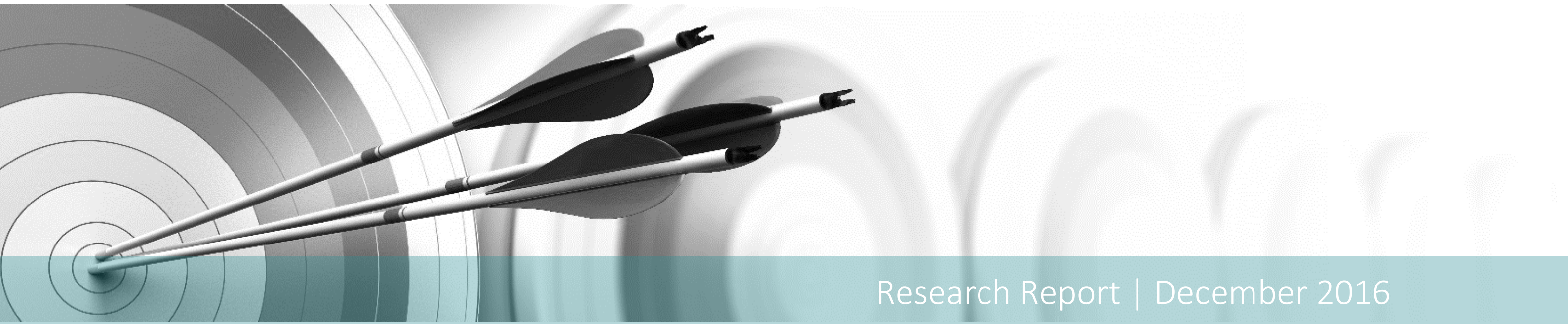

Towards the Right Policy Mix for a Thriving European Capital Market

Rapporteur: Cosmina Amariei

On top of the vulnerabilities stemming from the incompleteness of the economic and monetary union, the financial and sovereign debt crises showed not only that the 'intensity' but also the 'quality' of the financial integration process matters. With the banking union and the capital markets union, one would hope for more 'sustainable' cross-border financial flows that could strengthen the virtuous circle of financial integration, financial stability and economic growth. For this to actually materialise, the remaining building blocks need to be put in place, national barriers to be knocked down while other policies (monetary, fiscal and structural) to become increasingly effective.

At present, capital markets are at different stages of development across EU member states and matching the supply and demand of capital on a cross-border basis remains problematic. While the banking sector is expected to remain the dominant source of finance, well-functioning, deeper and highly integrated European capital markets could provide alternative funding opportunities for companies and better choices for retail and institutional investors. Advancing with CMU is even more important in the current economic and political environment. Overall, bolder actions are needed in the coming years, and the mid-term review of the CMU Action Plan should not be relegated to becoming a mere tick-box exercise.

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This paper is based on the discussions at the annual conference organised on 9 November 2016.

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What is the impact of negative interest rates on Europe's financial system? How do we get back to normal?

Macroeconomic and institutional outlook

Keynote speech

Peter Praet, Executive Board Member and Chief Economist, European Central Bank

Keynote presentation

Miles Kimball, Eugene D. Eaton Jr. Professor of Economics, University of Colorado Boulder

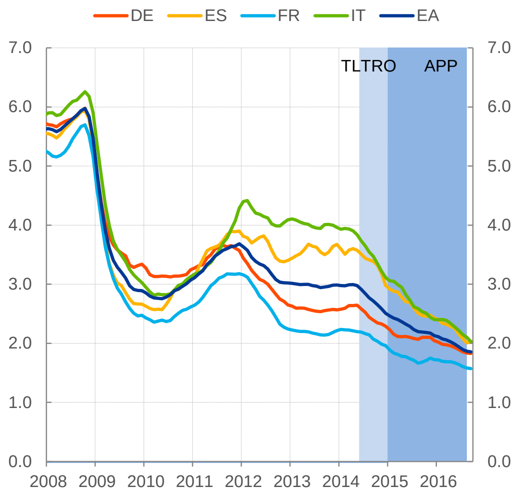
Panel discussion

Daniel Gros, Director, CEPS
Alberto Gallo, Partner, Portfolio Manager and Head of Macro Strategies, Algebris Investments
Andy Jobst, Adviser to the Managing Director and CFO, World Bank Group
Jan Vincent-Rostowski, Professor of Economics, Central European University, and former Minister of Finance, Poland

Moderator: **Mathias Dewatripont**, Director, National Bank of Belgium and Professor of Economics, Université Libre de Bruxelles

In his introductory remarks, **Peter Praet** stressed that the monetary policy pass-through on financial conditions, in general, and on borrowing conditions, in particular, has been quite strong, even though it is a relatively recent phenomenon.

