

Regulators, pension funds and efficient financial markets

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Steven Maijoor
Chair
European Securities and Markets Authority

Ladies and Gentlemen,

Two Dutchmen in Edinburgh, it sounds like the start of a good joke, but we are here today to discuss serious business: how can capital markets perform well to the benefit of investors, including pension funds?

Let me first say that I am pleased to share this panel with the chairman of the International Accounting Standards Board (IASB), Hans Hoogervorst, with whom I have always worked well, both when we were at the Dutch Authority for the Financial Markets but also today in our roles at the IASB and ESMA.

The European economy is on the verge of gaining strength but we cannot exclude a possible deterioration. All possible efforts need to be made to get the economy back on track and in the right direction. The European Central Bank (ECB) embarked earlier this week on its Public Sector Purchase Programme. However, monetary policies alone will not be sufficient and should be supported by policy initiatives introducing structural reforms. Increasing the role and performance of capital markets should be part of these structural reforms.

The European Commission's initiative to establish a Capital Market Union, or CMU, builds further on the European Union's longstanding tradition of integrating the capital markets of its 28 Member-States. We more than ever need to develop alternative funding channels to ensure that the benefits of capital markets and non-banking institutions are maximised for the real economy. Pension funds, with their longer-term focus and willingness to take calculated risks, are ideally placed to actively participate in this development.

Europe is still heavily reliant on bank financing and there are still many unnecessary barriers within the Internal Market. Although one could argue that for the large so-called blue chips companies we have created a CMU, an investor wanting to invest in a mid-sized company still has a strong bias towards companies in his own country. This means that because of this

bias, transaction are not happening that would be beneficial for both the investor and for the company.

What is needed to achieve a strong and integrated EU capital market to increase capital availability and support economic growth? With a five year time-horizon in mind, choices will need to be made. In my view there are four main building blocks of a Capital Market Union which are all interlinked and on all of which we need to progress:

- (1) Greater diversity in funding;
- (2) Increasing the efficiency of capital markets;
- (3) Strengthening and harmonisation of supervision; and
- (4) Increasing the attractiveness of capital markets for EU investors.

In my contribution I will explain all four building blocks. However, as I would like to go into greater detail on how to increase the efficiency of capital markets and increasing the attractiveness of capital markets for investors, let me first go into the need for greater diversity in funding and the strengthening and harmonisation of supervision.

Let me start with the first building block: greater diversity in financing. This implies a shift in the balance from bank funding to non-bank funding, but also developing and maintaining a wide variety of funding channels within the non-banking sector, including investment funds, initial public offerings, venture capital, securitisation, private equity and crowd funding.

Regarding the latter channel, I should mention that in January ESMA provided policy advice on crowd funding to the European institutions. The advice balanced the opportunities for crowd funding platforms to develop their business with ensuring adequate investor protection. This balance is absolutely needed as it is naïve to assume that risks of investing via these platforms would be lower than traditional investing.

More funding channels will increase choice and competition in the financial system, and I think it is up to investors and market participants to decide which channel best suits their investment and funding needs. Policy makers and regulators should be careful in assuming the superiority of one channel over the other.

On the building block regarding supervision, Europe has the most to benefit from open markets and we should avoid fragmentation along national lines. To ensure the success of the CMU, we need to avoid regulatory arbitrage. Converged supervision, by which I mean consistent application of the same rules and using similar approaches across the 28 EU Member States, is and will be a continuous effort over the coming years. It is needed to ensure that the single rulebook on paper is a single EU market in practice.

Given the breadth and complexity of the single rulebook, regulators need to make many choices regarding their supervision, including the interpretation of the rules and the intensity of supervision. Diversity in these choices will have the result that the single rulebook will not in fact be seen as such by investors and market participants. This is not an academic debate or power game between regulators but has important practical implications. Any (retail)

investor or company that has been active in different countries will without doubt underline the importance of applying, supervising and enforcing basic technical rules consistently.

Regarding the second building block, increasing the efficiency of EU capital markets, policies are needed to increase capital market financing with deep, liquid and well-functioning markets in the EU. This is affected by many factors, including disclosure requirements, accounting standards, corporate governance, transparency around pricing and the legal arrangements regarding the various stages of a financial instrument's lifecycle. Deepening European capital markets is at the heart of ESMA's activities by for example developing Technical Standards for securities markets that directly apply across the EU.

