Towards Variable Union in Europe's Capital Markets

Report of the 2017 ECMI Annual Conference

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Towards Variable Union in Europe's Capital Markets

Final Report of the 2017 ECMI Annual Conference

In the past seven years, the European Capital Markets Institute (ECMI) has brought together academics, policymakers and industry representatives to take stock of the progress made so far in building a genuine European capital market. At the Annual Conference organised on 23 November 2017, the participants identified the challenges and opportunities that lie ahead but also assessed whether more ambition is required. In particular, they shared their views on long-term investment, supervisory architecture, derivatives markets and fintech.

The key message was that the capital markets union (CMU) must go beyond the actions set for end-2019. CMU is a long-term project that will require the support of multiple stakeholders from both the public and private sectors. Capital markets, in particular equity, and long-term institutional investors, are best suited to finance real assets in the economy. There are certainly areas that should be brought within the remit of ESMA, but achieving supervisory convergence will be the main objective where this is neither possible nor necessary. Brexit-driven relocation might lead to a more balanced landscape of the euro-denominated clearing activities in Europe. With respect to the potential of distributed ledger technology, it is essential to establish a critical mass of market players and interoperability with the existing infrastructures.

Cosmina Amariei
Researcher, ECMI

Apostolos Thomadakis
Researcher, ECMI

Disclaimer. This report includes the main conclusions from the 2017 ECMI Annual Conference. Its content should be attributed solely to the rapporteurs. The speakers participated in their personal capacity and their statements do not necessarily reflect the official position of the organisation they are affiliated with. A detailed overview of the proceedings is available **here.**

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Introductory remarks

The CMU Action Plan, slightly amended after the mid-term review, has identified the right areas for further harmonisation at EU level but also much needed work by member states and their NCAs.

The main objective is to improve the access to market finance and mitigate the risks inherent in a financial system that is too dependent on the banking sector. This Action Plan should therefore be continued, if not accelerated.

That being said, the time has come to articulate a post-2019 vision. The current CMU was conceived before Brexit, with a list of priorities that did not consider a Union without its most important financial centre. Undoubtedly, the EU needs to engage in strategic thinking on what the post-Brexit CMU with 27 member states should look like. Moreover, tectonic shifts in financial markets are simply unavoidable. To this end, a group of 'wise persons' is needed in order to take a fresh look at the Single Market for financial services. Most importantly, this group should take a helicopter view that is not connected to the current legislative agenda, the Brexit negotiations and other third country issues, and ignore the on-going competition between existing financial centres.

To mention but a few of the issues to be considered by such a group:

- Will some key financing and refinancing markets have sufficient critical mass post-Brexit?
- Will this affect the capacity of the Union to finance its economies, or will it run the risk of being dependent on outside financial centres?
- What kind of markets, products, infrastructures and talent pools should be created, attracted and incentivised?
- How will the EU compare in terms of technology, innovation and disruptive forces in financial flows and markets?
- What kind of intermediation would best serve a self-sufficient and vibrant EU27 capital market?
- How would this new CMU interact with the EU, the Eurozone and the Banking Union?
- What about the global positioning and enhancing the attractiveness of European capital markets?

Finally, market participants will continue to create financing channels and markets within evolving regulatory frameworks. What is really missing today is a strategic and ambitious sense of direction to ensure that the Union will be properly equipped to finance itself.

Fabrice Demarigny

Global Head of Financial Advisory Services, Mazars

Chairman, Board of ECMI

Opening speech

Prof. Dr. Claudia M. Buch
Deutsche Bundesbank

The European financial system remains bank-based but other financial institutions have caught up in recent years. Equity capital was a stable source of funding during the financial crisis and the reliance on cross-border debt finance has declined since the crisis. Cross-border risk-sharing through capital markets in Europe remains limited. There is potential for the CMU project to further develop and integrate European capital markets. In particular, a higher share of equity in finance and in cross-border capital flows has the potential to generate a 'double dividend' in terms of growth and stability. There are three main priorities for reforms. First, dealing with the stock of non-performing assets, as these can impede structural change and distort credit allocation. Second, as regards the flow of new funds into firms, barriers to the development and integration of European capital markets should be removed. Third, takeover rules and corporate governance structures can be impediments to (cross-border) investments and M&A transactions. Nonetheless, the full harmonisation of national regulations may not be needed or desirable. In addition, promoting the financing of SMEs should not be a policy goal per se. Rather, creating a competitive landscape for firms to contest markets and to promote innovations should be a priority. The CMU should also avoid creating additional distortions. The political importance of, for example, long-term infrastructure projects and environmentally friendly forms of investment for society at large can hardly be questioned. But steering investments into particular asset classes by means of financial regulations may lead to a misallocation of resources and create incentives to engage in excessive risk-taking. For instance, changing risk weights to encourage the development of specific market segments or asset classes sets the wrong incentives. The full speech is available **here.**

Short vs long-term investment: What will capital markets deliver?

At present, capital markets have reached varying stages of development throughout Europe, and there remains a marked mismatch between supply and demand on a cross-border basis. The degree of (in) direct participation of retail investors and also the size/structure of the non-bank financial sector vary significantly across member states. The strengthening of long-term savings and investment channels through well-functioning, deeper and highly integrated capital markets remains a priority. Many factors ¬– the central banks' stance on tapering, changing economic/financial conditions, evolving demographics, regulation and technological developments – will impact asset allocation in the coming years. What themes are likely to dominate the investment space? Does the current supply of products meet the needs of retail investors? Are institutional investors equipped for major market/regulatory/technological shifts? Do current rules provide adequate incentives for long-term, sustainable investment?

Ulrich Bindseil
European Central Bank

Rick Lacaille
State Street Global Advisors

Laurent Clamagirand
AXA Group

Martina Macpherson
Network for Sustainable Financial Markets

In the coming years, market participants are expected to better align their capital allocations with the long-term needs of the real economy. More transparency is needed and confidence in the financial sector must be restored. **Ulrich Bindseil** (presentation) stressed that efficient capital markets are best suited to finance real assets, and therefore further enable the transition towards more sustainable growth models. This is coupled with a renewed emphasis on the need to increase retail and institutional activity in the equity markets, i.e. initiatives aiming to 're-equitise' the investment culture. **Rick Lacaille** (presentation) emphasised that the demand for long duration and spread assets is huge but the pools of 'sticky' capital remain rather small. When it comes to the capacity of insurers and pension funds to engage in long-term investments, there are numerous constraints related to their balance sheets, the overall market conditions, prudential/accounting requirements or tax regimes. **Laurent Clamagirand** (presentation) noted that Solvency 2 has been a major driver of asset allocation; reviewing the regulatory treatment of equity and accounting standards is necessary, in his view. Most importantly, institutional investors and asset managers should be equipped seize the opportunities risks and tackle the risks arising from material sustainability/ESG factors (and maybe captured by prudential rules) in order to fulfil their obligations to end-investors. **Martina Macpherson** (presentation) indicated that ESG integration into various asset classes is moving steadily from niche to core investment strategies. As regards corporates, there are multiple reporting standards and valuation models, often leading to misalignment with investor expectations. On the investors' side, there are challenges related to fiduciary duty expectations and the lack of investment vehicles and appropriate benchmarks.

Reforming the derivatives markets: Is the puzzle complete?

The UK's withdrawal from the EU seems to have injected some energy into the ongoing reform process. Among others, the current proposals include provisions to extend the temporary exemptions from central clearing obligations for some end-clients and a more centralised supervisory mechanism within ESMA. Moreover, the existing prudential, operational, oversight and risk-management rules are being complemented with a recovery and resolution framework for central counterparties (CCPs). Is the continuity of the critical functions of CCPs guaranteed without an unlimited backstop? Are resolution colleges well placed to resolve CCPs? What role can ESMA play in CCP supervision and recovery and resolution in a post-Brexit environment? Are the Commission's proposals sufficient to make the derivatives markets Brexit-proof? Is there a need for transitional arrangements? And are additional reforms required to make the European derivatives markets more efficient without harming financial stability?

Haoxiang Zhu
MIT Sloan School of Management

Fabrizio Planta
European Securities Markets Authority

Daniel Maguire
LCH Group

Eric Litvack
International Swaps and Derivatives Association

Franklin Allen
Imperial College London

Despite the reforms in the US OTC derivatives market, multilateral trading is still sparse. Eliminating the bifurcation of liquidity should be a priority as it will increase competition and improve market quality. Basel III incentivised the dealer banks to innovate and reconsider their business models. **Haoxiang Zhu** (presentation) argued that trade compression should not be viewed as a complete substitute for mandatory central clearing. While EMIR certainly represents a regulatory milestone, **Fabrizio Planta** (presentation) indicated that the ongoing review offered the opportunity for warranted amendments. The current proposals aim to ensure further supervisory convergence, accelerate certain procedures and improve cooperation with responsible central banks. A new two-tier system for third-country CCPs, and those deemed systemically important (Tier 2) will be subject to stricter requirements. An area that requires attention is avoiding the duplication of data reporting among ESMA, NCAs and the central bank of issue, which could create uncertainty in the market. In parallel, related issues with respect to an enhanced role for ESMA must be separately examined under the review of ESAs. **Daniel Maguire** highlighted that the industry embraced the post-crisis reforms, which have already delivered significant improvements. Nonetheless, the risk of fragmentation may materialise, namely by creating two sub-markets. **Eric Litvack** argued that reviewing, improving and recalibrating EMIR should largely be driven by the objective to encourage greater liquidity and access to risk hedging/transferring for end-users. Regarding the impact of Brexit, the easy option (i.e. location policy) may not be the best option. The hardest option (i.e. enhanced regulatory cooperation and supervision, transitional arrangements) could deliver better and more robust results.

2017 ECMI Best Paper: The failure of a clearinghouse: empirical evidence

Authors: **Guillaume Vuillemey**, HEC Paris and **Vincent Bignon**, Banque de France

Academic Committee (Chair and Vice-Chair)

Andrei Kirilenko, Imperial College London and **Florencio López de Silanes**, SKEMA Business School

CCPs are becoming critical institutions in post-crisis financial markets, due to regulatory requirements to centrally clear all standardised derivatives. This paper provides the first detailed empirical analysis of the failure of a derivatives clearinghouse. Using archival data, the authors find three main reasons for the failure. First, the ill-constructed pool of investors consisting of unsophisticated and non-diversified retail investors. Second, the failure to contain the growth of a large position by its largest member, due to a misuse of the available instruments to manage risk. Third, risk management wasn't as strong as it should have been when prices collapsed, and a large clearing member approached distress. As the interests of the CCP aligned with those of the defaulted member, the CCP engaged in risk-shifting behaviour. While better capitalised CCPs are desirable to reduce risk-shifting incentives near distress, the paper concludes that a governance structure that gives more weight to hedgers than liquidity providers, as well as well-designed default management schemes (i.e. default waterfalls) can significantly curb risk-shifting behaviours.

The full paper is available **here**.

DLT and its applications: Revolution or evolution?

Distributed ledger technology (DLT) is still at an early stage, but more solutions will come to the market in the next five years and be subject to 'business' proof-of-concept testing. In particular, the financial services industry needs to address longstanding operational inefficiencies and find ways to enable further simplification, standardisation and transparency. Most benefits are expected in the areas of trade and post-trade. Nonetheless, there remain many questions about the robustness, accessibility, interoperability, governance and the risk-management framework. In which segments is DLT most likely to bring about major benefits and achieve the necessary scale? How can be the potential risks introduced by DLT be mitigated? Will DLT lead to further disintermediation in the financial sector? How does DLT interact with the existing EU regulatory framework for securities markets (MiFID 2, EMIR)?

Angela Walch
St. Mary's University, Texas

Jan Bart de Boer
ABN AMRO Clearing

Tom Casteleyn
BNY Mellon

Simon Toms
Allen & Overy

David Ostojitsch
Association for Financial Markets in Europe

DLT has been linked to various segments of the capital markets, such as clearing and settlement activities, securities issuance and trading, fund management/distribution, record of ownership and safekeeping of assets, transaction and securities data reporting. **Angela Walch** (presentation) emphasised that while we are moving beyond the DLT hype, many misunderstandings and overstatements persist. A critical and relentlessly practical approach to how we design and use the technology is mandatory. Most of the changes witnessed in capital markets over the last decade were driven by regulation and/or technology. For **Jan Bart de Boer**, there is no reason to believe that market participants implementing DLT will not have to comply with the existing regulatory framework. Radical changes to incumbents' business models might not happen as soon as expected. For **Simon Toms**, regulation and governance are key. Some important questions are yet to be answered: what happens when DLT goes wrong; how do we get our records back; if there is a dispute, where do we litigate that dispute and which law applies? DLT could be used in-house to improve certain operational processes and resilience but also to create, transfer and prove ownership of assets in a centralised network. **Tom Casteleyn** sees a clear opportunity, especially for those asset classes where there is no centralised infrastructure market yet (i.e. gold, corporate/syndicated loans, trade finance). Nonetheless, a critical mass of market players and interoperability is essential for the DLT to take off. Taking big 'chunks' of capital markets activity and putting them on the DLT might not happen in the short to medium run. For these reasons, the disruptive forces of the DLT may be more incremental than revolutionary or fully transformational.

Closing speech

Ugo Bassi
European Commission

CMU is a pro-growth, pro-business, pro-jobs project that aims to rebalance the financing structure in Europe and create new opportunities for all types of investors. The objective is to deliver on as many actions as possible before end-2019. The next Commission will certainly continue to support the CMU project. As concerns the Review of ESAs, there are areas that could benefit from centralised supervision at ESMA, such as the approval of certain prospectuses, benchmarks, Europe-wide CCP or any type of purely European product. When it comes to FinTech, targeted interventions are needed so that developments continue to take place in a more controlled manner. To this end, the Commission will issue an Action Plan on FinTech. A first example will be in the area of crowd funding. Another top priority on the agenda is sustainable finance.

The transition to a low-carbon, climate resilient and circular economy requires the full backing of private investors. In particular, the EU has committed to implement the Paris Climate Agreement in a firm, determined and rapid manner. More and safer corporate bonds would allow companies to diversify their funding sources. Nonetheless, a number of concerns need to be addressed, in particular making issuance easier for companies, increasing access for investors and ensuring liquidity, transparency and stability in this segment. As for the public equity markets, high costs and excessive regulatory burdens often outweigh the benefits. Small and targeted adjustments to the existing rules should encourage SMEs to go public. This is particularly relevant for the success of the SME Growth Market.



Final remarks

The future of Europe's capital markets is uncertain in the face of policy, market and technological developments.

In the wake of the financial crisis, the Juncker Commission set the ambition of further aligning the different markets in Europe and allowing for better risk-sharing mechanisms.

Three years on, it is clear that it remains a useful project, but is probably also a distant objective. Asset allocation patterns in Europe continue to be very diverse. Political events in the most developed European capital markets will create additional barriers. Global technological developments raise big governance questions and market supervisory structures are evolving in a more ad hoc way, rather than being clearly structured.

For ECMI, this means that much remains to be done to monitor these developments and remind policymakers of the inefficiencies in Europe's capital markets.

Karel Lannoo

CEO, CEPS and General Manager, ECMI

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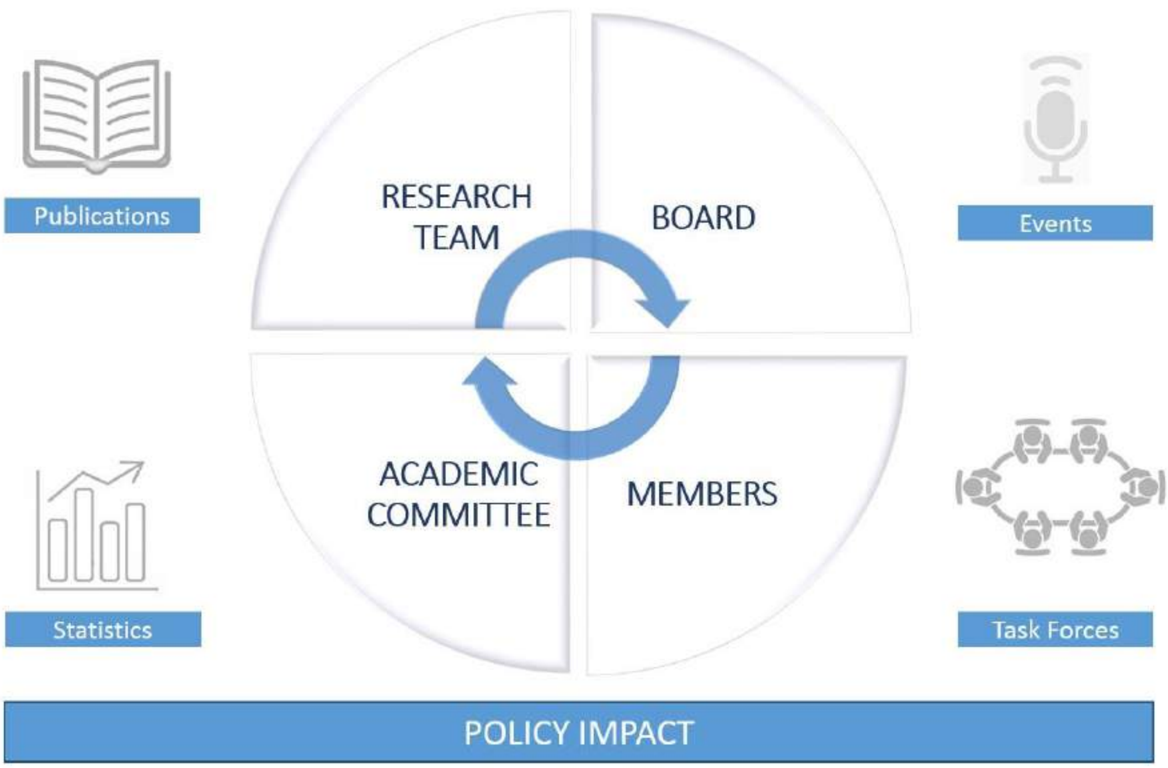
About the European Capital Markets Institute

Mission statement. ECMI conducts in-depth research aimed at informing the public debate and policy-making process on issues relevant to capital markets. Through its various activities, ECMI facilitates the interaction among policymakers, market participants, and academics. ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels.



Core activities. The exchanges among various stakeholders are fuelled by the work done by its researchers, such as opinion pieces, commentaries, policy briefs, research reports, working papers, event reports, statistical package. In addition, ECMI organises seminars, workshops, conferences, task forces that offer multiple networking opportunities. ECMI also undertakes studies commissioned by the EU institutions and other organisations, and publishes contributions from high-profile external researchers.

Membership and governance. The membership is open to private companies/associations, regulatory authorities and academic institutions. The board members provide the strategic direction, supervise the management team and the financial soundness of the institute. The research staff works on the basis of an independent agenda; they are assisted by the members of the academic committee.

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CEPS EVENT REPORT

Thinking ahead for Europe

Towards the Right Policy Mix for a Thriving European Capital Market

Report of the 2016 ECMI Annual Conference

9 November 2016

Venue: National Bank of Belgium

Rapporteur: Cosmina Amariei

Abstract

On top of the vulnerabilities stemming from the incompleteness of the economic and monetary union, the financial and sovereign debt crises showed not only that the 'intensity' but also the 'quality' of the financial integration process matters. With the banking union and the capital markets union, one would hope for more 'sustainable' cross-border financial flows that could strengthen the virtuous circle of financial integration, financial stability and economic growth. For this to actually materialise, the remaining building blocks need to be put in place, national barriers to be knocked down while other policies (monetary, fiscal and structural) to become increasingly effective. At present, capital markets are at different stages of development across EU member states, and matching the supply and demand of capital on a cross-border basis remains problematic. While the banking sector is expected to remain the dominant source of finance, well-functioning, deeper and highly integrated European capital markets could provide alternative funding opportunities for companies and better choices for retail and institutional investors.

At the 7th Annual Conference of the European Capital Markets Institute, participants engaged in in-depth discussions on the right policy mix for creating a thriving European capital market. This high-level event featured four separate sessions with keynote speeches/presentations followed by panel debates on: i) the consequences of a prolonged low interest rate environment for the financial institutions and the real economy, ii) the suitability of capital markets-based solutions in dealing with the portfolios of non-performing loans straining the banking sector, iii) the need for a single European capital markets supervisor, iv) the impact of the distributed ledger technology on trading and post-trading market infrastructure. Most participants expressed the view that advancing with CMU is even more important in the current economic and political environment. Overall, bolder actions are needed in the coming years, and the mid-term review of the CMU Action Plan (scheduled for 2017) should not be relegated to becoming a mere tick-box exercise.

DISCLAIMER: *The content of this report is not a transcript of the speakers' interventions and should instead be understood as the interpretation of their views by the rapporteur. The speakers participated at the conference in their personal capacity and their views do not necessarily reflect the official position of the organisation they are affiliated with.*

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Towards the right policy mix for a thriving European capital market

2016 ECMI Annual Conference: Final Report

The 2016 ECMI Annual Conference was jointly organised by the European Capital Markets Institute and the Brevan Howard Centre for Financial Analysis at Imperial College Business School. Hosted by the National Bank of Belgium, this high-level event brought together over 30 speakers (academics, policy-makers, and market participants) to share their expertise with more than 300 participants from across Europe and beyond and to discuss the challenges in creating a genuine European capital market.

Karel Lannoo
General Manager, ECMI

"The ECMI Annual Conference was an excellent opportunity to hear the latest insights on a broad set of issues affecting capital markets in Europe, and to debate these views with experts from a wide variety of organisations. For the first time, ECMI also successfully organised a call for papers, which culminated in the award of two prizes to young academics, selected from a large set of submissions."

Fabrice Demarigny
Chairman, ECMI Board

"Against the background of growing uncertainty about the added value of the EU to society, it is clearly time for reflection. One of the most pressing questions is how the Capital Markets Union can contribute to more efficient investment and fluid financing of growth and job creation within the Single Market. ECMI events gather together a unique set of expertise and viewpoints coming from policy-makers, academics and representatives of the industry. Thanks to them, this year's Annual Conference provided solid thinking and evidence to define a proper policy mix to create prosperous European capital markets."

What is the impact of negative interest rates on Europe's financial system? How do we get back to normal?

Macroeconomic and institutional outlook

Keynote speech

Peter Praet, Executive Board Member and Chief Economist, European Central Bank

Keynote presentation

Miles Kimball, Eugene D. Eaton Jr. Professor of Economics, University of Colorado Boulder

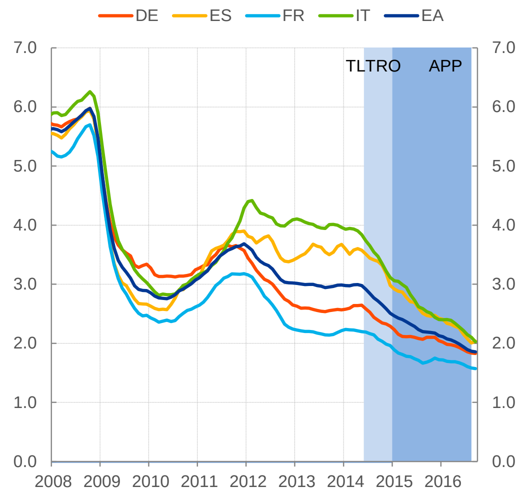
Panel discussion

Daniel Gros, Director, CEPS
Alberto Gallo, Partner, Portfolio Manager and Head of Macro Strategies, Algebris Investments
Andy Jobst, Adviser to the Managing Director and CFO, World Bank Group
Jan Vincent-Rostowski, Professor of Economics, Central European University, and former Minister of Finance, Poland

Moderator: **Mathias Dewatripont**, Director, National Bank of Belgium and Professor of Economics, Université Libre de Bruxelles

In his introductory remarks, **Peter Praet** stressed that the monetary policy pass-through on financial conditions, in general, and on borrowing conditions, in particular, has been quite strong, even though it is a relatively recent phenomenon.