Composite bank lending rates for non-financial corporations (percent per annum)



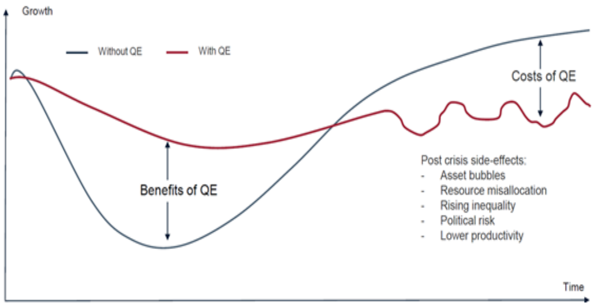
The banking sector plays a key role in the monetary policy transmission mechanism. To this end, the European Central Bank (ECB) will continue to monitor closely the effects of monetary policy measures on the position and prospects of the banking system. Banks are now more resilient than before the crisis, but they are not sufficiently profitable. This tension is likely to weaken the resilience of the banking sector. At this stage, the ECB doesn't see strong evidence that bank profitability, on aggregate, has been suffering from its comprehensive package of measures. Nonetheless, the longer the current low interest rate environment persists, the greater the pressure on bank profitability will be. In his view, banks will have to address multiple challenges related to legacy issues (accumulation of NPLs), cyclical factors (low growth, low inflation, low interest rates), structural change (operational inefficiencies), and the regulatory environment (uncertainty and lack of clarity). *The full speech and presentation are available here.*

Given the side effects of a prolonged period of low interest rates, **Miles Kimball** proposed the alternative of deeper negative interest rate policy (NIRP) for shorter periods of time. He argued that there are adequate ways of dealing with paper currency, balance sheet and political worries, and that there is effectively no lower bound on interest rates. For example, one measure that could help dealing with the banks' profitability and political costs is to use a multi-tier formula for interest rates, i.e. to subsidise banks to give zero rates to small household accounts (€2,000 per individual) and pass through the negative rates only to large household accounts. In terms of cyclical stabilisation policies, monetary policy can do the job, with fiscal policy able to focus again on the long run. In his view, there is still a lot of misunderstanding about the efficiency of the monetary policy transmission mechanism in a negative territory compared to a positive one. *The presentation is available here*.

Daniel Gros argued that the ECB might be chasing the 'wrong' target (CPI inflation). It could instead be looking at the evolution of the GDP deflator, which so far doesn't show clear signs of deflation or of an incipient deflationary spiral. This, in turn, would strengthen the case to exit the current accommodative stance. On the ECB's ability to 'engineer' short vs. long-term interest rates, he further questioned how much (in terms of basis points) from the downward trend in interest rates can be actually attributed solely to monetary policy. In his view, the net impact of low interest rates could be zero or even negative, i.e. what debtors gain might not be reflected in higher spending because of balance sheet constraints. In addition, what creditors lose might be reflected much more immediately in lower spending.

Alberto Gallo called for a normalisation of the monetary policy. The longer quantitative easing (QE) an NIRP are in place, the larger the collateral effects will be: on the real economy (resource misallocation), financial markets (asset bubbles) and society (income inequality).

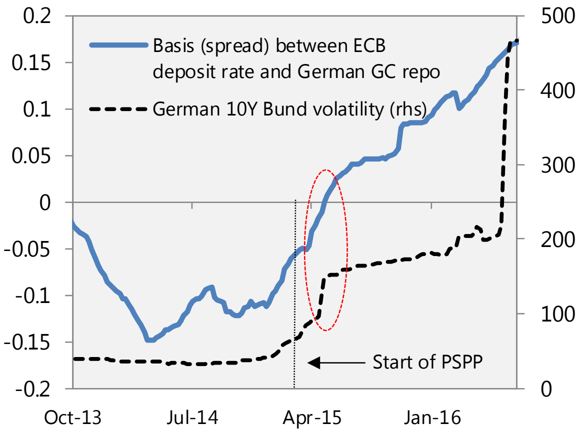
Policy Responses, Limitations and Collateral Effects