In the past years, we have made many contributions to the single rule book for capital markets in response to the financial crisis. While many of these new rules were implemented with a strong focus on financial stability, in reality they have been as important for further integrating EU markets. Let me provide an example: it concerns derivatives, which are very relevant for pension funds.

We have created already something which one could call a Derivatives Union, with a high level of consistency and coordination across the EU, both regarding regulation and supervision. The two main elements of this development are moving to central clearing of OTC derivatives and reporting all transactions to trade repositories – this will make this market safer and more transparent.

Since beginning the authorisation of all European Central Counterparties (CCPs) under the new requirements of EMIR in 2013, Europe has progressed a lot towards the implementation of the clearing obligation of OTC derivatives. Today 20 CCPs have applied for authorisation under EMIR, 18 colleges composed of the relevant regulators, including always ESMA, have been established, and 16 CCPs have been authorised.

Following the authorisation of those CCPs, ESMA started to analyse the OTC derivative contracts belonging to different asset classes to determine whether they met the relevant criteria to support the clearing obligation. As a priority, ESMA conducted an analysis of the liquidity of interest rate swaps, which account for more than 80% of the global OTC derivatives market, and they are frequently used by pension funds. Following a public consultation, ESMA sent a proposal to the European Commission on 1 October 2014 to establish a clearing obligation for certain interest rate swaps denominated in euro (EUR), Pound Sterling (GBP), US dollars (USD) and Japanese Yen (JPY). These proposed rules should be endorsed by the European Commission shortly. They will then be under the scrutiny of the Council of the European Union and European Parliament before entering into force, hopefully before the end of 2015.

This upcoming clearing obligation for Interest Rate Swaps (IRS) should achieve a significant reduction of systemic risk in Europe. Despite this overall positive development, I am fully aware that pension funds have always been particularly worried by the impact that a clearing obligation might have on them. In that context, as you probably are aware, the European Commission has recently extended the deadline for the temporary exemption for pension

funds from the clearing obligation for another two years until August 2017. The temporary exemption will not apply automatically for all pension schemes. For some, the national regulator shall grant the exemption following an opinion of ESMA, after we have consulted our colleagues of the European Insurance and Occupational Pensions Authority (EIOPA).

ESMA is already working together with EIOPA to ensure the smoothest possible process once the national regulators start receiving the requests for exemption, which will be after the entry into force of the clearing obligation. Another relevant requirement of EMIR that will affect pension funds is the requirement to exchange bilateral margins when entering into OTC derivatives transactions. On this issue we, together with EBA and EIOPA, are expected to issue a second consultation paper in a few weeks. I can ensure you that the implementation calendar will be fully aligned with the international one, including the minimum 8 billion EUR threshold below which no initial margins should be exchanged.

Let me go back to the topic of CMU and increasing the efficiency of capital markets. Despite good progress, as I have just illustrated with derivatives, there are still many areas where differences in rules hamper the development of an integrated EU capital market. One such area is SMEs. Capital market instruments like equity and bonds have remained a costly tool for smaller companies. This is the result of many factors such as the limited availability of credit information, different insolvency rules across EU Member States, and different disclosure requirements, including accounting standards. We cannot remove all barriers for SMEs. We need to focus on those areas where we can expect the biggest impact. For example, the introduction of IFRS has had a very positive impact on companies listed on regulated markets. With that in mind we should consider moving to a common accounting language for SMEs that would like to grow and get a broader investor base. That language should be based on IFRS but not as extensive as the standard set of IFRS.

And that brings me to the last item I would like to discuss with you today, or the fourth building block for the Capital Markets Union: increasing the attractiveness of capital markets for investors. 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 US. Just to share a statistic with you: participation of households in US securities markets has strongly increased in the past 30 years from about 45% to about 65% of all households. The Harvard professors Greenwood and Scharstein have convincingly argued that this development played a key role in lowering the cost of capital for listed companies, and has especially benefited young entrepreneurial firms.

While there are big national differences, participation of EU households in securities markets is typically much lower. To put it bluntly, Europeans like to keep their savings in deposits. However, this preference can be expected to change.

Pension systems in the EU are being reformed as a result of rising life expectancy, low birth rates, and a financial and economic crisis. According to the Council of Europe, 19 European countries have increased retirement age and 11 decreased the level of pensions in recent reforms. The “public share” in retirement income in Europe will decrease – on average by 10 percentage points until 2060.

