting this important event. Because New York plays such a pivotal role in our financial system, members of the New York City Bar have long taken a leading role in many of the most significant securities and white collar matters.

And the City Bar has been a key forum for education and dialogue about these important issues. I am honored to join today's distinguished group of speakers, panelists, and attendees.

This afternoon, I would like to address a practical topic that I hope will be useful for many in this audience: techniques for productive and effective communication with SEC staff during Wells meetings.

I have spent nearly 20 years focused on the criminal and civil enforcement of the federal securities laws, first as an Assistant U.S. Attorney, then in private practice, and now as Co-Director of the SEC's Division of Enforcement. Those of us who work on securities and white collar matters

often take for granted how fortunate we are to be able to practice in a bar that is populated by some of the best lawyers in the country. The opportunity to be part of such a bar is one of the things that attracted me to work on securities matters in the first place, and I know that I am a much better lawyer for having had the chance to do so.

Over the course of my career, I have had many opportunities to interact with opposing counsel – both on behalf of the government and while representing private clients. Experience has taught me that open, effective, and productive dialogue between the government and defense counsel is critical for both sides in handling a complex securities matter.

As a prosecutor, I found that frank communication with opposing counsel helped me understand complicated facts, focus an investigation, and – ultimately – reach the right result. In private practice, I think my clients were best served when the government was open to frank dialogue.

My time at the Commission has reinforced these conclusions.

At the SEC, we frequently confront issues that are novel, complex, or both. For the staff, productive communication with defense counsel can often provide a better understanding of complicated businesses, markets, and financial products. Effective communication allows us to tailor our theories, focus our inquiries and get to the end of our investigations efficiently.

I believe that the benefits of this communication flow in both directions. That is, effective dialogue can also yield significant benefits for defense counsel and their clients. In some instances, defense counsel will persuade us that we have gotten something wrong, leading us to abandon a charge, recommend different relief, or decline to pursue a matter entirely.

Even where that isn't the case, effective communication often helps defense counsel to better understand our thinking, which in turn allows them to provide better advice to their clients.

A SEC investigation provides many opportunities for dialogue – from the time of the first contact with the staff through discussions about possible settlement or litigation. As many of you know, one of the most significant opportunities for communication is the Wells process.

The Wells process takes its name from an advisory committee, headed by the distinguished corporate lawyer John A. Wells, which was convened in 1972 to review and evaluate the Commission's enforcement policies and practices.

As the Commission noted in responding to the recommendations of the committee, the purpose of the Wells process is to ensure that the Commission "not only [is] informed of the findings made by its staff but also, where practicable and appropriate, [has] before it the position of persons under investigation."

The Commission declined to adopt a formal rule or procedure requiring a prospective defendant or respondent to be given notice of the staff's charges and proposed enforcement recommendation and an opportunity to respond, deeming such a requirement to be impractical given that the Commission is frequently required to act with exigency. Nevertheless, the Wells process is one that the Commission staff has followed in most cases where doing so would not compromise other law enforcement interests.

The Wells process has significant benefits for the Enforcement staff. It provides us with a chance to learn – and understand – the "position of persons under investigation."

This, in turn, allows us to ensure that we make appropriate recommendations to the Commission, and that the Commission has a full and accurate picture of the positions of both sides when it reviews our recommendations.

While some may consider Enforcement staff and defense counsel to be adversaries in the Wells process, I think our interests are often aligned. A Wells notice is an invitation for defense counsel to respond to the Enforcement staff's preliminary conclusions and try to persuade us we are mistaken. We are focused on getting it right, not bringing cases for the sake of bringing cases. So if we are on the wrong track, we want to know that before we proceed further. That benefits everyone.

For these reasons, my Co-Director, Stephanie Avakian, and I place great importance on the Wells process – and Wells meetings in particular. I believe all of our Regional Directors and other Senior Officers are on the same page.

We view these meetings as among the most important parts of our jobs, and we devote substantial time and care to preparing for them. I know they are viewed as milestone events by defense counsel and their clients, and they too devote substantial resources to preparing and making these presentations.

As I approach one year on the job, overall I have been extremely impressed by the quality, sophistication, and effectiveness of the advocacy in the Wells process. Nevertheless, I've found that some Wells meetings have been more

productive than others. Drawing on that experience, I'd like to share some observations about what I have found makes for effective Wells meetings.

Before I do that, however, let me pause to make clear that I am not telling defense counsel how to do their jobs. At the SEC, we expect that counsel will zealously represent their clients. And nothing I say should dissuade counsel from doing what they think is in their client's best interest.

The arguments presented in a Wells meeting are – ultimately – up to the lawyer and the client. So I hope you will take the following in the spirit in which it is offered – which is an attempt to share my personal observations about what I have found does – and does not – tend to foster the most constructive, effective, and productive dialogue between Enforcement staff and defense counsel during a Wells meeting.