A more 'flexible' financial system is needed for the real economy, e.g. growth-indexed bonds, more efficient bankruptcy systems, and deeper capital markets. This, in turn, will allow the economy to be less sensitive to interest rates when another recession occurs, i.e. an economy that is more independent of its financial system than an economy that serves its financial system. In addition, fiscal policies and structural reforms could make the financial system more resilient to a low-growth environment, weaker demographics and technological deflation. *The presentation is available here.*

Andy Jobst emphasised that the decision of central banks to actively pursue a NIRP needs to be put in the context of the secular decline in the long-term interest rates (in both a nominal and real sense), the impact on the natural rate and the disinflationary pressures (mostly due to demographic factors). In his view, the negative lower bound has not been reached yet. He further explained that a NIRP has made the repo activity more costly (repo rate < ECB deposit rate), thereby reducing the incentives for market making in the area of governments bonds.

Impact of repo rates on cash markets volatility



Taking a full equilibrium view on the impact of NIRP on the banking sector (the lending channel, not only profitability) suggests positive aggregate effects. This largely depends on whether there are sufficient remedies in place in order to cope with 'sticky' deposits. *The presentation is available here.*

Jan Vincent-Rostowski explained that the current interest environment is a result of excessive savings and very little investment. The ageing population tends to save more and maybe one of the most effective structural reforms is to increase the retirement age. The investment is low because of the aggregate demand problem but also due to the technical progress in the form of capital savings. Wages are also not growing. In short, even though there are long-term underlying causes for real interest rates to be very low or close to zero, the problem of low aggregate demand in the short to medium run cannot be ignored. Looking forward, the real question should focus on the next recession and the challenges posed by the huge amounts of outstanding central bank money as a result of QE. In the presence of a liquidity trap, a fiscal channel could actually help monetary transmission, but this would require significant changes in underlying institutional structures.

Market-based solutions to bank restructuring: Can active financial markets help to clean up banks' balance sheets?

Law and Finance



Keynote speech

Gert-Jan Koopman, Deputy Director-General for State Aid, DG Competition, European Commission

Keynote presentation

Fernando Restoy, Deputy Governor, Banco de España

Panel discussion

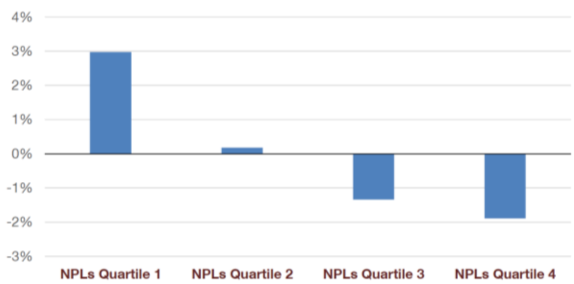
Luis D.S. Morais, Professor of Financial Regulation, EU Law and Competition Law, University of Lisbon Law School
Alessandro Penati, President, Quaestio Capital Management
Michel Madelain, Vice Chairman, Moody's Investors Service
Henrik Bjerre-Nielsen, CEO, Finansiel Stabilitet A/S

Moderator: **Franklin Allen,** Executive Director of the Brevan Howard Centre, Professor of Finance and Economics, Imperial College London

Gert-Jan Koopman stressed that the discussion about NPLs has to be seen in this wider context of a very challenging environment for banks. By mid-2016, the gross carrying amount of NPL in the EU amounted to over EUR 1 trillion while the average weighted NPL ratio stood at 5.5% of liabilities, with a notable improvement compared to the 6.7% recorded in September 2014. When designing specific solutions, it is necessary to understand that the situation differs greatly across European countries and across individual banks. In particular, in ten Member States the NPL ratio is still above 10% and more than 40% of the total stock of NPL in the EU is concentrated in the five countries with the highest NPL levels (Cyprus, Greece, Slovenia, Portugal and Italy). In his view, appropriate policies and regulations can and have to be developed in three main areas: provisioning policies, legal and judicial reforms and removing existing impediments to the functioning of secondary markets for NPLs. Also, an asset management company (AMC) could still remain an effective option provided that both bank-specific and sector-wide restructuring processes take place. The State Aid framework will continue to offer possibilities for member states in the form of non-aid impaired asset measures, intervention under the precautionary recapitalisation scenario (more suitable for moderate capital shortfalls, limited burden sharing and more contribution from the public sector) and liquidation under national legislation. If the bank is failing, there is no reason to deviate from the bail-in rules under BRRD. *The full speech is available here.*

