ECMI EUROPEAN CAPITAL MARKETS INSTITUTE

Conference Report| November 2020

IS EUROPE'S CAPITAL MARKETS UNION NOW IN SIGHT?

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The Covid-19 pandemic has served as a brutal reminder of the urgency to strengthen societal resilience as a whole. The extent of the socio-economic fallout has yet to be fully understood, however. But the Capital Markets Union (CMU) project has now taken on new relevance. Mobilising private funding for recovery coupled with sustainable and digital finance strategies is sorely needed. To this end, the ECMI annual conference brought together policymakers, supervisors, academics and industry representatives to exchange views on the continuation of the CMU, namely how to deliver the best outcomes for companies, investors and citizens in the coming years. It also featured a special debate on the evolving role of credit rating agencies.

Disclaimer. *This report includes the main conclusions from the 10th ECMI Annual Conference that was held virtually on 5 and 6 November 2020. Its content should be attributed solely to the rapporteurs. A detailed overview of the proceedings is available [here](#).*

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Mobilising funding for sustainable recovery

In Europe, capital markets are at differing stages of development, and are far from integrated. A fresh agenda for the financial sector that is both anchored in the needs of the real economy and shows regulatory quality is required now, for instance in the form of an ambitious second phase of the CMU project. How to ensure policy synergies with sustainable finance, digitalisation and industrial competitiveness?

Speakers:

- ***John Berrigan**, Director-General for Financial Stability, Financial Services and Capital Markets Union, European Commission*
- ***Stéphanie Yon-Courtin**, Member of European Parliament, ECON Committee*
- ***Corien Wortmann-Kool**, Chairwoman, Stichting Pensioenfonds ABP*
- ***Niamh Moloney**, Professor of European Capital Markets Law, London School of Economics*

*Moderator: **Fabrice Demarigny**, Global Head of Financial Advisory Services and Capital Markets Activities, Mazars Group & Chairman of ECMI Board*

From left to right: Fabrice Demarigny (Mazars and ECMI), John Berrigan (European Commission), Stéphanie Yon-Courtin (European Parliament), Corien Wortmann-Kool (Stichting Pensioenfonds ABP), Niamh Moloney (London School of Economics).

EU economies would have been better able to weather the Covid-19 crisis with more developed and integrated capital markets. CMU 1.0 may have not delivered the intended level of ambition in practice, but it was rather successful in terms of the legislative trail. More equity financing for SMEs, or retail participation in capital markets, continues to present multiple challenges. The CMU 2.0 Action Plan contains a series of legislative and non-legislative measures, for example creating a single access point to company data; supporting insurers and banks to invest long term; increasing the quality of advice and reducing the information overload for retail investors; and monitoring pension adequacy or simplifying withholding tax procedures. Some

longstanding files related to the single market dimension are still most likely to meet resistance from member states.

Europe should continue the process of building CMU in a way that guarantees robust recovery in the short term, while ensuring that its economy accelerates the transition to a more inclusive, sustainable and digitalised growth model in the longer term. Besides the public sector (e.g. NextGenerationEU and the associated Recovery and Resilience Facility, or national level), private sector funding will be necessary to fund sustainable economic recovery.

Investors and companies will not come to capital markets if there is no trust. The recent Wirecard case casts a shadow on financial services once again, and shows that seriously exposed households can find themselves in such instances, highlighting the need for further investigation into supervisory and accounting failures. A major challenge is to ensure that the regulatory system is strong enough to protect households, and that capital markets can secure them adequate returns.

Another crucial element concerns mobilising household capital in a period of increasing savings rates and search for yield due to the lower for longer-rate environment. The prerequisites are provision of sound advice, cost-effective products, coupled with strong enforcement of investor protection and product governance rules. For example, regarding sound and fair advice, the experience in the Netherlands and the UK shows that introducing an inducement ban can deliver much stronger competition, lower costs, but also a higher uptake of simple investment products.

Last but not least, the success of the CMU project can be measured against results/outcomes delivered to European citizens. In order to quantify such results, economic KPIs need to be established that will track changes (not only at EU-level, but also the progress in member states) and be monitored regularly.

This session can be re-watched here.

Credit rating agencies back in the spotlight

Regulating and supervising credit rating agencies (CRAs) has evolved considerably over the past decade. At present, priorities range from monitoring risks in outstanding securities to the access and usability of credit ratings, the quality and robustness of methodologies, and the overall effectiveness of CRAs' control environment. The incorporation of ESG factors has also gained prominence. What challenges lie ahead for issuers and investors?