Composite bank lending rates for non-financial corporations (percent per annum)



The banking sector plays a key role in the monetary policy transmission mechanism. To this end, the European Central Bank (ECB) will continue to monitor closely the effects of monetary policy measures on the position and prospects of the banking system. Banks are now more resilient than before the crisis, but they are not sufficiently profitable. This tension is likely to weaken the resilience of the banking sector. At this stage, the ECB doesn't see strong evidence that bank profitability, on aggregate, has been suffering from its comprehensive package of measures. Nonetheless, the longer the current low interest rate environment persists, the greater the pressure on bank profitability will be. In his view, banks will have to address multiple challenges related to legacy issues (accumulation of NPLs), cyclical factors (low growth, low inflation, low interest rates), structural change (operational inefficiencies), and the regulatory environment (uncertainty and lack of clarity). *The full speech and presentation are available here.*

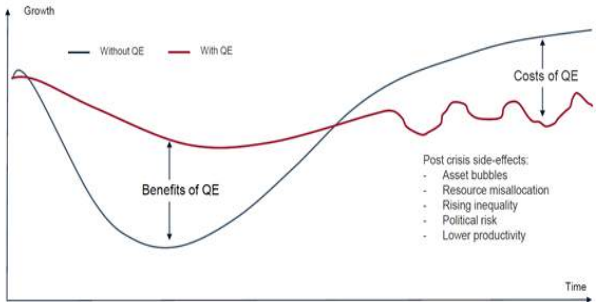
Given the side effects of a prolonged period of low interest rates, **Miles Kimball** proposed the alternative of deeper negative interest rate policy (NIRP) for shorter periods of time. He argued that there are adequate ways of dealing with paper currency, balance sheet and political worries, and that there is effectively no lower bound on interest rates. For example, one measure that could help dealing with the banks' profitability and political costs is to use a multi-tier formula for interest rates, i.e. to subsidise banks to give zero rates to small household accounts (€2,000 per individual) and pass through the negative rates only to large household accounts. In terms of cyclical

stabilisation policies, monetary policy can do the job, with fiscal policy able to focus again on the long run. In his view, there is still a lot of misunderstanding about the efficiency of the monetary policy transmission mechanism in a negative territory compared to a positive one. *The presentation is available here*.

Daniel Gros argued that the ECB might be chasing the 'wrong' target (CPI inflation). It could instead be looking at the evolution of the GDP deflator, which so far doesn't show clear signs of deflation or of an incipient deflationary spiral. This, in turn, would strengthen the case to exit the current accommodative stance. On the ECB's ability to 'engineer' short vs. long-term interest rates, he further questioned how much (in terms of basis points) from the downward trend in interest rates can be actually attributed solely to monetary policy. In his view, the net impact of low interest rates could be zero or even negative, i.e. what debtors gain might not be reflected in higher spending because of balance sheet constraints. In addition, what creditors lose might be reflected much more immediately in lower spending.

Alberto Gallo called for a normalisation of the monetary policy. The longer quantitative easing (QE) an NIRP are in place, the larger the collateral effects will be: on the real economy (resource misallocation), financial markets (asset bubbles) and society (income inequality).

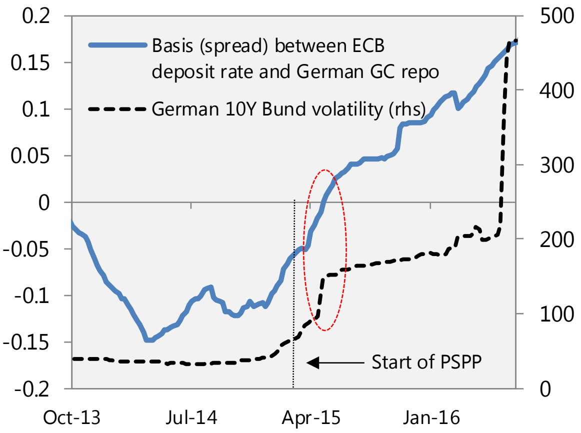
Policy Responses, Limitations and Collateral Effects



A more 'flexible' financial system is needed for the real economy, e.g. growth-indexed bonds, more efficient bankruptcy systems, and deeper capital markets. This, in turn, will allow the economy to be less sensitive to interest rates when another recession occurs, i.e. an economy that is more independent of its financial system than an economy that serves its financial system. In addition, fiscal policies and structural reforms could make the financial system more resilient to a low-growth environment, weaker demographics and technological deflation. *The presentation is available here.*

Andy Jobst emphasised that the decision of central banks to actively pursue a NIRP needs to be put in the context of the secular decline in the long-term interest rates (in both a nominal and real sense), the impact on the natural rate and the disinflationary pressures (mostly due to demographic factors). In his view, the negative lower bound has not been reached yet. He further explained that a NIRP has made the repo activity more costly (repo rate < ECB deposit rate), thereby reducing the incentives for market making in the area of governments bonds.

Impact of repo rates on cash markets volatility



Taking a full equilibrium view on the impact of NIRP on the banking sector (the lending channel, not only profitability) suggests positive aggregate effects. This largely depends on whether there are sufficient remedies in place in order to cope with 'sticky' deposits. *The presentation is available here*.

Jan Vincent-Rostowski explained that the current interest environment is a result of excessive savings and very little investment. The ageing population tends to save more and maybe one of the most effective structural reforms is to increase the retirement age. The investment is low because of the aggregate demand problem but also due to the technical progress in the form of capital savings. Wages are also not growing. In short, even though there are long-term underlying causes for real interest rates to be very low or close to zero, the problem of low aggregate demand in the short to medium run cannot be ignored. Looking forward, the real question should focus on the next recession and the challenges posed by the huge amounts of outstanding central bank money as a result of QE. In the presence of a liquidity trap, a fiscal channel could actually help monetary transmission, but this would require significant changes in underlying institutional structures.

Market-based solutions to bank restructuring: Can active financial markets help to clean up banks' balance sheets?

Law and Finance

Keynote speech

Gert-Jan Koopman, Deputy Director-General for State Aid, DG Competition, European Commission

Keynote presentation

Fernando Restoy, Deputy Governor, Banco de España

Panel discussion

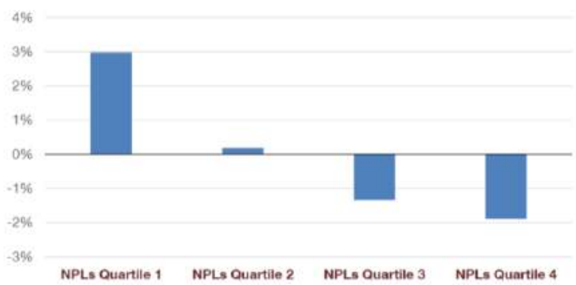
Luis D.S. Morais, Professor of Financial Regulation, EU Law and Competition Law, University of Lisbon Law School
Alessandro Penati, President, Quaestio Capital Management
Michel Madelain, Vice Chairman, Moody's Investors Service
Henrik Bjerre-Nielsen, CEO, Finansiel Stabilitet A/S

Moderator: **Franklin Allen,** Executive Director of the Brevan Howard Centre, Professor of Finance and Economics, Imperial College London

Gert-Jan Koopman stressed that the discussion about NPLs has to be seen in this wider context of a very challenging environment for banks. By mid-2016, the gross carrying amount of NPL in the EU amounted to over EUR 1 trillion while the average weighted NPL ratio stood at 5.5% of liabilities, with a notable improvement compared to the 6.7% recorded in September 2014. When designing specific solutions, it is necessary to understand that the situation differs greatly across European countries and across individual banks. In particular, in ten Member States the NPL ratio is still above 10% and more than 40% of the total stock of NPL in the EU is concentrated in the five countries with the highest NPL levels (Cyprus, Greece, Slovenia, Portugal and Italy). In his view, appropriate policies and regulations can and have to be developed in three main areas: provisioning policies, legal and judicial reforms and removing existing impediments to the functioning of secondary markets for NPLs. Also, an asset management company (AMC) could still remain an effective option provided that both bank-specific and sector-wide restructuring processes take place. The State Aid framework will continue to offer possibilities for member states in the form of non-aid impaired asset measures, intervention under the precautionary recapitalisation scenario (more suitable for moderate capital shortfalls, limited burden sharing and more contribution from the public sector) and liquidation under national legislation. If the bank is failing, there is no reason to deviate from the bail-in rules under BRRD. *The full speech is available here.*

Fernando Restoy indicated that NPL reduction may have an immediate negative impact on profitability and capital buffers. There are enforceability difficulties, especially for less capitalised banks which in turn are those with higher NPLs on balance sheets.

CET1 JUN 2016 (relative to SSM average)



The main avenue for dealing with the NPL problem is to further develop the secondary market for distressed assets. To this end, a series of obstacles on both the demand and supply need to be tackled and further action by supervisors is needed. In particular, it is important to enhance transparency in order to reduce the prevailing information asymmetry. As for other solutions, securitisation can help only partially while an AMC can facilitate the cleaning up of balance sheets but not necessarily activities in the secondary markets. It

might not always be obvious whether a purely private sector intervention would actually be sufficient. There should scope for a more pragmatic, flexible interpretation of the BRRD and State Aid rules (asset transfer valuations, resolution triggers, the scope of burden sharing) in order to facilitate some form of public sector involvement for certain banks, without creating a destabilising effect. For example, the estimate for market price by the European Commission experts is based on a concept that is closer to a fire sale than the real economic long-term value. *The presentation is available here.*

Luis D.S. Morais emphasised that the different constraints and prospects in various national markers show there is no one-size-fits-all type of solution. Securitisation may have a role to play, but the STS proposal lacks consistency. An active involvement by the supervisory authorities in the certification process might be needed. In his view, solutions that entail excessive forms of legal and financial engineering should be avoided. Also, state incentives for market-based solutions may represent a hybrid approach. In certain markets, government-funded or partially-funded or supported vehicles could be an alternative. Nonetheless, the extent to which such measures could be employed depends on the interplay with state aid control rules and the BRRD. *The presentation is available here.*

Michel Madelain noted that there is no simple solution to a problem of such dimension. It is important to put in place some intermediate steps in order to avoid making the banking system more vulnerable during the transition, i.e. allowing banks to be able to sell assets in an orderly manner. With respect to the contribution of securitisation, he believes it will be quite marginal (in the first half of 2016, SME loans securitisation amounted to EUR 5bn). There is also a limited track record in handling such assets. The traditional drivers – funding or capital arbitrage – are missing. He also listed numerous impediments to the securitisation of NPLs: the absence of price transparency, the lack of a clear credit history, assets with no predictable cash flows, capital charges, etc. It is also difficult to assess the volume of credit enhancement needed to achieve a certain level of credit quality and to verify the availability of collateral.

Henrik Bjerre-Nielsen shared from Denmark's experience in dealing with distressed banking activities. After taking over a bank, the FSC first tries to sell the so-called 'green' exposures (deposits, retail and commercial exposures) to other banks. The second step is to turn the so-called red exposures into cash by bundling and selling them to other (foreign) financial firms that would use those for securitisation. This tool has been used seven times. Lastly, after the sale of the remaining assets, the bank is turned into a financial company without a banking license, more like an AMC. When a foreign investment fund is involved, there is the possibility to decide on the application of Danish customer protection rules, on a contractual basis, with potential disputes to be settled in Danish courts. *The presentation is available here.*

In his written intervention, **Alessandro Penati** argued that a market-based solution requires banks to deleverage either by raising capital or by shedding assets. At present, Europe lacks the investors, the intermediaries, the infrastructure and the regulatory and legal framework for an efficient market for the sale of loans. The market for non-bank credit is also in its infancy compared to the US. Thus the whole burden of deleveraging falls on raising capital. At the same time, bank profitability is too low to allow banks to raise the capital required by the regulators. In many cases, this has induced governments to step into banks' capital. In his view, further regulatory and government action should aim to create a credit market in Europe that disintermediates banks.

Reshaping the governance of Europe's capital markets: Is enforcement the 'weakest link'?

Governance

Keynote presentation

Sébastien Raspiller, Deputy Director, Corporate Financing and Financial Markets Division, Directorate General of the Treasury, French Ministry of Economy and Finance

Panel discussion

Raffaella Assetta, Team Leader, Free movement of capital and application of EU law Unit, DG FISMA, European Commission
Alexandra Hachmeister, Chief Regulatory Officer, Deutsche Börse AG
Josina Kamerling, Head of Regulatory Outreach EMEA, CFA Institute
David Wright, Partner, Flint Global and Chairman, Eurofi
Carmine Di Noia, Commissioner, Italian Securities and Exchange Commission – Consob

Moderator: **Fabrice Demarigny,** Global Head of Financial Advisory Services and Capital Markets Activities, Mazars

Sébastien Raspiller emphasised the need to de-fragment and further develop capital markets in Europe. Capital Markets Union (CMU) should be first and foremost about greater diversification of funding sources for the real economy (households, corporates, and infrastructure). A common rulebook is necessary but not sufficient. The quality of rules determines the efficiency of market supervision. Less room for divergent interpretations at national level is needed for a uniform application of rules and convergence of supervisory practices. As for the twin peaks model, he highlighted the difference between market supervision and financial supervision, i.e. supervising entities versus financial activities. On the role of ESMA, the focus should be on the available toolkit and the capacity to use it in order to achieve better market supervision. He also called for more pragmatism on this issue than simply placing it very high on the political agenda.

Raffaella Assetta indicated that EU rules have to be implemented in a timely and correct manner. In practice, there are delays and divergences in the transposition in national legislation (gold plating of EU rules), which undermines the level playing field. In the recent call for evidence, these were presented as creating additional costs and burdens for firms.

Once the legal framework is in place, the national supervisors are on the frontline to ensure enforcement. European supervisory authorities (ESAs) will continue to play a key role in achieving supervisory convergence. The Commission usually carries out a number activities in order to facilitate the transposition, assesses the completeness and tries to address potential issues with the member states.

Alexandra Hachmeister pointed out that the current legal framework and governance structure proved to be fit for purpose in the recent turmoil over the summer. Markets were able to cope with the situation and communication channels between industry and supervisors functioned very well. What has been observed in practice is that there are different levels of expertise across supervisory authorities either at the national or European level. National supervisors are closer to their markets and it's important that their valuable know-how is not lost in case of further transfer of powers (subsidiarity principle). Nonetheless, frictions in cross-border transactions and home bias by national supervisors need to be overcome. In her view, achieving a level playing field and supervisory convergence should be looked at also from a global perspective.

Josina Kamerling stressed that investors still lack trust in financial services providers and need more transparency/clarity on fees and costs and better returns. This has been achieved only partially through MiFID2/MiFIR, PRIIPS, etc. In addition, the discussion needs to be put in the wider context of still underdeveloped capital markets in Europe, markets that move so quickly and fintech developments coming very strong (e.g. automated advice, crowd funding). To this end, she advocated stronger EU-wide horizontal investor protection and redress rules (to clarify *the how and where from* for individual investors*).* At the same time, ESMA should be given stronger harmonising powers at EU level for investors. In this way, the CMU could be a true counterbalance to banking union.

On the progress on the substance**, David Wright** believes that CMU is going too slowly, there is insufficient urgency or focus and the big pieces seem to be blocked. In his view, a major test for building a bigger supply of investable capital in Europe is the Commission's proposal on Pan-European Personal Pension Products coming out next year. On ESMA, he explained that so far it has done a huge amount of technical regulatory work, has some supervisory and enforcement powers (trade repositories, credit rating agencies) and has fined and recently carried out its first mediation case. A lot more needs to be done on supervisory convergence and it would help greatly if member states were to move towards more regulations rather than variable implementation of directives. In his view, it is important to think by the end of next year about a staged approach, a practical set of things towards a shift of power to ESMA overtime.

Carmine Di Noia indicated that the first review of ESAs (December 2014) was, by all metrics, very timid. The increasing number of papers by the Joint Committee of ESAs shows the cross-sectional dimension. In the short run, he argued for a new governance of ESAs, in general, and ESMA, in particular (similar to the Management Board at ECB) as a prerequisite to give more supervisory powers at least on systemically important capital market institutions (big issuers, capital markets intermediaries, brokers). In the financial union, central supervision for systemically important institutions would run alongside national supervision for other entities. In the long run, he proposed a 4-peaks model (separating macro- and micro-stability, investor protection and competition) irrespective of the nature of intermediaries. *The presentation is available here.*

Fabrice Demarigny questioned the extent to which further capital markets integration in Europe can be achieved without addressing a number of issues on the institutional front (supervisory efficiency, enforcement capacity, governance, financing of ESAs). There is a real need to think at least 10 years ahead in terms of ambitions for diversifying financing sources for companies and giving more choice to investors within the EU27.

Blockchain and other new technologies: What will capital markets look like as the 21st century unfolds?

Market structure



Keynote presentation

Andrei Kirilenko, Director of the Centre for Global Finance and Technology, Imperial College London

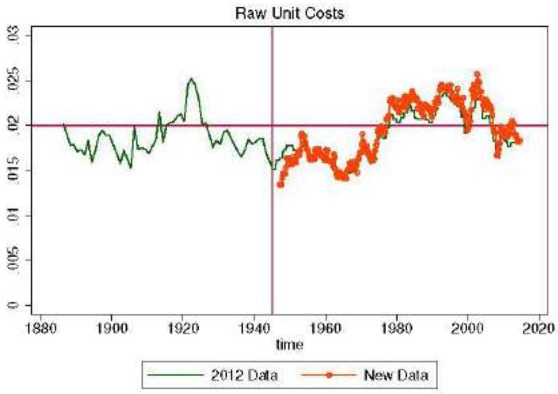
Panel discussion

Hugh Grant, Innovation Director, Investment Banking Technology, Barclays
Corentine Poilvet-Clediere, Head of Regulatory Strategy and Post Trade Policy, Europe, LSEG
Anne Choné, Senior Risk Analysis Officer, Innovation and Product Team, ESMA
Pēteris Zilgalvis, Head of Unit, Digital Single Market Directorate, DG CONNECT, European Commission

Moderator: **Alistair Milne,** Professor of Financial Economics, Loughborough University

Andrei Kirienko stated that a paradigm shift may be needed in order to create/increase net benefits of financial intermediation.

The costs of financial intermediation (Philippon (2016))



The block chain elements (in particular the potential of the underlying DLT) stood out in the recent years. The incumbent financial institutions took notice, the fintech start-ups continue to proliferate while regulators are manifesting increased interest in understanding the benefits, risks and the regulatory implications. At the moment, it appears that more work is needed to be done around parts of the technology and its economics, and the interaction with the regulatory aspects. For the issuance and custody of assets, the use of ISDA master agreements and additional templates for smart contracts are now being tested. Technology is not an issue for IPOs and secondary trading, but quite some work is envisaged on the regulatory side. In the clearing and settlement space, there is a race for various solutions. In his view, whoever comes up with the solution will most very likely become the dominant player. *The presentation is available here.*

Hugh Grant indicated that are very few fintech companies (1 in 10) that are actually building solutions around real business problems (cost reduction, better internal and external processes). What helps them to find the right focus is the close interaction with well-established financial institutions, greater use of mentoring programmes, participation in innovation labs, incubators as well as regulatory sandboxes. Cost reduction and Regtech are a priority in the current environment. Every bank is doing some experimentation with the DLT in the clearing and settlement space (also smart contracts), either alone or in small groups. There are real opportunities to leverage the technology in the capital markets space, but issues around common standards on reference data, KYC processes and interoperability need to be addressed.

Corentine Poilvet-Clediere argued that DLT promises new efficiencies for financial markets infrastructure (FMI), but this will largely depend on the specific-use cases. There is tremendous potential for evolution but not a revolution in the financial structure. The first concern is about the regulated functions, i.e. how to properly and proportionally adapt the regulatory framework in order to absorb the block chain innovations. The second concern is commercial, i.e. it is yet to be seen whether the cost savings will translate into material improvement for the end client. Lastly, this technology should be looked at in relation to the complexity of products and the market, e.g. real-time settlement might not work in markets that do not have sufficient liquidity. *The presentation is available here.*

Anne Choné explained that deciding to take a balanced approach would giv a better understanding of the DLT and how this innovation would fit into the existing regulatory framework. The technology is still at an early stage; there is no DLT system operating at a large scale in financial markets yet. In her view, the technology will act more as an 'enabler' rather a 'disrupter'. It could bring key benefits in the post-trade area (more efficient back-office, less time, less reconciliation) but also improve reporting capabilities and KYC processes. There are a number of challenges (adopting common standards, sharing the same reference data, using the same protocols) to be addressed, in addition to the technology itself (privacy, governance of the network) and the regulatory constraints.

Pēteris Zilgalvis explained in detail the priorities on innovation, digital agenda for financial services and fintech. He referred to the Commission's Start-up and Scale-up Initiative (foreseeing also an enabling framework for regulatory sandboxes) and the Financial Technology Task Force (FTTF), co-chaired by DG FISMA and DG CONNECT. In his view, block chain has the potential to be a transformative technology with wide applications in various economic sectors. A study has been commissioned for 2017 to look at the link between standards and block chain for interoperability purposes. The Free Flow of Data Initiative is also very relevant for the financial sector, in particular associated data with the block chain (jurisdictional governance, ownership of the machine generated data, standards and quality of data).

ECMI Call for papers

Presentation of the winning papers

Stephanie Chan (University of Amsterdam): "Contingent convertible instruments(CoCos): Design, Risk Shifting Incentives and Financial Fragility" (with Sweder van Wijnbergen)

Yannick Timmer (Trinity College Dublin):"Cyclical Investment Behaviour across Financial Institutions"

Discussion with

Florencio Lopez de Silanes, Professor of Finance, EDHEC Business School & Vice-Chair, Academic Committee

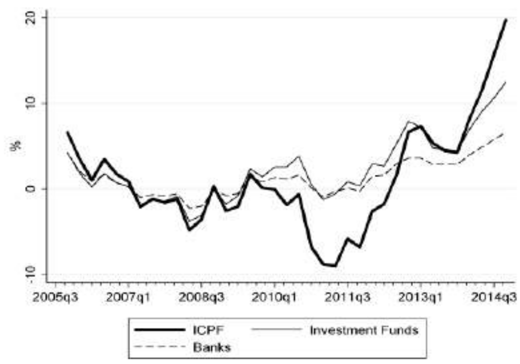
Moderator: **Andrei Kirilenko**, Director of the Centre for Global Finance and Technology, Imperial College London & Chair, Academic Committee

In her paper, **Stephanie Chan** indicated that if the conversion leads to a wealth transfer from CoCos holders to equity holders, it gives rise to undesirable risk-shifting by banks. Moreover, the incentives for risk-shifting increase as the financial environment becomes more fragile. Therefore, CoCos may encourage, instead of mitigate, the creation of a financial crisis. In order to sidestep these consequences, their use by banks must be tempered by increasing capital requirements, and as such, they cannot be treated as true substitutes for equity. *The presentation is available here.*

In his paper, **Yannick Timmer** analysed the investment behaviour of different financial institutions with a particular focus on their response to price changes. He shows that while banks and investment funds are pro-cyclical investors (i.e. they exacerbate price dynamics that can lead to higher market volatility), insurance companies and pension funds act counter-cyclically (they buy when prices have fallen and sell when prices have gone up). These results could have important implications for financial regulation of non-bank financial institutions. *The presentation is available here.*

Annual CoCo Issuance of European Banks

Cumulative Capital Gains on Debt Security Holdings





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Informing policy on European capital markets

Navigating the Storm:
Setting long-term goals in volatile market conditions?

2015 Annual Conference · October 20th · National Bank of Belgium, Brussels

2015 ECMI Annual Conference: Final Report

The 2015 ECMI Annual Conference was jointly organised by the European Capital Markets Institute (ECMI), the Centre for European Policy Studies (CEPS) and the Brevan Howard Centre for Financial Analysis at Imperial College London. Co-hosted by the National Bank of Belgium and the Belgian Financial Forum, the high-level event brought together academics, policy-makers, and market participants from across Europe and beyond to discuss the challenges in creating a true European capital market.

