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Subject:	COMMISSION STAFF WORKING DOCUMENT Accompanying the documents Proposal for a directive of the European Parliament and of the Council amending Directive 2014/65/EU as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries to help the recovery from the COVID-19 pandemic Report from the Commission to the European Parliament and the Council on the creation of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic

Delegations will find attached document SWD(2020) 120 final.

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Brussels, 24.7.2020
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EU Capital Markets Recovery Package

COMMISSION STAFF WORKING DOCUMENT

Accompanying the documents

Proposal for a directive of the European Parliament and of the Council amending Directive 2014/65/EU as regards information requirements, product governance and position limits to help the recovery from the COVID-19 pandemic

Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries to help the recovery from the COVID-19 pandemic

Report from the Commission to the European Parliament and the Council on the creation of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation

Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic

Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic

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Introduction

The Capital Markets Recovery Package forms an integral part of the Commission post-COVID-19 strategy. EU securities market regulation provides for a flexible environment in which the market can operate, even in stress conditions. There is room, however, for further enhancing the role securities markets can play in the recovery. A timely recovery from the COVID-19 pandemic relies on achieving three key objectives:

- Facilitating investments in the real economy;
- Allowing for a rapid recapitalisation of companies listed in the EU;
- Maintaining and enhancing the capacity of banks to lend to the economy, in particular to households and SMEs.

To this end, the Commission proposes a Capital Markets Recovery Package, encompassing light–touch adjustments of MiFID II and the Prospectus Regulation as well as targeted amendments of the securitisation framework (Securitisation Regulation and Capital Requirements Regulation). MiFID II, the Prospectus Regulation and the securitisation framework are at the core of the Capital Markets Union aiming at better integrating national capital markets and ensuring equal access to investments and funding opportunities across the EU.

The purpose of this staff working document is to present the rationale of the proposals in the Capital Markets Recovery Package, and to explain their benefits compared to the status quo, and where relevant, compared to alternative policy options that the Commission has decided not to pursue.

The current crisis makes it even more important to not impose burdens where they are not strictly necessary. Certain requirements could be significantly alleviated, leaving more resources for dealing with the consequences of the crisis. The Commission therefore strives to recalibrate those areas where the right balance between a sufficient level of transparency towards the client, the highest standards of protection and acceptable compliance costs for the firms, is not met.

The targeted amendments to the **Prospectus Regulation** relate to the creation of a new type of short-form prospectus (the "EU Recovery Prospectus") as well as to releasing pressure on financial intermediaries. This proposal therefore aims at simplifying the procedure for issuers to quickly raise capital due to the economic urgency resulting from the COVID-19 pandemic.

In the context of the recovery and to ensure that financial institutions can optimally fulfil their essential function in financing the real economy, a quick adjustment of certain **MiFID II** requirements is indicated. The Commission started looking into measures that would facilitate the recovery of the financial markets at a very early stage. In the light of the MiFID II review, stakeholders had already addressed the Commission in 2019 a warning that several conduct

requirements were unnecessary and overly burdensome, leading to operational constraints and a less optimal allocation of resources which would negatively influence European entities' global competitiveness.

The **securitisation framework** has only entered into force very recently. Nevertheless, the Commission has identified two very specific areas where it can be improved to play a more constructive role in the economic recovery. For a large part, securitisation is used as a funding tool, raising the liquidity banks need to lend to households and businesses. However, banks also need capital to lend and securitisation can help them make the best use of their capital. In particular, their lending capacity can be enhanced if professional investors share the risk of loans with banks, thereby freeing up banks' capital to support new loans. Securitisation techniques that use guarantees or similar instruments to share the risks of loans that remain on the balance sheet of the bank are particularly helpful in this context, and a sound framework that makes them simple, transparent and standardised can promote their use in a way that is beneficial for financial stability. Such a framework is part of the present proposals.

Furthermore, non-performing exposures on banks' balance sheet are a serious burden on the operational capacity and capital resources that banks need for fresh loans to households and businesses. Securitisation can play an important role in providing relief. As it currently stands, the prudential framework, set out in the **CRR**, limits the incentives of banks to make use of securitisation. But with limited improvements to that framework, this problem can be addressed. These improvements are also part of the present proposals.

As the amendment aims at mitigating the effects of the COVID-19 pandemic that are expected to fully surface in the coming months, an early application of the amendments would be most beneficial. The goal should therefore be that the proposed amendments should therefore become applicable at the earliest opportunity.

It is important to prepare now the tools that will be needed to boost the equity of corporates and to maintain and possibly even enhance the lending capacity of banks. These amendments should be considered urgently given their usefulness for economic recovery. Waiting for the upcoming comprehensive review of MiFID II/MiFIR due in 2021 and of the securitisation framework due by January 2022 with possible legislative initiatives if appropriate, would lead to desirable legal adjustments probably only in a few years' time and thus frustrate the goal to promote the economic recovery in the coming months.

Chapter 1 – Changes to the Prospectus Regulation

1 PROBLEMS THAT THE PROSPECTUS PROPOSAL AIMS TO ADDRESS

Need for liquidity - Restoration of equity levels

The COVID-19 pandemic has left a wide part of the real economy in dire need of liquidity to weather the economic consequences that stem from preventive measures that were necessary to curb the spread of the virus. Governments and central banks have organised multiple channels to ensure that short-term funding remains accessible to companies to pursue (and restart) their operations. The immediate focus is on ensuring business continuity.

The initial response to the crisis, in the form of guaranteed loans to safeguard liquidity (phase 1 liquidity), has further contributed to increase the already very high amount of corporate debt, to a level that risks becoming unsustainable for the solvency of many corporates. Whilst the first wave of guaranteed loans have proven effective in maintaining corporate liquidity, it will shortly become necessary to restore the debt-to-equity ratio (solvency restoration). This requires a better market ecosystem for the issuance of new equity.

Restoring the debt-to-equity ratio to levels that were prevalent before the crisis is indispensable in the near term, but it will not be enough to fuel a sustained investment-based recovery. For an effective restoration of the ecosystems/value chains in the EU and a rapid and sustainable recovery based on investment it is necessary to further strengthen the equity base of companies, especially in the small and midcap market segments, over and beyond the pre-crisis level.

To prepare this second wave and facilitate issuing of capital, issuers and investors must be equipped with the right tools to easily issue new capital on the one hand (an objective to be achieved through the implementation of the a new short-form Prospectus) and easily get access to an increased investor base on the other hand (an objective to be achieved through targeted changes to MiFID II under Chapter 2). The earlier these tools are operational, the better for companies and investors alike.

2 CONTENT OF THE PROSPECTUS PROPOSAL AND COST-BENEFIT ANALYSIS

2.1 Creation of a new short-form prospectus for secondary issuances

Problem to be addressed

A prospectus is a legally required document presenting information about a company and the securities that such companies offer to the public or seek to admit to trading on a regulated

market. This information should be the basis on which investors can decide whether to invest in securities issued by that company. The cost of drawing up a prospectus might act as a deterrent for issuers in financial distress seeking to raise new funds, in particular equity. Due to the situation resulting from the COVID-19 pandemic, it is crucial to ensure that the prospectus regime does not act as a barrier to raise capital on public markets. This proposal therefore aims at simplifying the procedure for issuers to quickly raise capital due to the economic urgency resulting from the COVID-19 pandemic.

Options

As part of the measures to soften the impact of the COVID-19 pandemic on the real economy and financial markets, the Commission would consider introducing a new type of short-form prospectus called the "EU Recovery prospectus". Option 1 creates a new prospectus that could be used for initial public offerings and secondary issuances of all types of securities, including complex securities.

Under Option 2, the short-form prospectus could only be used for secondary issuances of shares by issuers already listed for at least 18 months.

Policy choice

The preferred option is Option 2 and thus to create a short version of the current prospectus for secondary issuances of shares. Its specific features are detailed below.

Scope. The EU Recovery prospectus would be available only to issuers that have shares already admitted on a regulated market or an SME Growth Market for at least 18 months. It would take advantage of the fact that, being listed, issuers have already experience with capital markets and are subject to comprehensive disclosure requirements, such as under the Transparency Directive or the Market Abuse Regulation. In particular, subject to certain exemptions, the Transparency Directive requires issuers whose securities are admitted to trading on a regulated market to publish the annual and half-yearly financial reports. The same requirement, subject to certain exemptions, applies to issuers whose securities are traded on an SME Growth market, in accordance with Commission Delegated Regulation (EU) 2017/565. The Market Abuse Regulation sets out several disclosure requirements applicable for regulated issuers, Multilateral Trading Facility issuers (including SME Growth market issuers) and Organised Trading Facility issuers. Such disclosures include the requirement for the issuer to inform the public as soon as possible of inside information which directly concerns that issuer.

For the reasons mentioned above, the EU Recovery prospectus would not be suitable for initial public offerings where potential issuers would have no long track record on financial markets. In addition, to reduce the debt-to-equity ratio for companies highly indebted due to the COVID-19 pandemic, the short form prospectus could only be used for share issuances.

Content and approval of the EU Recovery prospectus. The EU Recovery prospectus would focus on essential information. As an exception to Article 6 of the Prospectus Regulation, key items have been identified as elements to be disclosed by issuers and are listed in the new Annex Va to the Prospectus Regulation. The EU Recovery prospectus would be shortened to a maximum of 30 pages. However, as a balancing measure, incorporation by reference of information already available in the market as defined in Article 19 of the Prospectus Regulation would be allowed and that information would not be taken into account in the above mentioned maximum size of 30 pages. It would also include a short-form summary.

A fast track approval procedure already exists in the Prospectus Regulation. Based on this, the EU Recovery prospectus would also benefit from such fast track approval of no more than 5 working days.

Temporary regime and assessment of the regime. Such a short-form Prospectus aims at helping recapitalisation during the recovery phase. It is therefore conceived as a temporary regime that expires 18 months after the date of application of the regulation. As part of the Prospectus Regulation review, it should be assessed whether this initiative meets its objectives. In particular, key parameters to measure achievement of the stated objectives of the EU Recovery prospectus would be (a) the number of EU Recovery prospectuses approved and an analysis of the evolution of such number as well as (b) the cost of preparing and having an EU Recovery prospectus approved compared to the current costs for a secondary issuance prospectus together with an indication of the overall financial savings achieved. To make this assessment useful, the proposal would require that the ESMA centralised storage mechanism collecting prospectus data from national competent authorities would also collect data on EU Recovery Prospectuses. This should not incur significant additional costs.

Cost-benefit analysis. The simplified disclosure regime of the EU Recovery prospectus aims to significantly reduce compliance costs for issuers. Based on the fact that, compared to a full secondary issuance prospectus, approximately half of the disclosure elements are not required to be disclosed in an EU Recovery prospectus, the cost of an EU Recovery prospectus could be estimated to be by about 50% lower than the cost of a prospectus for secondary issuances.

The costs of a prospectus generally depends on the market capitalization of the company, legal and auditor costs, the type of security issued as well as the amount of the issuance. Based on the analysis performed in the impact assessment for the Commission proposal for the Prospectus Regulation[1], the average cost of an equity prospectus is EUR 1 million and the average cost of a secondary issuance prospectus is expected to be EUR 800 000 (20% estimated savings compared to a full equity prospectus). Based on the assumption that the cost of an EU Recovery prospectus is half the cost of a secondary issuance prospectus, issuers would save approximately EUR 400 000 per prospectus. Pursuant to the latest report on EEA

[1] SWD(2015) 255 final.

prospectus activity[2] published by ESMA on 31 October 2019, a total of 3 390 prospectuses have been approved in the EEA in 2018, including 21% of share prospectuses (i.e. 712 prospectuses).

Based on the analysis performed in the impact assessment for the Commission proposal for the Prospectus Regulation, an average of 70% of all equity prospectuses were relating secondary issuances. Taking as an assumption that 70% of share prospectuses approved in the EEA in 2018 (i.e. 498 prospectuses) are secondary issuance prospectuses, the estimated total amount of yearly savings in the EEA stemming from the EU Recovery prospectus regime would account for about EUR 200 million per year. The EU Recovery prospectus should also reduce the workload of national competent authorities as less information would have to be scrutinized. At the same time, the approval process would be faster.

2.2 Targeted amendments for financial intermediaries

2.2.1 Supplements

Problem to be addressed

An issuer is required to publish a supplement to the prospectus for any significant new factors, material mistakes or material inaccuracies relating to the information included in a prospectus which may affect the assessment of the securities and which arises or is noted between the time when the prospectus is approved and the closing of the offer period or the time when trading on a regulated market begins, whichever occurs later. The publication of a supplement triggers a withdrawal right for the investors to be exercised within two working days from the publication of the supplement. As part of their duty to protect investors, financial intermediaries must contact investors to inform them that a supplement was published on the day where the supplement is published. Such a deadline, as well as the broad qualification of "investors", have created difficulties for financial intermediaries.

Options

To deal with these difficulties and free up resources for financial intermediaries, both Option 1 and Option 2 would propose to extend to 1 working day (rather than the same day) the time period during which financial intermediaries should contact investors. To maintain a high level of investor protection, the period during which the withdrawal right could be exercised by investors would be extended from two working days to three working days from the publication of the supplement. Both Options would also require the financial intermediaries to only contact investors that benefit from a withdrawal right.

Under Option 1, there would be a distinction between situations where the financial intermediaries provided advice to investors and situations when it did not. In situations where

[2] https://www.esma.europa.eu/sites/default/files/library/esma31-62-1360_eea_prospectus_activity_in_2018.pdf

investors received an advice from the financial intermediary and the investors benefit from a withdrawal right, the financial intermediary shall contact the investors to inform him that a supplement has been published. In other situations, the financial intermediary would only have to publish a notice on its website informing that a supplement has been published. Under Option 2, such distinction would not be made. All investors benefiting from a withdrawal right would be contacted by the financial intermediary.

Policy Choice

The preferred option is Option 2. Financial intermediaries would benefit from targeted amendments that will help them to overcome the difficulties they met to effectively reach investors when a supplement is published while maintaining a high level of investor protection. As the targeted amendment on supplements would fix difficulties, such amendment would not be limited in time.

