3. DIVERSIFYING THE FINANCING OF THE EU ECONOMY

CMU: is it on the right track?

KEY ISSUES | *This roundtable examined the progress made with the CMU action plan and whether the short term actions were likely to foster a significant diversification of financing and better opportunities for investors. The key longer term priorities of the CMU and the way to keep sufficient momentum over time were also discussed, as well as the need for a stronger focus on technology.*

The CMU, an ambitious project facing several challenges in the implementation phase

The importance of developing capital markets and of diversifying the financing of businesses in Europe that was intended with the CMU initiative was emphasised by the panel. At present EU capital markets were too fragmented and under-developed, they said, and did not allow a sufficient diversification of financial sources or an effective transformation of savings into investments across the EU. The CMU could also help to improve the stability of the financial system with a better diversification of financing. Moreover, thanks to the CMU, EU capital markets could be made more competitive and more transparent. The long term policy aim of the CMU was not to revive just individual segments of the market, but capital market financing as a whole; CMU should therefore be considered as a comprehensive undertaking.

Some speakers felt that there could be a stronger emphasis in the project on SMEs and the local financing ecosystems that were needed for them, as SMEs were the most likely to generate growth and employment. A stronger focus was also needed on measures to rebuild retail investor trust, such as investor protection measures, in order to encourage more investment.

Although it provided many opportunities, the CMU also contained significant challenges, some panellists considered. A poll conducted during the Eurofi seminar showed that 59% of participants felt that the CMU was 'not quite' or 'not at all' on the right track.

There was first a risk of loss of momentum with the four year timeframe of the CMU implementation and the relatively high number of initiatives that the action plan comprised, that were somewhat difficult to promote and explain from a political perspective. Several speakers were in favour of accelerating the implementation as much as possible. A mid-term review is to be carried out by the European Commission (EC) in 2017, in order to review priorities and instil a new momentum. A speaker also felt that it should be acknowledged that the CMU was a complex project, deeply intertwined with national traditions and cultures, which thus required careful implementation in connection with the Member States. This would take time but was essential for the success of the CMU. Ultimately the CMU should be pursued in a determined manner without expecting immediate results, an official concluded.

A second challenge was related to the economic growth and job creation objectives associated with the CMU which might be difficult to achieve with the CMU action plan alone. The CMU was a necessary, but not a sufficient condition for achieving these objectives, a panellist emphasised. Some speakers considered that a broader and more holistic approach was needed, because the achievement of the CMU objectives was also dependent upon the economic conditions prevailing in Europe; in addition diversification in the sources of financing would only work if the overall variety of financing options, including traditional banking activities, was taken into account. Such a holistic approach should encompass also the Juncker Plan, the Banking Union and measures to enhance investor trust; this approach also needed to address the banking sector with measures relating to risk reduction, the expansion of lending capacity to the real economy and SMEs in particular and a capitalisation >>>

>>> on the links between banks and the capital markets, some speakers suggested.

The potential impediments that the ongoing bank prudential reforms could create for the development of capital markets, notably the measures targeting market making, were a further challenge, a panellist felt. There needed to be deep reflection on whether it was possible to meet Basel prudential objectives in a way that did not interfere excessively with the development of European capital markets and the financing of the economy e.g. with a possible re-calibration of certain requirements.

Progress made so far with the short term CMU actions

The implementation of the first phase of the CMU action plan was well underway with the proposals that had been made regarding securitisation and prospectuses, the recalibration of Solvency II capital requirements for investments into ELTIFs and infrastructure projects and actions conducted by the private sector regarding private placement. Several speakers however considered that the progress made so far was not sufficient and that the adoption of the pending legislative texts regarding securitisation and the prospectus review needed to be accelerated. Flexibility and adaptability also had to be built into these regulations, as capital markets evolved in a dynamic way, a panellist emphasised.

There were mixed perceptions regarding the STS (simple, transparent and standardised) securitisation proposal in particular. Securitisation was considered as the main short term initiative of the CMU, but the EU securitisation market was declining compared to covered bonds and the volumes were 8 times smaller than in the US. Even for the most liquid products, the inventory of broker dealers and trading were a small fraction of what they had been prior to the financial crisis, which made price discovery increasingly difficult and favoured volatility. There was also a reduction of transparency with increasing trading of loan portfolios instead of ABS and an increasing proportion of privately-placed transactions. There were different possible reasons for these trends, but some speakers considered that cumulative regulation played a significant part. Consideration would need to be given to the question of how to reverse these trends.

The STS initiative to revive the securitisation market on a sound basis had the potential to spur capital market financing and to support banks' capacity to lend. For this potential to be realised, however, appropriate capital charges needed to be adopted in particular for insurance investors, otherwise there would not be sufficient buyers, a speaker claimed; these prudential requirements and whether junior tranches would be recognised as good securitisation still needed to be decided and transposed into law. In addition it should be determined whether the adjusted capital charges for banks, decided under the Basel provisions, went far enough.

Regarding infrastructure investments, the Juncker plan was regarded by one panel member as a 'good start', but it did not fundamentally change the capacity of large institutional investors to invest; the project pipeline had been increased, but mainly with small projects. A positive step forward had been made by EIOPA in defining specific capital charges for infrastructure investments, but there was still the risk that corporate infrastructure might be treated in a restrictive and rigid way.

The longer term action plan of the CMU

The longer term part of the CMU action plan concerned some of the core building blocks of the financial market and covered a number of difficult topics deeply embedded in aspects of Member State law, public administrative practice, and culture. These included insolvency and securities laws, domestic withholding tax procedures and accounting standards. Supervisory convergence was another important area of focus on which ESMA was working. Four areas related to the longer term actions of the CMU were emphasised by the panellists; these were areas where action was initiated in the short term but their full impact would only be felt in the longer term.

Forthcoming EU initiative on insolvency regimes

There was general support within the panel for the ongoing initiative of the EC regarding insolvency regimes. A consultation had been launched, with the aim of tabling a legislative proposal towards the end of the year. The EC did not intend to harmonise everything, but to focus on certain key elements. Benchmarking domestic regimes could also help to make sure that such regimes would become more efficient and predictable. Significant progress was for example being made in Italy in this regard.

The objective was to facilitate the risk assessments of cross-border investors and to reduce the time currently spent rescuing viable companies and also potentially lost with the ones that could not be rescued, all of which hindered the full achievement of the Banking Union in particular. Current EU processes were on average sub-standard compared to other OECD high income countries and excessively heterogeneous. According to AFME calculations, an increase in EU GDP by somewhere between 0.3% and 0.55% of GDP could be achieved with an improved insolvency framework. >>>

>>> Achieving a full harmonisation of insolvency frameworks seemed difficult, but was eventually necessary, some speakers considered, in order to obtain a full integration of EU capital markets; the approach proposed by the EC would be a first step towards this.

Capital market liquidity

Liquidity was important for the CMU. A policymaker stressed that much care had been taken by the EC to evaluate and mitigate the potential impacts on market liquidity of ongoing regulatory initiatives such as MiFID II and Basel III and of developing asset management rules; work was also being done at FSB level on this issue. A comprehensive assessment was to be undertaken by the EC notably regarding corporate bond liquidity, the results of which would be available in 2017. Some speakers however emphasised it was a given fact that liquidity was a problem in European markets and that the situation needed to be urgently addressed, as it was not going to improve with the development of HFT and the intervention of the ECB. It was also felt that the harmonisation of tick sizes imposed by MiFID II could further impact the liquidity of SME markets, reducing the incentives for market makers to operate in this market.

Some other upcoming initiatives would have a major impact on capital markets, such as MiFID. It was felt that good work had been done in ensuring that the transparency regime in particular would strike the right balance between protecting investors and not undermining liquidity.

