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ESMA Financial Innovation Day

Welcome and opening comments

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I am delighted to welcome you all to ESMA's second Financial Innovation Day.

Over the past three years we have worked to put in place a framework within which the Financial Innovation Standing Committee ('FISC') can best operate. In designing this framework we have been guided by three core objectives - investor protection, market integrity and financial stability.

The objectives serve to ground the analysis of financial innovation for a number of reasons. First, while some innovation in finance has contributed to economic growth, other financial innovation has been identified as a factor that gave rise to financial instability during the recent crisis. We can work to ensure that supervisors, policy makers and market participants are more aware of the types of innovations that may give rise to financial instability and those which support growth and prosperity. Second, innovations that lead to deliberate misinformation or fraudulent behaviour among market participants threaten orderly markets. This in turn can lead to a loss of confidence among investors and participant withdrawal. We must ensure that regulatory conduct underlying the emergence of innovation is known and of the requisite standard. Third, investor confidence is critical to the robust functioning of markets. In the monitoring of innovation we must guard against information asymmetry. Investors must have sufficient information about the risk/return profile of a product to make investment decisions appropriate to their circumstances and needs.

Importantly, we realise that financial innovation has also contributed beneficially to the key economic pillars through which finance operates – providing a system of payments, a means to pool funds for savings, mechanisms to transfer savings for productive investments, and ways in which to manage and optimise the allocation of risk. In turn, innovation has brought investors and consumers material benefits whether through the widespread use of credit cards, the growth in index mutual funds or access to futures and swaps to manage risk. However, we have also observed that those positive benefits originating from financial innovation are sometimes overlooked when the topic is discussed in favour of adverse innovations tied to the financial crisis. We bring to the subject a balanced approach, both protective and supportive.

The theme of today’s discussion is how financial innovation can support the development of more inclusive and more vigorous capital markets, improve access to finance and spur investment across the European Union.

Europe’s current biggest challenge is the quest for economic growth to ensure our welfare and to maintain our position in the global economy. The development of the Capital Markets Union (CMU) is of strategic importance in that respect.

The crisis has hit Europe and many other parts of the world severely. It has made us – not surprisingly – more risk averse. But, economic growth needs the willingness to take risks. Not the type of risks associated with exotic financial instruments but the kind of risks that allow entrepreneurs and investors to start new projects and businesses, to generate new revenues and jobs. And to do so, companies need capital which is not always available within the banking sector.

Europe needs to develop alternative funding channels to ensure that the benefits of capital markets and non-banking institutions are maximised for the real economy. Policy makers and regulators should ensure that the regulatory framework provides for various funding channels and that they can function well. However, it is up to market participants to actually select the preferred channel depending on the funding and investment problems they are faced with. In simple terms, we should refrain from identifying in advance a champion among the funding channels or giving the impression that there are risk free investments. Crowdfunding and leveraged loans funds are two forms of alternative funding that we will explore today.

A successful capital market requires active participation by investors, including retail investors. The frequently used example of a better balance between bank funding and markets funding is the United States of America (USA). Participation of households in US securities markets has increased significantly in the past 30 years from approximately 45% to 65% of all households. While there are national differences, participation of EU households in securities markets is typically much lower, at about 20%. In the long term, households investing carefully in securities markets will be better off than if they keep their savings concentrated in deposits. Of course, we all know that there are risks in financial markets, and especially retail investors need to carefully consider these risks. When discussing crowdfunding and leveraged loan funds our focus will also be on how to facilitate participation by investors in those alternative funding channels, while making sure that they understand the risks that they are exposed to.

Europe also needs deep and liquid markets to deepen financial integration, lower costs and increase European competitiveness. For larger companies, corporate bonds are a key mechanism for raising debt finance on a larger scale. Some market participants have raised concerns about the lack of liquidity in secondary markets for corporate bonds. Lower liquidity could translate into higher liquidity premiums and higher borrowing costs. It could also affect the stability of the financial system in case of shocks. Innovative ways to bring together potential buyers and sellers and to increase transparency in the market are therefore needed. This is something that we will explore in our panel on trading innovations in corporate bond markets.

Finally, the distributed ledger technology cuts across a number of the objectives of the CMU, because of the potential benefits that it could bring in terms of cost, efficiency, transparency and security to financial markets and users of financial services.

I will discuss each topic in turn.