2.2.2 Non-equity securities issued by credit institutions

Problem to be addressed

An offer of non-equity securities issued in a continuous or repeated manner by a credit institution is, under certain conditions, not subject to the obligation of publishing a prospectus if the total consideration is less than EUR 75 million per credit institution calculated over a period of 12 months (Article 1(4)(j) of the Prospectus Regulation). These non-equity securities should not to be subordinated, convertible or exchange and should not give the right to subscribe for or acquire other types of securities and are not linked to derivative instruments. Credit institutions have been active in the recovery to support companies that needed financing and are expected to be a fundamental pillar of the recovery.

Options

Option 1 would consist of the status quo for credit institutions. Under Option 2, in order to help credit institutions by making it easier for them to have more financing and bring them a breathing space to support their clients in the real economy, it would be proposed a targeted temporary increase of the threshold from EUR 75 million to EUR 150 million.

Policy choice

The preferred option is Option 2. This targeted amendment aims at supporting the financing of credit institutions in the recovery phase by increasing the prospectus exemption threshold for certain type of offers of securities. As this measure is directly linked to the recovery phase, it should be available for a limited period of time of 18 months.

Chapter 2 – Changes to the MiFID framework

3 PROBLEMS THAT THE MIFID PROPOSAL AIMS TO ADDRESS

3.1 Operational constraints and allocation of resources

With the anticipation that revenues might decrease in a number of sectors, companies focus on reorganising their operations and allocating their internal resources where most value is created. The compliance/reporting functions of investment firms could focus on what contributes to the orderly functioning of the markets and the safeguarding of high investor protection standards.

A recent study by the sector shows that MiFID II provisions have resulted in an increase in resources spent on interactions with clients and, on average, in more than EUR 4 million of recurrent costs.[3] A significant part of the compliance costs[4], as indicated by another source, relates to the drafting, producing and emailing of reports. In the current circumstances, these budgets could be partially reallocated to support the business lines. Other key business projects have been delayed to allow IT and compliance departments to implement the new MiFID II requirements.

Furthermore, it often proves more costly and time-consuming to produce information remotely than to produce the same information from the centralised offices where access to IT systems and servers works more efficiently. This is for example evidenced by ESMA's

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[3] For the German market see Paul, S., Schröder, N. and Schumacher, S. (2019), "Impact study of MiFID/MiFIR and PRIIPs Regulation: effectiveness and efficiency of the new rules against the backdrop of investor and consumer protection – a qualitative empirical analysis", Ruhr University Bochum on behalf of the German Banking Industry Committee. For Luxembourg, LU ABBL indicated a yearly compliance cost of EUR 1,8 million on average per member. The European Federation of Financial Advisers and Financial Intermediaries (FECIF) highlights the significant costs also for smaller firms: Professional insurance for a very small company (0 to 110 000€ turnover): 1500€/year; Basic software: 7000€; Association and Authorities: 1500€/year; Training: 500 to 2000€/year/person; Compliance company: 1500 to 7000€/year; Documentation : 1000 to 2000€; Compliant website: 2500€ + cost of staff time if 50 customers (level which seems low for any standard, viable companies): 30000€ + management and updating of internal procedures compliance (1 week full time/year): 5 to 10 000€. In total: between 50000€ and 63500€, i.e. more than 50% of turnover.

[4] Study by the Johannes Kepler University Linz "Studie Buerokratiebelastung der Banken in Niederoesterreich 2017" (May 2018) came to the conclusion that the implementation costs of MiFID II have been very high and for some banks even higher than the burden of other regulatory acts. Table 5.1 (page 49) shows that in some areas MiFID II produces more costs for Austrian banks than the Capital Requirements Regulation (CRR). The running costs including overhead and pro rata non-recurring costs (as can be seen in the table) which were caused by MiFID II exceed the corresponding costs caused by the CRR in two of the three reference banks (No. 2 and No. 3). For reference bank No. 3, the costs which were caused by MiFID II were more than twice as high as the costs caused by CRR.

statement[5] that firms may need to deprioritise efforts for the publication of best execution reports due to the exceptional circumstances created by the COVID-19 pandemic. Once again, alleviating the reporting burden would help companies to remain efficient and competitive in the recovery phase.

In parallel, ESMA will continue to collect the necessary data for monitoring the effects of the COVID-crisis on investment firms and investment activities in Europe and how the crisis affects markets and supervisory practices. This will allow for the future evaluation of the new policy tools. Additionally, the Commission services will continue to carefully monitor the latest developments and to engage in the relevant fora, such as the European Securities Committee (ESC).

Compliance and enforcement will be ensured on an ongoing basis where needed through the Commission launching infringement proceedings for lack of transposition or for incorrect transposition or application of the legislative measures. Reporting of breaches of EU law can be channelled through the European System of Financial Supervision (ESFS), including the national competent authorities and ESMA.

3.2 Risk to competitiveness at global level

In the aftermaths of the COVID-19 pandemic, companies around the globe will face similar economic and organisational challenges. Those able to recover promptly are likely to be those companies that can adjust quickly and allocate their financial and human resources to prepare the exit from the crisis. EU companies must therefore be given the flexibility to adjust quickly and restore profitability.

Absent such flexibility, the risk is that EU companies would be slower in exiting the crisis and less competitive at international level compared to their competitors. This reasoning applies particularly in the field of energy trading.

Energy exchanges play an important role for the real economy as they provide accurate and trusted price signals for market participants to hedge their risks. The COVID-19 pandemic caused an energy demand-shock followed by unusual changes in prices and volumes. Changing market fundamentals have required market participants to adjust their risk exposure.

The real economy needs to be able to react to the risk of price fluctuations. This allows to produce as efficiently as possible and to avoid costs that would otherwise have to be passed through to the end consumers. Certain provisions in the MiFID framework for energy trading could prevent a quick recovery and therefore changes are proposed to simplify requirements,

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[5] https://www.esma.europa.eu/press-news/esma-news/esma-provides-clarifications-best-execution-reports-under-mifid-ii.

provide for cost savings and ensure a level playing field with the global energy trading markets.

4 CONTENT OF THE MiFID PROPOSAL AND COST-BENEFIT ANALYSIS

4.1 Amendments in the field of investor protection

In order to situate the stakeholder impacts of the proposed amendments in the area of investor protection, it is useful to establish an overview of the different types of MiFID II stakeholders that will be affected by the proposed changes to the MiFID II rulebook. The MiFID II rules apply to two basic client categories: qualifying clients and retail clients. Within the category of qualifying clients, the following distinctions apply:

BOX 1: EU QUALIFYING CLIENTS

	Eligible counterparties	Professional clients
Authorised financial institutions	+	+
National governments and public debt management bodies	+	+
Central banks and supranational organisations	+	+
Large undertakings	*	+
Regional governments and public debt management bodies	*	+
Other institutional investors, including securitisation and financing SPVs	*	+

Notes: Classification of an entity as an eligible counterparty is subject to the entity's right to request treatment as a professional client or express consent to treatment as such. Authorised financial institutions includes investment firms, banks, insurance companies, UCITS, alternative investment fund managers and pension funds. Large undertakings must meet two of the following on a company basis: total assets of EUR 20 million; net turnover of EUR 40 million; own funds of EUR 2 million. There is overlap between the eligible counterparty class and the professional client class. It depends on the investment service or activity that is being provided or performed if a client is either a professional client or an eligible counterparty. A client, such as a financial institution, will be an eligible counterparty in the course of dealing on own account, execution of orders or receiving or transmitting of orders, while he will be a professional client in the course of portfolio management or investment advice.

* At Member State discretion.

4.1.1 Paper-based investor communications

Problem to be addressed

Currently, MiFID II requires all investment information to be provided in a "durable medium", which includes electronic formats (e.g. E-mail, a determined webpage or an electronic mailbox) but paper remains the default method for communication (i.e. if the client does not actively request the use of electronic information paper will be the default option). Not only have some firms anticipated difficulties in relation to the provision of paper-based disclosures to clients during the COVID-19 crisis, but this default option for communication is also in misalignment with the objectives of the Commission's Green Deal and its Digital Finance Agenda. In addition, the printing and mailing of the numerous information documents required by MiFID II leads to significant costs for investment firms. Almost all respondents of the MiFID II Public Consultation supported a phase-out of paper-based information. The economic downturn caused by the COVID-19 pandemic has made it even more urgent to facilitate the investment process to increase the funding alternatives for European companies and to enable investment firms to use resources more efficiently.

Relevant samples illustrate that only between January and May 2019 a Nordic medium sized banking group with 2.7 million private clients (31% of which had invested into capital markets) had 405 000 pages of ex-ante information printed and sent in paper. End-of-the year reports and first quarterly reports amounted to 8.8 million pages in 2019, of which 3 million pages were sent to clients in printed-paper. Another banking group from Southern Europe estimates that (pre-contractual and contractual) disclosure rules require 48 sheets on average per client in the first year and 4 sheets on average per client in each following year.

Based on the Nordic example, it can be estimated that around 1/3 of the clients still receive their investment information by post, which is expensive (paper, printing, postage etc.). Already in 2018 the public tariffs for 20gr letters sent within one country were on average roughly one euro. Considering the various information requirements throughout the phase of an investment, the most optimistic estimation requires that the information is at least provided on an annual basis to the client. Taking into account that in the first quarter of 2019, households' total holdings of securities at Euro area level reached EUR 3 707 billion[6] and extrapolating that around one third of them receives information by postal services, only the cost for the letters could amount to around tens of millions annually.

Options

Given that paper-based information is a model of the past that is not only causing significant cost but that is also detrimental to the environment, doing nothing would be the least favourite option. It is essential that resources are used efficiently and effectively. This is especially true now when firms need additional resources to recover from the economic repercussions of the COVID-19 pandemic.

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[6] See Household wealth and consumption in the Euro area, ECB Economic Bulletin, 01/2020: https://www.ecb.europa.eu/pub/economic-bulletin/articles/2020/html/ecb.ebart202001_01~6ce994a1f7.en.html

As professional clients are permanently able to view their investment portfolios online (or contact their investment advisor where necessary), providing them with a plethora of paper-based statements has already become superfluous. A complete switch to electronic communication would have the strongest impact on the reduction of carbon emissions[7], accelerating the Digital Agenda, and on cutting back costs for the printing and mailing of these documents[8].

This radical option, however, was dismissed at an early stage as it did not sufficiently consider the needs of retail clients. According to Eurostat[9], the share of EU-28 households with internet access has risen to 89% by 2018. More than four fifths (85%) of all individuals in the EU-28, aged between 16 and 74 years, used the internet (at least once within the three months prior to the survey date). The proportion of the EU-28's population that had never used the internet was 11% in 2018. While it can be assumed that the number of those citizens using the internet on a regular basis has risen since 2018 there still seems to be a relevant part of the European population that might not have access to information and communication technologies (ICTs) or that simply does not want or is not capable of using it.

The second option would therefore require firms to continue providing paper based information to retail clients where the retail client explicitly requested it.

Policy choice

While the first option would meet the objective of freeing up resources and of contributing to foster investments in the real economy even more than the second option, the second option has the advantage of duly addressing the needs of the weakest client category: clients that are not able or willing to use digital means of communication and that might therefore already be disadvantaged as regards to the timeliness of the information.

On the basis of the above assessment the preferred option would consist in a phase-out of paper-based communication as the default option in MiFID II. Retail investors may nevertheless be allowed to request paper based information.

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7 The European pulp and paper industry, the 4th largest industrial energy user in EU, has the potential to contribute to the main objectives (stemming from the global commitments) to combat climate change, that are a 20%, 40% and 80% reduction in GHG emissions compared to 1990 by 2020, 2030 and 2050, respectively. See JRC study "Energy efficiency and GHG emissions: Prospective scenarios for the pulp and paper industry" from 2018: https://publications.jrc.ec.europa.eu/repository/bitstream/JRC111652/kjna29280enn_jrc111652_online_revised_by_ipo.pdf

8 Large banks claim that these costs could amount up to EUR 4 million for all information documents provided within a year.

9 See Eurostat Article "Digital economy and society statistics - households and individuals": https://ec.europa.eu/eurostat/statistics-explained/index.php/Digital_economy_and_society_statistics_-_households_and_individuals.

4.1.2 Cost and charges disclosures

Problem to be addressed

Article 24(4) of MiFID II requires that information on costs and charges must include information relating to both investment and ancillary services, including the cost of advice, the cost of the financial instrument and how the client may pay for it, also encompassing any third-party payments. Firms are also required to provide further cost and charges information ex-post (e.g. annual post-sale aggregated information).[10] Cost information is supposed to provide investors with basic levels of transparency regarding pricing and enables them to compare different investment opportunities. Eligible counterparties (ECPs) and professional clients, however, have access to such information through other channels (especially their own parallel price enquiries). Such client groups also organise competitive tender procedures for investment services before choosing a provider. Professional clients and ECPs furthermore generally place a large number of high value orders compared to those placed by retail investors and attach great importance to swift order execution.

Options

One option to address this issue would be a clear-cut exemption from the cost and charges disclosure without any conditions. To ensure an adequate level of protection, however, this exemption should not cover investment advice and portfolio management. The advantage of this option lies in its simple application. This option would also allow for a significant reduction of red tape that would free resources that could be used more efficiently.

The second option encompasses a more tailored two-tier approach:

i. the introduction of a general exemption for eligible counterparties; and
ii. the introduction of an opt-out for professional clients, in relation to all services.

With an amendment to Article 30(1) of MiFID II, ECPs would be fully exempted from receiving costs and charges information as required by Article 24(4) of MiFID II. Further, the exemption and the opt-out for professional clients should cover all MiFID II services. Professional clients would have the possibility not to receive information (whether ex-ante and ex-post) on costs and charges. Further, firms would be required to keep records of the documented requests to opt-out and they should contractually agree with their clients what type of information the client will receive instead.

The exemption of eligible counterparties from the cost and charges information requirements would allow firms to stop producing information sheets[11] that are not read by their

[10] See also Article 50 of Delegated Regulation 2017/565.