Taxation

Consideration would also need to be given to the issue of taxation in order to pursue the goals of market integration and greater efficiency, although this was a difficult subject to broach. Withholding tax was still a major problem in Europe; investors were often double taxed, and the EC aimed to devise proposals to address this. The differing tax treatment of equity and debt, and how this influenced issuance and investment behaviours was another issue. The current debt bias should be addressed through the EC's legislative proposal on the common consolidated corporate tax base. Creating a catalogue of best practices that had arisen in EU Member States (e.g. fiscal incentives for SME equity investment) could also help, a panellist suggested.

Post-trading infrastructure

Creating a more efficient post-trading infrastructure in Europe and reducing costs in this area was also important for achieving the CMU objectives. Much had been done over the last few years, including EMIR, the regulation on CSDs, the SFTR legislation, and TARGET2 Securities. Next year, the EC aimed to evaluate what had already been done and what more was needed. Developing an appropriate framework for the recovery and resolution of CCP was a key issue in particular.

Technological innovation and fintech solutions: an important element of the CMU

The CMU and fintech were mutually reinforcing, several panellists stated and the importance of technology should not be underestimated by policymakers. The future of finance would be data driven, online, and heavily personalised. Fintech and technologies such as the distributed ledger, had the potential to make capital markets more efficient and broader and to develop cross-border investment, eliminating constraints related to geographic location and legacy processes and systems. Innovations, such as peer to peer lending and crowdfunding could also allow for closer ties between lenders and borrowers. In addition, data analytics and artificial intelligence used for example in robo-advice could potentially improve investor service and risk management.

However, the legal and regulatory barriers and the lack of standardisation that impeded unified capital markets would also hinder fintech development, some speakers believed. Moreover, technology created new challenges. The traditional financial sector players would need to balance the benefits of these new business opportunities against the risks of being disintermediated, and against those linked with sunk costs for obsolete ICT investments. Fintech would also lead to the loss of jobs in the financial sector, foster algo trading and the related disruption risks, and increase cyber-risks. ●

Output of the call for evidence: what key issues to be addressed in EU financial regulation?

KEY ISSUES | *The session highlighted the main themes and the supporting evidence emerging from the EU Commission consultation launched to understand if the legislation has struck the right balance between reducing risk and enabling growth, avoiding creating barriers. Attention had also been paid to the interactions between the different regulatory pieces and related possible unintended consequences. The influence on this review of the current economic and monetary environment was also be examined.*

The call for evidence has generated a great deal of interest.

The call for evidence was launched a few months ago. Around 300 responses had been received with something like 600 documents of supported evidence.

The panellists largely shared the view that the call for evidence was not about re-writing the legislative and regulatory rule book but about fine-tuning it where necessary. Stakeholders do not question the rationale of the reforms and the big picture as all the legislation responded to weakness in the run up to the crisis or during the crisis. It was not disputed that the core elements of the regulatory framework needed to be in place as it was part of the G20 commitments made after the financial crisis.

A policy maker explained that respondents provided very clear examples and descriptions of where rules are perceived to be inconsistent, overlapping and duplicative, notably in the area of reporting requirements. But he also stressed that there were a certain number of reasoning but generally a lack of quantitative evidence on the markets impact of the different rules that would need to be taken into account going forward.

Industry representative partly disagreed and said that there are certain effects of the regulatory change which were clearly demonstrable in terms of evolved behaviour within the markets, even if pinning them back to specific regulations was difficult.

The scale, the pace and interconnection of regulatory changes made the assessment difficult. In addition, many of the regulation in question were still in flight and it would be some time before their precise impact was known. Yet certain effects were clearly demonstrable, even though the task of pinning them back to specific regulations was a difficult one.

However, because so many changes had been introduced over such a compressed period of time a speaker wondered if for example the reduced potential for immediate execution In markets was a problem or if it was simply a growing pain coming from an evolved regulatory ecosystem. When it comes to the question of the cumulative impact of regulation, it was a single question that had a thousand complex and interconnected answers.

Three main concerns raised: proportionality, financing availability and market liquidity, compliance burden

Three main themes were emerging from the responses to the call for evidence explained a policy maker. They could be organized around three main themes: proportionality, financing availability and market liquidity, and finally compliance burden.

Some of the rules which not fit to the size of companies, their business models and their risk profiles, might stand in the way of the diversity of the financial system. Beyond the banking sector, investment firms were a good example. There should be a distinction between capital requirements imposed on large bank-like investment firms and those imposed on smaller firms. Proportionality was another concern. It had to do with derivatives trading. The rules are too complicated to be applied to small financial institutions and non-financial companies and, reporting requirements in EMIR (European Market Infrastructure Regulation) were too burdensome and costly. On banking, these elements were going to feed into the CRD IV/CRR (Capital Requirements Directive/ Capital Requirements Regulation) review which was taking place. EMIR was also underway.

The second main theme had to do with the amount of financing available to the wider economy. A number of respondents, unsurprisingly, claimed that capital ratios and liquidity rules made it more difficult for banks to lend to the economy. This will be assessed in the CRD review.

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>>> A second important sub-set was concerns expressed about the declining market liquidity, in particular in the area of corporate bonds. There had been, a very substantial contraction - between 40% and 75% depending on the asset class - in fixed income bank inventories. Many banks had also withdrawn a huge amount of repo capacity, which was crucial for the capital market union, and the consequence of which had been a reduced capacity for effective risk transmission between financial institutions. That was why the Commission was undertaking a comprehensive review of liquidity in corporate bonds markets.

The third theme had to do with often too high reporting duties due to unexpected interactions, inconsistencies and duplications between different pieces of legislation. Finally, there was also the point of the volume of information that was being asked for from market participants, which was not always proportionate to the risks that they actually posed to the system.

Three areas for progress relating to proportionality and compliance

A regulator suggested three areas for progress relating to proportionality and compliance: the remuneration guidelines, product information and two-side reporting.

A proportionate application of the remuneration guidelines there had been an intense internal debate on this issue at the EBA as well as at the ESMA (European Securities and Markets Authority). One should allow, for example, exemptions for smaller UCITS (Undertakings for Collective Investments in Transferable Securities) and also for smaller amounts.

On product information and the so-called pre-contractual information, PRIIPs (packaged retail and insurance-based investment products), which was coming into place, was a big step forward in terms of consistency across the three sectors. PRIIPs technical standards were made consistent with MiFID. However, the information demanded from UCITS do not meet the new MiFID requirements.

Under EMIR for smaller non-financials, one-side reporting where the financial counterparty would report on behalf of the couple, could be considered. Doing it for EMIR would also bring it in line with the STFR (the securities and financing transaction requirements), which was moving in that direction.

Industry representatives warned also on weak bank profitability, bank riskiness as perceived by investors and upcoming regulations from the Basel Committee

An extremely weak bank profitability came from the macro environment but also from the fact that the overall regulation, the resulting capitalisation (indeed leverage had diminished from 25 to 18), and the regulatory uncertainty that had increased. Indeed, before the crisis, the return on equity of the European banking industry was about 13% while it was standing now around 5%. But only five points had been lost due to the decline on return in assets, low volumes, slow growth and high NPLs and a high cost of risk.

Such a situation was very dangerous and counterproductive as it would lead to financial instability, upsetting the monetary policy, and to bank consolidation, which undermined 'too big to fail' policies. It might also lead to diminished lending.