Key takeaways

- ***Session 1.*** *Capital markets are needed to improve the funding of European corporates. But what drives financial integration and private cross-border risk-sharing, at the core of market-based systems? Certain legal and economic conditions are essential for the organic development of larger and more-liquid capital markets across the EU. While the Action Plan on Building a Capital Markets Union (CMU) champions the 'bottom-up' approach, some top-down action in the form of common institutions might be necessary due to pre-existing legal systems, market infrastructure and the economic interests in all 28 member states.*

- ***Session 2.*** *The effectiveness of quantitative easing (QE) programmes and the path towards a normalisation of monetary conditions are sources of great concern for central banks around the world. QE is beginning to produce an impact on inflation expectations in countries like Sweden, where the intervention was quite substantial (close to 20% of all local government bonds are held by the central bank). There are also signs of increasing risk-taking behaviour, impact on market prices and redistributive effects. The prospect of a prolonged period of low inflation, however, was considered particularly worrisome for investments and economic growth.*

- ***Session 3.*** *A structural shift towards more market-based finance is inevitable and Europe needs to find its own model. In normal times, financial institutions provide liquidity in the market, but we are not in normal times, as central banks are the key source of market liquidity. This is causing a vast restructuring of the financial landscape and bank business models, but it will take some time for capital markets intermediation to develop further in Europe. Bank financing will continue to play a major role. More needs be done to improve the functioning of "money market funding of capital market lending" at European level, with central banks providing the backstop as "dealer of last resort" to anyone running dealing activities (whether or not a traditional credit institution).*

- ***Session 4.*** *The stability of centralised market infrastructures, such as CCPs (central counterparties), is increasingly taking the centre of the discussion on crisis management. The regulatory framework around margining requirements and crisis management must take into account multiple risks, such as what comes after the 'end of the default waterfall'. In particular, in case of any market event that may hoard trades on a specific financial instrument, 'crowded trades' can increase the overall risk of the infrastructure without changing the portfolio risk composition of individual accounts. These large exposures and extensive interconnections may increase the vulnerability of the system and undermine investor confidence. The current regulatory framework does not take into account the negative network effects of crowded trades. Safeguards must be put in place in order to deal with increased risk that is not picked up by current initial and variation margining models.*

IMPORTANT NOTICE: This report was drafted by Cosmina Amariei, Research Assistant, and Diego Valiante, Head of Research, at the European Capital Markets Institute (ECMI). The content of this event report is not a transcript of the speakers' interventions and should instead be understood as the interpretation of their views by the authors.

Session 1. Europe's Capital Markets Union: What is the 'long-term' view?

Law and finance



Keynote speech

- **Lord Jonathan Hill**, European Commissioner for Financial Stability, Financial Services and Capital Markets Union

Keynote presentation

- **Paul G. Mahoney**, David and Mary Harrison Distinguished Professor of Law, Arnold H. Leon Professor of Law, Dean, University of Virginia School of Law

Preliminary findings of the Final Report of the European Capital Markets Expert Group (ECMEG)

- **Francesco Papadia**, ECMEG Chairman
- **Diego Valiante**, ECMEG Rapporteur, Head of Research, ECMI and Head of Financial Markets and Institutions, CEPS

Panel discussion

- **Kay Swinburne**, MEP, Member of Economic and Monetary Affairs Committee
- **Florencio Lopez de Silanes**, Professor of Finance and Law, EDHEC Business School
- **Yann Le Pallec**, Managing Director, EMEA Ratings Services, Standard & Poor's Europe
- **Philipp Hartmann**, Deputy Director General, Research, European Central Bank

Moderated by **Franklin Allen**, Executive Director of the Brevan Howard Centre, Professor of Finance and Economics, Imperial College London

The ECMI Annual Conference was opened by an in-depth keynote speech by **Commissioner Jonathan Hill,** who described the Capital Markets Union (CMU) as a single market project, a project intended for all 28 member states. The financial crisis showed that Europe's underdeveloped capital markets were not able to fill the gap left by a banking sector under distress. As evidence suggests, the US economy recovered at a faster pace after the crisis thanks to a greater range of funding sources and deeper capital markets. Moreover, the gap between Member States is even bigger than that between Europe and the US.

The integration and development of Europe's capital markets are therefore of paramount significance. While the Action Plan includes a few early measures, it does take a long-term view, aiming to build the CMU step-by-step and bottom-up by identifying long-standing cross-border barriers to the free movement of capital, e.g. insolvency law, tax treatment and securities law. Several areas were highlighted by the Commissioner, such as providing more funding choices to European businesses at different stages of their development, increasing investment choices for retail and institutional investors, and working with the supervisory authorities to strengthen supervisory convergence. *The full speech is available **here**.*

From an historical perspective, **Paul Mahoney** explained that the presence of such a large and integrated capital market in the US is the result of a bottom-up, evolutionary process, mostly driven by the needs of issuing companies, investors, brokers and exchanges. In fact, integration was already well advanced by the time of the Great Depression because financial markets developed around the trade of goods and services, well before financial regulation assumed a more important role. The first federal laws regulating primary securities markets, stock exchanges and listed companies entered into force only in the mid-1930s, as market developments needed some level of rules to minimise the risk of another crisis. The rules regarding negotiable instruments had evolved over a long period to reflect commercial practices and did not vary materially from one state to another. The US federal structure also helped to create uniformity in the choice of law. Over the years, many exchanges and broker-dealers disappeared through liquidations or mergers while a more organised market developed as more centralised structures for clearing, custody and settlement emerged. Only since mid-1970s, when Congress urged the Securities and Exchange Commission (SEC) for the first time to play a leading role in market structure, clearing and settlement and the dissemination of data has its regulatory presence started to intensify.

On the EU versus US comparison, Mahoney noted that the US had the fortunate history of developing its capital markets first and then regulation. Europe is currently doing it the other way around and some level of top-down intervention might be necessary in order to eliminate inefficient regulatory schemes at the country level. *The full speech is available* ***here.***

In discussing the CMU, **Francesco Papadia** indicated that it remains a fairly undefined concept, open to many interpretations. When compared to the monetary union and the banking union, the same degree of understanding and action is yet to be reached. In his view, achieving progress with the CMU is essential before Europe can improve its gloomy economic prospects.

Diego Valiante presented the preliminary findings of the forthcoming ECMEG Report on CMU, including a stylised representation of the European economy's balance sheet by matching the financial assets held by households with the financial liabilities of NFCs (non-financial corporations). Europe's financial system is over-banked and under-marketed and there's very little cross-border financial integration, except for interbank and sovereign bond markets. The equity markets are largely fragmented along geographical lines; and there is a lack of depth and activity in secondary markets with a poor quality of the trading flow. Bond markets are mainly OTC and as active as equity markets, their structure being largely driven by dealers' inventory. The asset management industry is fragmented and costly compared to the US, with fairly limited cross-border and retail penetration. Unlocking the sizeable amount of cash sitting on the balance sheets (estimated around €1.8 trillion) of the households could act as a real game changer.

He emphasised that CMU should be first and foremost about achieving sustainable financial integration in Europe. Other policy objectives (investment and financial stability) are indisputably important, but they should remain outside the CMU project. The financial crisis revealed that not only the intensity but also the quality of the financial integration process matters. The financial integration driven by senior wholesale interbank flows was far from complete and led to sudden stops and liquidity crises. This process can only be rebalanced by allowing for more cross-sectional (market-based) risk-sharing alongside inter-temporal (bank-based) risk-sharing on a cross-border level. The full harmonisation approach has failed in the past and would not work in the future.

Instead, efforts should focus on removing barriers that reduce cost predictability of a cross-border financial transaction (top-down), and leave the rest to regulatory competition (bottom-up). The ECMEG report will therefore revolve around three main building blocks: a minimum informational infrastructure (price discovery), an integrated infrastructure (execution), and a European legal and institutional architecture (public and private enforcement). *The report will be available* ***here.***

Kay Swinburne expressed the opinion that the CMU is a 'single market' piece of legislation. In her view, CMU is definitely not about the four or five most mature capital markets in Europe. Rather, it is about devising the tools to unlock and further develop capital markets across all 28 member states but also creating the opportunities for global investors to come in and participate. CMU has a very large goal at stake, namely to build confidence and trust in Europe's capital markets and try to instigate the cultural change to turn savers into investors and to connect them with the companies that need funding. There are many challenges ahead, but the bottom-up approach, which was never done in Europe, represents a huge opportunity for market participants to come forward with the ideas necessary to identify the barriers and what needs to be corrected/tweaked in the legislative framework. The European Semester country-specific reports and the cumulative impact study may help to highlight which member states are already raising additional barriers, e.g. gold-plating. A European capital market will emerge even without a single supervisor if the plethora of rules enacted in the past five years, i.e. the single rulebook and the level 2 rules coming through ESAs, were enforced adequately by the Commission.

Another important component of the development of capital markets, namely investor protection, was brought into the discussion by **Florencio Lopez de Silanes.** Stronger investor protection, as measured by a series of indices, can create the conditions for deeper, safer and more stable financial markets, better returns for investors and better financing terms for firms. For example, the cost of capital is lower (roughly 25% less) in countries with higher investor protection. In Europe, the UK, but also NL, DK, SE, are leading in terms of investor protection. He indicated that over-regulation becomes problematic to the extent that it can hurt innovation, but investors need some level of protection, which mainly comes from disclosure requirements and the power to act (private enforcement tools). Enhanced disclosure of conflicts of interests and self-dealing is extremely important. There are EU member states in which transparency requirements are not aligned on average with those in the more advanced economies. These practices are expected to improve once the level-2 rules drafted by ESMA become applicable. *The presentation is available* ***here.***

Focusing on the funding structure, **Yann Le Pallec** argued that CMU needs to fundamentally diversify funding for mid-sized corporates and ultimately make them less reliant on bank funding channels. In 2014 alone, 60% of issuers in the US private placements markets were EU-based companies. In Europe, private placement and corporate bond markets are underdeveloped. A pan-European private placement framework and a common prospectus regime for bond issuance will definitely help these markets flourish. In his view, greater disclosure of standardised information by mid-sized corporates is of equal importance. For example, a body of IRFS disclosure standards catering to the needs of mid-sized corporates can make information available to investors across Europe.

This in turn would allow the private sector to produce a broad range of opinions, benchmarks and indicators so that investors can carry out their own due diligence, and ultimately stimulate more investments. Compared with funding patterns in the US, he observed that bank funding is deeply embedded in the European economy, and the CMU will only bring balance to the way in which the European economy is funded. The ability of an economy to finance itself through various and multiple channels is also important from the point of view of financial stability.

By bringing the inter-institutional perspective, **Philipp Hartmann** indicated that the ECB is strongly supportive of the CMU project as it will also improve the economic resiliency of EMU. The bottom-up approach specific to the capital markets union stands in contrast with the top-down approach specific to the banking union. Nonetheless, he made the point that some top-down action in the form of common institutions for capital markets would be required sooner or later.

He also drew the attention to something that is not yet featured in the Action Plan, which is the emphasis on cross-sectional risk-sharing via capital markets. In his view, cross-sectional risk-sharing is both wealth-enhancing, i.e. it helps consumers to smooth consumption, and it is more resilient, i.e. if there are asymmetric shocks it will not unravel like inter-temporal (interbank) risk sharing does. Evidence shows that in the US, 80% of cyclical shocks are buffered by equity, debt, savings and fiscal measures before hitting consumption, while in Europe it is at a mere 40%.

Session 2. Quantitative easing, asset prices and economic growth

Macroeconomic and institutional outlook

Keynote speech

- **Marianne Nessén**, Head of Monetary Policy Department, Sveriges Riksbank

Keynote presentation

- **José-Luis Peydró**, ICREA Professor of Economics, Universitat Pompeu Fabra and Barcelona GSE

Panel discussion

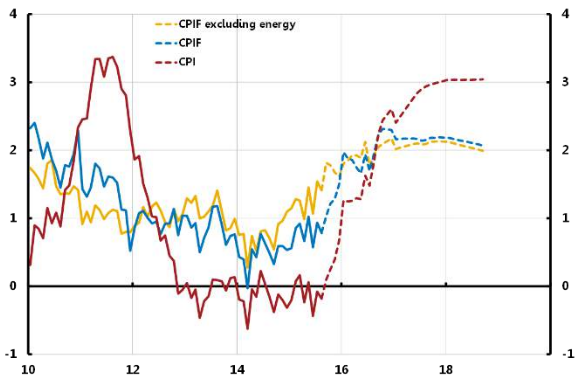
- **William De Vijlder**, Group Chief Economist, BNP Paribas
- **Olivier De Bandt**, Director of Research at the Prudential Supervision Authority, Banque de France
- **Colin Ellis**, EMEA Chief Credit Officer, Moody's

Moderated by **Daniel Gros**, Director, Centre for European Policy Studies

In the aftermath of the financial crisis, central banks around the world engaged in quantitative easing (QE) programmes in an attempt to fuel inflation and growth.

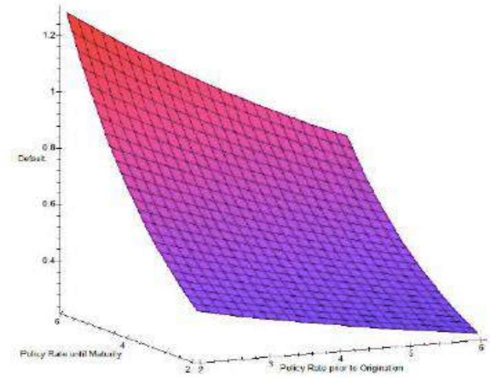
Marianne Nessén opened this session explaining what prompted the Riksbank's decision to significantly step up its intervention at the beginning of 2015, even though both the real economy and the financial sector were in fairly good shape. Firstly, in 2013 and 2014, there was a serious risk for inflation expectations to become unanchored. Stable inflation expectations are a sign of the stability and credibility of the regime but also extremely important in the wage-setting process. Secondly, the central bank couldn't stand idle when it became clear that the ECB was going to embark on a large QE programme, due to its impact on the currency. Since January 2015, the Riksbank has cut the repo rate from 0.0% to -0.35% and made purchases of government bonds on several occasions, which will amount to SEK 200bn by the end of 2016 (almost 20% of the debt stock).

As to the efficiency of these measures, the interest rate differential significantly narrowed, inflation expectations are rising and economic growth is near to the historical average. These measures also kept the effective exchange rate relatively weak, as the krona risked strengthening earlier and more rapidly than originally forecasted.



When it comes to the impact on other asset classes, house prices are rising very rapidly and so also is household indebtedness. Nonetheless, addressing such risk is not in the realm of monetary policy but of fiscal and macro-prudential policies. *The presentation is available* ***here.***

José-Luis Peydró presented empirical studies on the impact of ultra-loose monetary policy in advanced economies via several transmission channels. On the one hand, evidence shows that expansionary monetary policy reduces credit crunches and increases economic activity, especially during crises. Positive effects are stronger on agents (sovereigns, banks, firms and households) that are financially constraint, e.g. more impact on peripheral countries compared to the core countries in the euro area. On the other hand, conducting monetary policy over a prolonged period of time may encourage reckless financial behaviour and search–for-yield by financial intermediaries, which in turn may lead to the creation of credit and asset-price bubbles, and threaten financial stability. In his view, it should not be ignored that the macro-prudential framework has its own limitations. It has been not tested many times and is susceptible to regulatory arbitrage.



With respect to the impact of the Fed's 2013–14 'tapering' announcements on emerging markets, he explained that countries with stronger macroeconomic fundamentals and deeper financial markets, experienced smaller currency depreciations, smaller increases in government bond yields and almost no decline in stock prices compared to the countries that faced an abrupt reversal in capital flows.
*The presentation is available **here.***

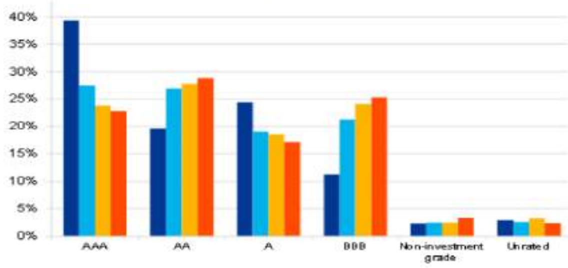
On Peydró's findings about the risk of fire sales by banks and the crowding-out effects on credit provision, **William De Vijlder** argued that in the midst of financial crisis there is a huge degree of uncertainty and opacity and the investment horizons are shortened, i.e. the focus is on instruments that could be priced on a daily basis and exited rapidly. It is only when the uncertainty declines that there is a tendency to move towards longer horizon commitments and extend the central loan book to SMEs. Furthermore, José-Luis Peydró indicated that a positive aspect of QE is that it made this business less attractive for banks but that banks may use central bank liquidity to support trading activities not providing credit to the real economy.

De Vijlder also stressed that current environment is characterised by increasing non-linearity, e.g. while monetary policy in the US is expected to gradually normalise, further stimulus seems to be necessary in the euro area. In his view, the spillover effects, and implicitly the reduced autonomy of monetary policy, have become evident in recent years, e.g. the US vs emerging markets, euro area vs non-euro area countries. On the issue of sequencing, he argued that the problem of too low inflation rates and inflation expectations in the euro area should be addressed first. A strong macro prudential policy framework can tackle the risk of unintended consequences, while the challenges posed by with policy normalisation can be dealt with at a later stage.

From the supervisor's perspective, **Olivier De Bandt** discussed the impact of a QE/low interest rate environment on the risk-taking behaviour of European financial institutions. With respect to insurers, concerns were expressed about a rising duration of their portfolios and a shift towards riskier assets. It was argued that in an attempt to minimise duration mismatches, insurers may increase the duration of their portfolio by investing in longer-term bonds, which may push long-term interest rates down even further.

Data between 2013 and 2014 revealed an increase of 3.6% in asset duration of the German insurers but no significant impact for the French insurers. Some insurers appear to be taking on more risks, with evidence of portfolio shifts towards lower-quality bonds.

Bond investments in selected large euro area insurers split by rating category (from 2011 to 2014)



With respect to banks, the low interest rates had an impact on their profitability. The decrease on net interest margins needs to be replaced by other sources of revenue, higher margin businesses, which are also riskier. Similar to insurers, the data show that banks have extended their asset maturities and started investing in riskier asset classes throughout 2014. All these categories of emerging risks differ across countries and their evolution needs to be further monitored by the supervisors. *The presentation is available **here***.

With reference to the current environment, **Colin Ellis** argued that it revealed something about the ability of central banks to anchor inflation expectations. A critical aspect of QE is the extent to which it feeds through into the real economy, namely lowering borrowing costs for households and corporates. He argued that this may happen much more quickly in a market-based system than in bank-based system, as is found in the EU. Overall, the impact of QE on growth has been much less than expected and the central banks may have overestimated the efficacy of the programmes.

Also QE didn't steer investment in either the US or Europe; the investment cycle picked up along with the broader economic conditions. He also argued that concerns over the impact of QE on asset prices are warranted but somehow unfounded as there are no signs of strong, pervasive asset bubbles at global level, possibly only isolated instances. Based on scenarios devised by Moody's, the idea that European high-yield corporate default rates would suddenly jump from current levels of 2% to return to crisis level of 10-12% seems unlikely. He also made a final point that monetary policy, whether conventional or unconventional, is always redistributive. Provided that QE succeeds in raising asset prices and pushing down yields, savers are going to be affected and those that serve them, namely pension funds, insurers and banks to a certain degree, will come under pressure as well.

Session 3. The rise of asset management and capital market-based financing: A cyclical or a structural shift?

Market structure



Keynote presentation

- **Perry Mehrling**, Professor of Economics, Barnard College, Columbia University

Panel discussion

- **David Blumer**, Head of Europe, Middle East & Africa, BlackRock
- **Rhodri Preece,** Head, Capital Markets Policy EMEA, CFA Institute
- **Huw Van Steenis**, Head of Financial Services Research, Morgan Stanley

Moderated by **Karel Lannoo**, CEO, Centre for European Policy Studies

From a 'money view', **Perry Mehrling** delivered a comprehensive presentation on the interplay between the real economy and the financial system, the interactions between so-called 'deficit' and 'surplus' agents in a bank-based vs. market-based system, and the evolution and co-existence of financial intermediaries of various types (banks, insurers, pensions funds, mutual funds, shadow banks).

In his view, it should be well understood that the monetary and financial system is not just another sector to be encouraged or discouraged according to various priorities, but rather the essential infrastructure for all sectors of any market economy. This is why when the financial plumbing 'runs into trouble', the real economy is going to suffer. Nonetheless, it is at present very difficult to assess the stability of the financial system given the interventions by central banks worldwide and the instability of the main global currency (the US dollar). He remarked: "We've been through 7 years of war finance, and it takes a long time to make the transition from war finance to peace finance. We aren't really sure how it's going to look like, so it's a good idea to walk really slowly and see how it goes."

With respect to market liquidity, he also stresed that one should look at not how much but at who is providing funding: "We cannot move to peace finance without market prices. QE replaced private dealers with public dealers, central banks became delaers of first resort. In a peace economy, the market liquidity is supplied by profit-seeking dealers, not central banks." With respect to the rise of shadow banking, he refered to as "money market funding of capital market lending", a natural form of banking in a globalised word, a centrally important channel of credit for modern times, which needs to be understood on its own terms. "We're all trying to figure out how the emerging new system works, and how its inherent instability can best be managed. In this new system with "mature money-dealing systems but immature risk-dealing systems", it is not the shadow bank that needs a liquidity backstop from central banks, but rather the dealers that stand in between, as shown in the stylised model below.

Capital Funding Bank		Global Money Dealer		Asset Manager	
Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
RMBS CDS IRS	MM funding	MM funding	"deposits"	"deposits"	Capital CDS IRS

Derivative Dealer

Assets	Liabilities
Credit Default Swaps Interest Rate Swaps	Credit Default Swaps Interest Rate Swaps

Mehrling explained that most large investment banks probably have elements of all four functions, while capital funding bank structures can be found on the balance sheets of most European universal banks, but also in off-balance sheet conduits of various kinds. MMFs (money-market funds) might be considered global money dealers, but they are not the only ones.

Pension funds might be considered asset managers, but also non-financial corporate treasurers and even synthetic ETFs (exchange-traded funds). CCPs might be considered derivative dealers, but so also is anyone running a bespoke swap book.

On the question of which model would be best for Europe and the comparison with the US, Mehrling explained that the US system itself is in institutional flux, and is therefore a moving target. Each financial system and its institutional framework are in fact the result of an evolutionary process and there is a particular organic logic behind it. Hence, Europe will have to find its own model (monetary union, banking union, capital markets union, and so on) and think about whether the group of financial services should be different (given that social insurance in Europe is much greater than in US). Equally important is how Europe wants to interface with the emerging new global system in terms of capital inflows and outflows. On the discussion about CMU, one should not be thinking about the 'perfect' model and then pass laws, but about how to contribute to an organic development of capital markets across Europe. *The presentation is available* ***here.***

On the growth of asset managers and AuM (assets under management), **David Blumer** explained that it is actually a reflection of the significant growth of asset owners (private individuals and institutional investors). He welcomed the renewed focus of policy-makers on stimulating greater funding from asset owners into the real economy, whether directly or through intermediaries.

In recent years, both primary and secondary corporate bond markets became extremely fragmented, which is unsatisfactory to both private and institutional investors. For example, the top 10 issuers in Europe and the US have issued together 20 equities but approximately 18,000 bonds. Consequently, he stressed that market participants and policy-makers should focus on repairing market plumbing, in order to not only lower the cost of capital for issuers but also to improve the fairness for the end investors by reducing execution costs in heavily fragmented markets.

Interestingly, more stringent bank rules also have an impact on business models, namely by encouraging banks to focus much more on low capital-intensive activities, such as private banking and retail wealth management, but also to revamp their asset management arms. In the post-crisis period, the financial system is far more robust and ready to go through periods of higher volatility and reduced market liquidity in a much more considered manner. For example, as a results of regulation, there is a shift towards business agency models, where the market risk is borne by end investors and not only by bank balance sheets. There is also a move towards more risk management applied not just within the banks but also at the level of investment funds.

Rhodri Preece indicated that a confluence of factors has allowed asset managers to step up into the credit provision space. First, there is a segment of alternative asset managers, in particular private equity vehicles, that are engaging in direct loan provisioning to borrowers such as mid-sized companies. Second, there is a set of funds that actually invest in loans marketed on peer-to-peer lending platforms. These loans can offer a relatively attractive rate of return to the end investor, who bears the risk, sometimes in the range of 10-15%, which makes them particularly attractive.