Observations

My first observation is an obvious one: Wells meetings tend to be the most productive when defense counsel focuses on the most important arguments and issues in the case, as opposed to taking a blunderbuss approach that attempts to address every possible argument, fact, element, and issue.

In most of our mature investigations, the true issues in dispute have been distilled, and there is typically one or a small number of live issues. In a fraud case, for example, perhaps it is a question of whether a statement was false or misleading? Or whether an omission was material? Or whether a person acted with scienter? Rarely, it seems to me, are all possible issues in serious dispute.

We view Wells meetings as counsel's opportunity to educate us on their positions on the key facts and issues before we make a decision about a charging recommendation. The time is yours, and you should use it how you see fit.

But meetings can only last so long – typically about an hour. When counsel attempt to make every argument and address every issue, it distracts. And in certain circumstances, contesting facts and issues that are not subject to reasonable dispute adversely impacts credibility.

In my experience, the most effective advocates pick their battles and focus on the central issues and arguments. This may mean foregoing discussion of every argument made in a written Wells submission. In my view, that is fine.

We read Wells submissions carefully, and we take them into account when preparing our charging recommendations.

I have also found that the best advocates listen carefully to us during a Wells meeting and adapt accordingly. If the discussion makes clear that we are not receptive to a particular argument, they move on. And if we suggest that counsel address a particular issue, they pivot to address it. Simply marching though prepared talking points is seldom the best approach.

My second observation is that while defense counsel should not try to cover all of the possible issues during a Wells meeting, the meetings tend to be most productive when the staff is aware of what defense counsel will contend are key facts before we meet.

By the time we reach a Wells meeting, the staff has concluded that the investigation is complete and that it has a sufficient record upon which to recommend charges. But the reality is that defense counsel and their client may know things that we don't.

We want to know as much as we can before we make a recommendation to the Commission. Educating the staff on what you believe are the key facts – and explaining why, in your view, those facts don't support an enforcement action, or a particular charge or form of relief – can be effective.

But for the discussion in a Wells meeting to be productive, all of what you believe to be the operative facts need to be on the table before the meeting so that we can consider and analyze them and discuss them meaningfully at the meeting.

In my experience, the parties are unlikely to make much progress during a Wells meeting if staff are surprised with new facts at the beginning of the discussion – especially if defense counsel takes the position that those facts are central to the case.

This is an issue that arises with some frequency where defense counsel has claimed privilege over supposedly key information during the investigation.

I have found that it is not helpful for counsel to disclose supposedly key privileged information for the first time in a Wells meeting, and then spend the rest of the meeting arguing that the information is a defense to the proposed charges.

Likewise, it is not useful when parties submit lengthy supplemental submissions on the eve of a long-scheduled Wells meeting. Those who do this must perceive a strategic advantage in dropping in a new submission at

the eleventh hour, providing staff with little time to digest it. But I think otherwise. This can make the meeting a waste of time. To be in a position to make progress at the meeting, we must know about – and have an opportunity to consider and test – information and arguments in advance.

Now, the reverse is also true. It makes no sense for defense counsel to go through the Wells process blind to key pieces of evidence that the staff has developed in its investigation. And so we have encouraged the staff to share with defense counsel key documents and information upon which our proposed case will rest.

There will, of course, sometimes be reasons why we are unable to share some things. But our dialogue will be most robust, and the process most effective, when we are all talking about the same factual record.

That point is related to my third observation, which is that it is not effective to allude to an advice-of-counsel defense without disclosing the key underlying facts, including the privileged communications themselves.

Sometimes, defense counsel will claim at a Wells meeting that privileged information they are unwilling or unable to share is central to the case. For example, during a meeting, they may allude to – but not formally raise – an "advice-of-counsel" defense by noting that they have privileged information that gives them comfort about the legality of the actions taken by a particular employee, or her lack of scienter.

In my experience, alluding to privileged information in Wells meeting – but not sharing it with the staff – is not effective. To be clear, I am not encouraging anyone to waive privilege in these circumstances.

The decision whether to share privileged information is one that must be made by defense counsel and the privilege holder. I simply note that we cannot ground our decision-making on documents we cannot see or testimony we cannot hear.

Fourth, I have found that it can be very effective when defense counsel grounds their arguments in case law and prior Commission actions.

It is ultimately the Commission – not the staff – that decides whether to bring an action, or to accept a settlement. We take very seriously the recommendations we make to the Commission.

In every case, we think hard about what we are recommending, why we are recommending it, and – critically – how it compares to what the Commission has done in past cases. This ensures that we are both fair to the

parties in the case at hand and that we are sending clear, consistent messages to the public.