Furthermore, the risk perceived by investors in the industry had not declined despite the policies implemented together and the subsequent decline in leverage. The cost of equity before the crisis was about 8% or 9%, of which around 3% to 4% were the risk-free rate. Yet, despite a risk-free rate, which was now close to zero, the bank equity risk premium continued to be 4%. If the industry was less profitable, it should also be less risky.

Concerns were also expressed regarding upcoming Basel Committee regulations. Firstly, banks applying the Basel Committee initial draft reforming internal models, would be pushed to only offer standardised credit to SMEs (small- and medium-sized enterprises). Combined with the (negative) consequences of IFRS 9 - which was in fact a trading view on the banking portfolios though notably SMEs loans were not saleable in the market and kept up to maturity on banks' balance sheet, this would lead banks to lend less to SMEs.

Similarly, specialised lending such as aircraft, railroad, shipping financing, and project finance... would face increases by more than four times of risk weights, which did not take into account EU banks track record in managing these risks. Those constraints would come on top of the difficulties faced companies and projects to get to the bond markets since banks were bringing less liquidity.

The Basel Committee reform on the IRRBB ignored also the track record of EU banks managing fixed interest rate mortgages that correspond to borrowers' wishes in certain countries, because of the regulatory cost of fixed interest rate kept on banks' balance sheet was much too high.

Need for a pause and a clearer view of what regulators want.

An industry representative asked for some kind of pause in terms of the introduction of yet more >>>

>>> regulatory changes. The idea was not that there were no needs of further regulatory changes. But it was very difficult to accurately anticipate what that should look like without having a better quality data to understand where we were now.

An appropriate balance between financial stability and growth

The call for evidence was just one building block of the whole programme of the capital markets union, the objectives of which were ultimately to foster economic growth in the EU. However, financial stability and the resilience of the systems needed to be kept provided that sustainable growth needed it as a foundation.

Regulator stressed that the objectives of prudential and consumer protection regimes were not to have long-term investments or to foster growth in the economy. Conversely a policy maker observed that if there were no growth in the economy, there would be instability in the economy, which would be mirrored by the financial system.

Looking at the impact of regulation on financial markets with partners from other regions

An industry representative made the point that EU institutions should not be too inward looking as the relationship between the EU and partners elsewhere was critical for looking the impact of regulation on financial markets. A European policy maker suggested that Europeans should wait at least a year after the US implementation of international banking regulations before adopting to take into account potential changes requested notably regarding Basel 4.

Better balance between Level 1 and Level 2 approaches

A public decision maker stressed that a big part of the regulatory framework was in level 1, which was more difficult to adjust while technical standards offer the possibility to adjust more easily once the impacts are observed. Regulators acknowledged that elements in the securities markets like the clearing of derivatives, the trading of financial instruments, the degree of liquidity of financial instruments, were now regulated with technical standards provided that to some extent, a supervision decision might be more appropriate. A European policy maker reacted by saying that experience showed that problems that had not been solved on Level 1 would never be solved on Level 2. ●

Juncker Plan: what lessons can be drawn from the first 6 months?

KEY ISSUES | *The EU Investment Plan was announced in December 2014. It has been launched to remove obstacles to investment notably in infrastructure and SMEs, to provide visibility and technical assistance to investment projects and make smarter use of financial resources. This Investment Plan was intended to mobilise investments of at least €315 billion in three years. In July 2015 the related legislation entered into force, in the Autumn 2015 the European Fund was created, and finally the European Investment Project Portal was launched at the end of 2015.*

In this context, the session tried to contribute to a first assessment of the steps already taken by this EU initiative, provided that by mid 2016 the EU commission was expected to start taking stock of those recent initiatives.

A three-pillar approach to unlock investment in the EU

Weak investment was a major concern for Europe. The investment level in the EU had fallen to 18% of GDP, against a historic average of 21-22%. There had also been a number of regulatory barriers needing to be tackled, and constraints such as low rates and little margin in the EU budget. >>>

>>> Therefore, it was necessary to take some action, and this had been one of the first decisions announced by the new Commission in December 2014: to launch an investment plan for Europe, consisting of three pillars. The first was the EFSI, a €21 billion guarantee from the EU allowing the EIB to lend €63 billion, leading to a total additional investment of €315 billion on riskier projects. The second was an attempt to help promoters to put forward well-defined projects, via the Investment Project Portal, and advice and technical assistance for project structuring, via the Investment Advisory Hub. The third was improving the investment environment via removing barriers and reinforcing the internal market.

The Juncker Plan: main innovative constituents

The EFSI had been designed to maximise efficiency of public spending, with the guarantee allowing the EIB to act differently. The Commission wanted the EIB to focus on investments which truly needed EFSI presence in order to take place or be more ambitious. Thus the Commission was helping the EIB to take more risk, and ensure that the investments it made were truly additional.

The second pillar was helping investment to be unlocked. Advisory support had been beefed up, via the European Investment Hub as a single access point for technical assistance. Going further, the Commission wanted to make sure that the Hub could permanently be accessed even when EU funds were not used in the project. The idea behind the European Investment Project Portal was that a project promoter would be able to put a standard description of their project on the website, and investors from all over the world would access the portal and look for investment opportunities. It was expected to go live in June 2016.

Regulation – the third pillar - was the most important element in the medium-to-long term. The Commission had already taken a number of initiatives in this respect, aiming notably to facilitate market access for SMEs with, for instance, a revision of the Prospectus Directive. They were working on credit registers and improving securitisation, and had lowered capital charges in the insurance sector for investment. Other initiatives were also in the pipeline.

Juncker Plan in Action

The EIB used the same teams to appraise Juncker and non-Juncker projects due to the nature of the risks being taken, which require a great deal of expertise. The regulation was very clear that the EIB, who could be tempted to avoid risk, or be exposed to too much politicisation in the choice of projects, did not have to be a party to the decision for the EU guarantee eligibility. The decision on eligibility, was made by an independent investment committee, comprised of experts who assess the specific level of risk. Consequently prior to the Juncker Plan, the EIB had €4-5 billion of risky activities, out of a total of €80 billion a year and it is going to go up to €20 billion yearly. The speakers were very much on the same page talking about a first-loss piece or a real guarantee to kick the project off. However, there were blanket loans with no subordination. Indeed, private investors were looking forward to seeing more of equity pieces, as well as structured finance situations, which large insurance companies and asset managers could see as attractive, because they were actively seeking investments with 20 to 30 years' maturity

It was suggested that the policymakers had gotten the sequencing wrong. Ideally the Portal and the Hub should have been implemented first and the structural reforms would have to begin soon. In practice, the EFSI was moving faster than the other aspects of the Plan. The Portal and Hub was not seeing results as quickly as had been expected. However, the EFSI had made a good job advancing the objectives in unfavourable circumstances.

The SME window had worked well, in part because of the area's maturity. The EIF had first-mover advantage, but as the economy improved member states would put their own schemes in place. Many were putting in structural funds, but the EIF needed to keep its leading role given its expertise.

The infrastructure window also mainly had projects in sectors with more mature policy and pipeline. Energy and transport both had stable policy environments, whereas the digital union was still taking shape. An aggressive link to capital market financing should be looked into, but the infrastructure window was challenging as it was a big area with many interlocutors.

The National Promotional Banks were supposed to be aggregators for smaller projects, with local expertise. However, there was more fragmentation in public than private banking. The desire was for the national promotional banks to learn from each other.

Assessing Success

Presently, there was an investment and infrastructure window implemented by the EIB, and an SME window by the EFI. For both institutions, 220 transactions had been approved in 25 member states, with a total investment of €82 billion. The infrastructure sectors that had been very >>>

>>> attractive were energy – particularly energy efficiency and renewable energy – and transport. The Juncker plan was at 26% implementation.