[11] An Austrian Banking Group estimated that approximately 16 hours per day (summed up over all relevant front-offices of the group) would be spent on cost disclosure for eligible counterparties alone (not including systematic record keeping or additional costs and errors for systems, data storage etc.).

counterparties without establishing additional bureaucratic procedures for the opt-out process for ECPs. It will facilitate the provision of services for ECPs as the application of the cost disclosure requirements may lead to delays in the execution of transactions for participants for whom time is of essence and may therefore have a negative impact on best execution. ECPs will, on their own volition, put brokerage firms in competition when requesting pricing for their trades. This provides these investor groups with more influence and control of the prices than average retail clients. Both these type of investors and the involved firms should not have to invest resources in this part of the investment process. For these reasons, ESMA[12] and the vast majority of professional clients and ECPs requested a full exemption from the cost and charges information.

Option 2 would further include an opt-out for professional clients from information requirements across services. The introduction of an opt-out option for professional clients would allow for a tailor made regime that enables the client to take his/her individual situation into account. The inclusion of advisory services and portfolio management into the opt-out option would cover many more services than Option 1. There are currently around 10 000 (including third country) investment firms registered with ESMA.[13] According to information compiled by the EBA[14], around 85% of EEA investment firms limit their activities to investment advice, the reception and transmission of orders, portfolio management and the execution of orders. Nearly 40% of EEA investment firms are authorised exclusively to provide investment advice. Around 20% are authorised to carry out dealing on own account and underwriting.

While some professional clients that are less experienced might benefit from standardised information documents, those that prefer more individualised information would have the chance to negotiate a different information setting. Professional clients would thus gain much more flexibility without giving up their high level of protection. The disadvantage connected to an opt-out is that it would be considerably less suitable for reaching the objective of freeing up resources due to the policies and procedures firms would need to have in place to cater for the provision of the documents.

Policy choice

The preferred policy choice is option 1. ECPs and professional clients using other services than investment advice and portfolio management are deemed familiar with the way that capital markets function. Their need for information and for protection are significantly different from those of the more heterogeneous group of retail clients. Cost information is

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12 https://www.esma.europa.eu/sites/default/files/library/esma35-43 2126_technical_advice_on_inducements_and_costs_and_charges_disclosures.pdf

13 https://registers.esma.europa.eu/publication/searchRegister?core=esma_registers_upreg .

14 EBA report on investment firms, response to Commission's call for advice of December 2014 (EBA/Op/2015/20), Table 12: Population of investment firms, by category, by country, page 96. https://www.eba.europa.eu/documents/10180/983359/EBA-Op-201520+Report+on+investment+firms.pdf

supposed to provide investors with basic levels of transparency regarding pricing and enable them to compare different offers. ECPs and professional clients have access to cost and charge information as part of individual negotiations with their financial service providers. ECPs and professional clients furthermore generally place a large number of high value orders compared to those placed by retail investors and attach great importance to swift order execution.

Cutting red tape has become even more urgent during the COVID-19 pandemic, which placed the EU's economy and financial system under strain. Streamlining the investment process for wholesale clients will further channel alternative financing option to those enterprises that are in need of new equity. In order to simplify the administrative procedure as much as possible, the provision of opt-ins or opt-outs will not be required. In order not to reduce the level of information made available to retail investors, the proposed exemption should not apply to cost and charges disclosures for retail clients who have not opted into the professional client status.

4.1.3 Delayed transmission of cost and charges disclosures

Problem to be addressed

The information requirement in Article 24(4) of MiFID II also has an important timing element: the information should be provided in "good time". Many transactions with all categories of clients tend to be concluded over the phone or by online means. However, all client categories have come to expect immediate execution of such "distance orders" as a standard service.

Options

One option to tackle the current impediment to the usage of distant communication would be to only allow professional clients to make use of the general possibility to opt-out to consent into a delayed transmission of this information. While this option would maintain a high level of protection of retail clients, it would also put retail clients at a disadvantage as regards to the swiftness with which a transaction can be executed by means of distance communications.

The second option is to align the cost and charges information requirements with the requirement set-up in the Regulation (EU) No 1286/2014 and Directive 2002/65/EC. Where the agreement to buy or sell a financial instrument is concluded using means of distance communication, the investment firm may provide the information in an electronic format without undue delay *after* the client is bound by any agreement, provided both the following conditions are met: the investment firm has given the client the option of delaying the transaction and the client has consented to receiving the information without undue delay. The decision to undertake transactions on the phone is mainly driven by timing constraints. This option will thus enable all investor categories to invest fast.

Further, this option will not only follow the advice received by ESMA on 1 April 2020, but is also in line with the feedback received during the public consultation on the MiFID II review: almost all stakeholders agreed that, when using distant communication (telephone in particular), the cost information could also be provided after the transaction is conducted in order to avoid delays. As many participants were of the view that the existing ESMA Q&As already authorised the delayed provision of this information anyways, this option will finally harmonise diverging practices and address the existing legal uncertainty within the EU. This proposal is also best suited to free up resources to help the recovery from the crisis resulting from the COVID-19 pandemic and help to foster investments in the real economy.

Policy choice

In line with the views of ESMA and the majority of stakeholders in the MiFID II consultation, the preferred policy is an option for all investors, including professional investors as well as retail investors, to agree to the ex post delivery of cost and charges disclosures, in case an order is placed by means of distance communication. This corresponds to option 2.

4.1.4 Periodic statements and loss reports

Problem to be addressed

MiFID II requires investment firms to send a quarterly statement to clients describing the services they have received. Wholesale clients (ECPs and professional clients) have indicated that they see no value in receiving these statements. Stakeholders have therefore requested that these client categories are given the choice to stop receiving all of the regular reports. According to the majority view of participants in the MiFID II consultation, these client categories should be given the possibility to decide whether they see value in receiving these periodic statements or whether they do not derive any benefit from receipt of such standardised disclosures.

Article 25(6) of MiFID II requires investment firms to send service reports to clients regarding the services they have provided. These reports include the loss-reporting reports that are triggered by 10% portfolio losses. When markets are extremely volatile, these reports can even have negative effects on the clients when redeeming too early. These reports also include, client execution reports, quarterly performance reports and quarterly statements of client financial instruments or funds. Stakeholders have informed us that these reports provide little added value in wholesale relationships. The information is either already obtained through other means, or is not helpful or even potentially detrimental.

Client execution reports require firms to provide to clients information about the execution of an order. This information is potentially duplicative to trade confirmation requirements in EMIR and therefore should not have to be applied in case a wholesale client does not need it. Similarly for the quarterly statements on the performance of the portfolio wholesale clients, in particular other financial institutions, have other means of tracking their portfolio and might not be interested in receiving mandatory statements. The end of day loss reporting

requirements are triggered when the overall value of a portfolio depreciates by 10%, and every multiple of 10% thereafter. When markets are extremely volatile, these reports can have negative effects on the clients, inciting them to redeem their investments at a point in the market cycle which is least favourable to them.

Options

The first option is to exempt ECPs and professional clients from all the service reports that do not touch upon portfolio management or investment advice (general exemption).

The second option is to exempt eligible counterparties and professional clients from all the service reports and to offer professional clients the flexibility to choose to receive them by allowing them to opt-in (individualised opt-in).

Both option 1 and option 2 contribute to the objectives of freeing up resources and fostering investments in the real economy by firms no longer having to draw up and provide service reports and investors no longer having to receive and go through hem. Option 2 potentially frees up more resources as covers services reports in relation to all MiFID services (in particular in relation to portfolio management). The service reports would not have to be provided anymore but professional clients could still opt-in. This flexibility under Option 2 allows the individual interests and needs of professional clients to be taken into account instead of providing them standardised and automatically triggered information. Therefore the individualised treatment granted by option 2 is the preferred option

Policy choice

The policy choice is option 2. Periodic reports will therefore no longer apply with regard to eligible counterparties and professional clients, while professional clients have the choice to opt-in to receiving any or all of the reports. We propose to add Article 25(6) of MiFID II to the list provisions (laid down in Article 30(1) of MiFID II) that do not apply with regard to eligible counterparties and to the list in the newly to be created Article 29a of MiFID, containing the exemptions for professional those articles for which professional clients can opt-in to.

Retail clients will keep receiving all the service reports but the frequency of these reports will be amended (e.g. the reporting obligations for portfolio management will become biannual instead of quarterly) as the regular active provision of several reports will be unnecessary when clients will have constant digital access to their accounts (see phase out of paper-based information).

4.1.5 Best execution reports

Problem to be addressed

Article 27(3) of MiFID II requires that each trading venue and systematic internaliser for financial instruments subject to the trading obligation in Articles 23 and 28 of Regulation

(EU) No 600/2014 ('MiFIR') and each execution venue for other financial instruments, makes available to the public data relating to the quality of execution of transactions on that venue periodically. These periodic reports need to include details about price, costs, speed and likelihood of execution for individual instruments.

The Delegated Regulation (EU) 2017/575 provides regulatory technical standards that the best execution reports have to meet. The reports need to contain large amounts of detailed quantitative information about the execution venue and financial instrument, the price, the costs and the likelihood of execution. In reply to the public consultation almost 70% of respondents who provided input on best execution indicated that they do not find the best execution reports useful. An even larger percentage stated that the current granularity of best execution reports does not strike the right balance between the costs of generating best execution reports and the benefits for investors. Stakeholders indicate that the reports are rarely read by investors, evidenced by very low numbers of downloads from their website. It is therefore assumed that investors cannot or do not make any meaningful comparisons between firms on the basis of this data.

Buy-side firms informed us that they receive all the relevant information on best execution through other means (e.g., via brokerage meetings). Stakeholders mention that firms have spent significant amounts of money to implement the requirements, they mention numbers around EUR 1 million. Several stakeholders indicate further that the production of the reports is costly. The current crisis has increased the urgency to address problems with regard to the best execution reports. This is evidenced by ESMA's statement[15] that firms may need to deprioritise efforts for the publication of these reports due to the exceptional circumstances created by the COVID-19 pandemic.

Options

The Commission's services compared two options to the baseline of doing nothing. The first option is to provide an amendment to Article 27(3) of MiFID II in order to considerably simplify the reporting requirements. The second option is to suspend the requirement to publish the best execution reports altogether until 2022 in order to make an assessment whether changing the requirements would create meaningful information for investors. Given that it is clear that the reports in their current form provide little or no useful information and are therefore not read by investors, but that the production of these periodic reports is burdensome, doing nothing would be the least favourite option.

It is essential that investment firms use resources efficiently and effectively. This is especially true now they need additional resources to recover from the crisis. Due to the significant implementation costs, stakeholders advised to not make any changes to the reports that would necessitate additional implementation measures and costs, without a thorough cost-benefit

[15] https://www.esma.europa.eu/press-news/esma-news/esma-provides-clarifications-best-execution-reports-under-mifid-ii.

analysis. All the measures proposed in this Capital Markets Recovery Package need to be adopted and implemented urgently. As a consequence it is not possible to investigate sufficiently which requirements an effective best execution report would need to meet.

The first option would therefore not meet the objective to free up resources and to contribute to foster investments in the real economy. The second option, to suspend the best execution report altogether, would free up resources currently used for production of the report, without requiring firms and venues to invest in costly implementation. This option does not lead to a decrease of investor protection since investors currently do not read the reports at all and buy-side firms receive the relevant information through other means. In the context of the full review of MiFID II in 2021 the Commission will assess whether the requirement to publish the report should be deleted permanently, or if the reports need to be reintroduced in a revised manner.

Policy choice

The preferred option is therefore to insert a new subparagraph in Article 27(3) of MiFID II in which the reporting requirement will be suspended until 2022 which corresponds to option 2. The time limit reflects that there will be a new assessment of the reports during the review with legislative initiatives, if appropriate, that is provided for in 2021.

4.1.6 Cost-benefit analysis in case of switching

Problem to be addressed

As part of their suitability assessment, investment firms are currently required to undertake a cost-benefit analysis of certain portfolio activities, which involve a "switching" between products. In this context, before executing a product switch, investment firms are required to obtain the necessary information from the client and be able to demonstrate that the benefit of the product switch outweigh the costs.

Article 25(2) of MiFID requires firms to perform a suitability assessment when they provide investment advice or portfolio management. This provision applies to retail clients and to professional clients. Eligible counterparties are excluded by virtue of Article 30(1) of MiFID. With regard to clients that, based on Annex II, chapter II, paragraph II, MiFID are professional clients on request, firms need to obtain such information as is necessary to have a reasonable basis for determining that the specific transaction to be recommended, or entered into meets the investment objectives of the client, including the client's risk tolerance, and that the client is financially able to bear any related investment risks consistent with his investment objectives. With regard to professional clients in Annex II, paragraph I, firms may assume that the client is able to financially bear the investment risks.

In case of ongoing relationships firms are currently required to undertake a cost-benefit analysis of certain portfolio activities, which involve a "switching" between products. In this context, before executing a product switch, investment firms are required to obtain the

necessary information from the client and be able to demonstrate that the benefits outweigh the costs. Suitability testing in case of a product switch is viewed as applying to all portfolio activity, rather than primarily to switches between comparable products, such as the sale of a European Equity investment fund and the purchase of a European Equity ETF, with broadly the same underlying components.

Options

The Commission compared two options to the baseline of doing nothing. The first option allows professional clients to opt-out of the suitability assessment altogether. The second and preferred option is a targeted exemption of the cost-benefit analysis in case of switching for professional clients, with the possibility to opt-into the requirement.

Doing nothing would have no effect with regard to achieving the objectives of freeing up resources and contributing to foster investments in the real economy. Allowing all professional clients to opt-out of the suitability assessment altogether would free up resources in firms that would have to perform less assessments and would, by allowing professional investors to invest in a wider range of instruments, contribute to fostering investments in the real economy. Currently, however, we do not have concrete numbers to quantify this effect. The category of professional investors consists of credit institutions and investment firms, but also to large undertakings that not necessarily have extensive financial experience or knowledge. Allowing them to be exempted from the suitability assessment exposes them to potential risks, which is the main disadvantage of option 1.