Fernando Restoy indicated that NPL reduction may have an immediate negative impact on profitability and capital buffers. There are enforceability difficulties, especially for less capitalised banks which in turn are those with higher NPLs on balance sheets.

CET1 JUN 2016 (relative to SSM average)

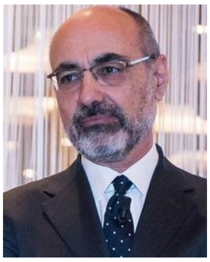


The main avenue for dealing with the NPL problem is to further develop the secondary market for distressed assets. To this end, a series of obstacles on both the demand and supply need to be tackled and further action by supervisors is needed. In particular, it is important to enhance transparency in order to reduce the prevailing information asymmetry. As for other solutions, securitisation can help only partially while an AMC can facilitate the cleaning up of balance sheets but not necessarily activities in the secondary markets. It might not always be obvious whether a purely private sector intervention would actually be sufficient. There should scope for a more pragmatic, flexible interpretation of the BRRD and State Aid rules (asset transfer valuations, resolution triggers, the scope of burden sharing) in order to facilitate some form of public sector involvement for certain banks, without creating a destabilising effect. For example, the estimate for market price by the European Commission experts is based on a concept that is closer to a fire sale than the real economic long-term value. *The presentation is available here.*

Luis D.S. Morais emphasised that the different constraints and prospects in various national markers show there is no one-size-fits-all type of solution. Securitisation may have a role to play, but the STS proposal lacks consistency. An active involvement by the supervisory authorities in the certification process might be needed. In his view, solutions that entail excessive forms of legal and financial engineering should be avoided. Also, state incentives for market-based solutions may represent a hybrid approach. In certain markets, government-funded or partially-funded or supported vehicles could be an alternative. Nonetheless, the extent to which such measures could be employed depends on the interplay with state aid control rules and the BRRD. *The presentation is available here.*

Michel Madelain noted that there is no simple solution to a problem of such dimension. It is important to put in place some intermediate steps in order to avoid making the banking system more vulnerable during the transition, i.e. allowing banks to be able to sell assets in an orderly manner. With respect to the contribution of securitisation, he believes it will be quite marginal (in the first half of 2016, SME loans securitisation amounted to EUR 5bn). There is also a limited track record in handling such assets. The traditional drivers – funding or capital arbitrage – are missing. He also listed numerous impediments to the securitisation of NPLs: the absence of price transparency, the lack of a clear credit history, assets with no predictable cash flows, capital charges, etc. It is also difficult to assess the volume of credit enhancement needed to achieve a certain level of credit quality and to verify the availability of collateral.

Henrik Bjerre-Nielsen shared from Denmark's experience in dealing with distressed banking activities. After taking over a bank, the FSC first tries to sell the so-called 'green' exposures (deposits, retail and commercial exposures) to other banks. The second step is to turn the so-called red exposures into cash by bundling and selling them to other (foreign) financial firms that would use those for securitisation. This tool has been used seven times. Lastly, after the sale of the remaining assets, the bank is turned into a financial company without a banking license, more like an AMC. When a foreign investment fund is involved, there is the possibility to decide on the application of Danish customer protection rules, on a contractual basis, with potential disputes to be settled in Danish courts. *The presentation is available here.*



In his written intervention, **Alessandro Penati** argued that a market-based solution requires banks to deleverage either by raising capital or by shedding assets. At present, Europe lacks the investors, the intermediaries, the infrastructure and the regulatory and legal framework for an efficient market for the sale of loans. The market for non-bank credit is also in its infancy compared to the US. Thus the whole burden of deleveraging falls on raising capital. At the same time, bank profitability is too low to allow banks to raise the capital required by the regulators. In many cases, this has induced governments to step into banks' capital. In his view, further regulatory and government action should aim to create a credit market in Europe that disintermediates banks.

