European Securities and Markets Authority

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Regulating for a truly single capital market: The case of bond markets

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Ladies and gentlemen,

Firstly, thank you for inviting me to speak here tonight and secondly, and just as importantly perhaps, for permitting me to speak to you in English. As you know, ESMA is a European authority and so our staff, Board members and stakeholders come from across the EU. The language skills I encounter on a daily basis never cease to impress me.

However, you didn't invite me to muse on EU polyglots but on the EU capital market and specifically, what do we mean by regulating for a truly single capital market? I would like to begin by first talking about the Capital Markets Union (CMU) and then focus on how we can improve the functioning of EU bond markets. In particular, I will discuss the topical issue of bond liquidity and transparency.

ESMA welcomes the publication by the European Commission of the Action Plan on CMU and supports its aims and objectives. The actions set out in the Plan are concrete and practical and the step by step approach proposed will help in measuring and monitoring the progress made.

In particular, identifying specific actions for companies at each stage of the funding process recognises the differing needs of companies through the development cycle. Also, in acknowledging there is a need to promote innovative forms of financing, such as crowd

funding and loan origination by funds, the CMU should help firms seeking to grow by offering them diverse ways of financing.

The way in which the CMU Plan breaks down action points with reference to the size and maturity of companies is important because if we are to truly deliver an effective CMU, a one size fits all approach will not work. Small and Medium Enterprises (SMEs) are a very important part of the capital market spectrum and are the lifeblood of the European economy. Channelling private capital to SMEs is crucial to support the development of jobs and therefore growth.

The Commission's proposals to improve SME credit information, together with a revamped SME prospectus disclosure regime, should help to raise the profile of SMEs and reduce the costs of accessing the capital markets. Careful calibration of disclosure requirements will be important to ensure that costs to SMEs are reduced but we must be equally mindful of ensuring that this does not come at the expense of investors. In my view, the approach to SME disclosure requirements should be a bottom up approach, rather than starting with disclosure appropriate to large caps and then subtracting from this. We need to focus on the issues that are most pertinent to investors, whilst bearing in mind the size and capabilities of the SMEs themselves.

Another very important part of the capital market spectrum is the asset management industry, which can play a major role in the CMU. While this sector already benefits from a strong and robust regulatory framework, ESMA welcomes targeted changes to legislation in this area, including those to EuVECA and EuSEF, in order to unlock private capital. We also welcome the commitment contained in the Action Plan to look at the transparency and performance of retail investment products. There are still too many barriers preventing retail investors from selecting the investment product that best suits their needs against the lowest costs and so improving transparency on costs will be essential. I would also add, with respect to those barriers, that we need to look at the pass-porting system of funds across the EU and what we as regulators can do to improve that system.

For ESMA, a successful CMU also needs greater investor participation coupled with robust investor protection. Investors must have sufficient confidence and trust in capital markets so that they are willing to participate in them and only then we can reap the benefits that may result from easier access to capital. Transparency is the cornerstone of investor protection

and necessary to ensure investor participation in capital markets, as I will discuss in more detail later when I talk about bond markets.

A single capital market also requires greater consistency in supervision across the EU and this is clearly an area in which ESMA should assume a leading role. ESMA is committed to expanding its focus on supervisory convergence in the coming years, and to adapting its approach to these activities through, for example, the development of a standalone supervisory convergence work programme. We are in the final stages of making the first annual supervisory convergence work programme, which we will publish in early 2016. The development of this supervisory convergence programme should ensure that we copper-fasten many of the gains made in recent years in terms of the regulatory work programme. We expect the intense focus on creating a single rulebook, which has been the principal activity of ESMA during its first five years, will reduce going forward, meaning we will be able to shift our focus and resources to ensuring the consistent implementation of the single rulebook across the Union.

Let me now zero in on bond markets and their role in the CMU. Bond markets already play an important role in current EU capital markets: for example, funding from bond markets increased 42% over the last 5 years[1] compared to 7% from bank funding for Eurozone non-financial companies. Of course, this development is partly the result of unique circumstances mainly related to challenges in the banking sector and the very low interest rate environment. However, it is important that this bigger role played by bond markets becomes a permanent feature and is supported with policy measures where needed. This importance is also recognised in the new European Commission proposal for the prospectus regulation, wherein it is proposed that the distinction between retail and wholesale denominations for debt securities is removed in order to increase liquidity in the bond market and offer retail investors a broader investment choice.