The Commission preferred the EIB to be generating additional investment rather than investment which would have taken place anyway. The second main ambition was a very high level of leverage between public guarantees and private investments. Thanks to the support of the guarantee €20 billion of risky activities would be reached each year for the next three years within the EIB. This was a clear change in the DNA of the institution. They were moving to smaller projects with much higher risks. The more additionality looked for, the riskier the projects, the more that public guarantees would be utilised.

The EIB had plenty of infrastructure on its books. On the other hand, there were many small- and medium-sized insurance companies that did not have the ability to assess infrastructure projects. Something that was being looked at was the securitisation of a number of projects that could then be bought by smaller investors. This did not deal however with the issue of existing regulatory constraints, but it could be part of the solution.

In the initial communication of the Investment Plan, the Commission had expected creation of between 1 and 1.3 million jobs, which had yet to materialise. The Investment Plan would have a positive impact, but it could not be immediate.

The EFSI was important for three reasons: first, supporting investment; secondly, showing the EU cared for investment as well as necessary structural reforms and fiscal adjustment; thirdly, to test a new medium- to long-term approach to public spending. If successful, it would generate €315 billion of investment with only €8 billion put on the table.

Investment focus issues

There were some question marks over whether the EFSI was entering areas typically financed by the private sector. Looking at geographic distribution of EFSI and EIF funds, 80% sat within Italy, France, Germany and the UK. This was understandable, but for those markets the private sector had sufficient firepower and experience itself. There was a need to channel surplus savings from northern European countries to southern European countries, rather than them going outside Europe. There was no quota per country, despite pressure from the Parliament, because it would create a permanent suspicion from private funds around the quality of the projects coming up under the EFSI label. However, the EFSI needed to take steps to make sure that projects were distributed among countries, with no country having too many.

At the same time, more effort was needed to engineer projects in the more vulnerable southern rim of Europe. Typically, it was this kind of country where, because of the level of risk, a first-loss piece was needed. The EFSI would along in the mezzanine and other investors in a senior tranche. It was one of the reasons why the Commission had provided guidance on how to associate structural funds with the EFSI. The Investment Plan not only allocated €8 billion to EFSI, but set out the target that 20% of the structural funds should be used in similar initiatives. There were big teams on the ground in countries like Greece to originate such projects, as well as a dedicated EIB taskforce, but it would take patience.

50% of funds were targeted towards the energy sector, but this was an area that was being served by the private sector notably as large insurance companies were targeting green or renewable investments; was the field getting a bit crowded? At the same time, there were a great deal of interesting projects, but almost nothing dealing with social infrastructure, in terms of education, health or social housing. There were more social projects on the way, particularly with EIF, and the Commission was working with to increase the firepower of the EaSI programme by 50%. They would support microfinance, social enterprises and incubators for social enterprises, a great deal of which would be rolled out in Q2 and Q3 2016. The social area was one where investment due to the high risk, but there was a real need to find a way to address it.

Geographic concentration was a negative element, but unfortunately monetary policy seemed to play against the mobility of capital, as it put a brake on the incentives for investors to diversify their portfolios. Governments and the Commission should examine the need for sectoral concentration. Perhaps a quota should be included around social investment in the overall plan.

Legal certainty for investors required strong efforts

There were fundamental concerns around legal certainty in Europe, a substantive issue in relation to longer term projects. There was a danger in changing the rules post-investment, and this should be avoided as it did not help private sector investors to feel comfortable with money committed for 20 to 30 year terms. Furthermore, private investors are facing a lack of a single market regarding tax law and insolvency and company law. If investment and growth in Europe was to reach the next level, then this would need to be tackled.

Moving Forward

In order to make sure this was not simply 'business as usual', the EIB needs to develop new >>>

>>> instruments and partnerships. The EIB is developing much more subordinated debt than it used to do, and was already taking more risks. It was working on an equity strategy. With the National Promotional Banks, the EIB was developing platforms, as well as strong relationships. there were a great deal of difficult issues to be discussed, such as delegation and how far the EIB could delegate the decision on the project to the platform. This had to be solved, because there was a need to avoid having too many people reviewing, and making it too heavy.

There was also work, country by country, to identify market failures and how the EU guarantee could make a difference. In addition, although it took more time because it was more difficult, they would also like to see cross border projects supported by the Juncker plan.

When the Juncker Plan had been launched, there had been a lot of commitments from the National Promotional Banks to provide co-financing alongside the EIB. They could also bring projects to the table, since they were to the ground, to local projects and SMEs. Bigger projects were easy to finance, but for those under €50 million it was difficult to access the market, whilst it was too small for the EIB to deal with directly. The success of the EFSI relied on the EIB, but also on the implementation of good projects, presented by promoters from both the public and private sectors. The National Promotional Banks could add value here, due to their networks.

The bigger the risk, the more the guarantee would face losses, but this was what the guarantee had been built for. A lost of €8 billion whilst generating €315 billion of investment would be a good deal. Risk-talking was the key element for success, otherwise they would be financing without the risk. There was a common responsibility for all parties to ensure projects were focused on risk. In addition, the Investment Plan was also important to signal reform of the use of EU money.

The steering board of the EFSI had refrained from being too prescriptive in terms of sectoral focus. Projects should be learned from and the market would adjust. It would have been abnormal to have a large quantity of social projects, when the EIB expertise lay primarily in energy and transport, so there was a need to use the good people and expertise and move on from there.

Finally, the third pillar of the investment phalanx, structural reform, was acknowledged as being the core of investment and growth policy for Europe, of which EFSI was one instrument. ●

Securitisation: is the EU proposal up to the challenges?

KEY ISSUES | *The session tried to clarify the ambitions and the expected contribution of the EU securitisation framework in the EU Capital Market Union context. The session also outlined how to make effective progress toward an efficient and consistent EU securitisation framework. In particular, the session addressed the risk specificities of securitisation techniques as a prerequisite to achieve an accurate calibration of the framework.*

Background to the Securitisation Proposal

The securitisation market was not only about how much was issued, but what was issued, what was placed, how many were buying, how many people traded, and what the secondary volume was. There was no single metric showing a positive development. Volume was in decline: 15 billion had been placed in Q1 2016, with 35 billion of retained issuance. Primary supply continued to be net negative, meaning the market was shrinking. In the last few months, four broker dealers and market makers had been lost, a trend which was continuing. Half of the research houses from five or six years previously were left, reducing market transparency and coverage. A reduction in trading, research, inventory and in-house infrastructure was very difficult to restore. There was also concern about two effects that were very specific to Europe: the sovereign cap and the tranche maturity.

In 2005, market issuance had been around €320 billion of European securitisation. In 2015, levels had been roughly two thirds of those in 2005. >>>

>>> For auto ABS, which was the largest chunk of this, issuance was around €7 billion in 2005 and €35 billion in 2015. That segment of the market was functioning fairly normally, where debt was placed with real investors; the CMBS and SME portions of the market, though, remained quite small.

Securitisation ticked many of the boxes of Capital Markets Union. For large banks that had the choice of issuing unsecured debt, tapping into covered bond programmes or using securitisation platforms was just one of many options. However, for small- and medium-sized banks and other small financial institutions, it was a primary source of funding. Securitisation also enabled banks to manage their balance sheets and recycle capital. Getting securitisation regulation right was critical, and time was of the essence. Expertise was leaving the market, and it was important to get this right. Furthermore, at present, many SMEs were too dependent on banking finance. A strong and profitable banking industry was needed in Europe, so this was a key moment to launch the CMU.