Speakers:

- ***Verena Ross**, Executive Director, European Securities and Markets Authority*
- ***Yann Le Pallec**, Executive Managing Director & Head of Global Rating Services, S&P Global Ratings*
- ***Bo Becker**, Cevian Capital Professor of Finance, Swedish House of Finance, Stockholm School of Economics*

*Moderator: **Josina Kamerling**, Head of Regulatory Outreach EMEA, CFA Institute & Member of ECMI Board*

From left to right: Josina Kamerling (CFA Institute and ECMI), Bo Becker (Stockholm School of Economics), Verena Ross (European Securities and Markets Authority), Yann Le Pallec (S&P Global Ratings).

Supervising CRAs was the first direct supervisory responsibility, instituted in response to the financial crisis. More than a decade later, the Covid-19 crisis has sparked fresh debate on the role of, and reliance on, credit ratings in the financial system. There is still a concern that key pieces of EU financial regulation and private contracts, such as investment fund documentation, contain references to credit ratings that could lead to a mechanistic reliance on ratings, and thereby a captive market. The remit of ESMA is expanding with other entities, for example central counterparties, trade repositories and benchmarks.

The CRA Regulation was a big step forward to ensuring the quality and reliability of credit ratings in the EU. ESMA is now supervising 27 different rating agencies, located in 13 member states, but the market remains characterised by a high degree of concentration, with the top three CRAs controlling 92.1% of the market. A number of medium-sized CRAs offer the same suite of rating offerings as the large CRAs, but with a much smaller market share. There are also smaller CRAs that are specialised in either certain industries or certain markets.

ESMA's areas of priority will be to identify and address new risks posed by Covid-19 for CRAs, monitor the independence of their rating processes and determine whether their methodologies are robust as well as address concerns in the areas of IT and information security controls. Since the crisis, ESMA has been actively engaging with the CRAs to ensure the continuity of their operations, to understand how they are factoring the economic impact into their analysis to avoid procyclicality. In addition, to deliver on climate change (and the European Green Deal), investors need to have certain information points to fully integrate ESG factors into their investment decision-making processes, including credit ratings.

The supervisory regime of CRAs is rather prescriptive; its implementation includes daily interactions, with information requests and thematic interviews, to ensure that policies, procedures and rating methodologies are followed by regulated entities. A key element in the supervision is the requirement for CRAs to manage conflicts of interest, with the 'issuer pays' as the dominant model. The regulation imposes a control framework, which is the core of the risk management model. An 'investor pays' model will never be available for everybody. With the issuer pay model, the ratings are available to everybody right away, but rating shopping should be managed. The best way forward is to expose ratings to scrutiny, and help investors understand uncertainty by giving insights into the sensitivity analysis and scenarios, and into what can be expected from rating decisions.

From an academic perspective, ratings have improved since the loss of reputation (i.e. too highly rated structured securities and costly settlements) in the aftermath of great financial crisis, but the oligopoly remains intact. Micro-management by ESMA is not recommended, but could be effective at providing a level playing field and transparency.

ESG ratings are the next frontier, and currently there is a wide variance across providers. As regards credit ratings, ESG risks are incorporated provided that these are financially material. CRAs are a good place to make ESG ratings, as CRAs have their reputation to defend. ESG ratings will force CRAs to be clearer and more transparent, and the quality of non-financial data is essential. Investors need to have the right access to rating data, to let market discipline work.

This session can be re-watched here.

Easing financing conditions for corporates

Private sector asset purchases continue to be a targeted element in the ECB's toolkit, in response to the disruption caused by the current crisis. Relying on the entire spectrum of bonds would also facilitate the transmission of monetary policy. For example, the commercial paper segment, crucial for corporates in managing their short-term financing needs, is rather underdeveloped. How can these market failures be overcome?

Speakers:

- ***Imène Rahmouni-Rousseau**, Director General of Market Operations, European Central Bank*
- ***Alberto Gallo**, Portfolio Manager and Head of Macro Strategies, Algebris Investments*
- ***Raúl Gómez**, Chief Financial Officer, Vidrala Group*

*Moderator: **Karel Lannoo**, CEO, CEPS & General Manager, ECMI*

From left to right: Karel Lannoo (CEPS and ECMI), Alberto Gallo (Algebris Investments), Imène Rahmouni-Rousseau (European Central Bank), Raúl Gómez (Vidrala Group).