Even though significantly smaller in comparison with traditional banking, there is a growth potential for this segment in the short to medium run, particularly in an environment with constraints on banks and low interest rates. Nonetheless, such conditions are likely to fade in the long run, so that the sector will depend on the sustainability of these channels and whether it can compete in a fair manner with the bank-based finance.

In the Action Plan on CMU, there is a special mention about loan originating funds. The Commission has acknowledged the need to look at different legal rules currently applying in different members states, the conditions in which these funds can originate loans and what may be hampering their ability to market these funds cross-border and make the loans available across jurisdictions.

Huw Van Steenis stated that the overreliance on an oversized banking system poses many challenges. A shift towards market-based finance is already happening. In recent years, the capital markets acted as a shock absorber. For example, the eurozone banks have reduced lending by €600 billion in the last five years, while the market-based finance has provided €370 billion more funding to same cohort of eurozone corporates, meaning that 2/3 of all the bank shrinkage has been replaced by market-based funding.

In looking at the possibility for mid-sized companies to tap long-term funding through a European private placement market, one should think about who are going to be the buyers of small bonds from unrated companies, which have not come to the bond market ever before or only episodically. These bonds are likely to be illiquid and quite risky for retail investors, and therefore they would be better placed with insurance companies and pension funds, which have long-term locked-up money, and potentially mutual funds.

He also emphasised that supervisors must be able to understand the risks and test them under various scenarios. For the stress testing of the banking system, the internal and external analytics have significantly improved. Adapting those in a less heavy-handed manner to the asset management community might be helpful, e.g. running mini-stress tests between the supervisor and the asset manager.

Session 4. Unravelling Penelope's web: Crisis management and resolution of financial market infrastructure

Crisis management



Keynote presentation

- **Albert Menkveld**, Professor in Financial Economics, VU University Amsterdam

Panel discussion

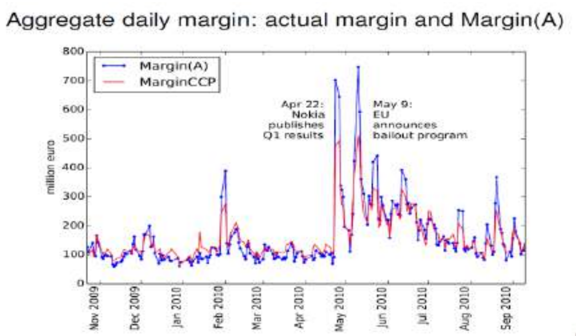
- **Martin Merlin**, Director Financial Markets, European Commission, DG Financial Stability, Financial Services and Capital Markets Union
- **Geert Vanderbeke**, Executive Director, Global Sales & Sales Support, ABN AMRO Clearing
- **Sheri Markose**, Professor of Economics, Essex University
- **Dennis McLaughin**, Group Chief Risk Officer, LCH.Clearnet

Moderated by **Andrei Kirilenko**, Visiting Professor, Brevan Howard Centre, Imperial College Business School

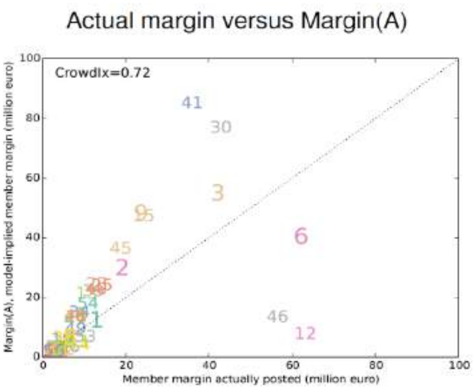
Albert Menkveld presented the main findings a recent paper entitled *"Crowded Trades: An Overlooked Systemic Risk for Central Clearing Counterparties".* Crowded trades, i.e. when the trades crowd on a single security/set of securities or risk factor, constitute a risk to a CCP (central counterparty), and even more when the markets get turbulent. They raise CCP tail risk without changing individual member portfolio (tail) risk. At present, the crowded-trade risk is not appropriately accounted for in the standard CCP risk-management practice of imposing margins on a member-by-member basis. The margins collected by the CCP reflect the risk in that clearing member's portfolio but the extent to which there is a correlation between a clearing member's portfolio returns (P&Ls) due to crowded-trades does not come up.

In order to manage the crowded-trade risk at the CCP level, Menkeveld developed two measures: i) *CrowdIx*, a crowding index, which can take a value between o and 1, in order to measure the size of crowded-trade risk; and ii) *Margin(A),* an alternative margin methodology, which takes a fundamentally different approach relative to standard margin methodologies, as it first computes the aggregate collateral needed at the level of the CCP and then disaggregates it across clearing members. In short, those who join crowded trades are required to post more collateral.

Furthermore, he calculated these two measures for a 2009-10 sample of trades in Nordic stocks by members of a large European CCP. The graph below shows, for the first peak margin day, that the difference between what was actually posted against the margin and what should have been posted, if crowded risk had been accounted for, amounted to €250 million.



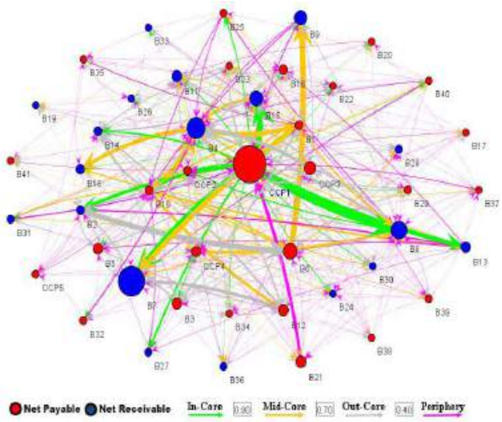
The plot below, in which 57 clearing members were anonymised by a random number between 0 and 100, pertains to day after Nokia's announcement of very disappointing Q1 earnings. For example, member 41, with a trade portfolio heavily exposed to Nokia (around 21%) posted less than €40 million but should have posted more than double that amount, while member 12, for which Nokia was not a top-ten exposure, posted more than €60 million but it should have posted less than €10 million.



As to how industry received the proposals to measure and account for the crowded-trade risk, it was indicated that unpredictable elements/inputs in the computation of the margins might affect trading in negative ways and therefore should be avoided. In other words, solutions that do not interfere with day-to-day trading need to be designed. For example, one possible way would be to measure crowded trades over time, and if the risk manifests itself a lot, then perhaps there should be a discussion of default fund contributions every quarter and an analysis of whether some members should contribute a bit more to the fund. *The presentation is available* ***here.***

Sheri Markose presented the main findings of a co-authored paper "*CCPs and Network Stability Analysis: Reforming OTC Derivatives Markets",* which uses data on derivatives assets and liabilities, Tier 1 capital and liquid asset holdings for the 41 largest banks active in the global OTC derivative markets (interest rates, credit, currency, commodities and equity) in Q2 2012. The network analysis confirms that the increased use of central clearing (under four different scenarios) is fundamentally changing the topology of the financial network, leading to higher risk concentration in CCPs.

Clearing scenario 1 (near term)



The analysis also underscores the importance of understanding the stability of networks in which central clearing and non-central clearing co-exist. Any shortcomings in the design or risk management framework of the CCP could, in the event of an extreme shock, have spillover effects throughout the system. Interconnectedness risk is becoming as important as other categories of risks. The data on banks' OTC derivatives positions also showed that there is a trade-off between liquidity risk and solvency risk. While collateralisation reduces credit risk, at the same time it increases liquidity risk by encumbering banks' high-quality assets. This has broader macroeconomic implications in a collateral-hungry financial system.
The presentation is available ***here.***

From a business perspective, **Geert Vanderbeke** indicated that is important for every CCP to have a diversity of clearing participants and to preserve their trust by fulfilling the payment obligations towards them, e.g. timely distribution of profits.

This suggestion is based on a number of financial safeguards, such as membership structure and supervision, a validated risk-management model, and an efficient default management process (loss absorption waterfall, default fund, recovery and resolution plans). Vanderbeke also stressed that the role of the general clearing member (GCM) should not be underestimated. In Europe, for instance, the GCM is liable for the positions of its portfolio of clients, including non-clearing members. In his view, the risk-management capacity of the clearing members is as important as that of the CCP itself, as they are managing the true risk of their clients. This should also be looked at in the context of highly interconnected global infrastructures, e.g. members clearing their clients' trades, executed on various trading venues, by guaranteeing positions in multiple CCPs. With respect to the burden-sharing in the case of a member default, he was of the opinion that all participants in the chain should participate, including end-investors and even trading platforms. This view may not be particularly welcome by the buy-side using clearing members' services, i.e. it would mean that clearing members will most likely pass-through certain losses to end-users.

Dennis McLaughin indicated that it will be helpful to look at the risks faced by CCPs in a more structured manner, e.g. counterparty risk, liquidity risk, investment risk, operational risk and externalities, focusing in particular on those risks that can hit directly the capital of the CCP – those that fall outside the normal clearing risk protection.

The default of one member or more will give rise to a temporarily unbalanced book and CCPs can apply various well-known tools in order to flatten the book, such as margins, credit policies against members, default funds and unfunded assessments, and even apply variation margin haircuts, if necessary. The CCPs are also facing a large liquidity risk that is related to the market risk of storing the initial margins. For example, EMIR doesn't allow CCPs to keep more than 5% of the collected initial margins unsecured in any commercial bank, which means by default that 95% must be invested in repo markets.

Liquidity risk is even more important at the present time. In McLaughlin's view, there are some contradictory forces at play, in which one set of regulations is mandating central clearing and increasing the liquidity needs of CCPs, while another set is contracting the various avenues available to the CCPs

in which to invest the initial margins, e.g. dealer banks retreating from the repo markets.

CCPs can also incur losses on their investment portfolio and directly hit the capital of the CCP, as there are no members' margins in the way to buffer against them. One way to reduce such an investment risk is for CCPs to introduce 'new skin in the game' rules for clearing members. CCPs are also facing custody risk if their ability to turn paper margins into cash is impaired.

McLaughin also referred to the pro-cyclicality risk, which manifests itself as a result of central banks' actions around the world that are keeping yields very low. In short, margins are falling vis-à-vis yields and volatility, thereby masking the risk in the CCP. Even though these risks have been acknowledged, it is very difficult for CCPs to justify the need for higher margins to their clearing members.

On the crowded-trade risk, he mentioned that three years ago LCH.Clearnet started to measure the alignment risk and charge a margin for the extra risk in the case of securities trading. The CCP is currently looking into extending this into derivatives trading where things are a bit more complex.

Martin Merlin indicated that the regulators have mostly focused on addressing the too-big-to-fail problem in the banking sector, the same questions are now being raised with respect to CCPs. Central clearing does not eliminate the interconnectedness and counterparty risks, but it basically reconfigures these risks within the CCPs. With more classes of OTC derivatives designated for central clearing in Europe, a greater accumulation of risk at the CCP level is expected in the future. The EMIR Review, which is currently under way, provides the possibility to revisit the legislative text if it finds that the prudential measures originally established are in need of further adjustment.

The European Commission is working on a legislative proposal on the recovery and resolution of CCPs within the EU, consisting of a comprehensive toolbox for recovery for CCPs and a comprehensive toolbox for resolution for regulators. It is desirable to stay at the recovery stage and never go into resolution, employing widely accepted tools such as 'cash calls', variation margin haircuts and possibly the forced allocation of contracts among non-defaulting members.

One issue that is still open is whether initial margin haircuts (IMH) should be added to the toolbox. This is particularly problematic as it does not fit well with many insolvency laws in Europe where initial margins, which contain the largest amount of money, are bankruptcy remote. It might also create distortions and possible regulatory arbitrage between the EU and US, which should be avoided. At the same time, in order to minimise taxpayers' losses, one should look upon haircuts of initial margins as a last resort. Dennis McLaughin replied that members have a choice: they can give cash or certain securities for initial margins. Those securities are locked up in a custodian box, which is opened up only if the members go into default, but this solution may also pose liquidity issues.

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The five years ahead:
A New Action Plan for Europe's financial markets?

2014 ECMI Annual Conference Brussels, 29 October · National Bank of Belgium

Report on the 2014 Annual Conference of ECMI

*by Cosmina Amariei and Diego Valiante**

The 2014 ECMI Annual Conference was a high-level event organised by the European Capital Markets Institute (ECMI) and Centre for European Policy Studies (CEPS). It brought together academics, policy-makers, and market participants from across Europe and beyond to engage a diverse audience in lively debates on the challenges facing Europe's financial markets.



Key takeaways

- ***Session 1.*** A lack of risk-sharing financial integration makes the financial system more prone to fragmentation when losses on financial claims materialise. Bank-based over-indebtedness in Europe's private sector has endangered the solvency of states and driven fragmentation. Banking union will not thrive without a fully-fledged fiscal backstop.
- ***Session 2.*** If not properly designed, new capital requirements on banks may have long-lasting effects on liquidity, but they are necessary to prop up the financial system against the risks we experienced during the last financial crisis. Law's elasticity also played a key role in creating the liquidity that financial markets needed to grow and, consequently, offer a space for central bank interventions. Nonetheless, policy-makers should pay more attention to pricing mechanisms. Illiquidity is not necessarily a problem if it is correctly priced.
- ***Session 3.*** Trading technologies have improved market liquidity and offered better price formation through increased competition among trading venues. Despite the unanimous view about the disruptive nature of those technologies advances, views still diverge about what the infinite race to be faster (continuous trading) may produce in terms of collateral damages for market quality. A proposal for discrete trading has reopened discussions about the future of market microstructure.
- ***Session 4.*** Led by social networks, crowdfunding has become a catalyst for the democratisation of innovation and finance. Its rapid development confirms that this social and financial phenomenon is here to stay and could soon complement traditional bank and capital markets funding, especially for start-ups and SMEs.

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* This event report was drafted by Cosmina Amariei (Research Assistant, European Capital Markets Institute) and Diego Valiante (Head of Capital Markets Research and Research Fellow, Centre for European Policy Studies).

Session 1: Reverting Financial Disintegration: What implications for the future of the Euro area in the European Union?

Macroeconomic and institutional outlook



Keynote speech

- **Thomas Wieser**, President of the Eurogroup Working Group and the Economic and Financial Committee, Council of the EU

Keynote presentation

- **Barry Eichengreen**, Pitt Professor of American History and Institutions, University of Cambridge and Professor of Economics and Political Science, University of California, Berkeley

Panel discussion

- **Fabian Amtenbrink**, Professor of European Union Law, Erasmus University Rotterdam and EURO-CEFG
- **Peter Grasmann**, Head of Unit, Economic Analysis of Financial Markets and Financial Stability, European Commission
- **Yves Lemay**, Managing Director, Financial Institutions and Sovereigns, Moody's
- **Philippe Gudin de Vallerin**, Chief European Economist, Barclays

Moderated by **Rebecca Christie**, Bloomberg News Correspondent.

Thomas Wieser, President of the Eurogroup Working Group and the Economic and Financial Committee at the Council of the European Union, opened the conference by discussing the importance of achieving sustainable financial integration for the euro area. While financial integration deepened significantly after the introduction of the euro, the incomplete nature of the financial integration achieved before the crisis - mostly debt-driven and over-reliant on bank-based financing, made the euro area susceptible to fragmentation during the crisis and created many vulnerabilities. Despite improvement in most market segments in the past two years, a relatively high degree of fragmentation still persists. Doubts over the viability and effectiveness of the euro area will only be removed if substantial steps towards economic, fiscal and political union are taken. Nonetheless, Mr Wieser stated that growth in Europe would not come from huge expansionary fiscal policies, but rather from continued reforms and higher levels of private investment. Finally, he argued that the creation of the banking union (BU) contributed to restoring confidence in the banking sector, and that the capital markets union (CMU) has the potential to deepen integration even further.

Barry Eichengreen, Pitt Professor of American History and Institutions at University of Cambridge, questioned the ability of BU to reverse financial fragmentation in the absence of a fully-fledged/adequate fiscal backstop to the resolution mechanism, and perhaps a common deposit guarantee scheme. Greater fiscal integration will create further tensions with EMU outs, he argued. The CMU project will also have to deal with greater integration of securities payment infrastructure, which is not currently as integrated as the currency payment infrastructure. This may be another area of conflict between EMU and non-EMU countries. According to Mr Eichengreen, Monnet's neo-functionalism triggered the law of unintended consequences, particularly if people are not asked about the merits of this approach. This statement was echoed by Fabian Amtenbrink, Professor of European Union Law at the Erasmus University Rotterdam, who called for more inclusive governance of the euro area in order to enhance citizens' support for the project and to avoid a generalised public backlash/resistance. This would also require a greater inter-institutional balance and more powers for the European Parliament.

Although the EU has and will continue to have a predominantly bank-based financial system, the panel saw a greater role for capital markets as the pressure on banks is likely to continue and credit growth will remain sluggish. Yves Lemay, Managing Director for Financial Institutions and Sovereigns at Moody's, argued that facilitating effective market discipline is crucial for the safety and soundness of the banking system. A clear roadmap for capital markets union (CMU) has thus been regarded as essential in view of the new economic climate, not necessarily due to novelty of the project. A more diverse financial system should be able to serve the real economy better and contribute to economic recovery. Peter Grasman, Head of the Economic Analysis of Financial Markets and Financial Stability Unit at the European Commission, made the point that a better understanding of the project is necessary.

With the high likelihood of recession and deflationary spectre in the euro area, Mr Eichengreen recommended more action on the demand side and more caution with respect to structural reforms and fiscal consolidation because they can have deflationary effects, especially in bad times. In the long run, however, these would indeed bring positive effects because the main problem in the euro area is a structural one. Philippe Gudin de Vallerin, Chief European Economist at Barclays, concluded that reforms could be a major contribution to restoring confidence and boosting consumption and investment.

Session 2: Regulating under uncertainty: The impact of financial reforms on liquidity

Law and Finance


Keynote speech

- **Mathias Dewatripont**, Vice Governor, National Bank of Belgium

Keynote presentation

- **Katharina Pistor,** Michael I. Sovern Professor of Law, Columbia Law School

Panel discussion

- **Ed Fishwick**, Co-head of Risk & Quantitative Analysis Group, BlackRock
- **Franklin Allen**, Executive Director, Brevan Howard Centre for Financial Analysis, Imperial College London
- **Enrico Perotti**, Professor of International Finance, University of Amsterdam

Moderated by **Alessio Pacces**, Professor of Law and Finance, Erasmus University Rotterdam and EURO-CEFG.

Matthias Dewatripont, Vice Governor at the National Bank of Belgium, argued that liquidity regulation, together with capital regulation and resolution mechanisms, have been considered necessary to make financial institutions more resilient, less reliant on central banks (free riding) and less likely to induce risk in the system. He nevertheless pointed to the conflict between liquidity requirements and the new "bail-in fashion", which is politically viable but enlarges the set of bank claim-holders, even under systemic stress. Greater long-term junior liabilities may be able to reduce pressure on senior debt-holders and thus reduce the likelihood of systemic stress (or even a run).

Katharina Pistor, Michael I. Sovern Professor of Law at the Columbia Law School, argued that law can shape liquidity in the financial system, given that liquidity vulnerabilities are in some way inherent to most forms of financial intermediation. The legal enforcement of property rights on the financial claim allows liquidity creation in times of growth but also rapid

liquidity shrinkage in times of crisis. Suspension of the law can control the downward pressures.

Franklin Allen, Executive Director at Brevan Howard Centre for Financial Analysis (Imperial College), claimed that the mispricing of liquidity caused panic and disorderly interventions during the crisis. Ed Fishwick, Co-head of Risk & Quantitative Analysis Group at BlackRock, echoed this statement by arguing that illiquidity is not a problem per se, as long as it comes with the right risk premium.

Financial reforms are gradually being implemented worldwide. Until a couple of years ago, liquidity risk was not the main focus of banking regulators. But the financial crisis showed how rapidly market conditions can change, exposing severe liquidity risks for some institutions. The pricing of liquidity should be factored in when deciding to regulate liquidity in one form or another. Liquidity pricing varies over time and depends on volatility in the market conditions, changes in the fundamentals and distortions caused by implicit guarantees (fictitious protection) or reliance on ex post intervention.

The panellists agreed that in the current climate of tighter banking regulation, the 'shadow banking' (or capital markets-based banking) sector is set to grow further. Enrico Perotti, Professor of International Finance at the University of Amsterdam, sounded a note of caution about the incentives that financial institutions have to arbitrage around regulatory capital ratios. Investment products that are similar to banking products will be treated in the same way. Mispricing of shadow banking liquidity requires costly (because unpredictable) ex post intervention.

Session 3: Too fast too furious? The future of market microstructure in shaping a pan-European financial markets architecture

Market microstructure



Keynote presentation

- **Eric Budish**, Associate Professor of Economics, Chicago Booth School of Business

Panel discussion

- **Mark Hemsley**, Chief Executive Officer, BATS Europe
- **Rhodri Preece**, Head Capital Markets Policy, CFA Institute
- **Johannah Ladd**, Secretary General, FIA European Principal Traders Association
- **Frederik ten Veen**, Chief Risk Officer Europe, ABN AMRO Clearing Bank

Moderated by **Gundars Ostrovskis**, Economic Analyst of Financial Markets, European Commission.

Eric Budish, Associate Professor of Economics at the Chicago Booth School of Business, described how the latest developments in trading technologies have radically changed the microstructure of today's financial markets. High-speed and sophisticated quantitative and algorithmic computer programs for generating, routing, and executing orders have become 'business as usual' in the high-frequency trading space. While recognising the benefits in terms of lower volatility and lower transaction costs of the first wave of HFT technologies, Mr Budish argued that a root problem emerges with the high-frequency trading 'arms race' in a continuous trading environment. In his view, this environment does not actually work in continuous time: market correlations that function properly on human-scale time horizons completely break down on high-frequency time horizons (Figure 1), i.e. at a margin of the highest technically possible speed. This correlation breakdown has real consequences: it creates purely technical arbitrage opportunities, available only to whoever is fastest (Figure 2). This is a violation of the efficient market hypothesis (EMH).