Innovative forms of business financing – The Crowdfunding case

Within ESMA's field, investment-based crowdfunding provides an alternative funding channel for start-ups and small businesses. It also provides new mechanisms for investors to get access to unlisted securities. This is in turn leading to demand for a new form of secondary market for unlisted securities.

There are opportunities here, but the risks come in several forms – from new technology, to the relative inexperience in terms of financial services of many of the entrepreneurs involved, to the lack of a regulatory framework designed with such developments in mind or, in some cases, a framework which is very complex because the businesses cut across traditional sectoral boundaries.

In value terms these markets are typically small, but what is remarkable is the growth rates. According to the European Alternative Finance Benchmarking Report, the total transaction volume of the online alternative finance market in the EU reached EUR 2,957m in 2014, with a growth rate of 144% with respect to 2013. Of this amount, peer to peer consumer and business lending account for EUR 2,117.7m.

Appropriately Panel One of today's discussion will discuss Crowdfunding and how it may support a growth orientated economy.

Trading innovations in response to the lack of liquidity in corporate bond markets

Our second panel will focus on trading innovations in response to the lack of liquidity in corporate bond markets.

We have been told by various market participants that regulatory and capital pressures are reducing the ability of sell side banks to hold large inventories and to act as market makers. This in turn, certain market participants argue, has reduced the secondary market liquidity of certain instruments, particularly corporate bonds.

The market has responded with a number of trading innovations that effectively aim at bringing closer together potential buyers and sellers, including through better connectivity or enhanced pre-trade information. Can these innovations help re-introduce liquidity in the market and which challenges do they raise for regulators?

The distributed ledger technology

Virtual currencies are one of the major financial innovations in recent years.

More recently, we have seen a growing interest for the distributed ledger technology, which underpins the virtual currencies, as an alternative mechanism to issue, trade and record ownership of securities. There could be opportunities here, but clearly also risks while these mechanisms are not well understood and generally operating outside regulation. We are also aware that many mainstream financial service providers are investigating ways to use distributed ledger technology in their existing businesses but are unsure as yet what form this could take.

Panel three of today's discussion will look more closely at the distributed ledger technology with a particular focus on how the technology may play a role in the securities markets.

Leveraged loan funds

We have observed that the comparatively low interest rate environment has encouraged investors to accept a greater degree of risk in exchange for higher returns. The increased risk comes in the form of assuming greater duration, lower credit quality and higher volatility. For example, the yield on 30-year German government bonds is 1.23% today, compared to 1.60% one year ago, while the yield on 2-year German sovereigns is -0.23%, compared to 0.04% one year ago. This translates into an investor being paid 1.23% today for taking much longer duration as opposed to the 1.60% they earned one year ago.

Not only are we observing strong flows into traditional sectors such as equities and investment grade credit, but also record flows into more peripheral sectors such as high yield and emerging markets. The reason has little to do with the attractive fundamentals of these sectors, in fact emerging markets' peak growth was 2008/2009: the motivation is yield.

Moreover, the search for yield has stimulated investor willingness to leverage their exposures. Investors have increased their exposure to leveraged structured retail products. According to the European Structured Investment Products Association, structured retail products had generated €30 billion in turnover by December 2014 and market volume stood at €267 billion, an increase of 20% and 32 % respectively from the previous year. At least two thirds of these increases came from leveraged products, such as knock out warrants.

In the case of a reversal of interest rates, the value of these investments may fall rapidly. Leverage will steepen losses. We remain concerned that investors may not be aware of these risks.

Our fourth and final panel of the day will look at one form of these innovative products, the leveraged loan market.

To discuss these topics we have the pleasure of having with us 20 remarkable speakers. I will not introduce each one of them now, as this will be done at the start of each panel. But please let me just tell you how pleased I am to have with us today, individuals with such a deep and diverse set of experience and knowledge. I want to thank all of them for their participation. I truly believe they will provide stimulating and insightful ideas that will contribute to our work on financial innovation.

We hope you the audience find the programme thought provoking and are as excited as we are about today's upcoming discussions.

We are delighted to have with us, Adrian Blundell-Wignall, who has graciously agreed to provide us with some introductory remarks as keynote speaker for the day. As well as being a member of ESMA's Consultative Working Group to the Financial Innovation Standing Committee, Adrian is the Special Advisor to the Secretary-General of the OECD on Financial Markets and Director in the Directorate for Financial and Enterprise Affairs (DAF) at the OECD. DAF supports governments to improve the domestic and global policies that affect business and markets.

Welcome Adrian, and to you the audience and panellists have a productive and 'innovative' day!