Option 2 would free up resources as a consequence of firms no longer having to perform the cost-benefit analyses in the course of portfolio management. In this option the professional investors will remain protected by the firm's general suitability requirements against taking unwanted risks, and moreover by the cost benefit analysis in case they have opted into this requirement. Option 2 is therefore the preferred option. This option is effective in achieving the objectives to free up resource, neutral with regard to fostering investments in the real economy, but has the advantage over option 1 that professional investors will remain protected against mis-selling. For retail clients the requirement remains unchanged.

Policy choice

The policy choice is option 2. The proposal is to insert a new paragraph to Article 25(2) of MiFID II setting the requirements for the cost-benefit analysis as they are currently in Article 54(11) of Delegated Regulation (EU) 2017/565, and to add a reference to this new paragraph in the new Article 29a of MiFID, thus exempting them, while allowing them to opt-in.

4.1.7 Changes to the product governance rules

Problem to be addressed

The product governance requirements currently apply to all financial instruments and regardless of the client, even though there seems little benefit in assessing the particularities

of a plain vanilla bond when transactions take place between eligible counterparties. In its guidelines on product governance, ESMA has already partially addressed this lack of proportionality by explicitly recommending further flexibility for "non-complex products".

Stakeholders have submitted evidence in the MiFID II consultation that product governance rules for certain instruments, which are often referred to as "plain vanilla" issuances have prevented an optimal allocation of capital by means of vibrant secondary markets. Stakeholders have also put forward the opinion that removing product governance obligations from, e.g., "plain vanilla" shares or corporate bonds with "make-whole" clauses would not increase the likelihood of mis-selling. Their argument is that for simple products such as plain vanilla shares or corporate bonds, the main protection against mis-selling are the suitability assessment, for advised sales and discretionary portfolios, and the appropriateness assessment in others cases. Product governance requirements for these asset classes have, on the other hand, the consequence of making these plain vanilla corporate issuances unavailable to retail investors. This is because compliance with the product governance rules tend to tip the balance of costs and benefits from the issuers' point of view in favour of selling even plain vanilla issuances to professionals only.

The debate on an immediate reform of product governance rules has a specific focus on debt issuances that contain a "make whole" covenant in their bond indentures. Currently, debt issuances that contain a "make-whole" covenant are considered as complex products that require a detailed assessment of potential target markets before being sold to retail investors. "Make whole" clauses are covenants that protect the investors ("make them whole") in case a bond is called by the issuer ahead of its natural expiry. Normally a make whole clause (MWC) provides that if the bond is paid early, the issuer must pay to the investor not only the capital amount but also a premium. The premium will be calculated as the net present value of future coupon payments that will not be paid as a result of the recall, with the premium being calculated using a pre-determined reference rate (mostly LIBOR). At the time the bond is issued, the investor knows the mechanism (formula) used to calculate the premium, and, in most cases, also which Treasury bond be used to determine the reference rate. Therefore, as long as the Treasury bond that acts as a reference is known, the debt investor can calculate the anticipated value of the MWC at any point in time. In any event, if the bond is recalled, the issuer will confirm the value being paid to investors.

Options

Option 1 would consider lifting the product governance requirements for simple corporate bonds with make-whole clauses (which are investor-protective features). The aim of this exemption, which would need to be complemented by a clear rule that a make-whole clause does not of itself make these instruments a PRIIP, is to make more plain vanilla corporate bonds available to retail investors. With Option 1, issuers who wish to raise capital in the bond markets would be faced with the choice of having:

- a retail-compliant prospectus (from the Prospectus Regulation point of view) and being able to issue in whatever size they think appropriate (including the very small EUR 1 000 and EUR 5 000 cuts that are popular in certain Member States); or
- opting for a denomination > EUR 100 000 and a shorter prospectus.

The key feature in Option 1, from the point of view of the issuer who needs access to funds, is that accessing the retail market would be less costly than before (because there would be no product governance requirements). On the other hand, the option of choosing the institutional market only would remain in place, as more sophisticated retail investors ready to invest EUR 100 000 could still be addressed with the shorter prospectus applicable to that investor category.

Option 2 would go further and remove product governance requirements for several simple/vanilla shares or corporate bonds. A broader exemption from the product governance requirements could help issuers to raise capital in both the debt and equity markets. On the other hand, suitability and appropriateness testing would continue to apply when these simple equity and corporate bonds are sold to retail investors, so advisers and portfolio managers would still need to check whether the products fit the objectives and risk profiles of the clients to whom they are recommended. Appropriateness would still apply as it does today, with the addition that once these products are clearly identified as non-complex it would be open for them to be accessed by clients directly in certain circumstances.

Initial consultation by the Commission's services show that there is some hesitance among regulators to dis-apply product governance rules for a widely defined asset class of "non-complex" products. An easy agreement on how to populate this asset class is not achievable at short notice. While there is some urgency to address the issue with respect to plain vanilla bonds (especially instruments with a "make whole" clause), there is less agreement on whether plain vanilla equity (shares) traded on a regulated market, initial public offerings (IPOs) and services provided by market makers and on an execution-only basis should be included in the "non-complex" category.

Policy choice

On balance, a targeted exemption for bonds with "make whole" clauses (not applicable to structured bonds or other complex products), such a proposed in Option 1, would achieve a number of the objectives the Commission's services aim to target with the recovery proposal: it would allow issuers to tap a broader base of investors, it would allow sophisticated retail investors' to access a larger choice of instruments and it would retain protection for all categories of investors, however categorised, when accessing complex products.

In order to deploy immediate effects, Option 1 preferred as it would also allow retail investors to invest in the European corporate bond markets. It is an essential part of a Capital Markets Recovery Package that retail clients can obtain exposure to fixed income products, as such products are essential for diversification and risk-reduction reasons.

Option 1 would have an immediate effect in allowing that retail investors invest a proportion of their investments in plain vanilla corporate bonds. This is a better alternative than to limit access to fixed income investments to vehicles such as complex structured bonds or units in collective investment schemes, with the additional costs that those indirect investment vehicles inevitably entail.

The preferred option which is option 1 is therefore to consider a debt issuance containing a MWC as a non-complex product. The clause is designed to ensure that investors receive back at least the market value of the bond at the time of early redemption and in no case less than par. This gives investor an opportunity to reinvest in an equal of (usually) better credit at the same yield. For this reason, an MWC is entirely in the investor interest and should not trigger the product governance requirements.

4.1.8 Research on small and mid-cap issuers and fixed income instruments

Problems to be addressed

In the immediate aftermath of the crisis resulting from the Covid-19 pandemic, small and mid-cap issuers will need to be supported by a strong ecosystem. This will be important for the economic recovery and it is also an important objective of the Capital Markets Union. One element of this ecosystem is investment research that helps issuers to connect with investors. Investment research ensures increased visibility of issuers and, in turn, a sufficient level of investment and liquidity. Issuers, and in particular small and mid-cap companies, have experienced a decline in research coverage for several years. Fixed income research documents have also showed a steady declining trend. After the entry into application of the new MiFID II provisions, and in particular the "research unbundling" rule, the overall trend of decline continues largely along the same trajectory.

The market for investment research has evolved since the MiFID II rules on research, including the unbundling rule, became applicable on 1 January 2018. The profitability of research departments has declined and the higher relative cost of covering small and midcap issuers relative to the smaller target market meant it was often difficult for brokers to justify maintaining their small and midcap coverage. The additional requirements imposed by the unbundling rule has convinced many asset managers that, rather than operating a separate research payment account, to move toward paying for investment research directly out of their own profit and loss account. But direct payment from the Payments and Loss account (P&L) have, for obvious reasons, accelerated the existing trend to reduce research expenditure across all asset classes.

Research coverage of a company decreased with its market capitalisation. Many stakeholders believe that increasing small and midcap research would lead to greater liquidity in those issuances - decreased availability of information about an issuer leads to lower liquidity.

This is not only true for small and midcap research, there have also been frequent stakeholder calls for reducing the scope of the unbundling rules to exclude non-equities. The unbundling requirement for fixed income research was controversial from the outset of the unbundling rules. The main argument was that, contrary to equity markets, the fixed income markets are principal markets, there are no brokerage commission that could or need to be unbundled from the cost of research. In addition, bid-offer spreads in fixed income depends on factors other than the provision of research to a counterpart (e.g. cost of capital, cost of hedging, size of the security and size of the market). Moreover, as fixed income research costs were not and are not embedded in spreads, introducing the unbundling rules added to compliance costs, but also lead to additional fees required to obtain research. The Commission's services therefore expect an exemption from the unbundling rules for fixed income research to result in an increase of business continuity resources and an increase the availability of information on fixed income issuances.

The exceptional circumstances resulting from the COVID-19 pandemic have instilled a sense of urgency into the debate on research on small and mid-cap issuers and fixed income instruments. Increasing the visibility of European companies to investors will promote more investment for the economic recovery.

There is also evidence that independent research providers are expected to be the biggest losers from the unbundling of research from brokerage commissions. The majority of respondents to a recent survey, including the independent research providers themselves, predicted that they will be the biggest eventual losers from a strict unbundling rule.[16] The overall reduction in buy-side research budgets that are an inevitable consequence of a research unbundling rule, the cost of managing all the reporting and accounting requirements associated with the new unbundling rules, as well as the ensuing difficulty to invest time and capacity in producing research that "stands out", make it difficult for independent research to be profitable.

According to an OXERA study[17] that focuses on small and midcap research provision, the unbundling rules – rightly focused on concerns about inducements (i.e. preventing brokers from competing on the basis of 'free research') - have not addressed another market failure: that relating to the positive externality that lies in the production of research. The new rules on unbundling further accelerate the trend of reducing the allocation of buy side resources to procuring research which results in a shrinking pool of analysts. A lower pool of analysts wold result in less analysts dedicated to the production of high-quality research on small and midcap companies. While the unbundling rules may have been successful in addressing the "over-production" of relatively 'low-quality' large cap research, an overlooked consequence of the streamlining of research budgets is an under-provision of small and midcap research.

16 https://www.fixglobal.com/home/independent-research-providers-will-lose-most-under-mifid/

17 https://www.oxera.com/wp-content/uploads/2019/11/Unbundling-what's-the-impact-on-equity-research.pdf

Options

Option 1 would allow for an exemption of the current research unbundling requirement if brokerage and research provision pertain to a small and midcap issuers. The application of such an exemption to the MiFID unbundling rules should, however, be optional, so that investment firms, even when executing trades in small and midcap issuers, would not be obliged to make expensive IT changes to their order and accounting systems. The exemption would therefore mostly benefit investment firms that specialise in small and midcap investments, but would also provide an "opt-in" for larger investment firms that run a dedicated small and midcap trading desk.

Option 1 would also apply to the provision of fixed income research, including rates, credit and loan research. Fixed income trading was never commission-based in the first place and therefore does not pose the conflicts of interests prevalent in broker commissions that comprise a mixture between brokerage and research.

Option 2 would aim to improve the availability of small and midcap research by establishing a clear set of rules on how to address the conflicts of interest that are commonly perceived to make both issuer sponsored and exchange sponsored research less reliable and useful for investors. Beyond the existing requirements aiming to address all potential conflicts of interest, such as disclosure of sponsorship, clear rules on how conflicts inherent in sponsored research are managed, as well as clear definitions on the borderline between investment research and marketing communications would help to improve credibility of sponsored forms of investment research and avoid the perception that sponsored research is more in the realm of advertisement or marketing material.

Policy choice

The preferred short-term option is Option 1. One would consider an alleviation from the unbundling regime in order to create a positive signal on research in the immediate aftermath of the strained economic situation that results from the Covid-19 pandemic. The Commission therefore expects that an exemption from the unbundling rule for small and mid-cap companies should result in an increase of research coverage for those companies. Implementation of Option 2 would be more complex and would require further analysis with research providers and national competent authorities to ensure that the conflict of interest rules are conceived in an appropriate manner.

In line with Option 1, targeted amendments to Article 13 of MiFID II Delegated Directive (EU) 2017/593 would create a narrowly defined exception authorising the joint payment for execution services and research on small-cap issuers and research on fixed income. Small and mid-cap issuers would be defined as issuers that did not exceed a market capitalization threshold of EUR 1 billion over a 12 month period.

In the case of joint payments for the execution of trades in the above described market segment, the current requirement to set up a research payment account (RPA) or to issue

separate invoices for investment research would not apply. As a counter-balance, there would, however, joint payments would only be allowed in case of an agreement between the investment firm and the research provider on what part of the joint payments are attributable to the provision of investment research. In addition, the investment firm would be required to inform its clients of the joint payment.

ESMA could continue to collect the necessary data for monitoring the effects of the decline of research coverage. Additionally, the Commission services will continue to carefully monitor the latest developments and to engage in the relevant fora, such as the European Securities Committee (ESC).

4.2 Measures for reviving nascent energy derivative markets

4.2.1 Position limits and hedging exemption

The COVID-19 pandemic caused an energy demand-shock followed by unusual changes in prices and volumes. The ability to cover against the risk of price fluctuations is crucial for the real economy in order to be able to produce effectively and alleviate their potential losses, thereby avoiding costs that would otherwise be eventually borne by the end consumers. The necessity to execute as many trades as needed has been particularly critical to small businesses who do not have large balance sheets to wear through the crisis or the bilateral relations to rapidly adapt to supply and demand changes.

The COVID-19 pandemic and its economic consequences have exacerbated the issues regarding the position limit regime and its inflexibility. Various position limits in energy derivatives markets are proven to be out of date, whilst adjusting them to accommodate for rapidly changing market conditions requires the completion of lengthy change processes. In the upcoming recovery there is a strong case for a different approach, to promote trading, position taking and turnover in the market which would underpin efficient and transparent price formation and contribute to market confidence. Many energy derivatives traders will reassess their trading strategy in light of the crisis. Energy commodity exchanges have already seen increased trading activity in otherwise illiquid markets. However, as a direct consequence of the position limit regime, some market participants were prevented from adequately entering the security and transparency of on-venue trading.