When you are asking us to make a particular recommendation to the Commission, it can be very helpful to show us how and why that recommendation compares with what happened in prior cases.

This is particularly true when you are asking the staff to recommend that the Commission bring certain charges and not others, or only seek or impose certain types of relief. In these circumstances, pointing to what has been done before can be helpful.

Likewise, if an analogous case has been litigated and resulted in a decision that is at odds with what the Staff has proposed, point us to those precedents as well. Showing us that we are proposing something that is inconsistent with what we would likely obtain if we were to prevail in litigation can be powerful as well.

While pointing to what the Commission or courts have done in the past can be very effective, I will offer a few caveats.

The first is that in most cases, the more recent the court decision or Commission action, the more persuasive it is likely to be. With some exceptions, cases that are superannuated do not speak as clearly about what approach the Commission should or will take today.

Second, while prior Commission actions are very important, there are certainly some matters in which – for case-specific reasons – the Commission has taken an approach that is at odds with what it tends to do in a particular type of case.

Where a case appears to be an outlier, you should take that into account before relying on it too heavily at a Wells meeting.

The third caveat is that we are fully aware that we, like you, are subject to the vagaries and vicitudes of litigation. The fact that the Commission suffered an adverse result in a particular litigation may be a relevant data point, but more often will not carry significant weight.

Fourth, while prior Commission actions are important, my experience has been that it is not particularly persuasive when defense counsel argues at a Wells meeting that we won't have the votes for a particular case, or that a particular Commissioner will not support what we propose recommending.

Stephanie and I are well attuned to the Commission as a whole, and the views of individual Commissioners. We meet regularly with each of them, and we study carefully how they approach various issues.

If you don't succeed in persuading us not to bring charges, you are of course free to take your arguments directly to the Commissioners. But, in my experience, telling us that you know the Commissioners' views better than we do is unlikely to meet with much success.

My next observation is that the most effective advocates think carefully about whether to use visual aids at a Wells meeting. And if they do, they are judicious about the materials they use.

We spend a great deal of time preparing for Wells meetings, and we are typically well-versed in the key facts and issues. For that reason, it is often not necessary for defense counsel to march through handouts or PowerPoint slides that cover background or elementary issues, facts, and legal standards, or which summarize the Wells submission.

So what is helpful? Consider not using anything at all. Although handouts and presentations have their place, they can sometimes inhibit natural and open dialogue.

If you do decide to use some sort of handout or visual aid, I have found that succinct presentations that cover the key evidence and central issues often have the most impact. Of course, what that looks like will depend on the case.

If a particular issue turns on a handful of key documents, a short PowerPoint that highlights those materials can be helpful. Or, if a specific witness is particularly important, it can be helpful to focus on key excerpts from her testimony. In short, I have found that presentations that are focused on the key evidence often have a greater impact.

My next observation is that I have found that it is rarely productive when defense counsel uses a Wells meeting to threaten to take us to trial. For me, saber-rattling is a rhetorical dead-end.

The SEC staff includes experienced and talented trial attorneys. We regularly solicit their views during the investigative process.

Defense counsel can safely assume that if a case has gotten to the Wells stage, we are serious about the case and we have come to the preliminary conclusion that we can prevail if the case is litigated. Simply telling us that the client will litigate achieves nothing.

That doesn't mean you should shy away from providing your views on the risks we will face in litigation and trying to explain to us why we are unlikely to prevail. I have found that it can be very effective if defense counsel summarizes how they might try a case. That could mean previewing anticipated trial themes, or summarizing how you plan to use or diffuse key evidence or witnesses.

I have also found that Wells meetings are least productive when defense counsel raise what I call "non-starters." By "non-starters," I mean issues of programmatic importance on which counsel knows that the Commission and the Division have taken clear and consistent positions, and on which we simply don't have any ability to compromise.

For example, defense counsel will not make much progress if they ask us during a Wells meeting to forego an injunction in a settled district court action due to possible Kokesh statute of limitations issues.

Our district court settlements uniformly include injunctive relief, and the Commission has consistently taken the position that the Supreme Court's Kokesh decision does not apply to injunctive relief.

You are welcome to try to persuade a court to extend Kokesh in a litigated case, but that is not something we are likely able to agree to in a settled context or to forgo based on litigation risks.

My next-to-last recommendation relates to cooperation credit. The SEC has a robust program that is intended to encourage cooperation in SEC investigations and enforcement actions. The program provides incentives to those who come forward and provide valuable information to SEC staff.

As many of you know, we use a framework to evaluate whether, how much, and in what manner to credit cooperation by individuals and entities. The factors we consider are well known and have been set out in a number of public documents, including the Seaboard Report and other Commission policy statements.

