

Speech by ESMA Chair Steven Maijoor at the ECB high level conference on Financial Integration and Stability

The sovereign debt crisis and the EU single market: where is further work needed from a securities markets perspective?

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Ladies and Gentlemen,

In my contribution today I will focus on the effects of the financial crisis on economic integration in securities markets in the European Union. I will talk about securities markets in a broad sense, including the fund industry and market infrastructures. We nowadays hear many concerns about the financial integration process being halted or even reversed as a result of the crisis, especially in the banking area. Maybe somewhat surprisingly, for securities markets, I will have a positive message on the crisis and its effects on economic integration. While there is variation in the various subsectors of securities markets, the current overall development is in the direction of more economic integration.

I will talk about three subjects. First, I will comment on the institutions needed for a single market in the securities area. Second, I will talk about how the financial crisis has affected economic integration in securities markets. Finally, I will identify three policy areas where further progress is needed to foster economic integration in securities markets. These three areas are: (1) transparency related to sovereign debt issuers; (2) financial planning of private households; and (3) the balance between loan-based intermediation and market-based intermediation.

Before I move on I would like to clarify that, as you probably already noticed, I will not limit myself to the Euro area, despite the title of this panel. For securities markets regu-



lators the distinction between the euro area and the non-euro area has limited relevance, as it is rarely made in securities markets regulation, and there are many market infrastructures that span the euro and non-euro area. Also, the developments during the crisis in securities markets in core euro-zone countries are more similar compared with some non-euro zone countries than compared with peripheral euro-zone countries.

Institutions and the integration of securities markets

A surprisingly positive by-product of the financial crisis has been the improvement of the institutions needed for an integrated single securities market in the European Union. Like the other two new EU supervisory authorities, ESMA has new powers that contribute to the EU single rule book, and that foster consistent supervision. On the basis of these new powers, we have for example just finalised the draft technical standards for the EU-wide short selling regulation. Also, based on the EMIR Regulation, we will consult before the summer on draft technical standards for the EU for mandatory central clearing of derivatives and for market infrastructures like CCPs and Trade Repositories. In addition, the new European supervisory authorities have already used their new powers that foster consistent supervision by issuing recommendations, opinions and guidelines. Further, in response to the financial crisis, new sectors have been brought under supervision, contributing to a level playing field in the EU for market players like credit rating agencies and hedge funds. Finally, there is the positive trend to move to Regulations instead of Directives, which further reduces the differences between institutions across member states. Concrete examples here include the proposed Regulations relating to product intervention and the transparency and trading of non-equities (MIFIR), and in the area of market abuse (MAR).

To conclude on this topic, the financial crisis has provided the momentum to substantially improve the institutions needed for economically integrated securities markets.

The financial crisis and economic integration in securities markets

Of course, improving the institutions for the single market does not necessarily mean that financial integration will automatically occur. I will therefore briefly discuss the

effects of the financial crisis on the economic integration of the various subsectors of securities markets.

As we all know, as a result of the crisis, debt markets for certain countries are not functioning properly any more. It also implies that, at the very least, that European sovereign debt markets are fragmented by the recent events, since those which still function tend to reduce any exposure to those markets which are essentially shut down for the moment. The developments in equity markets mirror the development in (sovereign) debt markets, with clearly better performance by equity markets in core-Eurozone countries compared with equity markets in periphery countries. As a result of the sovereign debt risks the interbank market largely dried up and both European and non-European money market funds reduced their exposure to the Euro area.

Hence, it can be concluded that the fragmentation of financial markets occurs mainly along risk classes. The geographical pattern is due to the differing risk profiles of the various member states and regions of the EU. In sum, while developments in (sovereign) debt and equity markets differ clearly between core and peripheral Eurozone countries, and indicate some de-integration of Eurozone securities markets, this is the rational response to risks in peripheral Eurozone countries.