Problems to be addressed

Position limits

MiFID II requires the application of position limits to every individual commodity derivative contract. Position limits indicate the number of derivatives (expressed in a standardised number of units or lots) a trader is allowed to own in a specific derivative. There is a broad consensus among stakeholders that position limits for energy derivatives have very limited to no (positive) impact on market abuse, orderly pricing and settlement conditions. However, there is a common understanding that the position limit regime has negatively affected the liquidity in new energy derivative markets. The impact is to such an extent that several new

initiatives have not been able to become real alternatives to Over-The-Counter (OTC) trading. In energy derivatives with a low total number of outstanding derivative contracts that are available for trading (i.e. open interest), there is typically only a small number of rather large counterparties trading these derivatives. Participants who seek liquidity in the derivative contract join typically only at a later stage. Due to position limits, those initial large counterparties are often forced to reduce their positions, reducing the overall open interest and this ultimately affects the growth of the derivative[18].

For new energy derivatives, participants cannot trade that amount of lots without exceeding the position limit. At the same time, competent authorities cannot raise the limit until the open interest has sufficiently increased. The COVID-19 pandemic and its economic consequences have exacerbated the impact of the inflexibility of the position limit regime. Current market conditions require near real-time adjustments to position limits. Under the existing rules, following the issuance of an adjustment request, an energy exchange needs to engage with its competent authority. It is not uncommon such a request takes about three to nine months to process.

Hedging exemption

The COVID-19 pandemic negatively impacts the ability of non-financial firms to make use of the hedging exemption under the position limit regime[19]. Competent authorities generally only process applications for hedging exemptions when a market participant is able to demonstrate a clear short-term need for relief under the position limit regime. Under the current market circumstances market participants can develop an urgent need to obtain hedging exemptions. However, in crisis conditions they may struggle to prepare and submit an application for a hedging exemption before a position limit unduly restricts their trading activity.

In crisis situations, it is even more important to make sure that all market participants whose positions are objectively measurable as reducing risk are able to do so. The most extreme price fluctuations have been witnessed in even the most liquid energy derivatives. When important market players are not able to trade because of a lack of hedging exemption, this has a direct impact on the market participants from real economy who find less liquid energy markets at the moment they most need them.

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[18] An example is the 'Italian PSV Gas market' where the growth in open interest started in the last month of Q4 2017 from 5 000 to almost 10 000 lots. In the first period of 2018, the introduction of MiFID II position limits regime reversed the growth trend as large counterparties were about to hit the de minimis position limit of 2 500 lots. Another example is the 'ICE Futures Europe TD20 West Africa to UK-Continent (Baltic) Future' where hedging is only effective when trading a specific amount of lots. To hedge a fleet of ten tankers on a year forward basis - the trade size will be 15 600 lots to hedge freight rates exposure for a single calendar year.

[19] Under MiFID II, positions that are held by, or on behalf of, non-financial entities which are objectively measurable as reducing risk (hedge), must not be counted towards the position limits. This hedging exemption is subject to prior approval by the relevant competent authorities. Investors must apply for it before entering into a position.

The lack of a hedging exemption for financial counterparties providing liquidity to non-financial counterparties that seek to hedge their positions, proves especially challenging in markets with low open interest (often characterised by one player or a very limited number of players acting as market maker or liquidity provider). Stakeholders note that some market participants have ceased to provide liquidity in energy derivatives for fear of breaching the position limit. Prior to MiFID II, commercial groups decided to register their market-facing entity as an investment firm, for the risk reducing transactions of the commercial entities of the group. Because they are now financial entities, these entities within a predominantly commercial group are not eligible for the hedging exemption.

Options

The policy options set out for positon limits and the hedging exemption are interlinked. The table below sets out two policy options to deal with nascent commodity derivatives markets in the areas of oil, coal, natural gas and power (energy derivatives). Agriculture derivatives, in particular those that have food for human consumption as underlying, would not be touched and remain under the position limit regimes.

Position limits should not prevent the real economy from entering into risk reducing transactions for energy derivatives. Therefore, reducing the scope of the position limit regime to only the most developed energy derivatives leaves less need for hedging exemptions.

Table – Interaction between policy options for position limit regime and hedging exemption

<table>
<tr><th></th><th colspan="2">Position limit regime</th><th>Hedging exemption</th></tr>
<tr><td rowspan="2">Option 1</td><td colspan="2">Dis-applying position limits for a certain period (‘Black out period’) only for new energy derivatives.</td><td rowspan="2">Broad hedging exemption
Extend the hedging exemption to all financial institutions (FI), in addition to non-financial counterparties (NFC) that already have an exemption.
Mandatory liquidity provision exemption both for FI and NFC</td></tr>
<tr><td>Sub-option 1.1: ‘Black out period’ of 12 months</td><td>Sub-option 1.2: ‘Black out period’ of 24 months</td></tr>
<tr><td>Option 2</td><td colspan="2">Limit the scope of position limits to significant or critical derivatives. Significant or critical derivatives are those derivatives that have an open interests of at least 300 000 lots.</td><td>Targeted hedging exemption
Extend the hedging exemption only for FI belonging to predominantly commercial group
Mandatory liquidity provision exemption both for FI and NFC</td></tr>
</table>

Under option 1, the Commission mandates ESMA to develop specific measures concerning new energy derivatives in the above mentioned asset classes. This entails a ‘black out period’ where no position limits apply so long as the derivative is ‘new’. The ‘black out period’, after which the position limits should start applying, could be 12 months (sub-option 1.1) or 24

months (sub-option 1.2). A large majority of respondents to the MiFID public consultation noted that although such a black out period would mitigate the problems for nascent markets, the overall competitiveness of the EU energy derivatives markets would not be achieved.

Option 1 would introduce a broad hedging exemption that extends the hedging exemption to all financial institutions, in addition to non-financial institutions that already have an exemption. An overwhelming majority in the industry (both market operators and commodity traders) welcome this option. However, ESMA notes that introducing a broad hedging exemption would not be consistent with the objective of limiting excessive speculation. Respondents to the MiFID public consultation stated that financial counterparties play a vital role in providing smaller commercial players with access to commodity derivatives markets. They argue that financial counterparties themselves need to offset their risk exposure to commercial players through hedging and that not permitting them to do so likely reduces liquidity in cleared, exchange traded derivatives by financial counterparts.

Option 1 also covers positions resulting from transactions undertaken to fulfil mandatory liquidity provisions. Non-financial counterparties could, subject to certain conditions, act as market makers in commodity derivatives without having to be authorised as investment firms[20]. This exemption would mirror the exclusion of transactions entered to fulfil obligations to provide liquidity on a trading venue from the ancillary activity test. The procedure to apply for the exemption would be clarified in a RTS. A vast majority of the respondents to the MiFID public consultation supported this option. As the current position limit regime fails to recognise the unique characteristics of those instruments securitised derivatives should be deleted from the position limit regime.

Option 2 limits position limits to commodity derivatives traded on trading venues and in economically equivalent OTC (EEOTC) derivatives designated as significant or critical and derivatives with agricultural commodities, in particular food for human consumption, as underlying. The criteria to be used to define those significant and critical derivatives would include the open interest, the number of active market participants, the size of open interest and underlying commodity. When it comes to the size of open interest, respondents to the MiFID public consultation stated that a 300 000 lot threshold would be a suitable threshold in order to define a critical contact. This threshold is also mentioned in the ESMA report on position limits. Respondents to the MiFID public consultation stated that the threshold would lead to around 20 significant or critical derivatives. This approach would produce an outcome broadly comparable with the US regime for position limits.

The “non-critical” energy derivatives would remain subject to the position reporting regime, to the pre-existing position monitoring, to the trading venue's position limits, position management measures by exchanges and oversight of the exchanges’ market supervision and market surveillance. Thus removing position limits for such derivatives would not pose a risk

[20] Article 2(1)(j) of MiFID II

to the transparency and functioning of the respective markets. On the contrary, attracting more volume to regulated venues instead of OTC contributes to a more transparent trading environment. Moreover, position management controls are an important tool to ensure the integrity and functioning of energy derivatives markets. ESMA notes that significant dissimilarities exist in the way positions are managed by trading venues. Therefore, ESMA will be mandated to reinforce position management controls where necessary. Finally, for competing venues trading commodity derivatives based on the same underlying and sharing the same characteristics, the current definition of "same contract" is detrimental to the less liquid market. To ensure the level playing field, the concept of "Same contract" is deleted and replaced with a more cooperative approach between competent authorities (CAs).

Option 2 is combined with a targeted hedging exemption. ESMA considered that there could be legitimate cases where financial counterparties could benefit from a hedging exemption. ESMA sought views on the possible introduction of a hedging exemption for a financial counterparty acting within a predominantly commercial group, where such positions are objectively measurable as reducing risks directly related to the commercial activities of the non-financial entities of the group. The overwhelming majority of respondents to the MiFID consultation support this approach. This hedging exemption would be available where, within a predominantly commercial group, a person has been registered as an investment firm on a voluntary basis and acts as a market facing entity of the group. The exemption would apply to the positions held by that financial counterparty that are objectively measurable as reducing risks directly related to the commercial activities of the non-financial entities of the group.

Just like Option 1, Option 2 also covers the same positions resulting from transactions undertaken to fulfil mandatory liquidity provisions and excludes securitised derivatives.

Policy choice

The preferred option is Option 2. Limiting position limits to the significant and critical derivatives allows for more Euro denominated trading while safeguarding the energy markets from excessive speculation. Moreover, the targeted hedging exemption for financial counterparties that are part of a predominantly commercial group, and obligatory liquidity provision ensures that all relevant market participants are able to enter into positions that are objectively measurable as reducing risk. This allows the energy markets to continue their important role to allow the real economy to cover risk of price fluctuations. This option entails changing Article 57 of MiFID whereby the scope of position limits would be amended to only agricultural derivatives and significant or critical derivatives. The preferred option would also introduce in the last paragraph of Article 57(1) of MiFID a hedging exemption for: (i) financial counterparties acting as the market facing entity of a commercial group for the positions held to reduce the risks of the commercial entities of the group, (ii) financial and non-financial counterparties for positions which are objectively measurable as resulting from transactions entered into to fulfil obligations to provide liquidity on a trading venue, in

accordance with letter (c) of the fourth subparagraph of Article 2(4) of MiFID, and (iii) securitised derivatives.

4.2.2 Ancillary activity test

Market participants who trade in energy derivatives on a professional basis are exempt from a MiFID authorisation under certain conditions. This is the case when market participants deal on own account or provide investment services to the customers or suppliers of their main business. This exemption is only available for each of those cases individually and on an aggregate basis where this is an *ancillary activity*, when considered on a group basis. Market participants have to notify annually their competent authority that they make use of this exemption and provide necessary elements to satisfy the quantitative tests. These quantitative tests are particularly complex and during the crisis present a significant burden for market participants working in business continuity mode. Moreover, any reduction of administrative burden would be most welcome to help facilitate the recovery process.

Problem to be addressed

The new EU commodity derivatives landscape will have a dramatic impact on the ancillary activity test and more specifically on the market size test. This entails more entities potentially being considered as financial counterparties and no longer eligible to the hedging exemption. Since the application of MiFID II, no commodity firm has failed the ancillary activity test[21]. This makes the EU regime so far comparable to the US, Singapore and Switzerland. However, the necessary elements for the quantitative tests in the EU, compared to other jurisdictions, are associated with a considerably higher organisational, administrative and thus financially burdensome effort while leading to the same result. Whereas Singapore and Switzerland both apply only a qualitative test, the US uses a combination of a qualitative and simpler quantitative test.

Options

Option 1 keeps a quantitative element in the test but simplifies the current quantitative test to determine whether a non-financial entity would be obliged to obtain a MiFID license for its own account trading activity. The quantitative elements of the current test would be replaced

[21] The Delegated Regulation 2017/592 ('RTS 20') sets out the method that allows non-financial entities to determine whether their trading activity is ancillary to their main business. This method consists of two tests. The first test (market share test) compares the size of an entity's speculative trading activity to the total trading activity in the Union on an asset class basis, to determine that entity's market share. The second test (ancillary activity test on group basis) compares the size of the speculative trading activity, with all asset classes included, to the total trading activity in financial instruments by the entity at group level. There is an alternative form of the second test, which consists of comparing the estimated capital used for the speculative trading activity to the actual amount of capital used at group level for the main business. If one of the thresholds set by RTS 20 has been exceeded, the entity must apply for authorization as an investment firm.

by a single threshold that is similar to the quantitative threshold of USD 8 billion for Swap Dealers under the US rules.

For Option 1, the ancillary activity test will need to be further aligned with the US rules whereby: (i) The threshold will be determined on the basis of financially settled OTC Derivatives; (ii) The threshold does not apply to (a) exchange traded products and (b) transactions which are physically settled or intended to be physically settled; (iii) In consequence, bilateral, physically settled commodity forwards are not included in the calculation as long as they do not fall under the MiFID II definition of commodity derivatives; (iv) The current scope of privileged transactions in Art. 2 (4) of MiFID II would remain as is; and (v) The threshold would be calculated on the basis of trading in the EU. This means that transactions concluded on exchanges in third countries are not counted as OTC transactions against the proposed threshold.

Stakeholders have indicated that the new quantitative test, although simpler than the current quantitative test, would still entail considerable cost and changes to their systems. Moreover, many alterations are required in order to make sure that entities can continue to benefit from the ancillary activity exemption. Regulators have noted that focusing on the OTC space brings specific challenges in terms of measurement that could reduce the benefit of the simplified quantitative test.

Option 2 entails a pure qualitative ancillary activity test. This would maintain the current scope of the ancillary activity exemption in terms of covered firms and activities, which is welcomed by all stakeholders. Moreover, the alleviation in terms of administrative burden will be highest as no figures have to be collected, processed, transferred by the market participants and then verified by the respective competent authorities. Stakeholders note that Option 2 delivers the level playing field that is deemed essential for European companies to avoid administrative burden and focus upon recovery of the COVID-19 pandemic. It would maintain their competitiveness vis-a-vis the US, Singapore and Switzerland. It should be noted that relying on qualitative measures does not entail that there would be no supervision of the derivatives traders. Competent authorities remain vigilant using position reporting. As soon as questions are raised with regard to the activity of a derivatives trader, the competent authority will investigate and ensure whether the derivatives trader does not breach the ancillary activity test.