Reshaping the governance of Europe's capital markets: Is enforcement the 'weakest link'?

Governance



Keynote presentation

Sébastien Raspiller, Deputy Director, Corporate Financing and Financial Markets Division, Directorate General of the Treasury, French Ministry of Economy and Finance

Panel discussion

Raffaella Assetta, Team Leader, Free movement of capital and application of EU law Unit, DG FISMA, European Commission
Alexandra Hachmeister, Chief Regulatory Officer, Deutsche Börse AG
Josina Kamerling, Head of Regulatory Outreach EMEA, CFA Institute
David Wright, Partner, Flint Global and Chairman, Eurofi
Carmine Di Noia, Commissioner, Italian Securities and Exchange Commission – Consob

Moderator: **Fabrice Demarigny,** Global Head of Financial Advisory Services and Capital Markets Activities, Mazars

Sébastien Raspiller emphasised the need to de-fragment and further develop capital markets in Europe. Capital Markets Union (CMU) should be first and foremost about greater diversification of funding sources for the real economy (households, corporates, and infrastructure). A common rulebook is necessary but not sufficient. The quality of rules determines the efficiency of market supervision. Less room for divergent interpretations at national level is needed for a uniform application of rules and convergence of supervisory practices. As for the twin peaks model, he highlighted the difference between market supervision and financial supervision, i.e. supervising entities versus financial activities. On the role of ESMA, the focus should be on the available toolkit and the capacity to use it in order to achieve better market supervision. He also called for more pragmatism on this issue than simply placing it very high on the political agenda.

Raffaella Assetta indicated that EU rules have to be implemented in a timely and correct manner. In practice, there are delays and divergences in the transposition in national legislation (gold plating of EU rules), which undermines the level playing field. In the recent call for evidence, these were presented as creating additional costs and burdens for firms.

Once the legal framework is in place, the national supervisors are on the frontline to ensure enforcement. European supervisory authorities (ESAs) will continue to play a key role in achieving supervisory convergence. The Commission usually carries out a number activities in order to facilitate the transposition, assesses the completeness and tries to address potential issues with the member states.

Alexandra Hachmeister pointed out that the current legal framework and governance structure proved to be fit for purpose in the recent turmoil over the summer. Markets were able to cope with the situation and communication channels between industry and supervisors functioned very well. What has been observed in practice is that there are different levels of expertise across supervisory authorities either at the national or European level. National supervisors are closer to their markets and it's important that their valuable know-how is not lost in case of further transfer of powers (subsidiarity principle). Nonetheless, frictions in cross-border transactions and home bias by national supervisors need to be overcome. In her view, achieving a level playing field and supervisory convergence should be looked at also from a global perspective.

Josina Kamerling stressed that investors still lack trust in financial services providers and need more transparency/clarity on fees and costs and better returns. This has been achieved only partially through MiFID2/MiFIR, PRIIPS, etc. In addition, the discussion needs to be put in the wider context of still underdeveloped capital markets in Europe, markets that move so quickly and fintech developments coming very strong (e.g. automated advice, crowd funding). To this end, she advocated stronger EU-wide horizontal investor protection and redress rules (to clarify *the how and where from* for individual investors*).* At the same time, ESMA should be given stronger harmonising powers at EU level for investors. In this way, the CMU could be a true counterbalance to banking union.

On the progress on the substance**,** **David Wright** believes that CMU is going too slowly, there is insufficient urgency or focus and the big pieces seem to be blocked. In his view, a major test for building a bigger supply of investable capital in Europe is the Commission's proposal on Pan-European Personal Pension Products coming out next year. On ESMA, he explained that so far it has done a huge amount of technical regulatory work, has some supervisory and enforcement powers (trade repositories, credit rating agencies) and has fined and recently carried out its first mediation case. A lot more needs to be done on supervisory convergence and it would help greatly if member states were to move towards more regulations rather than variable implementation of directives. In his view, it is important to think by the end of next year about a staged approach, a practical set of things towards a shift of power to ESMA overtime.