Today roughly half of retirement income comes from public schemes in EU countries. But this will be only 40% in 2060. And this is just an average. In some countries this share will be even lower. Since the share of private savings in the mix of retirement income increases, consumers depend more and more on their own financial decisions. With this greater personal responsibility for pension arrangements, more active participation in the capital market can be expected. Of course, this greater participation needs to go hand in hand with a good level of investor protection.

Only when investors feel sufficiently protected will they be willing to enter the capital markets and participate. As trust in the financial sector is generally low, a lot of work remains to be done here. While this has gradually been improving, in 2013 still only 35% of EU retail investors trusted investment services providers to respect consumer protection rules

To improve investor protection, MIFID II is probably the most important area on which we have worked in the past year. It provides a framework supporting investment firms to act in the best interest of their clients by improving governance and organisational requirements for investment firms, by strengthening conduct of business rules regulating the relationship with all categories of clients, and by introducing new powers to supervisors at national and EU level.

Over the last few months, the proposed measures in relation to a particular potential conflict of interest, those on inducements, have proven to be very sensitive. Allow me to touch shortly upon this particular item, because I know that it might come back during the questions later on: the framework for non-monetary benefits and, in particular, the treatment for research.

MiFID II strengthens requirements on inducements by introducing, inter alia, a stricter regime for portfolio managers and providers of independent advice. This regime goes as far as prohibiting firms from accepting and retaining monetary or non-monetary benefits paid or provided by third parties. The only exception to this rule concerns minor non-monetary benefits which, besides being capable of enhancing the quality of services provided to a client, are of a scale and nature that they do not impair compliance with the firm's duty to act in the client's best interest.

As you may know, the Commission asked for ESMA's advice on potential implementing measures on MiFID II and ESMA published a Consultation Paper in May 2014 that set out its draft advice on several topics. Investment research was discussed in the Consultation Paper, and the focus was not on research in general but on the mechanism, commonly used by industry, which enables portfolio managers to receive research from executing brokers out of dealing commissions. In the investor protection area, the treatment of inducements was the topic that received most of the feedback from stakeholders.

The majority of respondents raised a number of issues that might arise from too strict an approach. Some stakeholders emphasised that research is important to ensure the high quality of the service provided to clients. Others considered that conflicts of interest or best execution requirements are a sufficient safeguard to tackle the risks arising from the mechanism above. A number of respondents emphasised a few potential unintended consequences arising from regulatory intervention in this area, including limiting coverage of research for SMEs. We are pleased that NAPF broadly supported ESMA's proposals in this area.

ESMA has carefully reviewed the feedback received from stakeholders and has delivered its final advice to the Commission in December. In our advice, we have modified the initial proposal in order to specify and detail the conditions under which the receipt of research should not qualify as an inducement under MiFID II.

On the basis of ESMA's proposal, portfolio managers should be allowed to receive research from third parties and to charge clients for that research. Therefore, the proposed regime does not oblige firms to pay for research out of their own resources but it allows firms to pay for it from a separate research payment account controlled by the investment firm and funded by a specific research charge to the clients. However, in this context, ESMA's advice suggests, inter alia, that firms should budget costs for research on an ex-ante basis, should obtain clients' approval on these costs and assess and monitor the quality of research received and its effective ability to contribute to better investment decisions. A written policy, provided to clients, should document the approach of firms to research.

The proposal, in line with the legislative objectives, breaks the link between payments for research and for execution, it enables firms to choose different models to access research and it should lead to better informed investors and to a more competitive and transparent market for research. Concerning the possible impact on SMEs, no evidence has emerged that the current system ensures a better coverage of SMEs and better quality of research provided or that these objectives should be pursued through a system which bundles dealing and research commissions.

Ladies and gentlemen,

It is time to conclude. The CMU is an ambitious initiative. Actions need to be taken to build this much needed union which is an appropriate response to build a strong, safe and integrated EU capital market which will help the EU economy to flourish again.

The end goal should be a CMU based on an accelerated integration of the capital markets of the 28 Member States. This CMU should be competitive, efficient and provide a wide range of funding channels and the protection of investors should play a major role in building it. Because the CMU will only be successful if it is and remains trusted by investors.

Thank you very much.