Figure 1. Time Series at Human-Scale and High-Frequency Time Horizons

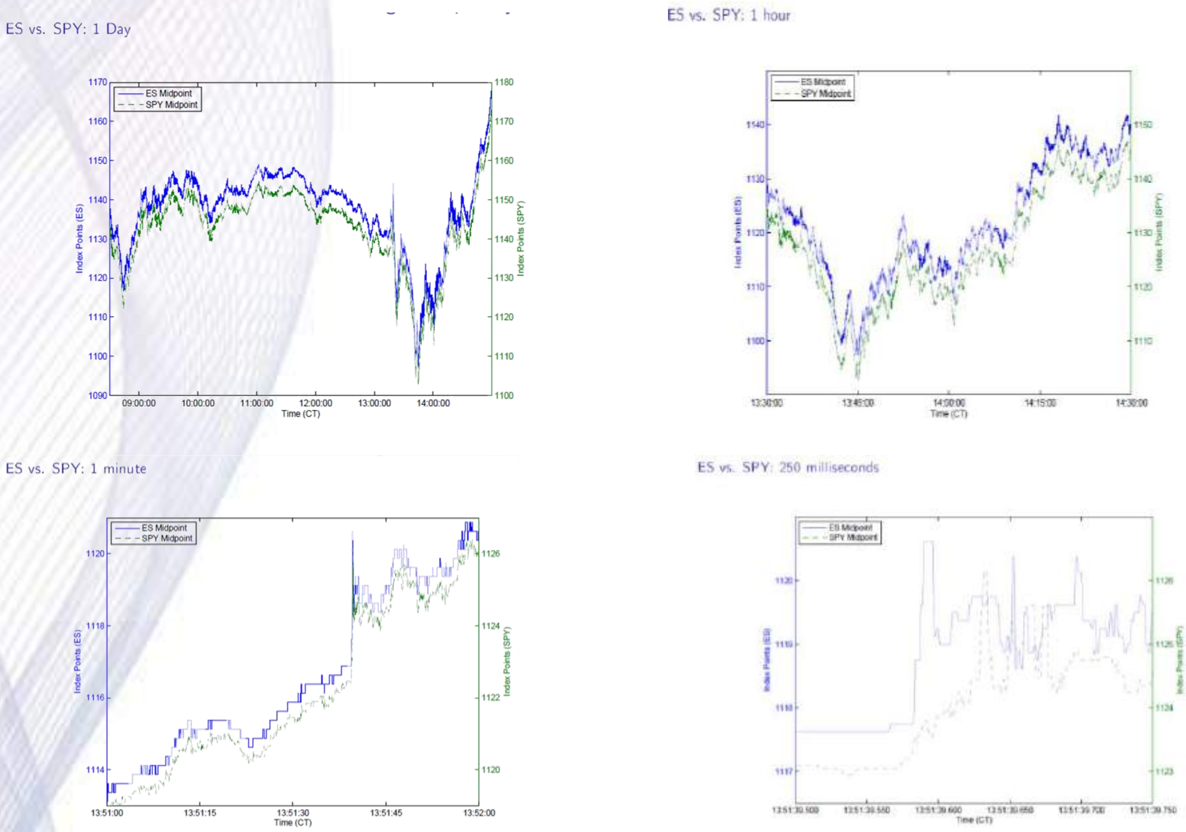
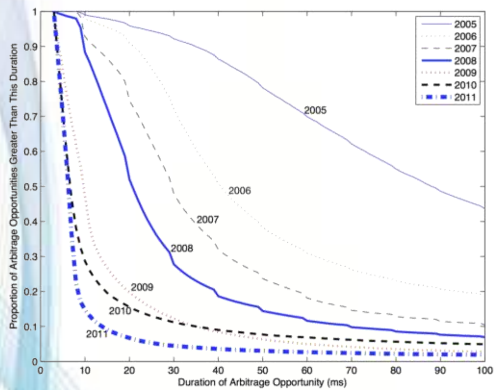


Figure 2. Arbitrage durations per year



Note: Figure 1 depicts the price paths of the two largest securities that track the S&P 500 index, the iShares SPDR S&P 500 exchange traded fund (ticker SPY) and the E-mini Future (ticker ES), on an ordinary trading day in 2011. Figure 2 illustrates how the ES-SPY arbitrage has evolved over time (2005-2011).

Source: Budish, Cramton and Shim (2013): *The High-Frequency Trading Arms Race: Frequent Batch Auctions as a Market Design Response*

The possibility to do arbitrage at the highest speed by occasional HFT 'snipers' creates an additional liquidity cost for market-makers (systematic liquidity providers) whose (by then) old quotes are picked off in the race. Market-makers then pass on sniping costs to investors through higher bid-ask spreads or decide to reduce their liquidity provision engagement. This situation may deteriorate market quality. As a result, Mr Budish and his co-authors proposed a switch to an alternative trading environment where time is discrete and orders are matched at time intervals via batch auctions. This will slow down the zero sum arms race; eliminate sniping and make markets deeper by narrowing bid-ask spreads; and remove purely technical arbitrage profits to achieve a more efficient market structure conducive to greater market quality. The panellists debated an alternative market design to continuous trading, namely discrete trading in the form of frequent batch auction. Mark Hemsley, Chief Executive Officer of BATS Europe, claimed that changing the market microstructure to a series of batch auctions would eliminate pre-trade transparency, which would then be substituted by high-frequency post-trade transparency information. Rhodri Preece, Head of Capital Markets Policy at the CFA Institute, echoed Mr Hemsley by doubting whether continuous trading and discrete batch auction could co-

exist. It was also not clear how feasible batch auctions would be for most non-equities, given their liquidity profile. At present, there are industry players that decided to run pilot tests using batch auctions.

Finally, Johannah Ladd, Secretary General at FIA European Principal Traders Association, argued that the HFT community is open to any market change that is sustainable and does not harm market quality or overly burden the industry. Frederik ten Veen, Chief Risk Officer Europe at ABN AMRO Clearing Bank, also stressed the importance of a well-functioning market infrastructure and the role of HFT to increase interconnection and market efficiency.

Session 4: Sourcing from the crowd: The 'democratisation' of finance?

Access to finance


Keynote presentation

- **Dan Marom**, Co-Author of "The Crowdfunding Revolution", Entrepreneur, Consultant and Researcher

Panel discussion

- **María Teresa Fábregas**, Head of Unit, Securities Markets, European Commission
- **Oliver Gajda**, President, European Crowdfunding Network
- **Karen Kerrigan**, Legal & Financial Director, Seedrs
- **Paul Belleflamme**, Professor of Economics, Louvain School of Management
- **Rainer Riess**, Interim Director General, Federation of European Securities Exchanges

Moderated by **Florencio Lopez de Silanes,** Professor of Finance and Law, EDHEC Business School.

Dan Marom, co-author of "The Crowdfunding Revolution" and entrepreneur, opened the session by claiming that crowdfunding is much more than money, it is a source of engagement and empowerment. He described the different types of crowdfunding platforms, of which there are more than 1,200 today. While still in its infancy, crowdfunding is growing at a very fast pace and Mr Marom believed that it is more than a financing tool as it keeps the capital provider engaged in the initiative over time. In recent years, crowdfunding has become a notable contributor to the democratisation of innovation and finance; an important social and financial phenomenon. It represents a source of funding for those firms that find the traditional intermediation channels very costly. Four models have been developing, based on: a reward, profit-sharing, a loan and equity.

While they all share the advantage of bringing down transaction costs and bridging the gap between fundraisers and funders, Paul Belleflamme, Professor of Economics at Louvain School of Management, argued that they vary significantly in terms of complexity. There are also risks associated with this form of financing, such as fraud, misleading financial promotion/advertising, no proper delivery on promised products, but also underestimation of funds needed to complete promised projects, overvaluation of the project/company, intellectual property rights, thin due diligence, limited exit options from the investment.

Crowdfunding is arguably an infant and deregulated industry. More steps need to be undertaken to raise awareness and gain the trust of the general public. The panellists discussed how industry rules function, to what extent they address various risks, how these could be further improved or complemented and the limitations of self-regulation and competition acting as a primary disciplining device. Having in place a clear legal framework will ensure that contributors are well informed and adequately protected. Several member states have introduced ad hoc legislation for crowdfunding, while others will introduce new laws soon. María Teresa Fábregas, Head of the Securities Markets Unit at the European Commission, claimed that it was important to bring more coherence to the fragmented national frameworks on crowdfunding. The European Commission is currently assessing the benefits and risks associated with this new form of finance, analysing successes and failures, as well as impediments to cross-border activities (fragmentation of the rules on prospectus, legal, tax and accounting treatment of the contributions collected on platforms' accounts, the applicable law in the event of insolvency of the platform).

Oliver Gajda, President of the European Crowdfunding Network, argued that crowdfunding is a disruptive form of financial intermediation that aims to replace segments of financing to start-ups and SMEs that are not covered by banks anymore, as they continue to scale down. Rainer Riess, Interim Director General of the Federation of European Securities Exchanges (FESE), stated that once the industry fixes issues of trust and rights for investors, it can develop on a larger scale as an alternative form of intermediation to business angels and venture capitalists. Karen Kerrigan, Legal & Financial Director at Seedrs, raised awareness about how important effective communication and educational policies are for a better positioning of the industry. Under certain circumstances, platforms may also allow for institutional investors to co-invest alongside the crowd (retail investors). In terms of investment schemes, the funds are either directly transferred between the investor and the company or there is an SPV in-between (one-shareholder type of structure with subscription arrangements in place). Some platforms play a more active role than others in screening and evaluating companies and during the investment and post-investment stages. However, investing in start-ups and early-stage businesses entails many risks, including risk of illiquidity, loss of investment, the possibility of equity dilution, and lack of exit. Some businesses offer pre-emption rights that protect an investor from dilution while some platforms might create put-and-call options that allow better exit options for investors. Increasing awareness about risks is important, especially for an intermediation channel that promises to invest in innovation and ultimately in renewed economic growth.

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CLOSING THE FUNDING GAP: Competition at the heart of the single market

20 years ECMI

Università Commerciale Luigi Bocconi

Jointly organised by the European Capital Markets Institute with Carefin - Università Bocconi and the Belgian Financial Forum

Belgian Financial Forum

Event Report

ECMI Annual Conference 2013
17 October, National Bank of Belgium, Brussels

As a landmark event in Brussels, the 2013 ECMI Annual Conference brought together once again international experts in capital markets from industry, policy-making and academia for a full-day of discussions on October 17th. This year's conference, organised in partnership with the Belgian Financial Forum and Bocconi University (CAREFIN), explained how competition in the single market can help to fill the funding gap. More specifically, it was structured around three sessions on the following topics:

1) **Competition among member states** - Balancing competitiveness and federalism in the eurozone
2) **Competition among financial market operators** - Making pan-European capital markets thrive
3) **Competition among funding sources -** Competition for funding and the role of capital markets





Key takeaways

- *Session 1.* Despite the fact that the eurozone begins to see the light at the end of the tunnel, uncertainty remains on the speed of institutional reform, such as banking union, and greater harmonisation of fiscal policies. More symmetry is needed to implement structural reforms by core countries and to ensure a mechanism of governance that does not create distortive incentives.
- *Session 2*. The financial market is a competitive setting that exhibits characteristics similar to multi-sided platforms. Therefore, it should be subject to ongoing supervision from competition authorities, while financial stability concerns are less significant than some years ago. European capital markets infrastructures need to find a way to succeed in a more competitive environment globally, perhaps by promoting a truly pan-European market architecture.
- *Session 3.* Governance is an essential aspect to ensure greater and better access to finance to corporates. Capital markets are testing several new tools to revive funding for fundamental parts of the economy, such as small- and medium-sized enterprises. The dilemma of promoting the risk-taking needed for growth while deleveraging and de-risking the financial system remains a tough objective to achieve for policy-makers in the aftermath of the crisis.

Session 1. Competition among member states: Balancing competitiveness and federalism in the Eurozone

Keynote speech

- **Thomas Westphal**, Director-General for European Affairs, Federal Ministry of Finance, Federal Republic of Germany

Keynote presentation

- **Andrea Beltratti**, Full Professor of Finance, Università Bocconi, and Chairman of the Board, Eurizon Capital

Panel discussion

- **Marco Buti**, Director-General for Economic and Financial Affairs, European Commission
- **Lúcio Vinhas de Souza**, Managing Director and Sovereign Chief Economist, Moody's Investors Service
- **José Manuel Campa**, Professor of Financial Management and International Economics, IESE Business School, and former Secretary of State for the Economy, Kingdom of Spain
- **Danuta Hübner**, Member of the European Parliament (EPP), and former Commissioner for Regional Policy, European Commission
- **Daniel Gros**, Research Director and Senior Research Fellow, Centre for European Policy Studies

  Moderated by **Freddy van den Spiegel**, Economic Advisor, BNP Paribas Fortis

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Keynote speech

Thomas Westphal, Director-General for European Affairs, German Federal Ministry of Finance, opened the first session focusing his keynote speech on the future political challenges that European governments face in order to restore Europe's competitiveness on the global scenario.

"The main problem of Europe not being a federal State is that politicians can win the elections in their national countries on opposite arguments to the policy indications decided in Brussels. As long this will be possible, we will need to set a proper framework of incentives in order to prevent member states from escaping the need to make the necessary structural reforms."

Westphal highlighted how the challenge for a more competitive Europe will call for important reforms like the definition of a common fiscal policy for the eurozone countries. The success of these reforms will be highly dependent on the way in which EU institutions will manage to rebuild a consensus around the European project against the opposition of national interests. A key area in which national governments chronically fail to pursue EU objectives is the EU budget. According to Westphal, the current EU budget looks like a pool of subsidies and is the clearest example of how national interests are prevailing over EU interests, endangering the credibility of the EU's actions in front of the citizens:

"The EU budget should be used to finance EU public goods and the European Parliament should have a higher control over it".

The implementation of reforms requiring member states to give away substantial parts of their national sovereignty is seen by Westphal as a precondition to restore the EU competitiveness. In any event, this does not mean that all countries will have to look like each other; once the institutional framework has been set, the key driver of international competitiveness still remain *Ricardian specialisation*.

Keynote presentation

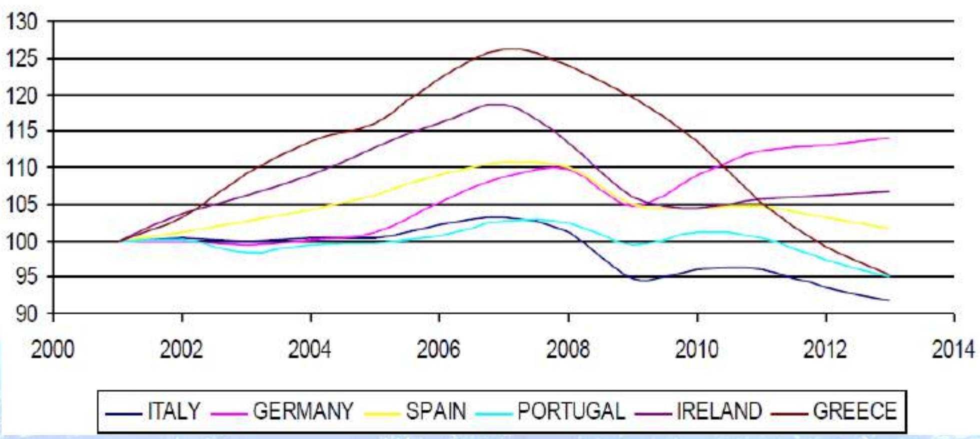
Andrea Beltratti, Professor of Finance at Università Bocconi and Chairman of the Board, Eurizon Capital, gave the keynote presentation of the first session. The first part of Beltratti's remarks aimed at assessing the status of the European macroeconomic environment and of the strategies that European leaders are undertaking in order to restore growth, especially for the GIIPS countries (Greece, Ireland, Italy, Portugal and Spain). From an institutional point of view, he saw positive progress for the development of a common European identity. In this regard, some steps forward have been taken in the form of more coordination at European level of national budgets and, despite the fact that we are still far from a common fiscal policy, all member states are cutting the deficit at the same time. The project of the banking union is another example of this institutional convergence, even though there are still big issues pending, such as:

- The role of the ECB as supervisor and as monetary policy institution,
- The European common deposit guarantee scheme and
- The consequences of bail-in procedures on banks' funding costs, as traditional sources of funding are the deposit base and bondholders.

Beltratti's presentation also included an analysis of the fiscal policy decisions taken by European governments to restore growth in Europe and thus the effectiveness of austerity measures.

"Something has been done on the aggregate supply side but no policy actions targeting aggregate demand have been put in place."

Figure 1. Peripherals' lost decade. GDP per capita, 2000-2014.



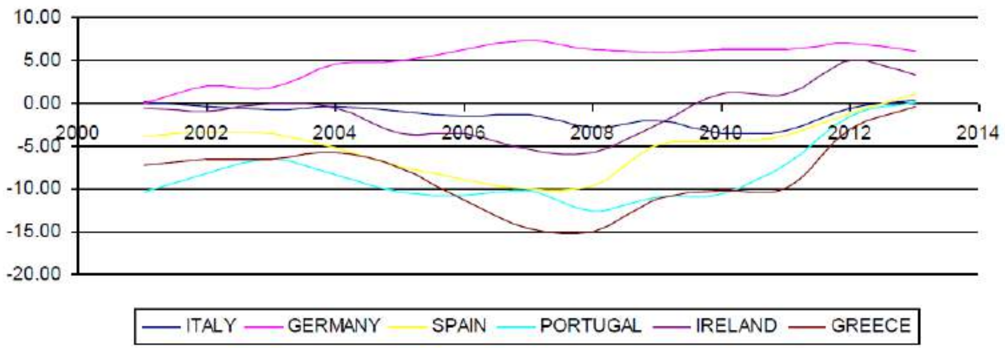
Source: Beltratti from IMF.

The initial response to the crisis has been *austerity* all over Europe. But learning from the experience of Greece and Italy, countries that have maintained fiscal discipline for many years with no positive effects on growth, and building on the new IMF position regarding an income multiplier estimation close to one (if not higher), the number of supporters of big cuts to public expenditures has drastically declined.

"We forgot that, as the Okun's law predicts, a drop in the aggregate output triggers a drop in productivity, which further worsen the competiveness of European economies."

Beltratti noted that the eurozone just returned to a positive growth path after 18 months, and other signals, e.g. the increase in current account surpluses, points at a Europe close to the end of the tunnel.

Figure 2. Current accounts in selected EMU countries



Source: Beltratti from IMF.

Some crucial questions remain: Is this the effect of the strong austerity measures imposed in the years after the crisis, which has cut aggregate demand (imports), or is this the consequence of the easing of such measures in recent months? Can we expect current account surpluses to grow fast enough to have positive effects on demand even when public demand is falling? If the shrinking of the public sector seems unavoidable, how can we avoid the vicious circle triggered by unitary fiscal multipliers? Growth will then have to come from other sources. Beltratti then concluded with some remarks on the EU banking sector:

"To regulate successfully a banking sector, you need one that is alive, and it can be alive if it is profitable."

If we want the banking system to be one of the drivers of European growth, we need to carefully attend to the incentives that regulation is creating for banks. Banks' deleveraging is reducing dramatically credit available to the real economy. We can force bank to be better capitalised, but we cannot force them to lend, as the failure of the UK's Funding for Lending programme witnesses.

The **panel discussion** elaborated on the inputs of the keynote speakers regarding the challenges that European governments will have to face to create a balance between federalism and competitiveness among member states. According to Marco Buti, the "production function factors", both in terms of labour force productivity and the European macroeconomic environment, are areas on which a stronger European coordinated action is required. A more federal Europe, with more national sovereignty to be shared, is necessary to act effectively on those important issues for Europe's competitive position.

In Manuel Campa's view, the policy answers to the crisis made the eurozone countries more balanced generally but much more polarised in terms of foreign assets holdings (FDI), such as banks' holding of sovereign debts, etc. Moreover, Campa claimed that the debate is too unbalanced, especially on what peripheral countries should do while core countries are performing worse than the US, the UK and Japan. Symmetry on the implementation of structural reforms is necessary, as so-called 'virtuous countries' have not done much in that direction. Danuta Hübner, MEP and former Commissioner for regional policies, emphasised the different adjusting mechanisms that each country has, but she argued that a common pathway for structural reform shall be identified and eventually implemented. According to Lúcio Vinhas de Souza, Managing Director and Sovereign Chief Economist at Moody's Investors, peripheral countries are effectively implementing structural reforms and this is witnessed by significant improvements in their external imbalances. These first signs of recovery, anyway, do not have to stop the commitment of these countries in keeping following this reform path as it may take years for these structural changes to be fully received. Daniel Gros pointed that in some areas greater European action is required, i.e. in order to stabilise the financial system, but in others, this is not a priority. We should leave national governments the possibility to make mistakes and to be accountable for these mistakes to stimulate a healthy competition. More long-term political solutions will come once we have ensured that the financial system is stable.


* * *

Session 2. Competition among financial markets operators: Making pan-European capital markets thrive

Keynote speech

- **Joaquín Almunia,** Commissioner for Competition and Vice-President, European Commission

Keynote presentation

- **David Evans**, Executive Director, Jevons Institute for Competition Law and Economics, University College London, and Chairman, Global Economics

Panel discussion

- **Marc Antoine Autheman**, Chairman, Euroclear
- **Mark Hemsley**, Chief Executive Officer, BATS Chi-X Europe
- **Diana Chan**, Chief Executive Officer, EuroCCP
- **Jorge Yzaguirre**, Director of Equity Trading, Bolsas y Mercados Españoles (BME)

Moderated by **Paul Bodart**, Board Member of T2S project, European Central Bank, and former Executive Vice President, BNY Mellon

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Keynote speech

The second session discussed the state of competition among financial markets operators and was opened by the keynote speech of Joaquín Almunia, Commissioner for Competition and Vice-President, European Commission. Commissioner Almunia gave an overview of what DG Competition is focusing on in the area of financial markets.

"The state of competition in Europe's capital markets is uneven."

Mr Almunia remarked how, thanks to the MiFID Directive, competition in trading and post-trading activities for financial instruments like equities is quite strong while in other sectors like derivatives trading, many things still need to be done. To address this problem, the Commission proposed the MiFID II/MiFIR regulation in 2011 which is at the moment being discussed by the Council and the Parliament.

The second aspect on which the Commissioner focused its presentation is the special-regime of *state aid* that was introduced since 2008 in order to cope with the massive public support received by private banks. This tailor-made regime has been justified with three arguments: to preserve financial stability, to safeguard the internal market and to protect the interests of tax-payers. Since August 2013, a new regime of state-aid for banks, compatible with the developments on the Banking Union side, is in place and includes three main changes. First, before recurring to taxpayers money, banks will be asked contributions from shareholders, hybrid and junior/subordinated debt-holders; second, no state-aid recapitalisation will be allowed before a restructuring plan has been approved by the Commission; third, a cap on executive pay for all aided banks would be introduced.

Commissioner Almunia, finally, discussed the major antitrust investigations that DG Competition is carrying on at the moment in the financial markets area. One of the major cases concerns the possible sanction of main investment banks and Markit for having illegally blocked the entrance of Deutsche Boerse and Chicago Mercantile Exchange in the credit derivative business to protect margins. Another major investigation was launched into the Libor/Euribor manipulations. This investigation is assessing whether major investment banks and some brokers set cartel arrangements in the interbank interest rate. The investigation is at an advanced stage and very soon the Commission will disclose its findings.

Mr Almunia concluded its remarks by saying:

"Safeguarding competition in this sector remains a top priority. We will spare no effort to make sure that market players abide by EU competition law: from State Aid to merger control, from abuses of dominance to fight against cartels. When it comes to competition control, financial markets are markets like any other. They will not receive special treatment from us, only special attention when financial stability is at stake."

Keynote presentation

The keynote presentation of the second session was given by Professor David Evans, University College London and University of Chicago, introducing the audience to his studies on the competition policy implications of multi-sided platform businesses. Multi-sided platforms coordinate the demand of distinct groups of customers who need each other in some way; the business of running such platforms consists of matching in the most efficient way the needs of these customers, by subsiding access to a category of users from the fees charged on another set of users that need the services provided by the platform. Multisided platforms are present all around us, from payment systems and game consoles to shopping malls.

Figure 3. A typical day of a Londoner

Source: David Evans.

The most pertinent case for the financial markets industry is typically the business of stock exchanges and clearinghouses. According to Professor Evans, there are three basic conditions for the emergence of a multi-sided platform business: 1) the presence of two or more distinct groups of customers (i.e. merchants and customers in the case of payment systems); 2) there are externalities associated with the two types of customers (i.e. a cardholder benefits from a merchant accepting his card and a merchant benefit from the cardholder being able to pay with a card he accepts); and 3) an

intermediary is necessary to internalise the externalities created by one group for the other group (i.e. customers are not able to enter in a bilateral transaction).

"Competition authorities need to be particularly aware of the specificities of these kind of businesses as efficient pricing strategies can lead them to charge a price to a particular market side below the average variable cost or marginal cost incurred for customers on that market side."

The key message of Professor Evans's presentation is a warning to competent authorities not to limit the development of such platforms as they are a source of a great social value through the internalisation of externalities among different consumers and through the creation of products and services that could not exist without their role of intermediation.

"There is no basis for asking regulators or antitrust enforcers to steer clear of these industries. An understanding of the unique economic principles that govern pricing and investment in multi-sided markets will lead to discerning and efficient regulation of this important type of business."

The **panel discussion** of the second session focused on the topical issue of open access and interoperability in post-trade market infrastructures. Mark Hemsley strongly remarked how the future competiveness and attractiveness of European capital markets *vis-à-vis* global competitors is highly dependent on the accomplishment of a truly pan-European market for trade and post-trade services. The lack of a pan-European best bid and offer (EBBO) poses a potential obstacle to the creation of a competitive pan-European market. In this regard, Diana Chan explained how interoperability is a service that EuroCCP offers to its clients and that is highly valued by customers, who in fact pay for it. Opposition to offer interoperability comes, in Mrs Chan view, from inside the industry as it is seen as a threat to profitability, rather than as a high-value service to offer. Quite different was the view expressed by Jorge Yzaguirre concerning BME's clearing offer. BME is aiming to strengthen its vertical infrastructure and may soon launch its own clearinghouse in the Spanish market. A potential challenge to address, as Marc Antoine Autheman clarified, is the balance of competition policies' action in order to keep both vertical and horizontal models alive.