The fund industry in general has experienced relatively stable development. A major negative impact can only be found on the balance sheets of (UCITS) funds and here especially those funds which were specialized on equity and money markets. While the latter are clearly affected by the general shut down of money markets, the first group essentially suffered under the burden of a reduction of the general value of equity. A repatriation of funds in the sense that distributors blocked out foreign funds has not occurred. However, an increase in the home bias of investors implies that cross-border investments have decreased. On the other hand, the cross-border outsourcing patterns of fund managers indicate no real reduction in cross-border connectivity in the fund industry. Hence, so far there are no major negative effects of the financial crisis on the European integration of the fund industry, since the hopefully temporary increase in the home bias is merely a rational reaction to the increased risks within markets.

The European dimension of market infrastructures does not seem to have been at all negatively affected by the financial crisis. On the contrary, while there is fragmentation

of trading venues across the EU, this fragmentation is not so much based on national borders. In addition, this process of fragmentation started before the financial crisis, mainly as a result of the institutional changes as a result of the introduction of MIFID. The current new waves of institutional changes are a positive dominant development for economic integration in the area of market infrastructures. The upcoming legislative changes like EMIR and CSD, will improve the EU level playing field for market infrastructures and give a strong stimulus for market infrastructures to consider new strategic options pointing to integration across national and even regional boundaries, and across various parts of the industry chain.

Policy areas where further progress is needed

As you are all aware, the EU has responded with a broad range of measures targeted at securities markets to respond to the crisis. I will refrain from summarizing the many legislative changes which resulted in a long list of new acronyms. Instead, I will discuss three areas where I think further progress is needed.

1. Transparency related to sovereign debt issuers

In securities markets, the difference between corporate debt and sovereign debt is becoming more and more obsolete. We have learned the hard way that there is no zero-risk for sovereign debt. In response to this, while initially not sufficient, the transparency and financial reporting by listed companies holding sovereign debt has improved. However, the transparency of issuers of sovereign debt is lagging behind. There is currently a wide gap in the transparency obligations for sovereign debt issuers compared with corporate debt issuers. There are no common financial reporting standards for governments, and they are not subject to the Prospectus Directive and the Transparency Directive. We all know that a high level of transparency is needed for effective market discipline and good governance, and good governance is now especially needed in the Euro-zone.

A first area where we should progress is financial reporting by governments. A recent IMF paper shows that in the past decade, accounting devices have been used by governments in- and outside Europe to improve the appearance of their public financesⁱ. Hence, improving governmental financial reporting systems is very important and I very

much support the current assessment of International Public Sector Accounting Standards (IPSAS), which is part of the “six-pack” legislative package adopted by the Council in November 2011. While not committing at this stage to the IPSAS standards, it is important for securities markets that we move to a set of high quality financial reporting standards for governments in the EU. ESMA will certainly participate in the debate on public sector accounting and will respond to the consultation on IPSAS.

To conclude with stating the obvious: high quality public accounting is also directly relevant for the Excessive Imbalance Procedure as the size of government debt is one of the variables measuring internal imbalances.

2. Financial planning of private households

A second area where further policy work is needed concerns the financial planning of households. As the IMF convincingly argues in this month’s World Economic Outlook, high household debt amplifies downturns and weakens recoveries. There are very diverse effects of the financial crisis on household financial planning across the EU, and there are many country specific developments. Obvious generic developments are the move by financial consumers towards less risky products, and an overall worsening of the financial health of households.

While the most important element in households’ financial planning relates to mortgages and private real estate, financial products can also be an important part of the financial planning of households. In recent years, there has been EU-wide concern regarding the marketing of complex products to retail investors. Market and credit risk may not be fully appreciated and priced in by retail investors. The increased marketing of complex products to retail investors is driven, on the demand side, by the low level of interest rates and related search for yield, and, on the supply side, by the commercial interest of banks in structuring and promoting such products to support funding needs. Some of the products are directly competing with traditional savings products such as deposits that offer a constant return. Given the complexities of some of the products sold, retail investors may have difficulties in assessing the risk and the expected returns of those products.