Currently, the financing conditions of corporates are influenced by the interplay between monetary and fiscal policies as well as the solutions provided by the banking sector and capital markets. In the euro area, the ECB provides support through its lending/refinancing operations and market-neutral purchase programmes. Since 2016, private sector bond markets have been targeted, such as covered bonds, asset-backed securities, corporate bonds and commercial paper. Only investment grade and externally rated bonds are considered. Nevertheless, there are positive spillovers for non-eligible issuers that can come from indirectly freeing up part of the investors' portfolios. As a countercyclical tool, the 'fallen angels' phenomenon has been tackled with adjustments to the collateral framework and not direct purchases. In the commercial paper segment, the central bank acted temporarily as a backstop during recent stress episodes. From a European integration perspective, it was encouraging that an increasing

number of firms applied for the Short-Term European Paper (STEP) label, administered by EMMI.

The transmission further down to the real economy may not always be straightforward. For example, credit spreads continue to lag behind sovereigns. Some companies are benefiting more than others; in essence market conditions returned to normal only for large caps. In relation to SMEs, capital markets remain underdeveloped, and certain banks are risk-adverse or have tightened credit standards. The danger of increasing inequality at corporate level must be avoided, i.e. by making the strong stronger and the weak weaker on a relative basis. The search for yield has intensified, but so the bifurcation between investment and non-investment grade, rated and non-rated, liquid and illiquid. Many institutional investors/asset managers cannot perform that leap so swiftly. Some structural issues related to the depth of the investors' base as well as the allocation of households' wealth also require further attention.

Finally, the responsibility lies primarily with the companies in the real economy to understand, learn and try to access equity and debt markets, and avoid overreliance on banking/fiscal authorities or having unrealistic expectations from central banks. Starting a process of engagement with advisors and investors, and monitoring more carefully current market conditions is essential. Nevertheless, the direct and indirect costs for small and mid-caps should not be underestimated, in particular filling the necessary documentation, disclosing financial/non-financial information or going through the rating/scoring process. On the one hand, an entry point is the issuance of commercial paper for financing working capital needs. On the other hand, corporate treasurers should look into ways of diversifying the financing sources for long-term capital expenditures.

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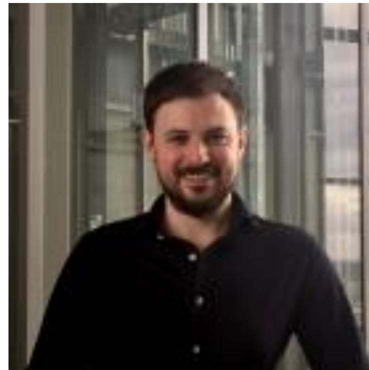
2020 ECMI Best Paper: Compressing over-the-counter markets



The winners of the 2020 ECMI Best Paper: Tarik Roukny (left), KU Leuven and Marco D'Errico (right), European Systemic Risk Board/ECB.

As the global financial crisis showed more than a decade ago, the combination of leverage and volatility in the derivatives market can threaten not only individuals and institutions, but the entire financial system. In an effort to reduce counterparty risk stemming from excessive leverage and the lack of liquidity in the positions of financial institutions, the regulatory framework for derivatives markets was reformed post global financial crisis. One of the actions that transformed the market is portfolio compression. Compression allows the combining and offsetting of trades with compatible economic characteristics, resulting in a reduction in notional outstanding amount. As a result, the number of individual positions in the portfolio goes down (as well as capital charges and trading costs), while the risk profile (as well as net exposures) remains unchanged.

Using transaction-level data of all OTC credit default swap (CDS) contracts bought and sold by legal entities in the EU over the period October 2014 to April 2016, the authors analyse the impact of portfolio compression on the size of the market in this 2020 ECMI Best Paper. They examine the feasibility and efficiency of a compression operation. The former refers to the conditions under which compression can strictly reduce total notional, assuming four types of compression (i.e. non-conservative, conservative, hybrid, and bilateral). The latter refers to the maximum level of notional (i.e. excess) that compression can eliminate.

Regarding feasibility, the results show that non-conservative compression is the most efficient, as it always eliminates all the excess in a market. The second most efficient compression operator is the hybrid, followed by the conservative and the bilateral compression. In terms of efficiency, the paper finds that 75% or more of total market size is in excess. Even under the most conservative scenario, in which all participants preserve their original trading relationships, compression eliminates more than 85% on average of the excess in markets. However, compression may affect both the level and distribution of exposures within the market. While reduction in exposures can reduce systemic risk, the distributional effects of compression may increase the systemic risk.

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