Policy choice

The preferred option is therefore option 2 to delete all quantitative elements and to retain the qualitative elements from the ancillary activity test. This would bring most benefit in terms of lower administrative burden for non-financial counterparties and competent authorities and it would avoid misalignment with global competitors.

Chapter 3 – Changes to the Securitisation framework (Securitisation Regulation and CRR)

5 PROBLEMS THAT THE SECURITISATION PROPOSAL AIMS TO ADDRESS

Credit institutions today are well capitalized and much more resilient than they were in 2008. Nevertheless, ongoing uncertainty related to the extent of economic damage and the pace of the subsequent recovery of economic activity has a negative impact on the banking sector. Therefore, it will remain key for banks to be able to continue lending to corporates in the coming months once the immediate shock of the COVID-19 pandemic will have passed. To that extent, it is important to prepare today the tools to allow banks to maintain and even enhance their capacity to lend to the real economy, in particular to SMEs, and securitisation can be a key enabler in this respect. By transforming loans into tradable securities, securitisation could free up bank capital for further lending and allow a broader range of investors to fund the economic recovery.

A new securitisation framework is in place since January 2019, promoting a safe, deep, liquid and robust market for securitisation, which is able to attract a broader and more stable investor base to help allocate finance to where it is most needed in the economy. This new framework is an important building block of the Capital Markets Union. The revamped framework includes a specific regime for simple, transparent and standardised (STS) securitisation, which aim to provide to investors a product, whose risk is easier to assess, and therefore is easier to invest in. Robust safeguards are built in, in order to revive this very useful instrument on a safe and sustainable basis, while keeping out of its scope structures that suffered significant losses in the global financial crisis. The EU framework for securitisation is significantly more robust than any other world-wide and it includes safeguards limiting the exposure of EU investors to complex risks imported from foreign markets.

Notwithstanding these improvements, the legal regime for securitisation can be further enhanced in two specific respects to encourage a broader use of securitisation, thereby better supporting banks in their effort to increase lending to households and businesses in order to both face the dire financial situation created by the falling economic activity during the lockdown period, and to foster the economic recovery. The proposed changes to the prudential treatment of securitisations of non-performing exposures (NPEs) will also make NPE securitisations a more economically viable avenue for banks to manage the foreseen increase in non-performing loans due to the economic impact of the COVID-19 pandemic.

5.1 On-balance-sheet synthetic securitisation

Securitisation techniques that use guarantees or similar instruments to transfer the risks of loans that remain on the balance sheet of the bank (a form of synthetic securitisation we refer to as on-balance-sheet synthetic securitisation in the following text) are out of the scope of the STS framework. This is an important risk management tool for bank lending to corporates, in particular SMEs. However, its use remains below its potential as investors cannot rely on a sound standard for these securitisations comparable to the one for traditional (true-sale) STS securitisations. Moreover, without incentives for the STS label, which result from reduced capital requirements reflecting the higher quality of STS securitisation structures, banks would be less inclined to use this instrument to free up capital for additional lending. As such, both the STS framework and the prudential framework should be reviewed together to promote further use of STS synthetic securitisation.

The unavailability of data has so far prevented a comprehensive review of both frameworks for synthetic securitisation. As such, synthetic securitisations are currently treated as true-sale non-STS securitisation, with the consequence that they cannot benefit from the preferential prudential treatment reserved to STS securitisation under the CRR.

Article 270 of the CRR allows only a differentiated treatment for a subset of synthetic transactions fulfilling a set of limitative criteria:

- 70% of the securitised exposures must be exposures to SMEs;
- the securitisation must meet the traditional STS criteria as applicable to a synthetic securitisation;
- the credit risk not retained by the originator has to be transferred through a guarantee, or counter guarantee, subject to the following criteria:
    - the guarantee/counter-guarantee complies with CRR requirements on credit risk mitigation;
    - the guarantor/counter-guarantor is either of the following:
        - a central government or central bank of a Member State, a multilateral development bank or an international organisation, provided that it can be assigned a 0% risk-weight under the standardised approach for credit risk;
        - an institutional investor, provided the guarantee or counter-guarantee is fully collateralised by cash on deposit with the originators.

These limitations, however, drastically narrow the use of the Article 270 of the CRR and as a result most of the synthetic securitisations are treated like true-sale non-STS securitisations.

The absence of a preferential capital treatment of synthetic securitisation goes against the purpose of synthetic securitisation to reduce the capital requirement linked to underlying assets, and therefore is detrimental to the interest banks can have in using this instrument to free additional lending capacities.

5.2 Securitisation of non-performing exposures

The current framework is not entirely fit for purpose for the securitisation of NPEs and in particular it contains disincentives for banks to avail themselves of this possibility to free themselves from the burden that non-performing exposures entail.

NPE securitisations have particular features that distinguish them from securitisations, which are issued on the back of performing assets with stable and predictable cash flows (see table below). These differences have consequential implications for the calibration of risk weights in the securitisation framework.

By definition, NPE securitisations differ from typical securitisations because the securitised loans are already defaulted when NPE securitisations are issued. While underlying loans from typical securitisations always have a chance of defaulting in the future, at inception of the securitisation transaction the loans are still performing. For this reason, in a typical securitisation the main role of the servicer is to receive the contractual payments from securitised loans and to pass them on to the holders of the securitisation instruments as they become due. This can be characterised as "passive" servicing.

Due to the reliance on cash flows from securitised loans to generate returns, investors in these transactions are essentially exposed to credit risk with respect to the underlying exposures. In contrast to these typical cases, since in NPL securitisations the borrowers have already defaulted before their loans are securitised, these loans do not generate cash flows automatically. Hence, repayment to the securitisation investors require cash flows to be generated through the workout of NPEs, or "active" servicing. This usually includes the renegotiation of the defaulted loans with borrower or enforcement of collateral (for example by taking possession of the collateral and selling/auctioning it).

The table below shows the relevant differences between performing and NPE securitisations:

	Performing securitisations	**NPE securitisations**
Profile of securitised loans at inception	Performing exposures at inception. Some of these may become non-performing over the life of the transaction. The main aim of the securitisation is liquidity for the originator.	Non-performing exposures at inception. The transaction is structured with the objective of removing these exposures from the originator's balance sheet.
Servicing	"Passive servicing". The originator typically retains the servicing of the assets	"Active servicing". The NPEs are normally serviced by an independent servicer.
Main driver of risk to bondholders	Credit risk of securitised exposures	Cash flow from NPE workout Collateral valuation risk
Current treatment under securitisation framework	Securitisation framework, which is conceptually based on the credit risk framework.	

Source: EBA.

The current Basel and CRR frameworks are designed to account for the most common features of typical (i.e. non-NPE) securitisation transactions, thus using credit risk as capitalised under the credit risk framework as its main regulatory driver, while correcting for "non-neutrality" factors reflecting the agency and model risks that are prevalent in securitisations. When applied to NPEs, this framework, based on credit risk, yields capital requirements that are considered to be disproportionate since the calibrations of the securitisation – internal ratings-based approach (SEC-IRBA) and the securitisation – standardised approach (SEC-SA) are generally not consistent with the risk drivers of NPE securitisations.

While repayment risk for investors in typical securitisations derives mostly from credit risk associated with the underlying loans, the repayment risk for the bondholders in an NPE securitisation mainly arises from two factors:

- the ability/skill of the servicer in working out the loans to generate sufficient recoveries to repay the bonds;
- the correct pricing of the NPL assets at inception of the transaction (collateral valuation risk).

With respect to the first factor mentioned above, it should be noted that the servicer's success will depend to a great extent on a sufficiently conducive "servicing environment", that is, the jurisdiction's legal framework and its judicial and extra-judicial infrastructure and remedies for debt restructuring and foreclosure.

The valuation risk results from the special purpose entity's (SPE) purchasing the NPEs at a non-refundable discount on the NPEs' gross book value (GBV), which is their nominal or outstanding value at the time of inception. This non-refundable purchase price discount (the NRPPD) reflects the buyer's assessment of the loss level in the portfolio and on the likelihood that the work-out of the NPEs may generate sufficient recoveries to (at a minimum) cover the NPEs net value (their GBV minus the NRPPD). The net value of the NPEs constitutes their residual value after losses have been written off and the maximum loss that the investors are exposed to (assuming an extreme scenario of zero recoveries). The larger the NRRPD, the smaller the amount of recoveries needed to cover the NPEs net value and, hence, the more likely that the NPE securitisation will be able to repay the holders of the securitisation instruments in full. In other words, the larger the NRPPD, the lower the non-repayment risk for investors.

The credit rating assignment process, as applied by the credit rating agencies, can be reasonably expected to have better regard to the preeminent NPL securitisation risk drivers, as described above.

Conversely, SEC-IRBA and SEC-SA rely on quantitative credit risk information from the pool and, as a result, yield risk weights that are considered too high when compared to the risk-weights applicable under the securitisation – external ratings-based approach (SEC-ERBA). The impact is particularly acute on the NPE securitisation senior tranches, which are

subject to proportionately larger risk weights under the SEC-IRBA and the SEC-SA than other tranches.

With the EU economy projected to shrink sharply in 2020[22], the economic recession, sparked by the COVID-19 pandemic, is expected to result in a considerable amount of bank loans becoming non-performing as borrowers struggle to keep up with payments. With a high level of delinquent assets on their balance sheets and the resulting increased capital requirements and operational challenges, banks would be effectively hampered to lend in sufficient quantities to underpin the economic recovery. That would happen at a time when banks are called to expand their credit support to corporates, large and small, as much as possible within the current prudential framework.

6 CONTENT OF THE SECURITISATION PROPOSAL AND COST-BENEFIT ANALYSIS

6.1 Extension of the STS regime in the Securitisation Regulation to on-balance-sheet synthetic securitisation

On-balance-sheet synthetic securitisation, which is a way for banks to share risks on their books via guarantees and similar instruments with investors thus creating additional capacity for new lending, is currently out of the scope of the STS regime. This type of securitisation is easier and quicker to execute than traditional true-sale securitisations and is used in particular to securitise assets such as large corporate loans or SME loans. On-balance-sheet synthetic securitisations are also a considerably easier way to execute on portfolios from different Member States, given that the legal complexities associated with the true sale of the underlying exposures subject to different legal regimes fall away. Furthermore, this is a particularly suitable instrument to share with investors the junior and mezzanine risks of a credit portfolio that bear the highest losses and therefore bind most of the capital. In addition, this type of securitisation is a particular efficient means to reduce risk and thus capital requirements when obtaining liquidity from the sale of exposures is not in the focus of bank managers. By extending the STS standard to on-balance-sheet synthetic securitisation investors will find the instrument more attractive and banks will thus get better access to a highly useful tool to create space to further increase lending capacities without any lowering of the prudential standards for bank lending.

Extending the STS quality label would in particular help market participants distinguish soundly structured on-balance-sheet securitisation from other forms of synthetic securitisation that were exposed to important losses during the great financial crisis and are understandably perceived as complex, risky, exposed to arbitrage and fraud, and involve information asymmetries.

[22] https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/summer-2020-economic-forecast-deeper-recession-wider-divergences_en

6.1.1 Cost-benefit analysis

Policy option 1: Maintain the status quo

After nearly disappearing as a practice in the years following the global financial crisis, balance sheet synthetic securitisation has been slowly coming back to the EU market in recent years. Indirect benefits following the introduction of the STS regime for traditional securitisation, such a reduced stigma towards securitisation in general among investors and supervisors, could reinforce this general resurgence in the coming years.

Maintaining the status quo, i.e. not expanding the STS regime to on-balance-sheet synthetic securitisations would have the benefit that the EU regime would stay within the Basel framework (apart from the limited deviation already provided for in Article 270 of the CRR). It would also allow more time to monitor the market of synthetic securitisations and to decide at a later juncture whether the STS regime should also include synthetic securitisations.

However, maintaining the status quo would have no positive effect whatsoever for achieving the goal of maintaining and enhancing the lending capacities of banks in the post-COVID-19 environment.

It would also uphold the inconsistent treatment of traditional and on-balance-sheet synthetic securitisation. Indeed, the EBA analysis did not find any technical reasons to justify this inconsistency as the synthetic securitisation structure does not inherently lead to higher risk of losses compared to the traditional true-sale structure.

Policy option 2: Introduce a specific STS framework, limited to on-balance-sheet synthetic securitisations with no concurrent changes to the prudential treatment in the CRR:

The analysis conducted by the European Banking Authority (EBA) in its report on an STS framework for synthetic securitisation[23] shows that extending the specific STS framework to on-balance-sheet synthetic securitisations would bring a number of benefits for achieving the legislative goal to maintain and enhance the lending capacities of banks. This new framework would recognise the relevance of this product for the economy, taking account of its specific characteristics and the types of assets that are usually associated with it, namely corporate loans and in particular SME loans. In addition, the market would be incentivised to develop within the robust STS framework, which entails greater transparency, easier due diligence and monitoring, as well as higher standardisation which could open the market to smaller players. The regulatory endorsement that is associated with the STS label would contribute to reducing the stigma associated with the product, encouraging more banks to issue synthetic securitisations, which would also expand the investor base. It would bring balance-sheet synthetic securitisations to the same footing, in terms of regulatory treatment, as traditional transactions thus ensuring consistency on the market and allowing the two types of securitisation to develop hand-in-hand.

[23] https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation

Just like with the traditional securitisation, creating a specific STS framework for on-balance-sheet synthetic securitisation might entail increased risk of moral hazard, such as negligence by less sophisticated investors, due to a possible perception that the STS label inherently means a low-risk product independent of differences between individual transactions or positions within transactions. Thus, the introduction of a specific STS framework for balance-sheet synthetic securitisation needs to be diligently accompanied by supervision to avoid negative consequences.

The prudential treatment of the new product will likely be a material factor in its attractiveness to the market. Compliance with the STS criteria will inevitably entail additional costs for originator banks, who are usually also investors in the senior tranche. At the same time, investors in the sub-senior tranches are usually entities that do not have capital requirements who would benefit mainly through increased investment opportunities, in case of higher supply, and a more standardised and easier to assess product. Therefore, keeping the capital treatment of STS on-balance-sheet securitisations unchanged will mean higher costs for banks that wish to issue such transactions (but no change for those that do not wish to seek the STS label), with no concurrent benefit in terms of capital treatment. This inconsistency will likely obstruct the growth of the market and would not contribute to the policy objective.