In addition, we should recognise that MIFID II already foresees a more important role for bond markets. Therefore, I now want to turn to what ESMA is doing under MiFID II and more specifically, what we are doing in relation to bond market transparency, an area of our work very much under the microscope.

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[1] Statistics Bulletin, ECB, December 2015.

ESMA submitted its final rules on transparency and liquidity for the bond market to the Commission in September and they are attracting attention from a wide range of stakeholders - sell-side, buy-side, trading venues and public authorities. This is natural: these markets are important and there are big interests at stake such as the profitability of the market making business; the impact on the markets in which governments and companies find their financing; and fairness for investors as a whole.

These interests mean, however, that there is some resistance to taking steps to enhance transparency in the bond market for fear of the impact on liquidity. I would stress at this point that I also believe that protecting the liquidity of the bond market is of paramount importance. Transparency applied indiscriminately to illiquid instruments can be extremely damaging, resulting in difficulties in executing trades and the thinning of already thin markets. However, I am not aware of any liquid market which is not also reasonably transparent.

In introducing transparency to the EU bond markets, it is not a matter of flicking on the switch to a high watt spot-light but carefully calibrating liquidity thresholds to provide investors with the right balance between transparency and protection and this, I believe, will contribute to fostering liquidity. In other words, a bond between liquidity and transparency exists as long as it's handled with care.

So at this point I would like to outline ESMA's rules on bond liquidity and transparency, which are the result of two years' work where we ourselves put bond data under the microscope, and represent, I am convinced, the best technical approach permitted within the construct of MiFID II.

We analysed the trading patterns of more than 54,000 bonds over one year with data that covered bonds admitted to trading on Regulated Markets or traded on MTFs or OTC from 25 countries in the EEA. 49% of these bonds didn't trade once during that period which is in line with the widely held view that a large part of this market is illiquid. We analysed the trading patterns of the 51% of the bonds which did trade to see whether certain features were predictive of how frequently a bond traded. Features that we considered included issuance size, time to maturity, currency, instrument type and issuer type. However, overall, we could not find a combination of features which predicted with sufficient accuracy whether a bond was liquid or illiquid. Therefore we had to abandon this approach, which we had called COFIA (Class of Financial Instruments Approach), except for newly issued bonds which have no individual trading history.

Instead our rules apply an approach where each instrument is assessed regularly against the following three criteria (known as "IBIA" or the Instrument by Instrument Approach):

- Is the average daily notional amount traded at least EUR 100,000;
- Does the bond trade at least twice a day on average; and
- Does the bond trade in at least 80% of the trading sessions available?

If the answer to all of these questions is yes, then the bond is deemed liquid. I want to underline this point because when stakeholders argue, "how can an instrument that trades twice a day be liquid", they are focusing on only one of three components.

The other important feature of this approach is that it is dynamic. The calculation is undertaken every three months so that changes in an instrument's liquidity are picked up quickly and the regime is adaptive to a market where episodic trading is common. At some point in their life, some bonds may be more liquid than the average equity share in the EU and so saying at the outset that they are not suitable for transparent trading without taking into account the lifecycle is too easy.

Using this method, we estimate that out of the 54,000 bonds we assessed, approximately 2,600 bonds, or 5%, are classed as liquid, a figure I'll return to in a moment.

So what are the consequences if an instrument is deemed liquid? Why is it the focus of so much attention and, dare I say, even passion? For this reason: if an instrument is classed as liquid, real time transparency obligations will apply, whereas illiquid instruments – generally speaking – can be exempted from pre-trade transparency obligations and can benefit from post-trade deferred publication.

However, exemptions from transparency for illiquid instruments are not the only ones available under MiFID II. Exemptions are also available for trades which are of a certain size, known as the "Large in Scale" and "Size Specific to the Instrument" exemptions. ESMA's role here has been to calibrate the level of the thresholds when these exemptions apply, in other words deciding the size at which a trade is so large that it should not be made public due to the risk of the market moving against it.