* * *

Session 3. Competition among funding sources: Competition for funding and the role of capital markets

Keynote speech

- **Colin Mayer**, Peter Moores Professor of Management Studies, Saïd Business School - University of Oxford, and former Director, Oxera

Keynote presentation

- **Julian Callow**, Chief International Economist, Barclays

Panel discussion

- **Paulina Dejmek-Hack**, Member of Cabinet for Commissioner Michel Barnier, Internal Market and Services, European Commission
- **Mark Cliffe**, Chief Economist, ING Group
- **Stefano Caselli**, Full Professor of Banking and Finance, Carefin Research Fellow and Vice-Rector, Università Bocconi
- **Theo Vermaelen**, Schroders Chaired Professor of International Finance and Asset Management, INSEAD Business School

  Moderated by **Thierry Timmermans**, Deputy Director, National Bank of Belgium

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Keynote speech

The keynote speech of the third session was delivered by Colin Mayer, Peter Moores Professor of Management Studies, Saïd Business School at the University of Oxford, who focused on the central role that financial intermediation has in promoting and sustaining economic growth.

Professor Mayer gave some examples of how financial intermediation can be successful and highlighted some common causes at the roots of successful entrepreneurial stories. The business model of the Swedish bank, Handelsbanken, has been used as an example of financial intermediation able to fulfil its role as long-term source of financing for the real economy and, in particular, to improve the access to finance for SMEs as opposed to the traditional UK banking business model. The interesting feature of the Handelsbanken model, which was not affected by the financial crisis, includes a highly decentralised structure where branch managers have complete discretion over each branch activity (from lending decisions to human resources management). As a consequence of this delegation structure, the bank does not have a central financial plan and does not set out long-term goals or a central marketing budget. The alignment of the incentives of executives and shareholders is given by the absence of traditional bonus schemes and the presence of a particular profit-share system: as long as the bank obtains a return-on-equity performance higher than its peer group, which has happened for the last 41 consecutive years, every employee of the bank receives an equal share of the bank's profit, this money is used to buy Handelsbanken's shares which can be accessed by employees only after they have turned 60 years old.

From the analysis of the common features of success stories of financial intermediation and through the comparison with the widespread business model of UK banks, Prof. Mayer drew some general conclusions on a set of priorities that may help the

banking system to be a primary source of long-term financing for the real economy:

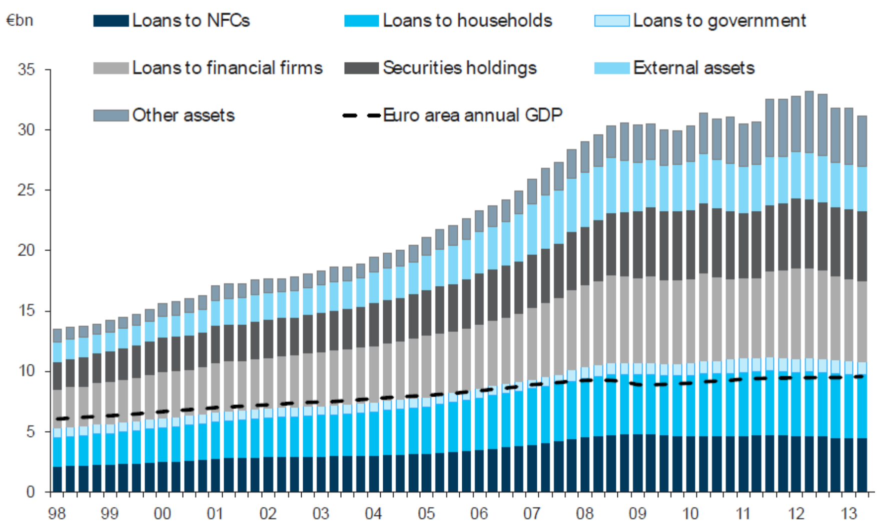
- A need for long-term ownership,
- A stronger focus on corporate financing,
- A deeper industrial knowledge,
- A higher delegation to local decision-making points and
- Long-term measures of performance and incentives.

Prof. Mayer also noted that, in order to revert the actual negative trends regarding the role of banks in SMEs financing structural, changes will have to come not only from 'inside' the banking industry, but also from policy-makers who will have to create more incentives for an active intermediation of banks. In particular, this will have to be done by promoting a more systemic regulation rather than a prescriptive one.

Keynote presentation

The keynote presentation of the third session was given by Julian Callow, Chief International Economist, Barclays. He presented to the audience the latest figures describing eurozone trends regarding the availability of financing sources to non-financial corporations (NFC) and households.

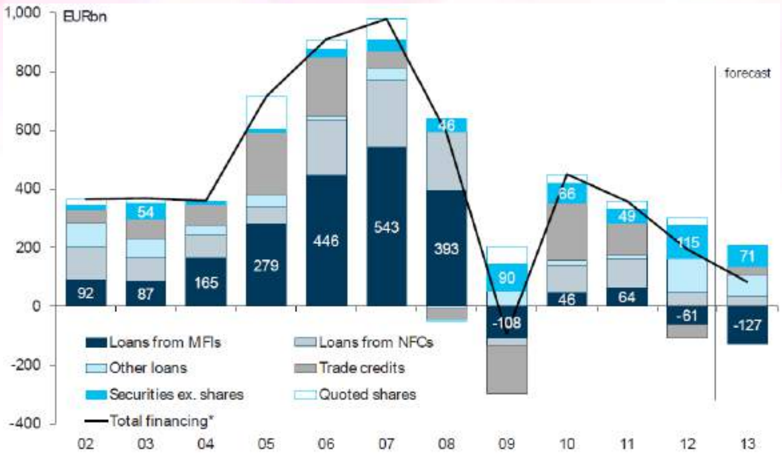
Figure 4. Assets held by euro area credit institutions



Source: Barclays from ECB data.

Data show how *divergent are trends in eurozone countries*: 2013 figures show in countries like France, Germany and the Netherlands positive growth rates of deposits and loans to NFCs and households. Conversely, in all the peripheral countries the same indicators are still facing a large deleveraging of financial institutions exposures towards NFC and households. An analysis of Eurozone banks' balance sheets reveals how, if from the end of the 1990s assets held from credit institutions more than doubled, the largest growth of these assets accounted for loans to other financial institutions, loans to governments and holding of securities while loans to NFCs and households remained grossly stable. In the meantime, non-financial corporations are increasingly relying on securities issuances (mainly debt) in comparison to past years.

Figure 5. Liabilities of non-financial corporations (annual transactions)



Source: Barclays from ECB data.

Other signs point at an *increased polarisation* within the eurozone concerning financing sources and access to credit: data on interest rates applied to new loans to SMEs and on house purchasing show a structural spread between Germany and France versus Italy, Spain Greece and Portugal, while the ECB survey on credit availability show how, again, that German and French SMEs have much lower refusal rate of loan applications compared to their Mediterranean peers.

In trying to show a possible way out from a situation in which bank de-leveraging is likely to continue, and where monetary policies actions are not reaching southern European countries, Mr Callow embraced some of the conclusions of the latest IMF World Economic Outlook, i.e. the *improvement of the securitisation agenda* via:

- The development of the primary and secondary markets for securitisation of SMEs loans,
- The problem of asymmetric treatment of securitised assets vis-à-vis other assets with similar risk characteristics,
- The introduction of governments guarantees for SMEs securitisation,
- The inclusion of SMEs loans in the collateral pool of covered bonds and
- The improvement of risk evaluation for SME securities by regulating and standardising information disclosure.





The **panel discussion** of the third session, elaborating on the two keynote presentations, continued to discuss the possible solutions to the issue of access to finance for SMEs in Europe. Mark Cliffe argued that capital markets can indeed be part of the answer to the sub-optimal

financing condition of SMEs, also driven by a strong 'home bias' and fragmentation in the banking sector, but the growth of these markets is driven by investors and issuer demands. Therefore,

> *"Policy-makers have to confront the dilemma of promoting the risk-taking needed for growth while deleveraging and de-risking the financial system."*

The view of the regulator, coming from Paulina Dejmek-Hack, is that indeed market regulation can impose some costs and burdens on market participants and might be seen as harming the development of capital markets, but the correction of market failures that are embedded in such markets lead to an overall 'positive sum' game. Solving the funding gap is a multidimensional problem that doesn't have a single solution. Prof. Vermaelen cautioned about the limited role that governance can have in generating risk-taking behaviours embedding innovation and so contributing to growth. He also warned about the need to avoid unnecessary burdens and to limit policy tools that discourage risk-taking, which is ultimately the only way to generate groundbreaking innovation and renew economic growth. Prof. Caselli, while ruling out highly beneficial developments in the bond-markets for SMEs, brought some examples of interaction between the public and private sector that proved to be effective in improving the access to finance for SMEs, such as the Venture Capital Trust in the UK, the Elite programme of Borsa Italiana and a model of private equity funds developed in the US where the investment in SME equity is done on a shared based between public and private investors and where losses are shared but profits are private (so called, 'crowdfunding').



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European Capital Markets Institute
Event Report • 2012 Annual Conference

Capital Markets for Growth

18 October 2012 • National Bank of Belgium

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Capital Markets for Growth

ECMI Annual Conference 2012

18 October, National Bank of Belgium, Brussels

Event Report

With over 400 participants, the ECMI Annual Conference 2012 brought together international experts in capital markets from industry, policy-making and academia for a full day of discussions in Brussels. This year's conference was structured around four sessions focusing on the following topics: 1) the macroeconomic outlook for the euro area, 2) the role of capital markets after bank deleveraging, 3) market structure reforms and 4) investor protection in the single market. ECMI organised this conference in partnership with CEPS and the Belgian Financial Forum.




Key Ideas

- *Session 1*. Despite the significant fiscal multipliers, the magnitude of the imbalances accumulated in the euro area over the past decade and its vulnerability to adverse market reactions should prevent any deviation from the agreed path to fiscal sustainability. There should be room however for member states with stable levels of debt to run small deficits, so as to ease adjustment and facilitate convergence.
- *Session 2*. Even though bank balance sheets remain stable (moderate bank deleveraging), the use of collateral has radically decreased since 2008 (significant deleveraging in capital markets). Lower use of collateral means less lubrication of markets and lower interconnection among financial institutions, which policy-makers have tried to mitigate through quantitative easing possibly at a higher cost. The overall implications of this process are not yet well understood.
- *Session 3*. The structure of European capital markets is undergoing profound changes due to comprehensive regulatory reform and innovation in markets. This process needs to balance the costs for investors of building up a more stable architecture with the need to realise a pan-European infrastructure to reap the benefits of the single market.
- *Session 4*. Investor protection merits more attention as the driving force of a (not yet fully realised) single market for retail investment products. Regulatory fragmentation at national level is a threat to the single market project. Regulatory and supervisory reform should be more ambitious and broader in scope. Increased transparency should be complemented with measures addressing directly the incentives of intermediaries.

Session 1: Macroeconomic outlook for the euro area: Which future without a 'transfer' Europe?

Introductory remarks

- **Olli Rehn**, Commissioner for Economic and Monetary Affairs and Vice-President, European Commission

Keynote speech

- **Paul De Grauwe**, John Paulson Chair in European Political Economy, London School of Economics

Panel discussion

- **Julian Callow**, Chief International Economist, Barclays
- **Sarah Carlson**, Vice President - Sovereign Risk, Moody's Investors Service
- **Paul De Grauwe**, Chair in European Political Economy, London School of Economics
- **Daniel Gros**, Director, Centre for European Policy Studies (CEPS)
- **Peter Vanden Houte**, Chief Eurozone Economist, ING Group [moderator]

Commissioner Oli Rehn opened the session by referring to the latest measures to address the sovereign crisis – citing the start-up of the European Stability Mechanism (ESM), the ECB's Outright Monetary Transactions (OMTs) scheme now in place, the consensus on the banking union and the wave of structural reforms in member states. He referred to two objectives, namely, rebalancing Europe and rebuilding the monetary union. While significant rebalancing of current accounts and labour costs has been achieved, there remain large differences across member states. Paul de Grauwe argued that rebalancing will remain elusive as long as core countries fail to boost demand because of austerity measures.

Rehn argued in favour of medium- to long-term fiscal sustainability but warned against stimulus packages in the current context. His main message was "this time is different", meaning spending cannot be used as in the past, not only due to the magnitude of the imbalances but also to the risks from market exposure.

De Grauwe argued that adjustments in all EU member states are leading to a homemade recession. He argued in favour of a more symmetric macroeconomic policy whereby debtor countries would continue to adjust but creditor countries would run small deficits, once the level of debt had stabilised. Sarah Carlson considered that such a policy would provide some relief and help the rebalancing process but would not be a long-term solution.

The Stability and Growth Pact drew much controversy. De Grauwe depicted a Commission obsessed with enforcing arbitrarily chosen deficit limits. Commissioner Rehn reacted by explaining that the Commission bases its decision on the fiscal space and macroeconomic conditions in each member state. Daniel Gros also argued that the Commission had indeed revised the deficit targets taking into account the cycle, as for Spain and Portugal this year.

Growth however remains elusive in Europe. Rehn presented the latest Commission forecasts which signal a period of stagnation. Fellow panellists received these figures with scepticism, given the pending threat of a recession. Julian Callow urged to focus on employment and growth, given the threats to social and political cohesion. Finally, Commissioner Rehn announced that the Commission will soon come out with a new blueprint sketching a proposal for a thorough reform of the EMU, whose institutional framework he claimed was "inadequate" to take long-term decisions.

Olli Rehn: Rebalancing Europe, Rebuilding the EMU

The process of rebalancing will inevitably take time, and the rebalancing needs are considerable. But what matters is that this process has already been going on for some time. And what matters even more is that the EU member states and EU institutions will maintain the momentum of reform and stabilisation through decisive policy action.

Competitiveness that was lost during the first decade of EMU is being regained, as the re-convergence of unit labour costs clearly shows. In the euro area in 2011, the largest declines in relative unit labour costs were seen in Ireland, Greece and Spain. The surplus countries, for instance Germany and Finland, are moving in the opposite direction, recording increasing wages, which would support domestic demand.

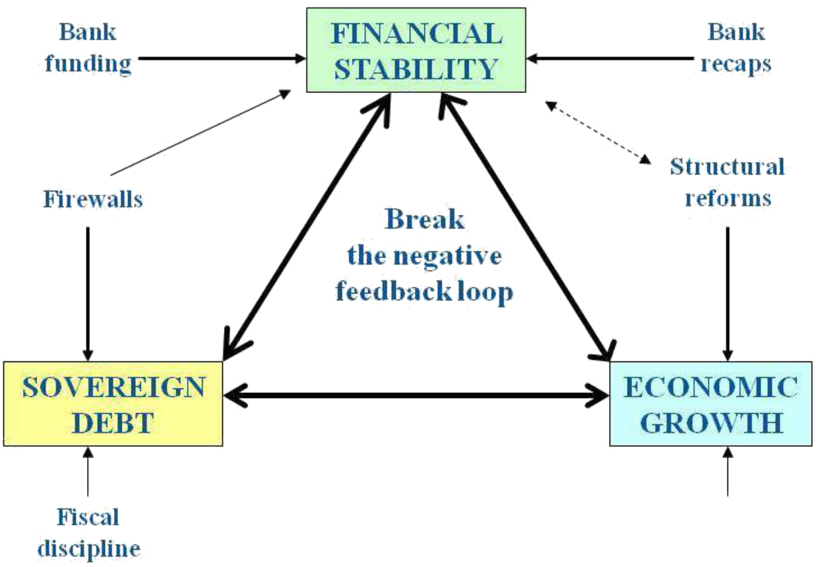
> "Investors and consumers do not need to be convinced that a country can boost growth by a few decimal points in a given year through higher spending. They need to be reassured that the country's public finances will be sound in the long-term", Olli Rehn.

It is correct that fiscal consolidation can have a dampening effect on growth in the short term. Attempts to quantify this effect through the so-called "fiscal multiplier" have been much in the news. However, in the current context, multipliers should not be measured against a business-as-usual scenario, but one in which drastic market reaction would not allow a managed unwinding of the unsustainable policies of the past.

A casual reader of much recent commentary could be forgiven for believing that EU governments are blindly enacting harsh policies of austerity, under the watchful eye of a European Commission obsessed with enforcing arbitrarily chosen nominal deficit targets. It is time to debunk this damaging myth. While the nominal targets may continue to dominate the headlines, the Commission focuses its assessments of member states' actions first and foremost on their compliance with the agreed structural effort.

Europe's efforts to address the crisis include notably the ESM, the ECB's Outright Monetary Transactions scheme, the proposed euro-area banking supervisor and the wave of reforms moving forward in euro area member states. But a far-reaching debate on the next steps is now getting underway. We have identified four building blocks that must underpin the EMU: the banking union, a fiscal union, an economic union and a political union. The Commission will put forward a clear roadmap this autumn.

The European comprehensive response to the sovereign debt crisis



Source: Olli Rehn (2012).

* Click here to see full presentation

Paul de Grauwe: Towards More Symmetry of Macroeconomic Policies in the Eurozone

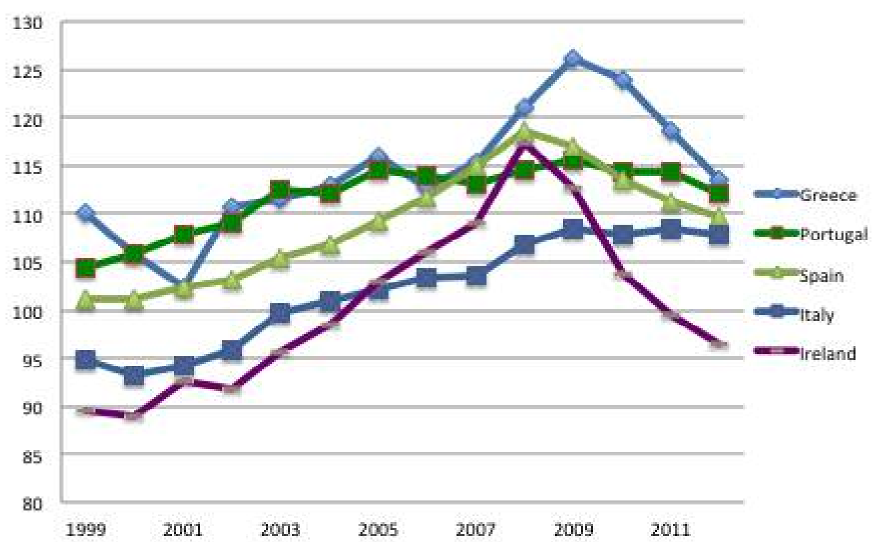
Paradoxically financial markets are more powerful in the monetary union than outside the monetary union, pushing some countries into good equilibria and others into bad equilibria. Policy-makers should not accept this market outcome, driven by fear and panic in financial markets. In the absence of a lender of last resort, individual governments of a monetary union can be driven into default by this panic.

Up until the crisis, there was a major increase in the unit labour costs of peripheral countries, but adjustment is now taking place (see figure below). So far core countries have not done their share to compensate adjustments in the periphery. This asymmetry may result in a deflationary bias in the eurozone as a whole.

The application of similar deficit limits in all member states is bringing the eurozone into recession, given the spill-over effects of national budget cuts. A more symmetric macroeconomic policy in the eurozone will see creditor countries running small budget deficits while keeping their debt levels stable. By coordinating the macroeconomic policies of member states in this asymmetric fashion, the eurozone would avoid the downward spiral and ease the adjustment in debtor countries.

"We should get rid of our fetish over numbers; there is no reason why the number three is so special. I am also surprised about the focus on structural reforms, which are necessary but will not stop the recession now", Paul de Grauwe.

Relative unit labour costs (Average 1970-2010 = 100)



Source: Paul De Grauwe (2012).

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Session 2: Capital markets and bank deleveraging: What are the implications and the role of capital markets in funding the European economy?

Keynote speech

- **Manmohan Singh**, Senior Economist, International Monetary Fund

Panellists

- **Philipp Hartmann**, Deputy Director General Research, European Central Bank
- **Margaret Doyle**, Director, Banking and Capital Markets, Deloitte UK
- **Stephen Dulake**, Head of Credit Research, JP Morgan
- **John Plender**, Senior Editorial Writer and Columnist, Financial Times [moderator]

Manmohan Singh introduced the audience to the 'other' deleveraging that takes place not inside the balance sheets of financial institutions but rather in the collateral chains that link them to form the backbone of the financial system. Singh explained the role of collateral in the European economy by comparing it to "money" serving as a guarantee in all sorts of financial transactions, mitigating counterparty risk and acting as a money substitute.

According to Singh's research, since the default of Lehman Brothers in 2008, the total volume of collateral pledged (collateral made available at source times the average number of times it is re-pledged) has gone down from $10 trillion in 2007 to $6.2 trillion in 2011. Such a deleveraging in the global financial system contrasts with the relatively stable position of bank balance sheets, which Singh showed have been kept artificially stable by unconventional monetary policy operations.

From Singh's perspective, central banks are de facto substituting collateral chains with money through credit easing operations, blocking collateral on their balance sheets. This certainly reduces interconnection among financial institutions, but it may dramatically increase costs of intermediation. He asserted that capital markets (as a direct source of funding) supplement the role of banks in the economy and could break the oligopolistic structure in some collateral markets.

Singh explained that the reduction in the use of collateral was mainly due to the surge in counterparty risk and new regulatory requirements limiting the use of collateral (e.g., higher capital requirements). He warned against additional regulation further limiting the volumes of collateral available in the market – "siloing" it for instance in central clearing counterparties.

Philipp Hartmann observed that the ECB monitors collateral and is aware of its importance when running its operations. He argued however that the volumes and velocity

of collateral seen in 2007 were perhaps excessive. Shorter chains in effect are positive for financial stability since they mean less interconnectedness and complexity in the financial system. He argued that the increasing reliance in collateralised transactions in the euro area is to a large extent the result of instability, which the banking union may ultimately reverse.

Hartman elaborated on the deleveraging that is taking place in bank balance sheets, which has so far been channelled through equity issuance (including government support) but is increasingly taking place by the shedding of assets. According to ECB's research, capital constraints, cyclical and structural funding pressures and restructuring plans would imply an estimated total deleveraging of EU banks in the order of EUR 1.5 trn by the end of 2013. According to a Deloitte survey presented by Margaret Doyle, banks expect deleveraging to extend over the next five to seven years and take place predominantly through natural runoffs (expiring loans) rather than divestments.

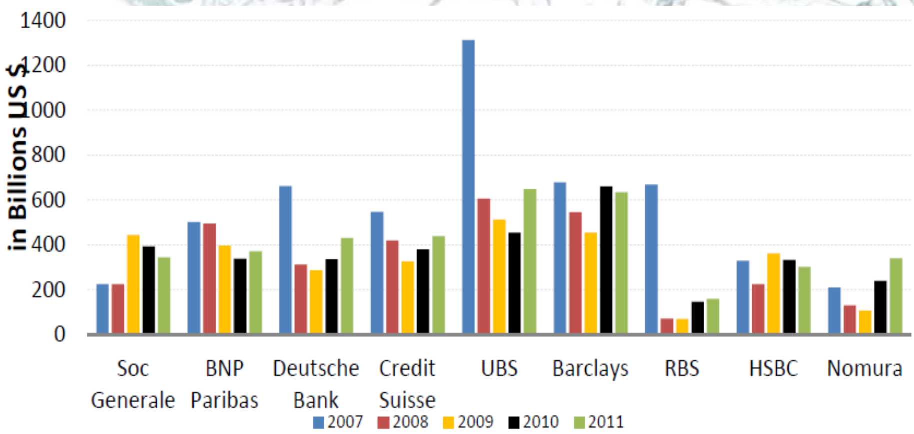
Stephen Dulake drew the link with capital markets by arguing in favour of policies to support their development as an alternative to corporate bank funding, in particular for SMEs. Hartman illustrated that capital markets had replaced bank funding since the crisis but only to a limited extent. Dulake proposed vehicles such as the securitisation of debt issuance by SMEs and/or ECB programme fashioned along the lines of the Bank of England's FLS (Funding for Lending Scheme).