There are also significant risks for financial institutions: these concern reputational risks and legal risks as in several European countries financial institutions have been fined either by regulators or by civil courts for not providing adequate information related to the riskiness of the products. In some cases, fines have been combined with massive compensation.

While existing regulation already requires that financial products in the securities area are transparent and should only be advised when they are suitable, this is not a sufficient response to the developments just identified. First, current practices across the EU do not yet meet the regulatory standard. Here is clearly a task primarily for the industry, but also for securities markets enforcers, to ensure that selling and advisory practices are in line with the regulatory requirements. Secondly, the current regulatory requirements vary for banking products, insurance products and securities products. To achieve proper financial planning for households, it is important that there is the same level of consumer protection for all types of financial products and that when they are advised and sold, the interactions between the three categories of products are taken into account. There are currently various legislative initiatives underway which will improve financial consumer protection (PRIPS, MIFID II and MIFIR). When further shaping these proposals we need to ensure that they result in effective regulation and supervision covering the complete range of financial products to ensure the ultimate goal of healthy financial households.

3. The balance between loan-based intermediation and market-based intermediation

The third policy area I would like to discuss is securities markets as a source of funding of the economy. The deleveraging process underway in the banking sector raises the question whether loan intermediation should be substituted by market-based intermediation. For example, for the US there is evidence that between 2009 and 2011 the decrease in loan-based intermediation has been more than compensated by the increase in market-based intermediation.

Proponents of the development of non-bank funding sources argue that market-based systems help protect economies from disaster-prone banks. Deep markets have a high

risk absorption capacity which enables them to experience fire sales with a limited impact on prices and hence to contribute to economic stability. The market is a buffer against financial stress as firms are provided with an alternative source of finance when bank credits freeze up.

Looking at the recent crisis period however, there are important disparities in access to finance across different segments of enterprises. It appears that issuance activity is highly biased towards large highly rated companies. SMEs face many barriers to accessing capital markets, some self-inflicted and others external. Many SMEs in Europe consider market finance irrelevant for their business. For most SMEs the fixed costs for accessing and maintaining a listing are perceived as exceeding the benefits of having a balanced capital structure. The small issuance of bonds also implies costs which typically include the costs of acquiring a credit rating and the illiquidity premium charged by investors. However, some SMEs, such as firms looking for growth, necessarily need equity as a relevant source of finance, because equity finance does not come with the obligation of repayments and immediate interest payment. Currently, most of the equity growth of small firms and start-ups comes from private equity funding. Once such firms have reached the critical size necessary for the listing benefits to outweigh its costs, they are natural candidates for being listed. However, as illustrated by the low IPO activity in the past years, the break-even point to move to a listing lies apparently at a high level. The relevant policy question is therefore whether changes in the institutions relating to primary and secondary markets can be made such that it becomes more attractive to become listed, without negatively affecting the protection of investors. This policy question needs an assessment of all requirements relating to obtaining and continuing a listing, and weighing the costs and benefits for SME issuers and their investors.

Other policies that will help market-based funding for SMEs is the improvement of the single market for venture capital with the proposed new EU Regulation in this area, and possibly the revival of securitization of SME loans. While securitization is obviously tainted by the financial crisis, we should not avoid the question whether this market can be re-established on a sounder basis with more transparency, as it can be a very important source of funding.



Conclusion

Despite the deeply negative effects of this financial crisis I would like to conclude with highlighting again the two positive developments I have discussed. First, the crisis has provided the momentum to greatly improve the institutions needed for integrated securities markets in the EU. Second, and finally, despite the crisis, the main parts of the EU securities markets seem to be continuing on their path of further economic integration. Thank you for your attention.

ⁱ T.C. Irwin, Accounting Devices and Fiscal Illusions, IMF Staff Discussion Note, March 28, 2012

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