When arguing in a Wells meeting that a client should receive cooperation credit, I have seen defense counsel take a number of approaches. Some are more effective than others.

Some, for example, simply run down a laundry list of actions their client has taken during the course of an investigation – such as producing a certain number of documents, or making a certain number of witnesses available for a certain number of days of testimony – and claim that they should receive cooperation credit. In my view, this is not effective.

For one, doing something that your client is already required to do – such as producing documents in response to a subpoena – is not what we consider "cooperation."

Second, simply listing out what actions your client has taken, without more, does not explain the significance of the cooperation. In my view, the more effective approach is to carefully and specifically explain at a Wells meeting how each action your client took aided the staff's investigation in a material way.

How did you help the staff to tailor its investigation, discover new witnesses, or uncover material facts they otherwise would not have known about? In short, explain to the staff – with specificity – how each action your client took materially aided our investigation. Doing so will assist us in explaining to the Commission why your client should receive credit for its cooperation.

My final observation is simple and straightforward: a Wells meeting is not the place to re-hash battles fought with the staff during the investigation.

Long-running SEC investigations – like any high-stakes litigation – can be contentious and hard fought. We strive to keep the scope of our work reasonable and proportionate, but our investigations can take time, and they can often require your clients to expend considerable resources.

While I understand the temptation, a Wells meeting is simply not the place to air grievances about the length of the investigation or shifting theories of the case, or positions the staff took on things like subpoenas, search terms, privilege logs, production deadlines, or testimony schedules.

Stephanie and I expect the Staff to conduct themselves professionally at all times. But just as your clients expect you to be aggressive in representing them, we also expect our staff to be appropriately aggressive as they work to support the Commission's mission of policing the markets and protecting investors.

Ultimately, the Wells meeting is your client's opportunity to educate us on your positions about the key issues. I have found that it is rarely a productive for defense counsel to rehash old disagreements with the staff about the way the investigation was conducted.

Those disagreements won't have a bearing on what we decide to recommend to the Commission. We will make more progress when everyone sticks to the facts and the law.

Conclusion

In conclusion, I'll say that, as I mentioned at the outset, my thoughts today are not grounded in some presumption that we can or should tell you how to do your jobs. How you represent your clients is up to you.

But I do hope that you will find my observations about what we find to be effective helpful as you prepare for your next Wells meeting.

Thank you again to the City Bar for giving me the chance to spend time with you this afternoon, and I hope you enjoy the rest of the conference.

Number 10

Gremlins on Track for Demonstration Flights in 2019

Airborne launch and recovery of low-cost unmanned aerial systems could enhance combat operations in contested areas, present significant per-mission cost savings

DARPA is progressing toward its plan to demonstrate airborne launch and recovery of multiple unmanned aerial systems (UASs), targeted for late 2019.

Now in its third and final phase, the goal for the Gremlins program is to develop a full-scale technology demonstration featuring the air recovery of multiple low-cost, reusable UASs, or "gremlins."

Safety, reliability, and affordability are the key objectives for the system, which would launch groups of UASs from multiple types of military aircraft while out of range from adversary defenses.

Once gremlins complete their mission, a C-130 transport aircraft would retrieve them in the air and carry them home, where ground crews would prepare them for their next use within 24 hours.

A recent flight test at Yuma Proving Ground provided an opportunity to conduct safe separation and captive flight tests of the hard dock and recovery system.

"Early flight tests have given us confidence we can meet our objective to recover four gremlins in 30 minutes," said Scott Wierzbanowski, program manager in DARPA's Tactical Technology Office.

In addition to preliminary flight tests, the team has focused on risk reduction via extensive modeling and simulation. The team looked at how fifth generation aircraft systems like the F-35 and F-22 respond to threats, and how they could incorporate gremlins in higher risk areas.

The gremlins' expected lifetime of about 20 uses could provide significant cost advantages by reducing payload and airframe costs, and by having lower mission and maintenance costs than conventional platforms, which are designed to operate for decades.

The C-130 is the demonstration platform for the Gremlins program, but Wierzbanowski says the Services could easily modify the system for another transport aircraft or other major weapons system. Modularity has made Gremlins attractive to potential transition partners.

“We are exploring opportunities with several transition partners and are not committed to a single organization. Interest is strong with both the roll-on/roll-off capability of the Gremlins system -- as it does not require any permanent aircraft modification -- and a wing-mounted system to provide greater flexibility to a wider range of aircraft,” said Wierzbanowski.

Gremlins also can incorporate several types of sensors up to 150 pounds, and easily integrate technologies to address different types of stakeholders and missions.

DARPA recently awarded a contract to a Dynetics, Inc.-led team to perform the Phase 3 demonstration. The DARPA program team currently is exploring the possibility of demonstrating different sensor packages with potential integration partners prior to program completion in 2019.

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