Manmohan Singh: Deleveraging – The Collateral Angle

QE (quantitative easing) and LTROs (long-term refinancing operations) are keeping the size of banks' balance sheets relatively stable, without any significant shrinkage. However, the interconnectedness among financial institutions has experienced great contraction since the financial crisis, at least in terms of pledged collateral. From 2007 to 2011, the total volume of collateral available at source decreased from $3.4 to 2.4 trillion in global financial markets, according to Singh's research. At the same time, the length of the velocity (the length of the average chain or average number of times the same collateral was re-pledged) decreased from 3 to 2.4. Therefore, the total volume of collateral pledged (collateral made available at source times the average number of times it is re-pledged) went down from $10 trillion to $6.2 trillion.

> "Restoring collateral appears as a less costly alternative to QE and LTROs and potentially more effective in helping the real economy", Manmohan Singh.

Pledged collateral – European banks plus Nomura ($ billions)

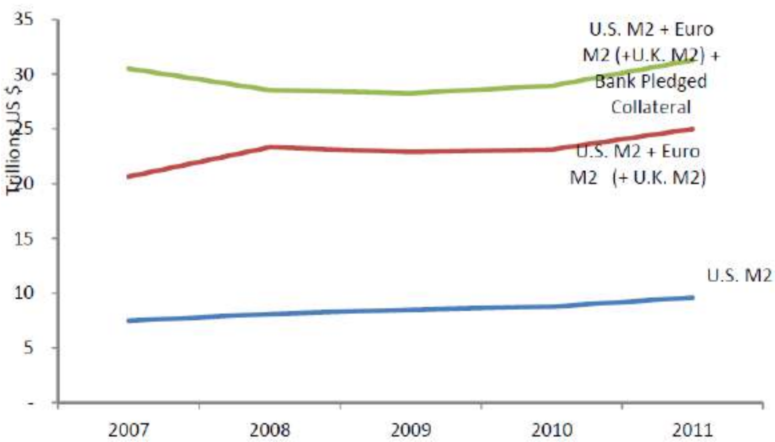


Source: Manmohan Singh (2012).

In parallel, the regulatory demand for collateral is increasing (as in Solvency II, Basel III, EMIR). As a result, collateral may become scarce in the near future while the application of these same regulatory requirements means important volumes of collateral will be blocked (for instance in CCPs), further reducing lubrication in financial markets.

From a monetary policy perspective, QE and LTROs have released more money into the economy (M2) but have had little effect from the point of view of the overall collateral pledged. QE has a cost that is not apparent today but will materialise in the next decade and may be quasi-fiscal (inflation). Moreover, the money printed in QE and LTROs is coming back to the central banks' balance sheets in the form of deposits by credit institutions rather than flowing to the real economy. Restoring collateral appears as possibly a less costly alternative to QE and LTROs and potentially more effective in helping the real economy.

Overall financial lubrication – M2 and pledged collateral



Source: Manmohan Singh (2012).

* Click here to see full presentation

Session 3: Capital market structure reforms: Will MiFID II and EMIR change the landscape for the better?

Keynote speech

- **Rodrigo Buenaventura**, Head of Markets, European Securities and Markets Authority

Panellists

- **Mark Beeston**, Chief Executive Officer - Post Trade Risk Business, ICAP
- **Jan Bart de Boer**, Chief Commercial Officer, ABN AMRO Clearing
- **Peter Randall**, Chief Executive Officer, Equiduct
- **Eric Litvack**, Managing Director, COO Global Equity Flow, Société Générale
- **Diego Valiante**, Research Fellow, CEPS, Head of Research, ECMI
- **Huw Jones**, EU Correspondent, Thomson Reuters [moderator]

Rodrigo Buenaventura presented an overview of recent and forthcoming regulation, pondering the key objectives behind them, namely reducing systemic risk, avoiding regulatory gaps and increasing transparency and capacity to supervise. He also highlighted the need for more "sustainable growth" of financial services and the economy overall, meaning less leveraged and more collateralised growth.

Reviewing the main provisions in MiFID, EMIR, MAR and the short-selling regulation, Buenaventura stated that regulation needed to adapt to new market practices in order to strengthen market integrity. He also highlighted the importance of creating an EU single market for post-trading services and extending regulation to cover commodity markets. In his view, however, EMIR was the single most important piece of regulation in its field since the crisis – a game changer in derivative markets.

Erik Litvack spoke of the difficulty in anticipating what the market would look like once all the regulatory reform comes into effect. With respect to clearing obligations in EMIR, he considered that most market participants are not yet ready, with the exception of the interdealer community and the largest buy-side. As for reporting to trade repositories, Litvack was more optimistic given the levels of reporting already prevalent in the marketplace. Mark Beeston stated that uncertainty is affecting liquidity in global derivative markets while regulatory fragmentation poses great operational challenges for global companies.

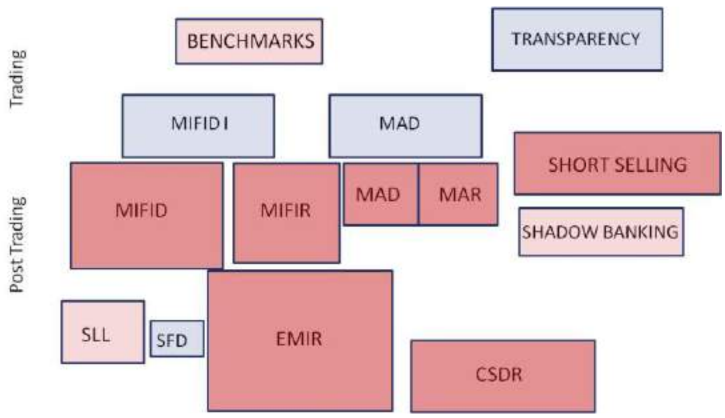
Jan Bart de Boer considered that the industry is asked to comply on many different fronts on short notice. He stated that related expenses are diverting the industry from its core business and impairing its ability to innovate, which is already affecting their customers. Peter Randall argued that the regulatory process had lost credibility in the past decade when it failed to implement legislation. Randall drew the link between poor enforcement and ever-more frequent regulatory recasts, introducing instability to the marketplace.

Karel Lannoo challenged the panellists by pointing to the many business opportunities arising from EMIR and other legislation, the opening-up of market structures and increased transparency, for instance in bond markets. Diego Valiante urged policy-makers to focus on creating a pan-European market that would boost cross-border flows and efficiencies. He pointed at the implications of siloing collateral in non-interoperable clearing infrastructure, which may distract locked-in users and distort competition, directing trading flows. In his view, the competitive environment that fuels the single market is fragile and should be strengthened.

Rodrigo Buenaventura: Capital Market Structures Reforms

A significant wave of new regulation is going to reshape market infrastructure in Europe, in both trading and post-trading sectors. The new regulations are driven by a number of goals, not always related to the financial crisis but also to the need to adapt to new market practices, technological innovation and latest market developments.

Regulatory outlook for capital markets structure



Source: Rodrigo Buenaventura (2012).

"We are witnessing a wave of new rules affecting market structure but EMIR is probably the most important piece of post-crisis regulation", Rodrigo Buenaventura.

As for MiFID, it is not yet the time for ESMA but for the co-legislators to agree to level one text. The top five topics from the perspective of ESMA are commodity derivatives, pre- and post-trade transparency, data (consolidation, publication, reporting), microstructure (tick sizes, fees, circuit breakers) and the trading obligation for derivatives.

EMIR is probably the most important piece of post-crisis regulation, introducing trade reporting obligations and central clearing obligations for eligible derivatives. The technical standards have been already drafted by ESMA and now need the endorsement of the European Commission before the Parliament's approval before year end. In drafting those standards, ESMA had to balance at all stages competing values, such as standardisation versus flexibility. ESMA also envisages that many aspects will need to be monitored and possibly adjusted in the future, such as clearing thresholds or admissible collateral.

*** Click here to see full presentation**

Session 4: Comprehensive investor protection: The Achilles' heel of the single market?

Keynote speech

- **Carlos Tavares**, Chairman, CMVM and Vice-Chairman, European Securities and Markets Authority

Panellists

- **Guido Ferrarini**, Professor of Business Law and Capital Markets, University of Genoa
- **Guillaume Prache**, Managing Director, EuroFinuse
- **Lindsey Rogerson**, Financial Services Consumer Panel, Financial Services Authority (FSA)
- **Jean-Baptiste de Franssu**, Chairman, INCIPIT [moderator]

Carlos Tavares presented an overview of market and regulatory developments since the financial crisis from an investor protection perspective. He portrayed investor protection as the overarching objective of securities regulation, crucial to the development of financial markets and the overall economy. Tavares presented the current EU legislative proposals to improve investor protection as steps in the right direction. However, he argued in favour of further action in areas such as pre-trade and post-trade transparency, best execution, remuneration of sales staff and enforcement. He also questioned whether financial innovation was serving investors and made ample reference to an ESMA study on the intrinsic value and return of retail structured products – lower on average than the risk-free investment.

The incentives driving the behaviour of intermediaries were one of the key points under discussion. Tavares argued that transparency alone is not enough since investors are not able to understand many of the features in even relatively simple products. In his view, incentives should be tackled at source by addressing the remuneration of intermediaries and in particular sales staff. Guillaume Prache referred to the case of simple index ETFs, whose lower fees are interesting for retail investors but yet are very rarely proposed to them since they do not pay inducements to the distributors. With reference to a possible ban of inducements, Jean-Baptiste de Franssu stated that it was not so much a question of "if" but "when" and warned that it had taken many years for the UK Financial Services Authority to put up a workable regime together. Lindsey Rogerson referred to the abundant evidence of widespread misselling justifying swift action for all advisers and all inducements.

The crucial importance of enforcement was also addressed by Tavares who compared the ability of the UK regulators to quickly settle cases with the long and painful judicial procedures prevalent in most other member states. He argued that enforcement should first and foremost ensure compensation to the victim instead of solely focusing on fining the intermediary. Guido Ferrarini reflected on the different judicial traditions across member states and the problems for cross-border enforcement which also need to be overcome

to complete the single market. Insufficient harmonisation of investor protection rules was also seen as a threat to market integration, in other words, truly the Achilles' heel of the single market.

Carlos Tavares: Investor Protection for the Future of Financial Markets

Investor protection is the overarching objective of securities regulators. It should be viewed as a broad concept including financial stability and market safety and fairness. Investors are the weakest link in the markets.

We have undeniable evidence of the consequences for investors of the crisis. Five years after the crisis first emerged, however, the picture is not encouraging. Consider, for example, the number of mergers and acquisitions that have resulted in bigger financial institutions, the increase in leverage (measured as financial assets to GDP), the increased fragmentation of equity trading, OTC and dark trading, the failure to fully pass the benefits of increased competition to end investors, the risks to market quality and stability derived from high-frequency trading, the slight increase in shadow banking in Europe and the growing complexity of products, among others.

> "Transparency is essential but not sufficient since investors are not able to assimilate key information from increasingly complex products; it follows that the policy response needs to be more comprehensive", Carlos Tavares.

Complex financial products have expanded significantly in volume and number in Europe and are increasingly sold to retail clients. The number of complex retail products launched each year has grown from about 200,000 in 2007 to about 900,000 in 2011. Between 2007 and 2011 more than 2 million have been launched representing roughly €1 trillion. A study from the Committee for Economic and Market Analysis (CEMA) at ESMA shows that the average intrinsic value of structured retail products was about 94% of their issue price and more than 80% of these products had an intrinsic value between 80% and 100% of their issue price. On average the return of these products was lower than the risk-free investment; actually the average and the median excess returns of the sample were negative. The counterparty risk faced by retail investors can be substantial and it was found to account on average for about 30% of the overall implied premium regarding complex products. Also, alternative UCITS assets under management tripled between 2007 and 2011 reaching €19 billion by end 2011. New complex products such as ETFs and ETPs have developed and experienced significant growth, also among retail investors.

Did regulators and market participants draw the right lessons? Are investors better protected today than previously? Has financial innovation had positive results for investors? What should legislators, regulators and supervisors do?

The reform of MiFID is taking steps to improve investor protection, rightly identifying the main issues. It is accompanied by the package retail investment products (PRIPs) initiative and is giving powers to national authorities and ESMA to forbid certain products. ESMA has also recognised the problem and has proposed guidelines on suitability requirements, MiFID compliance function and remuneration policies, among others.

But we need to go further in areas such as compensating for market fragmentation and increasing light trading, via a consolidated tape and more pre-trade and post-trade transparency not only for equities. The current definition of best execution is not clear and is difficult to enforce, in contrast with the US model. Algorithmic and high-frequency trading have been discussed in terms of financial stability but such practices should be discussed with the aim of preserving market quality (fairness, efficient price discovery and market abuse risks) and eliminating order cancellation. ESMA also needs efficient intervention powers, implementing Art. 9 of the regulation establishing this authority – for instance, it is not possible at the present time for ESMA to decree a suspension of trading in Europe in exceptional circumstances. Enforcement powers need to be more effective – the English legal system is a model when it comes to ease of enforcement. The goal of enforcement is to protect investors, including by ensuring compensation where appropriate, rather than over-focusing on fining institutions. Transparency is essential but not sufficient, since investors are not able to assimilate information from (growingly complex) products; it follows that the policy response needs to be more comprehensive, in particular with respect to the remuneration policy of sales staff and the monitoring by supervisors. Education of intermediaries and ethical values are also key.

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For more information contact us at ecmi@ceps.eu.

Speakers' biographies

Olli Rehn, Vice-President of the European Commission and Commissioner for Economic and Monetary Affairs, is a central figure in the efforts to re-stabilise the euro-area and plays a key role in the coordination of its member states. He is also in charge of the macro-economic surveillance of member states and represents the Commission in international discussions, notably in the G7 and the G20. His declared top priority as Commissioner is growth and jobs, in the context of macroeconomic stability. In these challenging times, he strives to balance strategic solutions and structural reforms with the day-to-day management of the euro-area crisis. A Finish national and Ph.D. in international political economy from the University of Oxford, Olli Rehn has a long career in national and European politics and has also worked in academia. Former Commissioner for enlargement, former member of the European Parliament and a senior civil servant, in his youth he played football for his hometown club in Finland's top division.

Carlos Tavares is the Vice-Chairman of the European Securities and Markets Authority (ESMA), as well as Chairman of the Portuguese Securities Regulator (CMVM) since October 2005. Between 2007 and 2010, he was Vice-Chairman and then Chairman of the Committee of European Securities Regulators (CESR). At the International Organization of Securities Commissions (IOSCO), he also chairs the European Regional Committee and the Standing Committee on Risk and Research. He has over 30 years of experience in both the public and private sectors in economic/financial related fields. Mr. Tavares held the position of Head of the Bureau of European Policy Advisers in the European Commission, and was also Minister of the Economy, under the José Manuel Durão Barroso premiership. Carlos Tavares is an economics graduate of the Universidade do Porto where he was a lecturer and is currently a member of its Board of Trustees.

Paul De Grauwe, John Paulson Chair in European Political Economy at the London School of Economics, is a world-class economist whose work focuses on international economics, monetary systems, monetary integration, foreign-exchange markets, and open-economy issues. He foresaw the financial crisis that is now rocking the European Union and the world: In a prescient piece published in 2010, he warned that the Greece sovereign debt crisis would have a destabilizing effect on the entire Eurozone unless immediate actions were taken. With a truly international outlook and a deep knowledge of US and European economic systems, he is a sought-after speaker and teacher. He has served as a visiting professor at some of the most prestigious universities in the world, including the University of Paris, the University of Michigan, the University of Pennsylvania, the University of Amsterdam, and the University of Milan. Paul is a regular contributor to the Financial Times and a Senior Research Fellow at the Centre for European Policy Studies in Brussels.

Manmohan Singh is a Senior Economist at the IMF in Washington DC. He continues to write extensively on topical issues including deleveraging in financial markets, rehypothecation of collateral, and counterparty risk in OTC derivatives. He was the first to identify the role cheapest-to-deliver bonds as a proxy for recovery value in CDS instruments. Manmohan has led workshops for the IMF on reserve management and strategic asset allocation to official sector policy makers. His articles have regularly appeared in the Financial Times, Wall Street Journal, Euromoney, RISK, Journal of Investment Management etc. His work experience covers several countries including UK, US, Chile, India, Japan, Pakistan, Hungary, Poland, the Gulf countries and more recently peripheral Europe. He holds a PhD. in Economics and a MBA from Univ. Illinois (Urbana-Champaign). He received his B.S. (magna cum laude) from Allegheny College, Pennsylvania. He was previously with ABN Amro Bank's emerging market syndicate team (Amsterdam/London).

[...] access the biographies of all the speakers at www.eurocapitalmarkets.org/2012AC

About the European Capital Markets Institute (ECMI)

ECMI is an independent non-profit organisation created to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends.

These exchanges are fuelled by the publications ECMI regularly produces for its members: topical commentaries and analytical research papers, as well as the frequent workshops and conferences it organises. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.

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Event Report • 2011 Annual Conference

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Unravelling the Puzzle

Challenges for Global Asset Allocation

To address *Challenges for Global Asset Allocation*, the 2011 ECMI Annual Conference brought together keynote speakers Luigi Zingales, Ian Domowitz and Ed Fishwick, with senior EU policy-makers and market practitioners. This report summarises the academic expertise and industry views presented at this special event.

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Unravelling the Puzzle

Challenges for Global Asset Allocation

2011 ECMI ANNUAL CONFERENCE

27 June, Palais des Académies, Brussels

Event Report

The 2011 ECMI Annual Conference brought together well-known capital market experts from industry and policy making, to discuss the challenges for global asset allocation in four sessions:

1. The Global Outlook in Asset Allocation: Where will systemic risk reside?
2. Funding Corporate Governance: Opportunities and challenges coming from debt markets
3. Asset Management at a Crossroads: Do we need new regulatory and theoretical foundations for a better asset allocation?
4. Economic and Regulatory Challenges for Capital Markets: The results of liberalisation and future steps

Key Ideas

- ***Session 1.*** The eurozone debt crisis is here to stay. Only stronger long-term actions, such as strengthening the single market, can provide relief. Systemic risk for Western economies may also come from the commodities markets (in particular, oil prices) and the US budgetary position.
- ***Session 2.*** A good corporate governance system must be capable of dealing with bad news in a transparent manner and channelling this information into prices. Creating the right incentives is a complex exercise that entails actions at different levels. It is difficult to induce shareholders to become engaged and may need to be supported by further regulatory actions.
- ***Session 3.*** Asset allocation theories need an overhaul. Volatility is only a measure of risk and not a suitable tool with which to forecast risk. Returns are mainly driven by events that we cannot model with traditional allocation theories (they are not normally distributed). How can we better equip ourselves to face liquidity risks?
- *Session 4.* The structure of capital markets has undergone sweeping changes thanks in part to the liberalisation process started by MiFID. The benefits of a more competitive environment must now be passed on to final users, such as retail investors. More should be done to ensure that competition delivers on its promises, e.g. by reinforcing intellectual property rights and discouraging anti-competitive market practices.

E C M I

Session 1: Global Outlook in Asset Allocation

Panellists

- **Olivier de Bandt**, Director of Business Conditions and Macroeconomic Forecasting, Banque de France, and Associate Professor of Economics, Paris X Nanterre
- **John Berrigan**, Director, Macro-financial Stability, European Commission
- **Anton Brender, C**hief Economist, Dexia Asset Management
- **Karel Lannoo**, Senior Research Fellow, European Capital Markets Institute (moderator)

After the financial turmoil and the economic crisis, financial institutions have arguably become more cautious in the way they allocate assets and manage risk. Imbalances remain both in private and public balance sheets and uncertainty about systemic risk lurks behind many policy decisions. The first session of the conference explored where systemic risk is likely to reside in the coming years and whether more action is needed to ensure financial stability.

Olivier de Bandt of the French central bank argued that the increased indebtedness of the euro area countries is leading to lower post-crisis GDP growth levels. During the crisis the average public debt level increased, whereas the private debt stabilised and has slightly decreased since the second half of 2010. Although the countries undertook consolidation plans on a large scale, the average public debt will most likely stay above the critical threshold vis-à-vis the GDP growth, i.e. above 80%, with strong differences among euro area countries. Mr de Bandt also looked at the evolution of housing prices, and confirmed the link between global international aspects of crises and domestic prices. In most countries housing prices dropped while affordability increased during the crisis, but in some countries, like France, prices have increased and affordability has decreased. This opposite trend may need further investigation.

Anton Brender of Dexia Asset Management built three potential scenarios in which systemic risk can emerge: the eurozone debt crisis, a shock in oil prices and the US fiscal situation. He argued that the euro area sovereign debt is the most severe source of systemic risk at the moment. He showed that there is a discrepancy between euro area countries' risk premia (CDS), and contagion within groups of countries with low (AT, DE, FI, FR, NL), medium (BE, ES, IT) and high (GR, IE, PT) risk premia. This distribution may suddenly change however as risk premia are inherently very volatile, especially for France, Spain and Greece.

On the developments in the oil market, Mr Brender showed that world demand for oil products decreased at the beginning of the crisis, but the medium/long-term trend is certainly upward. At the same time, due to unrest in North Africa and the Middle East and a lack of unity within OPEC, there are strong risks of oil-supply constraints. A sudden increase in the oil price can lead to a rise in inflation and lower economic growth. Finally, he mentioned the risks surrounding the US federal government debt. The high

budget deficit and consequently the fast-growing debt are clearly unsustainable and may bring about a strong depreciation of the US dollar in the longer run. Despite this higher demand for funds, the risk premium on treasury bonds has decreased due to the intervention by the Federal Reserve.

John Berrigan of the European Commission stressed the importance of current measures taken to tackle the financial and sovereign debt crisis. To minimise the impact of future crises, a European Systemic Risk Board (ESRB) has been formally approved as a system of early warning on systemic risk. Other measures are in the pipeline to increase the absorptive capacity of the financial sector and reduce the likelihood of future state interventions. Temporary measures have been put in place, such as lighter conditions for state aids to financial institutions during the crisis and a European Financial Stability Facility (EFSF) to assist euro area countries. The latter will assume a more prominent role when the European Stability Mechanism (ESM) will be introduced by mid-2013.

Despite these measures, Mr. Berrigan argued that strengthening the single market should be the priority in order to reduce economic imbalances within the euro area. This will not be an easy task, however, given the current sentiment among eurozone countries.

Session 2: Funding Corporate Governance

Keynote speech

- **Luigi Zingales**, Professor of Entrepreneurship and Finance, Chicago Booth School of Business

Panellists

- **Carmine Di Noia**, Deputy Director General, Assonime
- **Claudia Kruse**, Head of Governance and Sustainability, APG All Pensions Group
- **Florencio López de Silanes**, Professor of Finance, EDHEC Business School (moderator)

In the keynote speech, Prof. Zingales focused on how to devise a good corporate governance system that is able to minimise the likelihood of scandals and crisis. He pointed to two major issues revealed by the financial crisis:

1. Excessive risk-taking behaviour on the part of managers/shareholders and
2. Incompetent and/or uninformed and/or ineffective boards.

He then argued that the former was not necessarily the result of a shift in risk since there were many instances where managers lost money in the crisis (e.g. Lehman Brothers). He pointed in particular to three corporate governance failures:

1. *Debt holders did not constrain managers who are typically overly optimistic (it is one of the reasons why they are hired!).* They expected full protection from the government. Debt markets can actually constrain managers through: the quantity of finance, price and covenants (managers hate the inclusion of strong conditions in contracts). He proposes a system that allows regulators to intervene early and in particular, to impose haircuts on long-term debt if the financial institution is not well capitalised. The triggering system should be a mechanism of early warnings based on CDS spreads.