The issues that regulatory proposal needed to address

It was important to have true recognition of the risk transfer in securitisation, as securitisations were generally quite an expensive form of funding. In actuality, experience of dealing with regulators suggested that it was very difficult to prove that no remaining risks or rewards stayed with the bank. The Basel capital calculation had been done in a very opaque way. The negative 'c' in the 'p' factor in the IRB formula was one example. Taking complexity and structural risks into account in terms of capital charges on the whole waterfall, might make sense to a certain extent, but the reduction of those risks via the conditions set by the STS regime should also be taken into account and lead to a relief of this extra capital cost. It was also important that STS securitisations had equivalent treatment to similar instruments. AA treatment, at least, should be achieved from a liquidity perspective, such as covered bonds, in all LCR determinations.

Insurers had more liability than asset managers, and for them this period had been quite difficult. Securitisation would not be bought if it was either more complex or riskier than other classes. The simpler it was, the easier it was to put money into. Compared to covered bonds, securitisation in Europe was not at all competitive. Securitisation was the only class of asset where there was a risk of criminal sanctions; therefore, covered bonds would be the preference. There should be real proportionality in terms of the sanctions to market participants linked to due diligence, whenever they acted in good faith; this should be recognised and credited. Penalties should only be applied in cases of negligence or deliberate misconduct.

The functioning of the secondary market was also important. The Commission should ensure that the market transparency requirement and other rules impacting market-making were fully aligned with the objective of the CMU. Borders should be opened up to make sure that securitisations were open to non-EU investors and originators. Only then would there be stronger capital markets in the future.

Sensitive issues related to securitisation

The proposal was to take the prospectus and securitisation into a dialogue in Parliament soon. There was a constructive attitude in the European Parliament. However, building a political and broad majority in the Parliament would take time, given the level of detail. In addition, the lessons of the past needed to be learnt, not only for explaining it to the public, but to reach a majority in the Parliament.

Securitisation had two functions: to be a stable source of finance, and to be able to transfer risks from banks to other financial institutions. Looking at the past performance of the market, it had been less than stable. It was now approximately one tenth of pre-crisis levels, and it had nearly halved from 2008 to 2009. New issuance had decreased dramatically from pre-crisis levels. The difference between failure rates in the EU and the US was staggering. The same went for the transfer of risk. Securitisations were now seen, but they were largely retained.

The incentives needed to be examined from the investor side, but also from the supply side. However, if capital charges were higher and it was more complex, it was not clear that investors would enter this market.

Securitisation was indeed toxic in most people's minds, but it meant different things in Europe and the US. The default rates of AAA securitisation products in the EU, at the start of the crisis, had been 0.1%, compared to 16% in the US. In addition, after the crisis, European regulators had introduced significant restrictions in underwriting standards. The fact that underwriting standards had been restricted effectively meant that it would be difficult to create a bad product to go into securitisation.

Two things were being conflated within the word 'securitisation'. The results of the securitisation of the US were fundamentally different from those in the EU. One type of securitisation >>>

>>> could be separated from the other by the introduction of criteria, some of which were fundamentally different to those in the US, such as the requirement for 'skin in the game', the diversification requirement and the transparency requirement. STS capital requirements in the EU were already more ambitious than at an international level. A convergence with the US was positive, but it needed to be debated. The Commission, having produced these criteria, had enabled the international discussion to evolve.

According to the agreed schedule, they would pass both regulations in the European Parliament in November. They were at a key political moment, and could not afford delays in the dossier. What mattered was that it was being looked at carefully. If the work of the Parliament was such that it increased the appetite for STS, this would be positive. However, it was also not clear that removing the stigma alone was sufficient to make the market stable.

Potential Solutions

There were two levels: the political and the technical. There was no doubt that at the technical level there would be close co-operation and solutions would be found easily. Among the different responses of the industry, there had been quite a few workable proposals as to how to address some of these issues. The point, however, was that the stigma made the political debate very difficult.

Despite talk of toxic securitisations, this was really a portion of the market where the risk had been emanating from the US housing market. In Europe, less than half of 1% of rated securitisations had suffered any principal loss, and that had been during a period of extreme economic stress.

Finally, there was not concern around the direction of travel, but around whether the destination would be reached. ●

Equity financing: what priorities for developing equity markets in the EU?

KEY ISSUES | *This roundtable discussed the main obstacles to equity funding in the EU, whether the on-going actions (CMU, MiFID II...) are likely to foster a development of equity markets in the EU and the additional actions that may be needed. The role that the on-going expansion of fintech solutions and electronic platforms may play in the development of equity markets will also be examined.*

Obstacles to the development of equity financing and issues to be addressed

A funding gap between £2 million and £10 million revenues had been identified in the UK market for small growing companies that could not go to the banks for money and needed to access long-term finance. A specific fund had been successfully set up backed by banks (the British Growth Fund - BGF) to invest equity in this SME segment. The standardisation of the investment process and the close contacts of the banks backing the fund with the companies involved were the key factors in their success, as was the diversification of the investments that had thus been achieved.

Several panellists however felt that the European economy as a whole did not at present have a funding gap, although one might materialise in the near future if banks continued to deleverage and if Europe's capital markets could not provide sufficient alternative funding. The current issue was more a lack of diversification, with under-developed equity channels relative to the size of the total economy.

One speaker stated that Europe lacked an equity culture, particularly compared with the US. There was a general lack of equity demand, both from retail and institutional investors and retail participation in particular should be encouraged by all possible means – directly or indirectly via investment products. Another speaker emphasised that equity investment was very difficult and best performed by professional investors (e.g. fund managers) who had the necessary time and expertise to make appropriate diversification decisions. Private equity markets also needed developing.

The European Commission (EC) had been attempting to make progress on this issue, >>>

>>> but this required time, as the issues were related to historical legacies, societal choices, and sometimes culture. Negative economic forecasts both globally and in Europe and a lack of good projects to invest in were other potential obstacles to equity financing; some panellists believed that although growth prospects were reasonably good, leadership and the collective willingness to realise these achievements were lacking. Moreover the absence of regulatory and fiscal harmonisation within Europe was an obstacle to cross-border investment, as well as the lack of easily accessible information on SMEs. Additionally, there were now fewer analysts in the market, which was increasing the reluctance of investors to invest cross-border and increasing the disconnect between retail and institutional investors.

On the issuer side, taxation currently favoured debt financing over equity financing. Moreover there was a lack of awareness among SMEs of the different available financing options. Some domestic initiatives regarding business education had been put in place but this needed extending. Bankruptcy regimes sometimes showed a punitive approach to failure and this discouraged risk taking in the EU, which the EC was aiming to address legislatively, as well as improving insolvency law in general.

Possible EU level solutions for increasing equity financing

The EC had begun the roll-out of the CMU Action Plan, which aimed at developing EU capital markets and reducing reliance on bank funding, but a great deal remained to be done and the approach was incremental.

The review of the Prospectus Directive (PD) was among the short term priorities of the CMU. Currently prospectuses were too long and complex for most investors and were mainly used by issuers as a legal tool and by professional equity analysts. Some short term improvements were suggested: a simplification of prospectuses for existing issuers (representing about 70% of UK prospectuses for example), relying on the information that had been provided previously; a streamlining of disclosures for SMEs; and thirdly, taking smaller issuances out of the pan European regime. One institutional investor believed that the PD review could have been more radical in allowing the prospectus to be brought forward within the IPO timetable, with the publication of research into the company in question delayed until investors had already received this prospectus.

MiFID 2 which would come into force at the beginning of January 2018 would introduce additional rules for the improvement of investor protection and advice, as well as tools such as SME growth markets which could further contribute to developing equity investment. However, the unintended consequences of these rules which may in particular limit the willingness of banking networks to sell equity should be avoided. The new form of ELTIF that had come into place at the end of 2015 together with adjustments to Solvency II requirements was another positive development.