So let me return to that figure of 5% I quoted: under the liquidity parameters we propose, approximately 5% of the bond market would be assessed as liquid. Out of that 5%, those

trades which are above the Large in Scale or Size Specific to the Instrument thresholds will not be transparent. To put this in another way, ESMA's rules will still result in over 95% of bonds being exempted from transparency as even for the bonds which are, in principle, subject to the transparency requirement, there will be exemptions for transactions of a certain size. Therefore, when stakeholders say our rules are too stringent I cannot agree. The introduction of these rules will mark a change from the current status but that is the objective of MiFID II: to bring more light, and more liquidity, to the bond market. It is also important to remember that we are not starting from zero: transparent bond trading already takes place in the EU and what we risk, if we cut down these rules any further, is a future market where less bonds are transparent. We should not introduce rules which create darker bond markets than exist today.

But to repeat what I said earlier, I believe the methodology ESMA proposes is the right one, calibrated to introduce a judicious level of light into this market but with sufficient safeguards in place to avoid drying up fragile liquidity. To this end, I recently read in Financial News[1] that Trax, the capital markets data provider, analysed how our rules would have impacted Volkswagen bonds – had they been in place - following the September revelation about the company's emission tests.

Corporate bonds are a particularly illiquid segment of the market. Speaking in very broad terms, there is a brief period of trading around the time of issue followed by the occasional spike of activity when the market is galvanised into action by an event or announcement which is what happened to Volkswagen bonds in September. Trax found that overall the number of Volkswagen bonds subject to transparency in October would actually have been less than in September, despite the increased volume of trading in September, and they account for this by saying that very few bonds met the liquidity parameter that the bond must trade at least 80% of days.

This goes back to the point I made earlier: the liquidity assessment is a three-pronged assessment. The safety valve for short term spikes of activity in otherwise inactive bonds is

[1] "VW scandal helps to road test EU's new bond trading rules" by Tim Cave, 2 December 2015, Financial News. http://www.efinancialnews.com/story/2015-12-02/vw-scandal-helps-to-road-test-new-bond-trading-rules

the number of days on which the bond traded. An event-driven frenzy of trading will not necessarily lead to a reclassification of a bond from illiquid to liquid if it is not sustained.

So far I have looked within the EU but the capital market is of course an international one and a question we are asked frequently is how do our rules compare to those of other jurisdictions, especially the US? Are we using a 100watt bulb when other countries are using 60watts?

The US is a particularly interesting case because it is frequently used as an example of an economy which achieves a better balance between bank funding and markets funding than the EU and partly inspired the CMU programme to increase the bond financing of companies.

What we have found is that overall, the US post-trade transparency regime, which has been in place for over a decade, is stricter than the EU's, with no exceptions for illiquid instruments whereas the EU's pre-trade transparency regime goes further than that of the US.

Finally, I can hardly mention a proposal which involves calculating the trading activity of each EU bond every three months without highlighting that a sophisticated IT system is needed to bring this about. In turn that leads me to the issue of when MiFID II will come into force, something which has been much discussed recently. From what I've said so far, you'll appreciate the scale of the task for implementing the bond rules alone: the need to obtain transaction data and reference data for each instrument before the number-crunching can even start. And this is something that must be undertaken for other asset classes too.

Investment firms, trading venues and supervisors need to rebuild their transaction and reference data reporting systems almost from scratch. ESMA itself is also building a substantial IT system to collect financial instruments reference data and trading data from venues in order to publish a complete, single list of financial instruments trading, which will serve for both MiFID and the Market Abuse Regulation (MAR), which requires a similar list. We will be well into 2016 before the rules are final and the building of these IT systems, which will take at least a year, can really only start when these rules are set in stone. There are similar data and IT issues with the transaction and position reporting requirements in MIFID II. Given MiFID II should apply from 3 January 2017 there is clearly a timing issue and it was for this reason that ESMA raised the concern with the European Commission. Whether elements of MiFID II, or even as a whole, will be delayed is now subject to discussion and

agreement between the Commission, Parliament and Council, and we are awaiting their decision. ESMA's interest in this matter has been and continues to be one of practicality.

Ladies and gentlemen, it is time to conclude. We are living in changing times which brings both challenges and opportunities to us all. The financial crisis was the alarm bell that it was time to change and it is now, just as the memory of it begins to recede, when we need to ensure we do not lose momentum and carry through on the actions we realised were necessary at that time. I know that it is more comfortable to stay with what we have and what is known, but ultimately I believe the rewards will be greater if we step forward, away from the past.

Thank you very much for your attention.