European Securities and Markets Authority

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Keynote Speech

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Steven Maijoor

Chair

European Securities and Markets Authority

Ladies and gentlemen,

First of all I would like to thank you for the invitation to participate in ICMA's 2014 Annual Conference. ICMA brings together issuers, market intermediaries, asset managers, market infrastructures and investors, and has been an important stakeholder of ESMA since our creation.

I am pleased to be here to present about the ongoing regulatory and supervisory developments in securities markets and I am looking forward to taking a few questions in the Q&A session.

The world of financial markets and financial regulation is changing rapidly. Since the financial crisis hit us, the EU regulatory reform based on the G20 commitments has been unprecedented. We are approaching the end of the legislative phase of the regulatory reform, but a lot still needs to happen: we are only half way there. Let me reassure you, this is not at all a suggestion that we should introduce new pieces of legislation, but what is needed now, is to complement the legislation issued in the past years, with the following two essential elements:

1. The EU single rule book for financial markets needs to be implemented and supervised. Implementing measures like technical standards are needed to ensure that the legislation works in practice and the rules need to be subject to credible supervision; and
2. Supervisory convergence between the 28 EU member states is needed to ensure that the single rule book also results in a truly single EU financial market. Differences in supervision, and regulatory competition, will undermine the achievement of the objectives of stability and investor protection.

In today's earlier session you have discussed the role of capital markets in financing economic growth and you will hear more about the prospects for the intermediated bond markets. I believe both topics set the scene well for what I want to talk about today. In addition, both topics are very relevant for the current MIFID II consultation.

MiFID II introduces the biggest overhaul of EU financial markets in more than a decade. MIFID II will improve the functioning of EU capital markets and more specifically the bond and derivatives markets. ESMA has an important role to play in its implementation and has recently published a discussion and consultation paper setting out our initial thinking on a very wide range of issues. A crude indicator of this is the fact that the papers span in total about 800 pages. Out of the many MIFID II issues, I would like to focus today on two specific topics: transparency in bond markets, and the role of inducements when advising on financial instruments like bonds. In addition, while not covered as such in MIFID II, I will make a few comments on the fluidity of collateral as I know that this is an important topic for ICMA.

Finally, I will make a few remarks on the role of market participants. To summarise what I will say: to achieve the objectives of the regulatory reform you are more important than all legislators and supervisors together. Your commitment is needed to make sure that the regulatory reform achieves its objectives of stable financial markets with a high level of investor protection.

<u>MiFID II: transparency and liquidity</u>

Let me now move to discussing MIFID II in more detail. As can be expected of the biggest overhaul of EU financial markets in more than a decade, it is also ESMA's biggest regulatory project since our inception. In the legislation, there are about a hundred empowerments for ESMA, both covering technical standards that we will need to draft and technical advice that we will give to the European Commission. To ensure that MIFID II will work as well as possible in practice, ESMA will extensively consult stakeholders, including market participants, and listen carefully to what they say.

At the end of May, we published a discussion paper concerning the technical standards, and a consultation paper concerning the technical advice to the European Commission. This difference relates to the different time schedules of technical standards and technical advice: for the latter we have less time and therefore had to move directly to a consultation paper. For the technical standards we have more time and we expect to publish the consultation paper by the end of the

year. In total, we will spend 4 months in public consultation out of the 12 months we have to complete the technical standards.

MIFID II will result in a new regime for pre- and post-trade transparency for a variety of asset classes. ESMA is a strong supporter of this as it will make opaque segments of the financial markets more transparent. MiFID I trade transparency only concerns equities. MiFID II will very much extend the scope of transparency, for example to bonds, exchange traded funds, and all classes of derivatives.

MiFID II intends to improve transparency without harming liquidity by introducing a complex set of waivers and deferred publication options. One of the major tasks for ESMA in this context is to specify the notion of liquidity per asset class or sub-asset class.

The existence of a liquid market basically divides the world of bonds and derivatives into those where real-time transparency applies on the pre- and post-trade sides and those where pre-trade can be waived and post-trade only applies on a deferred basis.

But what is liquidity? It is easier to recognise than to define. As a starting point one can say that liquidity is the likelihood of being able to trade at a price equal to, or close to, the price of the last transaction. But how does one make that operational? Over the last three years we had many – and to be honest often difficult – discussions on how to define liquidity in the context of EMIR, CSDR, IFRS… and so far no single definition has emerged.