A stronger focus of trading venues on equity markets was also needed. For there to be a true equity culture and equity market across Europe, there first needed to be proper equity focused venues, connecting those who had money with those who had projects or business ideas. Properly regulated markets, capable of addressing the needs of all types of issuers and investors, needed to be in place. Trackers, indices and HFT were extremely important for the provision of liquidity to equity markets, but without market infrastructures focused on equity, the 'critical mass' necessary to ensure an alignment of interests between all market participants in the ecosystem would not be created; the focus on channelling funding towards projects and businesses would be lost also.

Some panellists also emphasized the importance of a common vision and of a single rulebook. Many of the achievements that had been realised thus far had not resulted from new regulation, but from vision and determination. The core elements that were necessary for promoting European equity financing were present; the challenge was pulling them together and approaching them with a degree of vision and sufficient scale and efficiency, as had been done in the case of the BGF fund mentioned previously.

There also needed to be a collective transition towards a single rulebook that would encourage the development of risk capital on a domestic and cross-border level. Europeans needed to be more self-confident about their collective capacity to make these developments happen. The CMU was achievable and should not be impeded by those who were sceptical about its chances of success.

The possible role of technology and electronic platforms in fostering equity financing

Some regulated platforms e.g. some e-brokers were increasingly working with robo-advisers for which they sent orders to the stock exchange. Other venues had a more passive attitude to these developments for the moment, monitoring innovations and focusing instead on their core business. Sufficient scale and standardisation were needed for innovative solutions to expand, which was not the case at present. >>>

>>> Regulators and politicians often did not feel familiar, or comfortable, regarding new technologies, but the EC nevertheless aimed to have legislation in place that did not hinder their development. Taking the example of crowdfunding, it would be beneficial to have a single European framework that was resilient, conducive to investor confidence, and enabled a free cross border flow of services; however, proposing legislation at too early a stage might hamper the development of crowdfunding and 'fossilise' the market. As such, the EC had not proposed to legislate on this issue at this stage.

Some domestic regulators were taking action. The UK had announced a 'regulatory sandbox', which meant allowing firms to test particular product offerings with live consumers, in a safe environment with no risk of 'ex-post' repercussions. Regarding crowdfunding, simple investor protection rules had been put in place in the UK to restrict the proportion of a portfolio that an investor could put in a crowdfunding investment. France had established a national regime a year and a half ago; a light-touch approach had been chosen that aimed to find the right balance in the market and allow requirements to be adapted relatively quickly if necessary.

Many discussions were presently taking place among regulators at the European and IOSCO levels regarding fintech and blockchain; one panellist noted that, in the case of blockchain, it was important that someone should be held accountable for making the server work. Transparency and security were critical for these solutions to be operational. The speaker was confident that these innovations could be incorporated into the market. The challenge was aligning regulators, innovators and market players, and this could be achieved. ●

Retail investment: how to attract retail investors to EU capital markets?

KEY ISSUES | *This roundtable discussed the importance of retail investors for the development of capital markets in the context of the CMU, the main obstacles to overcome and the regulatory and market-driven actions needed to increase the engagement of retail investors in securities markets. The role that technological innovation may play in developing retail investment was also examined.*

Retail investment needed to be redeveloped

Both institutional and retail investment in securities had decreased over the last few years. In the current economic conditions, greater participation from retail investors was necessary. Capital markets needed retail investors in order to develop and retail investors needed capital markets to get better returns on their money than with savings products. In Europe the two did not interact sufficiently. It could have been assumed that retail investors would complement their portfolios with securities in order to have higher returns, but this was generally not the case. The current reality was that investments in funds and shares were unsatisfactorily low, investments in bonds had plummeted and cash and deposits were increasing. Moreover 85% of investors had less than €50,000 to invest in capital markets.

There were many reasons behind this situation. European culture mostly favoured saving over investment. There were also issues related to financial education, the limited development of pension products and tax. A shift in that dynamic and asking retail investors to take more risks in their investments was necessary, but was difficult to achieve and would take time, particularly in the current economic circumstances and at a time of low confidence.

Retail investors also lacked experience of the functioning of capital markets and were generally the last ones to gain from upcoming momentum in the market and the last ones to get out from a market that was slowing down.

There were many obstacles to further developing retail investment

A first obstacle was a lack of trust in financial markets. Surveys had indicated that whilst savings gave investors feelings of confidence and control, investments generally produced confusion and anxiety. The market was riskier and less certain, and so work needed to be done to build >>>

>>> trust. This required providing investors with the appropriate information and advice, as well as strengthening financial education. Better information was preferable to more information. Investors also needed more experience of the capital markets in order to better understand how markets fluctuated, the related risks and how profits could be made.

Less than one in five investors actually got some advice with their investments either because they were not able or willing to pay for it. This was significant, as it had been established that individuals who received assistance did then go on to think longer term and make more appropriate investments.

There were four stages identified on what investors considered when deciding what to do with their money. First was the understanding of investment products; second was being sold the right product; third was maintaining a flow of information on the development of the product; and finally was the issue of redress, should the investment go wrong. Each stage carried the potential to significantly impact trust in the financial market. Regulation should help in this respect, but improvement would take time. Some speakers also considered that the regulations aimed at improving investor protection could have negative side-effects that needed to be considered, making it more difficult for intermediaries to sell investment products and making costs higher and access to the markets more difficult in some cases.

Some improvements should be expected from the Capital Markets Union (CMU) action plan

The EU Commission (EC) had worked on the regulatory framework over the recent years in an attempt to provide retail investors with better information, improve investor protection and rebuild trust, but those regulations were still in the implementation phase.

The CMU had relaunched the idea of the personal pension plan, possibly in the form of a 29th regime, some proposals for which would follow later in the year. Tax incentives were a key issue to examine in this regard with the Member States. A public consultation would also be launched, prior to the summer, on what more could be done to create a single market for investment funds in order to generate better returns for investors. Furthermore, the EC planned to conduct a study on retail investment products and how the European market functioned, to see whether retail investors could access sustainable products on cost effective terms. They also wanted to analyse how the policy framework should develop for the market to benefit from online-based services.

Finally, they had not reached a decision on the financial services green paper. A policy paper would be tabled after the summer which could propose additional actions to help retail investors get better value for money when entering capital markets.

The CMU was ultimately favouring more harmonisation and actions to attract more investment in the EU. This could be done through three routes: internationalisation by encouraging more cross-border investment notably with a stronger role of on-line platforms, disintermediation which would reduce the obstacles created in the market by intermediaries, and long term thought compensating the usual short-term bias of investors.

Additional actions were suggested regarding advice, investment products and market infrastructure

Actions to make investment advice more affordable and accessible were needed to restore trust. European regulations should help in this respect. A proposal had also been made by investor representatives to require advisors to connect with their customers regarding their portfolio on an annual basis.

Moreover the retail capital market ecosystem needed to be restored. Retail investors were currently taken aback by the fragmentation and complexity of the European market, a panellist emphasised, with multiple venues focusing on institutional investors, blue chip securities and execution-only services. This was damaging the ecosystem serving retail investors, stock exchanges were a part of; in addition, local intermediaries that were providing services for retail investors were stifled by constant changes in regulation. Regulatory developments such as MiFID would however help create greater transparency and reduce costs in markets, a panellist pointed out.