Different prudential treatment of on-balance-sheet synthetic securitisation vis-à-vis traditional securitisation is not justified by available performance data[24]. Indeed, the lifetime default rates of on-balance-sheet synthetic transactions appear to outperform traditional securitisations for all rating grades and asset classes.

Finally, it should be noted that currently, the international framework for simple, transparent and comparable securitisation, developed by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), excludes synthetic securitisation from its scope. Based on the data collected and the technical analysis performed by EBA, there is prudential evidence to consider a specific STS framework for on-balance-sheet synthetic securitisations..

Policy option 3: Introduce a specific STS framework, limited to on-balance-sheet synthetic securitisations, and a limited, differentiated regulatory treatment for qualifying transactions

Taking into account the eligibility criteria that the on-balance-sheet synthetic securitisation would need to meet in order to qualify for the STS label, the agency risk and modelling risk of that securitisation will reduce compared to non-STS on-balance-sheet synthetic securitisation. Provided that the underlying asset classes of the securitisation are eligible under Article 243 of Regulation 2017/2401, this would justify a differential regulatory treatment compared to non-STS on-balancesheet synthetic securitisation.

[24] Even though availability of data on volumes and historical performance of synthetic securitisation has improved considerably as a result of the EBA's work, it likely does not yet capture the market in its entirety.

Preferential capital treatment, extending the scope of Article 270 of the CRR, can be expected to lead to higher demand and issuance of on-balance-sheet synthetic securitisations, thus increasing banks' lending capacity, freeing up capital, provided that significant risk transfer has been achieved, and ensuring a broader risk diversification across the financial system. As such, it would contribute significantly to achieving the goal of maintaining and enhancing the lending capacities of banks in the post-COVID-19 environment.

This approach, however, would create a misalignment between the EU securitisation framework vis-à-vis synthetic securitisation and the Basel regime, which does not foresee a risk-sensitive capital treatment for qualifying simple, transparent and comparable synthetic securitisations. As explained under option 2, such a misalignment, however, is justified by the fact that synthetic securitisation for the time being falls outside the scope of the BCBS/IOSCO framework for simple, transparent and comparable securitisations.

Moreover, seeking to extend the benefits of the STS label might be premature at this stage as there is not yet sufficient data and practical experience with the revamped securitisation framework to support a claim that an STS-compliant on-balance-sheet synthetic securitisation deserves any preferential prudential treatment. Indeed, the STS framework has been in application since January 2019 and the first traditional STS transaction was notified only in March 2019. The technical analysis, however, does not indicate reasons why an STS on-balance-sheet securitisation would be riskier than a traditional STS securitisation, justifying a different capital treatment.

Policy choice

Overall, the analysis conducted by the EBA shows that it is possible to set standards for synthetic securitisation that allow mitigating the main drivers of structuring risk, such as agency and model risks, in the same way as for traditional securitisation, thereby creating a subset of synthetic securitisation that is comparable to STS traditional securitisation. In fact, evidence shows that historical performance of on-balance-sheet synthetic securitisation tends to exceed that of traditional securitisations for the same asset class. Indeed, from a technical perspective, there is no evidence that would suggest that synthetic securitisation structure inherently results in higher losses than traditional securitisation structure. A sound synthetic structure does not negatively affect the performance of the securitisation.

The analysis does not point to any material negative consequences that could be foreseeably generated by the creation of a specific STS framework for balance-sheet synthetic securitisations. On the other hand, reviving the synthetic securitisation market and ensuring that it develops within the robust STS framework entails a number of positive benefits for banks, financial market and financial stability in general. The risk transfer from banks to the non-banking sector is one of the main objectives of the Capital Markets Union and by facilitating the availability of credit to those who need it, could promote economic growth.

On balance, creating a specific STS framework for on-balance-sheet synthetic securitisations would be most beneficial for the stated policy goal. In terms of the prudential treatment of the

new product, taking into account lingering data limitations and the specific characteristics of on-balance-sheet synthetic securitisations and its usage, a limited differentiated regulatory treatment, rather than a fully-fledged preferential regulatory framework similar to the one for traditional STS securitisation, represents a balanced approach. The preferential regulatory treatment would extend only to the senior tranche of the STS on-balance-sheet securitisation when it is retained by the originating bank.

6.1.2 Description of the proposal

The Securitisation Regulation only allows traditional true sale securitisation to obtain the STS label. In a true-sale securitisation the ownership of the underlying exposures is transferred or effectively assigned to a securitisation special purpose entity, whereas in on-balance-sheet synthetic securitisations the credit risk associated with a pool of underlying exposures is transferred to investors (protection sellers) by way of financial guarantees or credit derivatives, while the assets themselves remain on the balance sheet of the originating institution (the protection buyer). On-balance-sheet synthetic transactions are distinct from other synthetic securitisations where the originator of the securitisation does not own the underlying assets and, instead of hedging credit risk, seeks to benefit from real or perceived arbitrage opportunities in the pricing of different tranches of credit portfolios.

The EBA has published its Report on an STS framework for Synthetic Securitisation (the 'STS synthetic report'), analysing the feasibility of a specific framework for STS synthetic securitisation, limited to balance-sheet synthetic transactions, and the Commission followed up with the report accompanying this legislative proposal. Both reports have been drawn up in accordance with to Article 45 of the Securitisation Regulation. On this basis, the Commission proposes to define a set of STS criteria for on-balance-sheet securitisations that is consistent with the STS criteria for traditional securitisations, adapting them where necessary and introducing new criteria to capture the specificities of using guarantees or similar instruments to tranche and transfer credit risk. Securitisations that meet these requirements should be able to claim the STS label and be able to benefit for capital relief limited to the senior tranche.

The creation of a STS label for on-balance-sheet synthetic securitisation, coupled with a targeted review of the Article 270 of the CRR, would allow to extend to synthetic STS securitisation a partially similar preferential capital treatment currently applied to traditional STS securitisation. This extension of the preferential capital treatment would be targeted, with a partial review of the Article 270 of the CRR in order to:

- broaden the types of underlying assets used for the STS synthetic securitisation;
- limit the preferential treatment to the senior tranche of the STS synthetic securitisation retained by the originator.

This proposal is deemed balanced, as it would promote further use of STS on-balance-sheet securitisation through a preferential treatment of the senior tranche, but also maintain a certain degree of conservatism both through the application of adapted STS criteria to obtain the STS label and the limitation of the preferred capital treatment to the senior tranche, considered the less risky.

6.2 Targeted amendments of the Securitisation Regulation and CRR in order to remove the constraints to securitising NPEs

The securitisation framework was designed with performing assets in mind and therefore certain elements of it are not entirely fit for purpose to be able to absorb non-performing exposures from credit institutions' balance sheets. In its opinion submitted to the Commission in October 2019, the EBA has highlighted this problem. The assessment of the EBA is supported by data on market developments that show that currently sales of whole NPE portfolios are more often used for off-loading NPEs from the bank balance sheet, while securitisation plays so far no big role in the EU. Amending the securitisation framework to cater for the specificities of NPE securitisations, while maintaining high prudential standards, could enable the broader use of this tool by banks to offload non-performing portfolios from their balance sheets.

6.2.1 Cost-benefit analysis

Policy option 1: Maintaining the status quo

Keeping the current capital treatment of NPE securitisations would continue limiting substantially the role of securitisation as a funding tool for reducing NPEs banks' balance sheets due to comparatively high capital requirements, in particular under the SEC-IRBA and the SEC-SA.

The comparatively high capital requirements generated by the current framework make holding NPE securitisation instruments particularly capital intensive for banks, in particular in the case of senior tranches[25].

Higher funding costs would continue translating into higher price discounts and, as a result, higher losses for the bank seeking to dispose of its non-performing loans, making securitisations particularly unattractive for EU banks to off-load NPEs from their balance sheets.

Policy option 2: Implementing a more risk sensitive capital treatment of NPEs

Under option 2 the calibration of capital requirements of NPE securitisation would be adjusted in a very simple and straightforward way. In addition, a clarification would be included that the cap provided for in Article 268 of the CRR must be calculated making use of the full net basis approach.

With regard to the adjustment to the calibration, in line with the emerging international standards, the capital requirements for NPE securitisations (defined for the purpose of capital requirements as securitisations that are backed by credit exposures with an impairment level of 90% or higher) would be amended as follows:

[25] According to the EBA, the return on equity (RoE) for senior tranches under the above assumptions (1.5-4.5%) would materially underperform European banks equity (RoE targets of over 10%). To achieve a 10% RoE, the margin on senior tranches of NPE transactions would have to more than double (e.g. 6.8% under SEC-SA).

- senior tranches of traditional NPE securitisations with a non-refundable purchase discount equal to or above 50% of the securitised portfolio's outstanding amount will be subject to a flat 100% risk weight;
- all other exposures to NPE securitisations, either traditional or synthetic, would be subject to the usual securitisation framework and to two specific provisions: a general 100% floor for these exposures and a ban on the use of Foundation IRB parameters in the SEC-IRBA.

With regard to the clarification to Article 268 of the CRR, in line with the EBA opinion on the regulatory treatment of NPE securitisations ('the EBA NPE Opinion'), it would be made clear that a "full net basis calculation" should be the preferred approach for the computation of expected losses. This means that the expected losses referred to in Article 268(1) of the CRR should be netted by the amount of the relevant NPEs' NRPPD and, in the case of the originator, any additional specific credit-risk adjustments. This would reflect the fact the NRPPD has the effect of writing off the underlying exposures' expected losses and leaves a residual value subject to the risk that recoveries may be insufficient to repay that residual value (unexpected losses).

The option under discussion would enhance the coherence of the CRR securitisation framework, better reflect the actual riskiness of securitisation of NPEs and incentive banks to use this tool to free capital to support the real economy in the post COVID-19 pandemic recovery context. The proposed option would have a limited impact on the administrative burden for institutions and on the costs for them to adapt their internal operations. The limited costs would be largely offset by benefits derived in terms of capital availability and reduced funding costs.

Policy choice

Option 2 is the preferred option since it would be the one able to remove the regulatory constraints in the area of capital treatment on the use of securitisations for banks and to increase the capacity of banks to use it as an economically viable funding tool. It will help the process of reducing NPE holdings for the banking system as a whole.

6.2.2 Content of the proposal

Based on the recommendations included in the EBA 'NPE Opinion' and the latest developments of relevant international standards, the Commission proposes to:

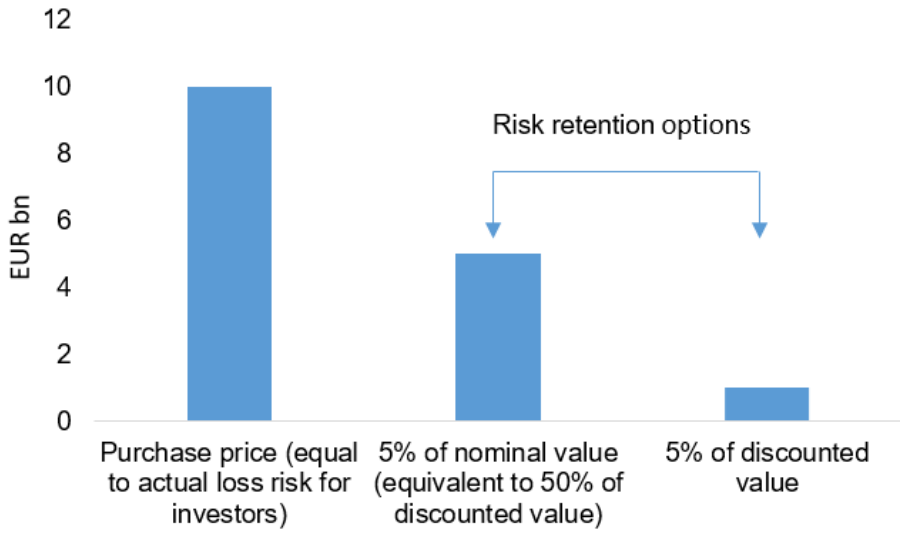
- Amend the Securitisation Regulation by allowing risk retention in the case of NPE portfolios based on the discounted value of the portfolio (after taking into account the non-refundable purchase price discount) and by allowing the risk retention by the servicer under certain preconditions; and
- Introduce a more risk-sensitive capital treatment of NPE securitisations in the CRR.

Amendments to the Securitisation Regulation

NPEs are securitised at a discount on their nominal or outstanding value and reflect the market's assessment of, inter alia, the likelihood that the debt workout process will generate sufficient cash flows and asset recoveries. The risk for investors is, therefore, that the workout of the assets generates insufficient recoveries to cover the net value at which they have been purchased.

The requirement of at least 5% risk retention by originators, sponsors or original lenders aims to ensure alignment of interest between such actors and investors in a securitisation. The Securitisation Regulation foresees that the retained amount is calculated on the basis of the nominal value of the securitised exposures. In the case of NPE securitisations, however, using nominal values for risk retention purposes disregards the price discount at which the underlying assets are transferred and which represents the actual risk loss for investors. This is inconsistent with the economics of the transaction, constrains the flexibility for the parties involved in originating and structuring NPE securitisations and distorts the intended risk alignment between the sell-side and the buy-side. Therefore, the EBA recommends to allow calculating risk retention amount in case of NPE securitisations after applying the non-refundable purchase price deduction.