Carmine Di Noia indicated that the first review of ESAs (December 2014) was, by all metrics, very timid. The increasing number of papers by the Joint Committee of ESAs shows the cross-sectional dimension. In the short run, he argued for a new governance of ESAs, in general, and ESMA, in particular (similar to the Management Board at ECB) as a prerequisite to give more supervisory powers at least on systemically important capital market institutions (big issuers, capital markets intermediaries, brokers). In the financial union, central supervision for systemically important institutions would run alongside national supervision for other entities. In the long run, he proposed a 4-peaks model (separating macro- and micro-stability, investor protection and competition) irrespective of the nature of intermediaries. *The presentation is available here.*

Fabrice Demarigny questioned the extent to which further capital markets integration in Europe can be achieved without addressing a number of issues on the institutional front (supervisory efficiency, enforcement capacity, governance, financing of ESAs). There is a real need to think at least 10 years ahead in terms of ambitions for diversifying financing sources for companies and giving more choice to investors within the EU27.

Blockchain and other new technologies: What will capital markets look like as the 21st century unfolds?

Market structure

Keynote presentation

Andrei Kirilenko, Director of the Centre for Global Finance and Technology, Imperial College London

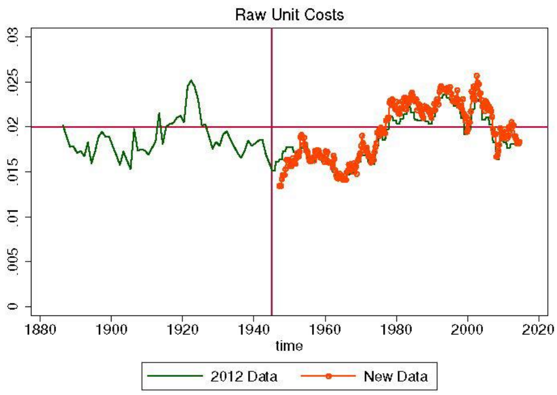
Panel discussion

Hugh Grant, Innovation Director, Investment Banking Technology, Barclays
Corentine Poilvet-Clediere, Head of Regulatory Strategy and Post Trade Policy, Europe, LSEG
Anne Choné, Senior Risk Analysis Officer, Innovation and Product Team, ESMA
Pēteris Zilgalvis, Head of Unit, Digital Single Market Directorate, DG CONNECT, European Commission

Moderator: **Alistair Milne,** Professor of Financial Economics, Loughborough University

Andrei Kirienko stated that a paradigm shift may be needed in order to create/increase net benefits of financial intermediation.

The costs of financial intermediation (Philippon (2016))



The block chain elements (in particular the potential of the underlying DLT) stood out in the recent years. The incumbent financial institutions took notice, the fintech start-ups continue to proliferate while regulators are manifesting increased interest in understanding the benefits, risks and the regulatory implications. At the moment, it appears that more work is needed to be done around parts of the technology and its economics, and the interaction with the regulatory aspects. For the issuance and custody of assets, the use of ISDA master agreements and additional templates for smart contracts are now being tested. Technology is not an issue for IPOs and secondary trading, but quite some work is envisaged on the regulatory side. In the clearing and settlement space, there is a race for various solutions. In his view, whoever comes up with the solution will most very likely become the dominant player. *The presentation is available* *here.*

Hugh Grant indicated that are very few fintech companies (1 in 10) that are actually building solutions around real business problems (cost reduction, better internal and external processes). What helps them to find the right focus is the close interaction with well-established financial institutions, greater use of mentoring programmes, participation in innovation labs, incubators as well as regulatory sandboxes. Cost reduction and Regtech are a priority in the current environment. Every bank is doing some experimentation with the DLT in the clearing and settlement space (also smart contracts), either alone or in small groups. There are real opportunities to leverage the technology in the capital markets space, but issues around common standards on reference data, KYC processes and interoperability need to be addressed.