ESMA will have to set specific quantitative parameters in order to assess whether a financial instrument has a liquid market. To that end we need to consider specific criteria when determining the quantitative thresholds aimed at assessing the liquidity of a market, namely:

1) The average frequency and size of transactions having regard to the life-cycle of products;
2) The number and type of market participants; and
3) The average size of spreads, when available.

ESMA will carefully analyse the market model and the peculiar characteristics of bonds, because a bond's liquidity might be driven by many other different factors such as issuance size, currency, maturity, credit quality, and seasonality.

Apart from the challenge of finding the right balance for an extremely large group of instruments, ESMA also faces the operational challenge of getting hold of high quality data per asset class which allows for a precise calibration of thresholds. In that context we need your help and receiving these data from market participants during the consultation will really support our work.

Be aware, after all the technical standards and advice is completed next year, more work on MIFID II will be needed once it comes into force. As stated earlier, to ensure that the regulatory reform is really achieving its objectives, we will need supervisory convergence work in addition to the implementing measures just discussed. This can include issuing Q&As, guidelines, and opinions and conducting reviews of supervisory practices at national level. For those who are following ESMA closely in the area of derivatives will be aware that we have already done a lot of that supervisory convergence work for EMIR.

MIFID II: Inducements

Increasing the transparency of financial instruments will improve the functioning of securities markets. However, more is needed to support capital markets playing a more central role in the financing of the economy. We need to have a well-functioning intermediation process ensuring that financial instruments, like bonds, find their way properly into the portfolios of asset managers and end-investors. MIFID II very much recognises that this process is still distorted and further improvements are needed in the way investment advice on financial instruments is provided.

Supervisory experience and market research demonstrate that important factors leading to unsuitable financial instruments, or more broadly financial products, being recommended include:

1. the conflicts of interest arising due to payments provided to investment firms in relation to the service they provide to clients (so called inducements); and
2. biases such as the limited range of products from which an adviser can select for recommendation.

These problems cannot only be solved with more transparency. This holds true even when the

information is “fair, clear and not misleading”. We know now that too much information can confuse investors, especially unsophisticated retail investors, and can lead to them making poor choices or wrong decisions. The combination of rational decision-making by consumers, full transparency and competition among suppliers solves many problems in markets. However, experience has shown that this market mechanism does not always work effectively in financial markets and that regulation and supervision is needed to get the right outcomes and to protect investors.

In this respect, MiFID II has made important progress in the area of inducements and the draft ESMA advice for the Commission included in the consultation paper mentioned earlier proposes further strengthening the framework.

In short, disclosure of inducements is simply not sufficient. At a minimum, we need to ban inducements in certain cases and we need to ensure that inducements are effectively used to serve clients appropriately.

MiFID II strengthens the investor protection framework regarding inducements in a number of areas:

- It introduces a ban on inducements for portfolio management and investment advice provided on an independent basis (with the limited exception of minor non-monetary benefits). Independent advisors might still receive monetary inducements but they should pass them to investors as soon as possible after receipt;

- It confirms, for the other services, the requirement that inducements:
    a. should be disclosed to clients;
    b. should not impair compliance with the firm’s duty to act honestly, fairly and professionally in accordance with the best interest of the client; and
    c. should be designed to enhance the quality of the relevant service to the client.

The Commission will have to adopt delegated acts in these areas and has requested ESMA to provide advice in relation to the future delegated acts. The ESMA advice on inducements will focus on the following main aspects:

- **Minor non-monetary benefits** (portfolio management and independent advice) – ESMA believes that this exemption from a general ban should be interpreted narrowly. Non-monetary benefits received by the portfolio manager and the advisor should not be allowed when they are likely to inappropriately influence their behaviour. A specific type of non-monetary benefit is research, which may play a role in the provision of portfolio management to clients and in the way in which portfolio managers choose their brokers for the execution of orders.

  ESMA believes that portfolio managers should not choose their brokers on the basis of the research received from them. ESMA considers that in order to be considered as a minor non-monetary benefit, research should be intended for distribution so that it is accessible by a large number of persons (or by the public) at the same time. Any higher-value research could not meet this test and could be judged to impair compliance with the portfolio manager's duty to act in their client's best interest.