Favouring simpler investment products more directly connected with the markets and the companies concerned was also suggested. This would be a way of better aligning the long term interests of investors with those of the companies they were investing in and of developing the experience investors had with capital markets. Some speakers regretted that investors were often driven towards packaged products which were more difficult to understand and more costly than ordinary securities. Actions to foster investment in stocks and bonds were not emphasised enough in the CMU, some considered. A suggestion was made that distributors should be required to show and explain differences between complex investment products and simpler, cheaper alternatives. This was however considered to be difficult to enforce through regulation. Another suggestion was to favour simple fund structures that would allow retail investors to invest in SMEs that could for example provide them with specific rights in return. >>>

>>> Technology could also help to facilitate retail investment

Technology had the potential to link individuals with the capital markets more efficiently, and to simplify the paper chase currently used in taking out investment products. Two thirds to four fifths of people dropped out of the investment process because of the on-boarding process required when making investments.

Robo-advice had the potential to be used to provide guidance with investment decisions, asset allocation and consistent client servicing in a cost effective way, reducing significantly the data collation process in particular. Additionally, giving an individual a view of their entire balance sheet was thought to be important for encouraging a long term perspective. However, it was strongly suggested that robo advice could never replace face to face consultations; it could only supplement them. The two could work in tandem to create a superior service that would be led by human experts. The on-line version of robo-advice would indeed be more appealing to millennials, people who had smaller amounts to invest or those who liked 24/7 accessibility, some suggested. Work in the directions of cybersecurity, confidentiality, and investor protection also had to be considered.

Technology often came with fear and excitement. The task of the regulators was not to fear such instances of new technology, but to understand them. In the future, they needed to collaborate more with those investing in and producing technology, in order to elaborate appropriate rules. Crowdfunding and peer to peer lending was one technological development that had already arrived. Such solutions offered many advantages (direct contact, developing a sense of community) but also came with less investor protection and required more risk analysis.

Developing a digital investment passport comprising all the data required to provide an individual with appropriate investment advice would make the relevant data more accessible and allow a better use of technological solutions related to investment, such as robo-advice. Individuals however needed to be in charge of their own data and to own it, some emphasised, in order to be able to share it whenever, with whomever and to whatever extent they wished, which was not the case in all jurisdictions. ●

Repo and market making: what trends and possible actions in the current regulatory context?

KEY ISSUES | *This roundtable discussed the current and future trends of capital market activities, notably repo markets and market making activities, their underlying drivers and what impacts these evolutions may have on markets and on the broader economy. The regulatory approach that was needed for such markets was also addressed, as well as the means needed to monitor these activities at a European and global level.*

Current and future trends and underlying drivers

Repo and Securities Financing Transactions (SFT) were essential for developing capital markets and achieving the objectives of the Capital Markets Union (CMU). They allowed market participants to access secured financing and were a crucial tool for the functioning and the liquidity of secondary markets.

The European and US repo markets were similar in size, but there were some differences between the two markets. The tri-party market, where the post-trade processing of the transaction is outsourced to a third-party agent, was much larger in the US (50% compared to about 10%). In Europe, roughly 25% of transactions were related to equity collateral, compared to around 10% in the US. The US repo market was dollar-denominated, whereas there was a range of currencies in Europe. The US also tended to be an overnight market, whereas in Europe there was a laddered tenor structure.

There was liquidity in the European repo market, but costs had increased and the longer term prospects were unclear. In the Bund market for example, there was no decline in activity, but tickets were bigger and volatility and failures had increased; the Bund market was however not a market of primary dealers. There was anxiety lest reduced liquidity in the SFT market should increase the impact of a possible market >>>

>>> dislocation. Vulnerability to fire-sales and run risks had been exhibited in the US repo market during the crisis. The Tri-party Repo Infrastructure Reform had since established rules that mitigated these risks to a large extent, but post-default fire-sale risk remained to be tackled.

The repo market was evolving towards higher-quality underlying collateral and relatively standardised terms of price and maturity that could be easily understood and modelled for risk management purposes.

Regulation and monetary policy were the two main drivers of the on-going trends

Regulation had had positive and negative impacts on the repo market. Basel requirements such as the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR) and the Supplementary Leverage Ratio (SLR) had increased costs but also made the market safer; moreover demand for secured financing was expected to increase. The impacts of these requirements however had to be examined at the business line level a speaker pointed out. Since greater capital had to be applied to some business lines, bank managers would naturally move capital to those with a greater yield and within these business lines to the most profitable clients who were also the most transaction-oriented ones. The other clients, such as pension funds, insurance companies and long-only money managers may end up having less access to the market and higher prices as a result.

Prudential requirements would also impact traditional market-making activities. Alternative providers such as HFT firms were entering the market. MiFID II would impose obligations on those providers if they acted as market-makers, with the objective of levelling the playing field. MiFID II would moreover fundamentally change the way non-equity markets operated.

The monetary policy of the ECB also had a deep impact on the repo market, affecting pricing and the length of maturities. Pricing at present was distorted. It was no longer determined by demand and supply, but mainly by the deposit rate and the view taken towards the future actions of the ECB. At present about 10% of outstanding debt was being bought by the Eurosystem but this had a major influence on market prices; it also helped to maintain the liquidity of the market. More clarity was also needed on the securities-lending programmes of central banks. The ECB and the Eurosystem were at the same time part of the solution, a panellist noted, developing market infrastructure, encouraging tri-party repos and lending to the market, all of which contributed to increasing the velocity of collateral, which was essential for repo.

Way forward and possible actions

A possible regulatory pause

Some panellists suggested that given the current uncertainty in the market, caution was needed. It was suggested that the best that could be done was to take a regulatory pause and to develop a clearer view of how the market was functioning and how pricing was determined, in order to decide the best course for action. A pause would also help to see how much price transparency and depth there was in the market, particularly in relatively standardised trades and instruments.

Other participants considered that there was no need for a regulatory pause. Some issues needed to be addressed and it was preferable for analysts to go over the data urgently. Another suggestion was that regulation – i.e. the SFT Regulation (SFTR), the CSD Regulation (CSDR) and secondary legislation regarding CCPs - could be a way around the obstacles to increasing collateral velocity.

Adopting a notion of 'do no harm' was proposed by a panellist. As long as the impact was not known, care should be taken regarding the speed of implementation of new changes. A continuous monitoring of market trends was also necessary. More importantly, if significant issues were identified during the implementation of a regulation, a 'reverse gear' mechanism should be available in order to stop or amend the process. This was the type of approach that was intended with the Call for Evidence, which should be used more systematically across legislations. The SFTR would also help to better measure trends.

Central clearing

Developing the central clearing of repo was also proposed. This could alleviate some of the balance sheet constraints of dealers. There would be netting benefits which could release more assets in the market. There might also be benefits for financial stability, potentially reducing the risk of fire-sale under stress. Central clearing was however not a panacea because it increased risk concentration. In addition with repo the underlying assets would have to be disposed of in case of default. Further standardisation of products and of underlying assets would be needed in this perspective. Issues related to leverage ratio rules would also have to be further assessed.

Haircut floors

The FSB had tabled a proposed framework for haircut floors, which Europe would decide >>>

>>> in 2017 whether to implement. Haircut floors aimed at making markets more resilient by addressing contagion and procyclicality risks and excessive leverage. This was a measure that would be desirable, but required further modelling and analysis in order to understand how it would be implemented. There was indeed much variety in the market (types of collateral, tenors) and it seemed difficult to reconcile interests in this perspective. It was moreover suggested that, although the FSB proposal was useful, it was perhaps not the right timing. Developing benchmarks and metrics would in any case be helpful.

Monitoring repo and SFT activities

There were many data gaps in securities financing markets at the EU and global levels.

SFT data that should be available in the EU following the implementation of the SFTR was critically important to monitor the on-going trends in the market, assess the impacts of different factors, evaluate whether there was a failure in the market and determine which tools could help. A challenge was that SFT data was spread out over multiple databases in Europe. A project had therefore been launched at the Eurosystem level to consolidate those databases into one that could be used by the ECB for supervision.