2. *Failure of governance systems to uncover bad news* (what he called the 'Laocoön syndrome'). Bad information does not necessarily flow into prices and still today we do not have an efficient system for aggregating information to induce better decision-making and make reputation work. Reputational mechanisms are not enough. There is a need for efficient financial markets and the possibility to feed bad news into markets through short-selling and CDSs. Other important aspects are: a market for news (media); a modicum of employee entrenchment (to make sure that people have enough power to say something different from what the board wishes to hear); and independently appointed directors (not by the CEO or in general by managers) to avoid a Board

becoming too homogeneous in its composition.

3. *'Group think' by boards.* There are few incentives to deviate and more incentives to conform.

In implementing these strategies, however, he pointed out major challenges such as identifying which minority shareholders should be entitled to sit on the board or the risk of balkanisation of boards if there is no clear identity, or the excessive short-termism of directors.

Finally, he concluded that the best way to motivate people to report negative information is to create positive career incentives for people who report bad news ('minority directors'?).

The subsequent panel discussed the importance of active corporate governance. Drawing on her experience with APG, Mrs Kruse illustrated how a dedicated corporate governance activity is part of the responsible investment process. Engagement with companies by actively exercising voting rights aims at guaranteeing sustainability of corporate policies in the long-term.

While Mr Di Noia emphasised the limited role of transparency, he stressed the importance of simplifying the flow of information, in particular towards retail shareholders. He also discussed the results of the Assonime survey on slate voting in Italy. Minority shareholders did not present lists for the Board of Directors in 60% of total listed companies and the average quorum when presenting the list was just 2.1%. In more than 90% of the cases, only two lists were submitted.

Session 3: Asset Management at a Crossroads

Keynote speech

- **Ed Fishwick,** Managing Director and Co-head of Risk & Quantitative Analysis, BlackRock

Panellists:

- **Fabrice Demarigny**, Global Head Capital Markets, Mazars, former Secretary General, CESR
- **Sergio M. Focardi**, Founding Partner, Intertek Group, and Professor of Finance, EDHEC
- **Daniel Lehmann**, Managing Director, Allianz Global Investors
- **Tilman Lueder**, Head of Unit, Asset Management, European Commission
- **Robert Parker**, Chairman, ICMA Asset Management and Investors Council, and Senior Adviser, Credit Suisse (moderator)

Ed Fishwick gave an overall picture of the asset management industry by first illustrating its current market size. European markets are worth roughly $16 trillion, more or less the same size as the US market ($16.215 trillion). The composition of Europe's portfolio is usually rather conservative, with investments mainly in fixed income and money markets. The landscape is highly diversified by country and the institutional segment counts on average for 60% of total client assets, while the retail segment is roughly 40%. In this landscape, exchange-traded funds (ETFs) are becoming an important part of the industry.

Major market trends are reshaping the asset management industry, among them the growing allocation to alternatives investments, the underfunding crisis facing pension plans and financial reforms. In addition, Fishwick stressed the easily adoptable investment framework of traditional allocation strategies for an optimal portfolio, which assume that markets are fairly priced, risk aversion is constant over time and returns are normally distributed. These assumptions are particularly tested during times of crisis and growing risks and they are further undermined by market uncertainties.

Surprisingly, volatility has returned to unusually low levels, even though Europe's economies are no less risky than they were three years ago. In effect, volatility is only one of the measures of risk and in many cases is not useful (e.g. in forecasting events). Correlations with other asset classes are also very volatile. Risk composition changes over time.

Mr Fishwick showed that, on a historical series from 1926, returns have been driven by unexpected growth. 'Noise', which is uncorrelated with anything that can be modelled, drove returns in the last century more than any other variable. For instance, volatility for bond and equities in 1995 versus 2000 was basically the same, but it changes radically where first moments averages are located. There should be a rethinking of allocation theories, and in particular of the way in which asset managers perceive risk ('when' is a crucial variable for assessing risk). Flexible risk management is crucial. Risk should be deliberate, diversified and scaled.

The subsequent panel discussion responded to a number of the points made by Mr Fischwick. In particular, Bob Parker agreed that volatility is a useless measure by itself and we should rely more on dynamic allocation theories, which take into account other potential risks (e.g. Greece defaulting).

Prof. Focardi highlighted the importance of understanding local trends in equities markets and designing models that take into account diverse market structures. Returns are not normally distributed and the risk of contagion effects is always around the corner.

Tilman Lueder stressed that "the financial sector has not been at the service of the real economy". The European Commission will promote the contribution of the financial sector through two major initiatives: the launch of a consultation exercise on venture capital financing (the AIFMD is not enough); and the promotion of more socially responsible investments by investing in firms operating in niche industries. Other inititiatives, such as UCITS V and regulation of alternative investments, are already well advanced.

Fabrice Demarigny picked up on Mr Fishwick's point about the impact of noise on returns by asking how much of that would be explained by regulatory changes. He argued that about the impact of the ongoing re-regulation is uncertain. In particular, he mentioned that we are undergoing a massive flow of new regulation that does not necessarily address the problem of the shadow banking system.

Daniel Lehman issued a warning about liquidity risks and their implications for asset allocation. Asset managers should show this information to clients by creating different scenarios for them and managing liquidity in a different way than has been the case in the recent past. Trust and performance are key to the success of the industry in the long term.

Session 4: Economic and Regulatory Challenges for Capital Markets

Keynote speech

- **Ian Domowitz**, Managing Director, ITG, and former Professor, Northwestern University

Panellists

- **Jeremy Grant**, Editor, FT Trading Room (moderator)
- **Raj Mehta**, Executive Director, Principal Strategic Investments, Goldman Sachs
- **Peter Randall**, CEO, Equiduct
- **Kay Swinburne**, Member of the European Parliament
- **Steven Travers**, Head of Regulatory Law and Strategy, London Stock Exchange
- **Diego Valiante**, Research Fellow, European Capital Markets Institute
- **Tatjana Verrier**, Head of Unit - Financial Services Antitrust, DG Competition

Ian Domowitz discussed the implications of market structure regulation for competition and costs. He illustrated the beneficial effects of MiFID in terms of liquidity and efficiency, as well as execution costs (both spreads and commission costs). However, costs went up slightly for broker-dealer execution and for some dark pool execution services. In the end, not enough beneficial effects have been passed on to final users such as retail investors. The exchanges business looks more like a technology company, although they always considered themselves as a financial institution.

Technological developments have boosted a convergence between broker-dealers' re-intermediation services and exchanges' re-bundling activities. Likewise, regulators continue to struggle with the legal definitions of market aspects that are the result of these technological developments (e.g. high-frequency trading). Finally, the financial crisis has mitigated the effect of the regulatory attempt to encourage competition. In effect, downward pressures on volumes is destroying nascent MTFs' efforts due to fixed costs and fostering consolidation, with exchanges taking over the 'independents'.

The panel discussion focused mainly on:

1. How to improve competition in the somewhat oligopolistic market structure
2. How to promote secure and more efficient trading systems
3. How to make technological advances and innovation work to the advantage of a broader group of investors (e.g. retail investors) that do not participate due to barriers hindering access to capital markets

MIFID is said to increase liquidity and efficiency, but regulators seem to be lost in the

process of allocating proper definitions, and this is the focus of the industry criticism.

Tatjana Verrier was convinced that no matter what type of market structure is adopted, it is fundamental to set the right conditions to foster efficiency and competition. The Commission will need to look more closely into market practices pursued by the financial services industry; here there is often no conflict between competition and stability. The Commission will also look into the conflictual area of intellectual property rights, and in particular to those products considered as a benchmark for other financial instruments.

Kay Swinburne stressed that systemic risk reduction is still on top of the agenda. A level playing field needs to be created in order to increase efficiency. Regulation is pivotal to promoting consumer protection, and this cannot be set aside because many people are incapable of making their own investment decisions, so proper and independent advice is crucial. On the question about regulatory convergence between the US and the EU, Mrs Swinburne stated that the EU will not follow the US blindly. She also mentioned that London, being the financial centre of Europe, must be protected against other emerging markets, such as Asia.

According to Peter Randall, current regulation is far from clear. An environment with excessive regulation affects trading platforms. He also noted that not enough has been done to make investment tools more accessible to ordinary consumers who are still not adequately protected. Mr Randall deemed these initiatives to be still insufficient.

Raj Mehta agreed that a well-designed regulatory landscape is fundamental, especially to foster innovation and development. Competition is certainly healthy. Regarding the current MiFID revision, his view was that it has gone too far, in the sense that it has created some regulatory confusion.

Diego Valiante argued that the process of liberalisation that started with MiFID must go on. Stronger actions by regulators and competition authorities should continue in order to pass the benefits of competition on to final users, such as retail investors. Europe should not necessarily follow the US on every aspect, and regulatory changes should be designed around the model designed by the Markets in Financial Instruments Directive. In effect, most of the regulation needed is already there and must be implemented in the correct way (e.g. best execution). Areas of expansion should be the transparency of non-equity financial instruments, but the approach should be different from equity transparency requirements, as market structures are profoundly different.

Finally, Steven Travers argued that the focus on market structure is somehow excessive and that we should look more closely at the duties and their implementation, which is currently not satisfactory.

There was general scepticism about the prospect of all regulations being in place by the end of 2012.

Speakers' Biographies

Keynote speakers

Luigi Zingales

Luigi Zingales is an expert on the theory of the firm, the relationship between organisation and financing and the decision to 'go public'. Recently, he has been involved in developing the best interventions to cope with the aftermath of the financial crisis. He also co-developed the Financial Trust Index, which is designed to monitor the level of trust that Americans have in their financial system. In addition to holding his position at Chicago Booth, Zingales is currently a faculty research fellow for the National Bureau of Economic Research, a research fellow for the Center for Economic Policy Research, and a fellow of the European Governance Institute. He is also Director of the American Finance Association and an editorialist for Il Sole 24 Ore, the Italian equivalent of the Financial Times. Zingales also serves on the Committee on Capital Markets Regulation, which has been examining the legislative, regulatory, and legal issues affecting the functioning of public companies.

His research earned him the 2003 Bernácer Prize for the best young European financial economist, the 2002 Nasdaq award for best paper in capital formation, and a National Science Foundation Grant in economics. His work has been published in the Journal of Financial Economics, the Journal of Finance and the American Economic Review.

Ian Domowitz

Ian Domowitz is the CEO of ITG Solutions Network and a Managing Director at ITG (Investment Technology Group). Prior to joining the company in 2001, he served as the Mary Jean and Frank P. Smeal Professor of Finance at Pennsylvania State University and previously he was the Household International Research Professor of Economics at Northwestern University.

A former member of the NASD's Bond Market Transparency Committee, Domowitz also served as Chair of the Economic Advisory Board of the NASD. Ian Domowitz has held positions with Northwestern's Kellogg Graduate School of Management, Columbia University, the Commodity Futures Trading Commission, the International Monetary Fund and the World Bank. He is currently a Fellow of the Program in the Law and Economics of Capital Markets at Columbia University. His publications in the field of finance are numerous and he is ranked amongst the top 5% authors at IDEAS, the largest bibliographic database dedicated to Economics.

Ed Fishwick

Ed Fishwick is a Managing Director and Global Co-Head of Risk & Quantitative Analysis at BlackRock. He is also co-chair of the Global New Products Committee, a member of the European Executive Committee and the Global Operating Committee of the firm. He is also a member of the Editorial Boards of the Journal of Asset Management and the Journal of Portfolio Management, and is a member of the Management Committee of the London Quant Group.

Fishwick has worked in quantitative finance for over 20 years in London, New York, and Boston. Previously he was Head of Risk Management & Investment Process Development at AXA Investment Managers, and Director of Research at Quantec. He studied undergraduate and postgraduate economics at the universities of Liverpool and Cambridge respectively. He is the author of a number of papers and has served on the Board of Trustees of the Global Association of Risk Professionals.

Discussants

Olivier de Bandt

Olivier de Bandt is Associate Professor of economics at the University of Paris X Nanterre. He is currently Director of Business Conditions and Macroeconomic Forecasting at the Bank of France.

Olivier de Bandt's research by mainly deals with economics of banking, international economics, analysis of business cycles, macroeconomic forecasts and econometrics. He is also the co-editor with Heinz Hermann and Guiseppe Parigi of "Convergence or Divergence in Europe?" published by Springer Verlag.

John Berrigan

John Berrigan was appointed Director for Financial Stability at the European Commission's Directorate-General for Economic and Financial Affairs in April 2010.

After completing studies at University College, Dublin, Berrigan worked for a number of years in the Irish civil service before joining the Commission in 1986. Since then, he has worked mainly in the fields of monetary and financial economics and was Head of the Unit for financial sector analysis for 10 years before taking up his present assignment. He also worked at the International Monetary Fund for several years in the mid-1990s.

Anton Brender

Anton Brender is Associate Professor at Paris-Dauphine University, Director of Economic Research at Dexia Asset Management. He is a member of the Cercle des économistes, a French think tank founded in 1992.

Brender is Ph.D. in Economics by Paris I and has published extensively, including at the Centre of European Policy Studies – Global Imbalances and the Collapse of Globalised Finance (2010). This book, co-authored by Florence Pisani, also economist at Dexia Asset Management, considers the increase in the intensity of international transfers of savings and the wave of innovations that have changed the way savings and the risks associated with their investment can be transferred.

Karel Lannoo

Karel Lannoo is CEO of the Centre for European Policy Studies and General Manager of the European Capital Markets Institute. As a Senior Researcher, he has published several books and numerous articles in specialised magazines and journals on EU, financial regulation and corporate governance matters. He spoke at several European Parliament and European Commission hearings and participated in studies for national and international bodies.

Lannoo holds a baccalaureate in philosophy and an MA in history from the University of Leuven, Belgium and obtained a postgraduate in European studies from the University of Nancy, France. He is also an independent director Bolsas y Mercados Españoles (BME), the company that runs the Spanish stock exchanges.

Claudia Kruse

Claudia Kruse is Head of Governance & Sustainability at APG All Pensions Group, with over €270 billion under management. Her expertise encompasses both corporate governance and sustainability and has published on both topics. She has worked both in the sell-side (JP Morgan Securities) and the buy-side (F&C Investments).

Kruse was named Rising Star of Corporate Governance by the Millstein Center for Corporate Governance and Performance at the Yale School of Management in 2008. She chairs the Integrated Business Reporting Committee of the International Corporate Governance Network, is a member of the European Corporate Governance Institute, and a Fellow of the Royal Society of Arts in the UK.

Carmine Di Noia

Carmine Di Noia is Deputy Director General and Head of Capital Markets and Listed Companies at ASSONIME, the Association of the Italian corporations. He is also member of the consultative committee of Borsa Italiana (London Stock Exchange Group), the legal committee of European Issuers, the board of the Italian XBRL Association and the working group of the Italian Corporate Governance Committee.

He teaches Corporate Governance and Financial Market Law and Economics at LUISS-Guido Carli University in Roma. He received a Ph.D. in Economics at the University of Pennsylvania, USA, and a doctorate in Economic Theory and Institutions at the University Tor Vergata in Rome, Italy.

Florencio López de Silanes

López de Silanes is professor of Finance and Law, and Director of Corporate Governance Research Program, EDHEC Business School in France. He is one of the world's five most cited academics on business and economics topics. A co-author of the LLSV index, he taught at Harvard, Yale and the University of Amsterdam before moving to EDHEC Grande Ecole in France.

López de Silanes is academic member of the Board of the European Capital Markets Institute. He is also a research associate at the National Bureau of Economic Research and a member of the Academic Board of the Fraser Institute. In 2003, the World Economic Forum’s Management Board selected him as one of the 100 young outstanding international leaders for business and society.

Sergio Focardi

Sergio M. Focardi is a professor of finance at EDHEC Business School in France, and a founding partner of the Intertek Group. He is on the editorial board of the Journal of Portfolio Management and has co-authored numerous articles and books, including the Research Foundation of CFA Institute monographs as well as award-winning books on financial modelling of the equity market.

Most recently, Focardi co-authored “Investment Management after the Global Financial Crisis”, with Frank J. Fabozzi of the Yale School of Management, and Caroline Jonas of the Intertek Group.

Tilman Lueder

Tilman Lueder is the Head of the Asset Management Unit at the Directorate General for Internal Market and Services of the European Commission. Recently appointed to this post, he was previously head of the Copyright Unit at the European Commission. In his agenda the implementation of the Alternative Investments Managers Directive and the reform of UCITS IV. He also holds responsibilities in the Package Retail Investment Products work-stream and in some of the policies in the Single Market Act.

Lueder has developed most of his career in the European institutions but he has also worked in private practice. From 2002 to 2005, he was the Commission’s spokesman for antitrust policy.

Daniel Lehmann

Daniel Lehmann is member of the board at Allianz Global Investors KAG and Managing Director in Allianz Global Investors Europe. In this function he is responsible for the areas Product Development and Product Management of the European mutual fund range of Allianz Global Investors.

Prior to joining Allianz Global Investors in 2006, Lehmann was Product Manager at Deutsche Bank Private and Business Clients. He is now actively engaged in the work of the European Capital Markets Institute and the Centre for European Policy Studies on asset management regulation, in the framework of the task force “Rethinking Asset Management”.

Fabrice Demarigny

Fabrice Demarigny is Head of Capital Market Activities and Partner at Mazars group since 2008. He worked for eleven years in the French Securities Market Authority (AMF) before being appointed in 2002 the Secretary General of the Committee of European Securities Regulators (CESR).

In 2009, the French Minister of Economy Christine Lagarde asked Mr. Demarigny to consult and propose measures for an EU Listing 'Small Business Act'. The work was presented at the Centre for European Policy Studies in Brussels and published by the European Capital Markets Institute.

Robert Parker

Robert Parker is Chairman of the Asset Management Committee of the International Capital Markets Association and Senior Adviser at Credit Suisse. He is a member of the Chairman's Board of Credit Suisse as well as Credit Suisse's Investment Committee. Prior to joining Credit Suisse in 1982, he worked at N M Rothschild & Sons and Lloyds Bank International in France in Corporate Finance.

Robert Parker was one of the founding members of CSFB Investment Management and a member of the Advisory Boards of the European Institute and Funds Europe and is a member of the Advisory Council of the UK Society of Investment Professionals.

Tatjana Verrier

Tanya Verrier is Head of the financial services antitrust unit at the Directorate-General for Competition at the European Commission. Among her priorities is the intention of Commissioner Joaquin Almunia to work closely with financial regulators to promote fair, stable and efficient financial markets. Verrier has also worked as an advisor to the Commission in the field of financial services regulation.

Previously she worked at the Deutsche Börse Group in Frankfurt am Main and with OECD on issues of consumer financial education. Tatjana Verrier's research is focused on the liquidity in capital markets.

Kay Swinburne

Kay Swinburne was elected as the Conservative MEP for Wales in June 2009 and is currently coordinator of her parliamentary group at the Economics and Monetary Committee in the European Parliament and on the Special Committee on the Financial, Economic and Social Crisis. She joined politics after a successful career in investment banking, which gives her in-depth knowledge of the global financial markets.

Her political action is concerned about how quickly the European Union is responding to financial service regulation without having properly looked at the impacts of what it is doing. She believes that the EU should work within a global framework with the United States and the G20.

Peter Randall

Peter Randall is the Chief Executive of Equiduct Systems. He started his career in investment research and was named a leading analyst by Euromoney when he was at James Capel. He spent an extended time in Asia with the joint venture between Sanford Bernstein and James Capel where he was responsible for quantitative sales, after which he became the MD of Thamesway and then CEO of Instinet in Asia.

Randall relocated to Instinet Europe in 2005 and was responsible for delivering the MiFID compliant Chi-X platform. He latterly served as CEO of Chi-X Europe Limited.

Raj Mehta

Raj Mehta is Executive Director in the Principal Strategic Investments (PSI) group at Goldman Sachs and co-heads the team in London. PSI's mandate is to lead and manage strategic investments for the Securities Division; focus on market structure strategy and initiatives; and assist the Division in expanding into new businesses and geographies.

Mehta joined Goldman Sachs in 2004. Prior to joining the firm, he held executive roles in Strategy and M&A with 724 Solutions and Deloitte Consulting.

Steven Travers

Steven Travers is currently Head of Regulatory Law & Strategy at the London Stock Exchange. As a solicitor, he has worked both in private practice and in-house, in the UK, Hong Kong and Dubai. He has been associated with the London Stock Exchange in a variety of roles, including Head of Strategy and Head of Legal, until he left in 2001, when he worked as a consultant and adviser on securities and financial services matters.

He rejoined the Exchange in 2008 and became Head of Regulatory Law and Strategy the following year. He has also worked in the voluntary sector; he managed the British Council in Gaza and is a director of a number of UK charities.

Diego Valiante

Diego Valiante, Ph.D. has been a Research Fellow at the European Capital Markets Institute and the Centre for European Policy Studies since 2009. His specialties are financial and securities regulation, capital markets, market structure, competition policy, and corporate governance. He has published extensively and is involved in working groups of experts on capital markets.

Valiante holds a BSc in Economics and an MSc in Law and Economics from LUISS – Guido Carli in Rome, both degrees summa cum laude. He also received the LL.M. Master in Law and Economics from Hamburg and Bologna University, and the Ph.D. in Law and Economics from LUISS University.

Jeremy Grant

Jeremy Grant is Editor of the Financial Times Trading Room publication. He was previously financial regulation correspondent for the Financial Times in Washington. Mr. Grant joined the Financial Times in London in 1998, as editor of the pages focused on European corporate news and analysis. He previously worked for the newspaper as a stringer from Vietnam in 1994, where he established the Financial Times's first bureau in Hanoi.

Grant was previously employed by Reuters in Hong Kong from 1990 to 1993. He also served as business and arts reporter for the Sunday edition of the South China Morning Post.

Special intervention

René Karsenti

René Karsenti is Chairman of the European Capital Market Institute and the President of the International Capital Market Association. He joined ICMA from the European Investment Bank where he was Director General of Finance. He was also the Treasurer of the European Bank for Reconstruction and Development in London from its inception and held various senior positions in the treasury organisations of the World Bank Group in Washington.

Karsenti is a member of the Strategic Committee of Agence France Trésor and a member of the Investment Advisory Committee of the Food and Agriculture Organization.

About ECMI

Informing policy on European capital markets

In the aftermath of the recent financial crisis, the G20 has committed to leave no area of the financial markets unregulated. As a result, a sweeping wave of regulatory initiatives has made policy research on European capital markets even more important. The European Capital Markets Institute (ECMI) conducts original research into European capital markets, thereby informing current debate and policy-making. Through its various activities, ECMI acts as a focal point for interaction between market participants, policy-makers and academics.

ECMI was established as an independent non-profit organisation in 1993, in a collaborative effort by the European Federation of Financial Analysts Societies (EFFAS), the Federation of European Securities Exchanges (FESE) and the International Capital Market Association (ICMA). Membership of the institute is composed of private firms, regulatory authorities and university institutes. Since 2005, ECMI has been managed and staffed by the Centre for European Policy Studies (CEPS), a highly reputed, independent think tank in Brussels.

Through the publication of commentaries and policy briefs, ECMI analyses the latest regulatory developments and puts forward proposals at the vanguard of regulatory debates. ECMI also produces detailed research reports on key policy issues and market developments. In addition to conducting in-house research, ECMI responds to calls for proposals from external entities and hosts contributions from high-profile external researchers.

ECMI regularly organises workshops, seminars and task forces on a variety of issues facing European capital markets. Participation in ECMI events offers the chance to take part in workshops with senior business representatives and regulators on critical themes; to size up market developments that will shape the future of European capital markets and to network with lobbyists and academics from the regulatory community.

In addition, ECMI compiles a yearly statistical package with a substantial set of charts and tables that trace the evolution of European capital markets over time. Bond, equity and derivatives markets are also covered in the package, together with asset management related data. This gives members a 'one-stop shop' or broad snapshot of where European capital markets stand. The package compares trends across asset classes, market segments and countries, so as to track market growth, integration and convergence. All data is presented in intuitive and visually appealing forms.

ECMI also produces a quarterly newsletter. The purpose is to inform members of recent and upcoming research projects, task forces, conferences and meetings, and other relevant information on European capital markets.

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