- **Quality enhancement**. ESMA is advising the Commission to introduce a non-exhaustive list of circumstances and situations in which quality enhancement is not met and a fee, commission or non-monetary benefit may not be regarded as designed to enhance the quality of the service to the client. One of these cases is when the inducement is essential to pay for elements which are needed in the firm's ordinary course of business; another situation is when on-going inducements are not related to the provision of an on-going service to the client.

  In line with the obligation to enhance the service to the client, ESMA further proposes that inducements could be considered acceptable if high quality investment advice is provided to the client; i.e. advice going beyond the basic requirements for advice. This would be evidenced by granting access to wide range of suitable financial instruments (and not only providing advice on a restricted basis of financial instruments) or by providing advice to clients on an on-going basis (and not only one-off advice).

Furthermore, ESMA considers that future work could be helpful to provide further guidance to firms, for example with guidelines and Q&As.

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Fluidity of collateral

Let me now turn to collateral, which is high on your agenda. Collateral is playing an increasingly important role in financial markets and at times it can become relatively scarce. This comes from three drivers:

1. the flight from unsecured lending to secured lending (due to the crisis);
2. the new regulation that requires collateralisation of bilateral derivatives or more central clearing in order to have safer derivatives markets (due to the crisis); and
3. the expansion of monetary policy through conventional and non- conventional instruments (due to...the crisis).

To compensate, there is more available and eligible collateral that can be used because of:

1. increased issuance of EU sovereign debt (due to the crisis);
2. because the ECB has widened the list of eligible assets (to accomodate the monetary expansion following the crisis); and
3. because the market participants have put in place solutions to transform assets into collateral and lend it to those that require it (this time, not strictly due to the crisis).

In the past months, there has been the discussion whether there is sufficient collateral for all the regulatory and non-regulatory requirements. Several studies looked into this and the current general consensus is that, overall, there is enough available collateral. High-quality collateral availability (supply) in Europe is calculated between 10 and 12 trillion EUR (depending on whether and how you apply the haircuts and on the degree of availability) while demand is estimated around 4-5 trillion EUR (depending on different estimates). The question is progressively turning from how much collateral there is and how much is needed now, to two other more interesting questions:

1. How will that evolve in the coming years; and
2. How fluid is the collateral market to ensure that supply and demand can meet.

Let me reflect on the likely evolution. We can point out to two factors at least: 1) Bilateral margin requirements on collateral will start increasing from 2015 onwards; and 2) Monetary policy, assuming the EU wide economy will regain strength at some point in time, will change and put

into circulation a lot of collateral (at the same rhythm that gets the extra liquidity out of circulation). How that will fit and interact should be a priority for the bodies in charge of monitoring financial stability.

On the notion of "fluidity": this is the ability of the market to place the collateral in the right point at the right moment to allow its use by the market participants. Collateral, according to some, is "the new cash". Collateral has a certain "velocity", that depends on the rate at which it is re-used, like cash. There seems to be consensus on the increased importance of the collateral market (securities lending, repo market, collateral transformation) and its role in the general functioning of the financial system and even on financial stability.

From that perspective, some say that collateral fluidity and collateral availability is so important that it should not be inhibited, at the risk of causing systemic effects. Others say that if collateral is so systemically important, it should attract a higher degree of regulatory attention. Whatever the outome of this debate, it is clear that we do not have a sufficient understanding of the functioning of this part of the market.

Hence, apart from regulations designed to allow better infrastructures for the collateral cycle, like CSDR, we need measures to ensure that regulators have a good picture of collateral, and its risks to financial market functioning. Therefore, I am very happy that the Commission has proposed a regulation that will require the reporting of Securities Financing Transactions (SFT) to trade repositories. SFTs were left outside the scope of MiFID, so it is now an opaque market. I am confident that such a change could bring the same benefits as we are now observing with the reporting of derivatives to trade repositories under EMIR.

Role of the financial sector in the regulatory reform

I am coming to the end of today's speech, and I would like to come to your role in the regulatory reform. As I stated at the beginning of my contribution, market participants are more important than the legislators and supervisors together. The objectives of regulatory reform cannot be achieved on the basis of legislation, supervision, and enforcement alone. The financial sector needs to embed, or internalise, the objectives of the reform: stability and investor protection.

We, from our side, committed to ensure that the legislation works as well as possible in practice:

therefore, I would like to reiterate: please give us your views and feedback in the current MIFID II consultations.

In the long run, the objectives of the financial sector and the regulatory reform are aligned. A sector can only be viable and profitable when it is stable and trusted by investors and the wider public.

Thank you for your attention.