Another issue was that the ECB monetary actions were currently masking the underlying trends in the SFT market, which required further assessment. The cumulative impact of the different regulatory measures that were going to affect the SFT market in Europe also needed modelling.

Some modelling had been done in the US, but data was still missing; there was some aggregate information regarding securities lending, but more granular and detailed information was needed, particularly regarding bilateral repo transactions. The OFR was collaborating with the Fed and the SEC to conduct pilot data collections in the bilateral repo and securities lending markets, which were due to become permanent. Establishing a partnership between regulators and the industry was extremely important and valuable in order to define from the start what data represented and how to collect it. Moreover it was essential to standardise the data using standard legal entity, product and transaction identifiers. Supervisors were collaborating at the international level in order to understand the differences across markets, the interconnections and the transmission mechanisms of shocks.

There should also be a specific focus on collecting liquidity data regarding market depth or the time it took for a portfolio to be liquidated. Liquidity measures indeed lacked the history of data supporting them that those related to market or credit risks possessed. ●

Investment funds: how to reduce fragmentation in the EU investment funds market?

KEY ISSUES | *The objective of this roundtable was to discuss the key remaining areas of fragmentation of the EU investment fund market, their impacts for investors and the industry as well as the solutions that could be proposed at the EU level to reduce this fragmentation*

The EU investment fund market has remained fragmented

The EU investment fund market has remained fragmented despite the implementation of European product, distribution and investor protection regulations. Investment funds were key to making the CMU a reality, helping to reduce banking finance and increasing capital market finance in Europe. Funds had grown in the EU, but there was a question of whether investors got the best value for their investments and whether the cross-border penetration of funds was sufficient.

At first glance the European fund industry appeared successful. UCITS and AIFMD were appropriate frameworks allowing the passporting of investment funds across Europe. Many actions had also been undertaken with MiFID II, PRIIPs and the KID to harmonise client information and >>>

>>> investor protection across Member States and across different types of investment products. The objective of these measures was to facilitate investors' access to information and to simplify the process of comparing investment products on a domestic and cross-border basis. Service providers were also facilitating the access of their clients to a broad range of markets and supporting them with reporting requirements.

The EU investment fund sector however remained quite fragmented and some Member States had very few foreign funds. As a result, the EU had three times as many funds as the US; around 30,000. The average size of EU funds was one fifth of the size of those in the US, and the costs of managing EU funds were consequently 50% higher. The large number of small funds increased the regulatory burden for management companies and thus the cost of managing funds, which impacted investor returns. That was an important problem to address to make the CMU a reality.

The levels of fragmentation were however not the same across Europe a panellist emphasized, because some European funds, such as those domiciled in Luxembourg are well passported across Europe and outside Europe.

The EU fund sector was fragmented for various reasons

Only a small amount of the higher fragmentation of the EU market compared to the US could be attributed to different currencies.

Differing implementation across Member States of European legislations related to funds and specific domestic rules were a major source of fragmentation. Several examples were mentioned during the roundtable: additional disclosures required by domestic regulators on the marketing side; high registration fees; the requirement of local paying or facilities agents forcing UCITS to have a physical presence in a host Member State; and inconsistent definitions in AIFMD of who were the return investors and the professional investors which limited the extent to which AIFs could be distributed. Many of these barriers were due to the mistrust between regulators and to differences in the way directives had been implemented. Differences in taxation and concern over double taxation were another reason why retail investors were put off cross border investments within the EU, a speaker believed.

Another source of fragmentation were the inconsistencies across regulations affecting investment funds, for example regarding reporting, which made cross border distribution and compliance with each set of regulation increasingly more difficult; new regulatory developments such as MiFID II and PRIIPs would add to the complexity. The risk was that the demands of regulation could eventually become insurmountable for smaller players and new entrants, potentially reducing competition.

A further source of fragmentation was the structure of distribution channels in most of Europe and the vertical integration or banks selling their own funds, some panellists considered, which was at odds with creating a single market. Private and retail banks were still the largest distribution channels of funds in Europe, owning a total share of 75%. This part of the market was largely excluded from competition between funds. Moreover, certain well intended regulatory measures, such as the requirements related to the oversight of distributors in MiIFD II could favour the move towards more vertical integration. This could affect the level playing field in the market and hinder competition that was needed for service to clients to improve and for prices to fall.

Possible solutions for reducing fragmentation in the EU fund market

Different solutions were discussed during the roundtable to reduce fragmentation in the EU fund market including a better cooperation among regulators and supervisors, a central registration of funds, a streamlining of regulations and developing the use of technology.

A more coordinated and proactive approach to regulation and supervision at the EU level was first needed. When MiFID II, KID and PRIIPs were in place, regulators should be able to agree that there was little or no scope left for national gold plating. In passporting, the rules that applied should be those of the EU frameworks (i.e. MiFID II, AIFMD, UCITS...) and nothing else. There should be no possibility to add fees, to impose local agents or to have extra marketing rules. That was what the maximum harmonisation of regulation was about.
A central registration of funds at EU level was moreover proposed. The passporting regime in place indeed mainly focused on the sale of investment funds and did not deal with marketing requirements. Once an investment fund was registered and had met the requirements in one Member State, it should be possible to use that authorisation for more than selling the fund. This would give more power to ESMA and was considered by some speakers to be a positive step towards reaching a CMU. A concern one panellist expressed was that ESMA did not carry out sufficient peer reviews on the >>>

>>> implementation of legislation with domestic regulators. However, that was disputed. ESMA had a strategic plan for 2016 2020 on the single rulebook and supervisory convergence, amongst other initiatives and this was a priority for the authority.

It was also felt that national authorities needed a mechanism whereby they could work together towards a European goal; some however considered that that was already possible, but prevented by a lack of willingness among the participants. Some speakers suggested that the EU Commission could play a more proactive role by undertaking infringement procedures. If barriers to cross border fund distribution were not tackled, retail investors would suffer the most. They needed greater convergence amongst supervisors, which was currently easier than it historically had been thanks to technological developments.

A single rule book for investment funds and a streamlining of regulations were also proposed. Several panellists stressed that further harmonisation and a streamlining of existing rules affecting EU investment funds were needed, rather than additional layers of legislation. A single rule book already existed to a large extent with the measures related to passports, the notification procedure, the KID, the provisions regarding master feeder structures and fund mergers, but the implementation of these rules differed across Member States. It was difficult to anticipate how initiatives like MiFID II would impact the industry; they needed to see how they applied and how distribution models would evolve before considering whether or not additional rules were necessary. It was further recommended that superfluous parts of regulation should be removed. There would be an EU Commission consultation in Q2 of 2016 on these issues.

Better cooperation between regulators and the industry was also necessary, some suggested. Regulators needed to talk to the industry more and to understand market practices better. This would allow them to appreciate what level of regulation they needed to apply whilst also bearing in mind the need for consumer protection. The process should start with understanding the market before moving to legislation. Moreover the industry was encouraged to collaborate on creating industry wide templates for information exchange and communication with distributors when MiFID II was totally implemented.

New technology could also be used for the streamlining of processes and the improvement of distribution. However, it was noted that accessing optimal technology could then be a problem for small and medium asset managers. The prospect of new digital entrants reducing costs and challenging traditional methods of handling investment funds was also welcomed by some panellists, as an improvement for both consumers and the industry as a whole.

The industry also needed to look into products that would encourage retail investors, who only had 7% of their investments in funds, to move savings from low interest rate bank accounts into funds. ●