Figure: Risk retention in an NPE securitisation: an illustrative example for a transaction with original principal amount of EUR 100 million and a non-refundable purchase price discount of 90%



Source: EBA

An additional element of the risk retention requirement that impacts NPE securitisations is the identification of the party obliged to retain the risk. Typically, in securitisations of performing assets the prevalent interest on the sell-side is that of the originator, who is often also the original lender. The originator's interest is that the assets continue to be serviced as if they were not securitised, making sure that they provide the expected cash flow and that the relationship with the borrower is uninterrupted. On the contrary, in NPE securitisations

originators seek to offload the defaulted assets from their balance sheets as they may no longer wish to be associated with them in any way. Furthermore, NPEs tend to be sold to intermediate parties before being securitised, so the original lender is often not involved in the securitisation. In these cases, the servicer of the assets might have more substantive interest in the workout of the assets and value recovery. In addition, the servicer may retain a non-senior tranche in the transaction and its fees would usually be payable from the asset collections. It is sound market practice for the servicer to have "skin in the game" in the transaction and thus align its interest with investors. Accordingly, the Securitisation Regulation should allow, specifically for NPE securitisations, that also the regulatory requirement for "skin in the game", the retention requirement, may be fulfilled by the servicer.

Finally, the credit-granting standards requirement in Article 9 of the Securitisation Regulation also does not cater for NPE securitisations. The aim of the verification duty in Article 9 of the Securitisation Regulation is to protect against the risks of asymmetric information producing an "originate to distribute" model whereby assets of inferior quality are selected for securitisation to the detriment of investors, who would end up with more risk then they might have intended to take. While the overarching principle remains appropriate for NPE securitisations, the concrete terms of the requirement are problematic as it cannot be required that "sound and well defined credit granting criteria" were applied where the originator has already knowingly purchased the exposures as NPEs. In fact, the requirements have to take into account the specific circumstances of the purchase of the assets and the type of securitisation. In these cases, it may not be possible to gain certainty around the circumstances in which the assets were created, but it is nonetheless possible to carry out a due diligence on the quality and performance of the assets in order to make a sensible, well-informed investment decision.

Amendments to the CRR

As regards the calibration of capital charges, based on the work carried out by the EBA and on the consultation paper published by the BCBS[26], it is proposed to introduce a more risk-sensitive treatment of NPE securitisation through the following amendments to the CRR securitisation framework:

- NPE securitisations will be defined for the purpose of capital requirements as securitisations that are backed by credit exposures with an impairment level of 90% or higher;
- Senior tranches of traditional (i.e. true sale) NPE securitisations with a non-refundable purchase discount equal to or above 50% of the securitised portfolio's outstanding amount will be subject to a flat 100% risk weight;
- All other exposures to both traditional and synthetic NPE securitisations would be subject to the usual securitisation framework and to two specific provisions: a general

[26] https://www.bis.org/bcbs/publ/d504.htm

100% floor for these exposures and a ban on the use of Foundation IRB parameters in the SEC-IRBA.

In addition, to achieve the objective of a framework better suited for the specific features of the NPE securitisation, a couple of minor adjustments are also proposed:

- In line with the recommendation included in the EBA opinion of 2019, it is clarified that when institutions apply the cap provided for in Article 268 of the CRR to positions they hold in NPE securitisation, the expected losses referred to in paragraph 1 of this Article should be calculated net of the NRPPD and of any additional specific credit risk adjustments;

- It is also proposed to amend paragraph 3 of Article 249 of the CRR thereby aligning the credit risk mitigation rules applicable to the securitisation exposures to the general framework and to the revised Basel standards. Indeed, according to Article 249(1) and (2) of the CRR, an institution may recognise funded or unfunded credit protection with respect to a securitisation position in the same way and under the same conditions as provided in the general credit risk mitigation framework applicable to non-securitised exposures. However, paragraph 3 of this Article introduces an exception to that general treatment for institutions applying the standardised approach. In particular it introduces an additional eligibility criterion in the form of a minimum credit rating for almost all types of providers of unfunded credit protection, including central governments.

  This provision appears to be inconsistent with the general credit risk mitigation rules set out in the CRR and with the objectives of the CRR. It is indeed hard to justify why, for instance, a guarantee provided by an institution, or a central government, that meets the eligiblity criteria for protection providers contained in the general credit risk mitigation rules but that does not fulfil the minimum credit rating criterion in Article 249(3) of the CRR cannot be accepted as eligible credit risk mitigation under the securitisation framework, but can be accepted as eligible credit risk mitigation when provided for a non-securitisation exposure. In that respect, the revised Basel III framework agreed in December 2017 imposes a minimum credit rating requirement only to a limited set of protection providers in case of securitisation exposures. Specifically, in the revised Basel III framework, the requirement only applies to entities which are not sovereign entities, public sector entities, institutions or other prudentially regulated financial institutions.

  By way of clarification, it is therefore necessary to amend Article 249(3) of the CRR and align the credit risk mitigation rules applicable to the securitisation exposures to the general framework in line with what was agreed at international level by the BCBS. This amendment will enhance the effectiveness of national public guarantee schemes assisting institutions' strategies to securitise NPEs in the aftermath of the COVID-19 pandemic.

Chapter 4 Consultation

7 CONSULTATION AND STAKEHOLDERS

7.1 MiFID II/MiFIR consultation and stakeholders

7.1.1 Public Consultation by the Commission

The public consultation on MiFID II/MiFIR which ended on 18 May 2020 showed that there were **mixed views on whether MiFID II has been successful in achieving or progressing towards more investor protection.** However, the vast majority of respondents **disagrees with the statement that the costs and benefits of the MiFID investor protection requirements are balanced.**

With regard to the ex-ante **cost information** the vast majority is of the opinion that professional clients and ECP's should be exempted without specific conditions, only a few stakeholders indicated that only ECP's should be able to opt-out unilaterally. A large majority does not think specific conditions should apply to the opt-out. A large majority does not think that retail clients should be allowed to opt-out.

Almost all respondents would support a **phase-out of paper-based information**. The vast majority does not think that clients should explicitly opt-out of paper-based information, but that the client should be allowed to request to receive information on paper.

Almost all stakeholders agree that in case of **distant communication** (phone in particular) the cost information could also be provided after the transaction is conducted in order to avoid delays. Many are of the view that ESMA Q&As already authorised the delayed provision of this information. Further, the recording of telephone conversations is considered a useful tool by the majority to protect the retail client from mis-selling. Some stakeholders, however, criticise that the recording requirements interferes with the privacy and data protection rights of the client.

The majority disagreed that the best execution reports were of sufficiently good quality to provide investors with useful information. The majority of stakeholders suggested a deletion of at least the quarterly reports by execution venues on the quality of transaction execution ('RTS 27 reports'), as these reports were a part of the annual audit but not used by the clients. Those reports were very difficult to understand, often more than 40 pages and would not allow for meaningful conclusions. Further, those 'RTS 27 reports' are not comparable across different investment firms as information is reported in an inconsistent way and in different formats.

The comments on the best execution reports ('RTS 28 reports') were slightly more positive. Those reports would enable firms to provide some further information on their execution

strategy per financial instrument and client type. There was the general view that Transaction Cost Analysis (TCA) reports were the primary source of information used by clients to monitor their brokers for best execution in the equities markets.

In the section on **research**, participants were asked what was their overall assessment of the effects of unbundling research. A vast majority of respondents did not consider that it had a positive effect. Amongst options presented in the consultation, authorizing joint payment (bundling) for SME research was one of the options most favoured by respondents.

With regard to commodity derivatives, users, market operators and regulators agree that while **the position limit regime** has worked for mature benchmark contracts, it **introduced adverse effects on the development of new, illiquid and liquid non-benchmark contracts.** Due to overly restrictive (de minimis) limits and the inflexibility in the current regime, market participants are discouraged from on-venue trading which negatively impacts the orderly pricing of contracts and transparency in the market. **A vast majority of respondents does not agree that the cost and benefits are balanced**.

A vast majority of respondents states that the **current scope of the position limit regime is not fit for purpose**. An overwhelming majority sees clear merits in limiting the application of the regime to a restricted set of critical commodity contracts. The most supported criterion to identify critical and significant contracts is open interest, type and variety of market participants.

A very large majority suggested that **a position limit exemption for a financial counterparty under mandatory liquidity provision obligations should apply** in a similar manner to the liquidity provision exemption set out in Article 2(4) of MiFID. Furthermore, a majority of respondents were of the opinion that such an exemption should also extend to non-financial counterparties and that the exemption is needed also for liquid contracts.

A very large majority of the respondents are supportive of **extending the hedging exemption to financial counterparties**. Most of those respondents favour including all financial counterparties in the hedging exemption. .

7.1.2 ESMA's work

From 17 July to 6 September ESMA ran a "Call for evidence on Impact of the inducements and costs and charges disclosure requirements under MiFID II". The responses were published[27] and summarised in ESMA's final advice[28] sent to the commission on 1 April 2020.

[27] https://www.esma.europa.eu/press-news/consultations/call-evidence-impact-inducements-and-costs-and-charges-disclosure

From 24 May 2019 to 5 July 2019 ESMA ran a "Call for evidence on position limits in commodity derivatives". The responses were used to build on for the ESMA public consultation from 5 November 2019 to 8 January 2020. The responses of the public consultation were published[29] and summarised in ESMA's MiFID II Review report on position limits and position management[30] sent to the commission on 1 April 2020. On 17 December 2019, ESMA organised a roundtable with a limited number of stakeholders (trading venues, financial and non-financial counterparties) to allow for a more in-depth discussion on the different issues discussed in ESMA's Consultation Paper.

7.1.3 Member States Consultations (EGESC/FSC)

A list of measures to be part of a targeted Capital Markets Recovery Package containing amendments in MiFID II and in the Prospectus Regulation has been discussed with Member States in the course of three EGESC meetings, respectively on 11 May, 29 May, 16 June and 3 July, and during one FSC meeting on 5 June.

MiFID requirements on information and product governance

Experts were generally supportive of the amendments as long as they would not negatively affect the protection of retail clients. In particular, a majority can accept the default switch to paperless documentation, the delayed transmission of information documents for distance communication and the exclusion of corporate bonds with "make whole" clauses from the product governance requirements, also for retail investors, as long as retail investors have the opportunity to opt back into receiving information on paper.

Commodities

There is overwhelming support on the proposed reforms to the position limit rules for only significant and critical contracts, hedging exemption for mandatory liquidity provision and financial counterparties that are part of a predominantly commercial group and a qualitative ancillary activity test.

Investment research

A majority of delegations agree that research coverage, in particular for small and mid-cap companies, is too low across the Union and that urgent measures should be taken to improve this situation, which is particularly detrimental in the current crisis environment.

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28 ESMA's Technical Advice to the Commission on the impact of the inducements and costs and charges disclosure requirements under MiFID II : https://www.esma.europa.eu/sites/default/files/library/esma35-43-2126_technical_advice_on_inducements_and_costs_and_charges_disclosures.pdf

29 https://www.esma.europa.eu/press-news/consultations/consultation-mifid-ii-review-report-position-limits-and-position-management#TODO

30 MiFID II Review report on position limits and position management: https://www.esma.europa.eu/sites/default/files/library/esma70-156-2311_mifid_ii_review_report_position_limits.pdf

A consensus emerged that would favour the authorisation of joint payment for brokerage and services provided that this exemption to the unbundling rule is narrowed to brokerage services relating to companies with a market capitalisation of less than EUR 1 billion.

7.2 Prospectus consultation of stakeholders

7.2.1 Member States Consultations (EGESC/FSC)

The new EU Recovery Prospectus was supported by a majority of delegations and understood as a measure that could help issuers in the recovery phase after the crisis resulting from the COVID-19 pandemic. A majority of delegations stated that they would prefer the EU Recovery Prospectus to be limited in time (temporary regime) and in scope (this prospectus can only be used by issuers already listed for 18 months that want to issue shares).

The fact that market participants raised technical concerns about the operation of the obligation of timely notification of prospectus supplements was not contested during EGESC meetings. A majority of delegations agree with the principle of targeted amendments to financial intermediaries' obligations to notify prospectus supplements as necessary to free up resources for financial intermediaries and make the provision workable. A further temporary alleviation for the issuance of non-equity securities by credit institutions was discussed at the EGESC meeting on 3 July 2020.

7.3 Securitisation consultation of stakeholders

7.3.1 EBA's work and the Basel Committee

In preparing its report on synthetic securitisation, the EBA published a discussion paper in September 2019 for a two-month consultation. With most of the responses expressing strong support both for the analysis of the market and for the rationale for the development of an STS framework for synthetic securitisation, EBA was able to publish its report building on a pretty broad strong consensus among stakeholders, for both the feasibility of such framework and the relevant criteria that would make synthetic securitisation part of it. Moreover, both the EBA synthetics report and it opinion on NPEs were approved by a wide majority in the EBA Board of Supervisors, where all supervisory authorities – national and SSM – are present.

In addition, the adjustments to the NPE prudential calibration are based on the public consultation launched by the Basel Committee on 23 June 2020, where all the major global jurisdictions are represented.

7.3.2 Member States Consultations (EGBPI/FSC)

On 5 June 2020, the proposed changes to the Securitisation framework were discussed in the FSC. In that context, Member States had the chance to express their opinions and observations. A vast majority of MS showed support for the proposed targeted amendments.

On the proposal on synthetic securitisations, a broad majority was in favour of a specific framework for STS on-balance-sheet securitisation and they considered it useful to link such a

regime with a clearly defined differentiated prudential regulatory treatment in CRR. Only a small minority of Member States expressed formal opposition, while a few Member States had reservations about the timing of the proposals or their concrete implementation, rather than on the substance of the proposals.

The proposal on NPE securitisations was also supported by the majority of Member States. A few Member States expressed concern about the timing and practical implementation of the proposal, with only one Member State disagreeing on substance. A substantial majority also considered it useful to follow the compromise solution pursued by the Basel Committee. On the suggested amendment concerning the deletion of Article 249(3) of the CRR, a majority of Member States expressed their support for this proposal, with a few only more reluctant to take a position yet.

A discussion on the changes in the securitisation framework (including both the Securitisation Regulation and CRR) took place at the EGBPI meeting on 30 June. Overall, the meeting showed opinions very similar to the ones already presented by Member States in the FSC. On the general rationale, few Member States raised doubts about the usefulness of the legislative changes and questioned whether these changes should be introduced according to the proposed timeline. On the suggested extension of the STS framework to synthetic balance sheet securitisations, on the proposed amendments to the Securitisation Regulation and CRR to facilitate NPE securitisation and on the deletion of Article 249(3) of the CRR Member States experts' views broadly aligned with those expressed during the FSC.