Corentine Poilvet-Clediere argued that DLT promises new efficiencies for financial markets infrastructure (FMI), but this will largely depend on the specific-use cases. There is tremendous potential for evolution but not a revolution in the financial structure. The first concern is about the regulated functions, i.e. how to properly and proportionally adapt the regulatory framework in order to absorb the block chain innovations. The second concern is commercial, i.e. it is yet to be seen whether the cost savings will translate into material improvement for the end client. Lastly, this technology should be looked at in relation to the complexity of products and the market, e.g. real-time settlement might not work in markets that do not have sufficient liquidity. *The presentation is available* *here.*

Anne Choné explained that deciding to take a balanced approach would giv a better understanding of the DLT and how this innovation would fit into the existing regulatory framework. The technology is still at an early stage; there is no DLT system operating at a large scale in financial markets yet. In her view, the technology will act more as an 'enabler' rather a 'disrupter'. It could bring key benefits in the post-trade area (more efficient back-office, less time, less reconciliation) but also improve reporting capabilities and KYC processes. There are a number of challenges (adopting common standards, sharing the same reference data, using the same protocols) to be addressed, in addition to the technology itself (privacy, governance of the network) and the regulatory constraints.

Pēteris Zilgalvis explained in detail the priorities on innovation, digital agenda for financial services and fintech. He referred to the Commission's Start-up and Scale-up Initiative (foreseeing also an enabling framework for regulatory sandboxes) and the Financial Technology Task Force (FTTF), co-chaired by DG FISMA and DG CONNECT. In his view, block chain has the potential to be a transformative technology with wide applications in various economic sectors. A study has been commissioned for 2017 to look at the link between standards and block chain for interoperability purposes. The Free Flow of Data Initiative is also very relevant for the financial sector, in particular associated data with the block chain (jurisdictional governance, ownership of the machine generated data, standards and quality of data).

ECMI Call for papers

Presentation of the winning papers

Stephanie Chan (University of Amsterdam): "Contingent convertible instruments(CoCos): Design, Risk Shifting Incentives and Financial Fragility" (with Sweder van Wijnbergen)

Yannick Timmer (Trinity College Dublin):"Cyclical Investment Behaviour across Financial Institutions"

Discussion with

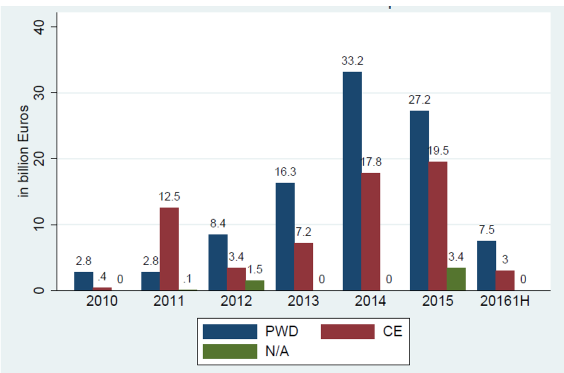
Florencio Lopez de Silanes, Professor of Finance, EDHEC Business School & Vice-Chair, Academic Committee

Moderator: **Andrei Kirilenko**, Director of the Centre for Global Finance and Technology, Imperial College London & Chair, Academic Committee

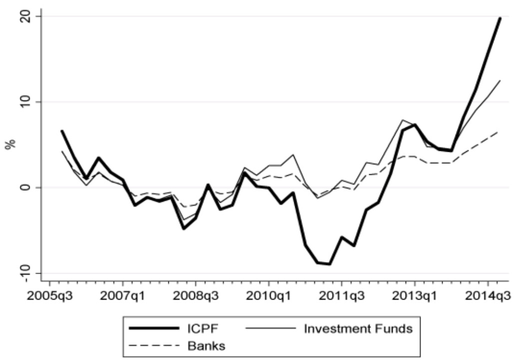
In her paper, **Stephanie Chan** indicated that if the conversion leads to a wealth transfer from CoCos holders to equity holders, it gives rise to undesirable risk-shifting by banks. Moreover, the incentives for risk-shifting increase as the financial environment becomes more fragile. Therefore, CoCos may encourage, instead of mitigate, the creation of a financial crisis. In order to sidestep these consequences, their use by banks must be tempered by increasing capital requirements, and as such, they cannot be treated as true substitutes for equity. *The presentation is available here.*

In his paper, **Yannick Timmer** analysed the investment behaviour of different financial institutions with a particular focus on their response to price changes. He shows that while banks and investment funds are pro-cyclical investors (i.e. they exacerbate price dynamics that can lead to higher market volatility), insurance companies and pension funds act counter-cyclically (they buy when prices have fallen and sell when prices have gone up). These results could have important implications for financial regulation of non-bank financial institutions. *The presentation is available here.*

Annual CoCo Issuance of European Banks



Cumulative Capital Gains on Debt Security Holdings



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