



Towards Variable Union in Europe's Capital Markets

Report of the 2017 ECMI Annual Conference

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Final Report of the 2017 ECMI Annual Conference

In the past seven years, the European Capital Markets Institute (ECMI) has brought together academics, policymakers and industry representatives to take stock of the progress made so far in building a genuine European capital market. At the Annual Conference organised on 23 November 2017, the participants identified the challenges and opportunities that lie ahead but also assessed whether more ambition is required. In particular, they shared their views on long-term investment, supervisory architecture, derivatives markets and fintech.

The key message was that the capital markets union (CMU) must go beyond the actions set for end-2019. CMU is a long-term project that will require the support of multiple stakeholders from both the public and private sectors. Capital markets, in particular equity, and long-term institutional investors, are best suited to finance real assets in the economy. There are certainly areas that should be brought within the remit of ESMA, but achieving supervisory convergence will be the main objective where this is neither possible nor necessary. Brexit-driven relocation might lead to a more balanced landscape of the euro-denominated clearing activities in Europe. With respect to the potential of distributed ledger technology, it is essential to establish a critical mass of market players and interoperability with the existing infrastructures.



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Researcher, ECMI



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Disclaimer. This report includes the main conclusions from the 2017 ECMI Annual Conference. Its content should be attributed solely to the rapporteurs. The speakers participated in their personal capacity and their statements do not necessarily reflect the official position of the organisation they are affiliated with. A detailed overview of the proceedings is available [here](#).

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Introductory remarks



The CMU Action Plan, slightly amended after the mid-term review, has identified the right areas for further harmonisation at EU level but also much needed work by member states and their NCAs.

The main objective is to improve the access to market finance and mitigate the risks inherent in a financial system that is too dependent on the banking sector. This Action Plan should therefore be continued, if not accelerated.

That being said, the time has come to articulate a post-2019 vision. The current CMU was conceived before Brexit, with a list of priorities that did not consider a Union without its most important financial centre. Undoubtedly, the EU needs to engage in strategic thinking on what the post-Brexit CMU with 27 member states should look like. Moreover, tectonic shifts in financial markets are simply unavoidable. To this end, a group of ‘wise persons’ is needed in order to take a fresh look at the Single Market for financial services. Most importantly, this group should take a helicopter view that is not connected to the current legislative agenda, the Brexit negotiations and other third country issues, and ignore the on-going competition between existing financial centres.

To mention but a few of the issues to be considered by such a group:

- Will some key financing and refinancing markets have sufficient critical mass post-Brexit?
- Will this affect the capacity of the Union to finance its economies, or will it run the risk of being dependent on outside financial centres?
- What kind of markets, products, infrastructures and talent pools should be created, attracted and incentivised?
- How will the EU compare in terms of technology, innovation and disruptive forces in financial flows and markets?
- What kind of intermediation would best serve a self-sufficient and vibrant EU27 capital market?
- How would this new CMU interact with the EU, the Eurozone and the Banking Union?
- What about the global positioning and enhancing the attractiveness of European capital markets?

Finally, market participants will continue to create financing channels and markets within evolving regulatory frameworks. What is really missing today is a strategic and ambitious sense of direction to ensure that the Union will be properly equipped to finance itself.

Fabrice Demarigny

Global Head of Financial Advisory Services, Mazars
Chairman, Board of ECMI

Opening speech



Prof. Dr. Claudia M. Buch

Deutsche Bundesbank

The European financial system remains bank-based but other financial institutions have caught up in recent years. Equity capital was a stable source of funding during the financial crisis and the reliance on cross-border debt finance has declined since the crisis. Cross-border risk-sharing through capital markets in Europe remains limited. There is potential for the CMU project to further develop and integrate European capital markets. In particular, a higher share of equity in finance and in cross-border capital flows has the potential to generate a ‘double dividend’ in terms of growth and stability. There are three main priorities for reforms. First, dealing with the stock of non-performing assets, as these can impede structural change and distort credit allocation. Second, as regards the flow of new funds into firms, barriers to the development and integration of European capital markets should be removed. Third, takeover rules and corporate governance structures can be impediments to (cross-

border) investments and M&A transactions. Nonetheless, the full harmonisation of national regulations may not be needed or desirable. In addition, promoting the financing of SMEs should not be a policy goal per se. Rather, creating a competitive landscape for firms to contest markets and to promote innovations should be a priority. The CMU should also avoid creating additional distortions. The political importance of, for example, long-term infrastructure projects and environmentally friendly forms of investment for society at large can hardly be questioned. But steering investments into particular asset classes by means of financial regulations may lead to a misallocation of resources and create incentives to engage in excessive risk-taking. For instance, changing risk weights to encourage the development of specific market segments or asset classes sets the wrong incentives. The full speech is available [here](#).

Short vs long-term investment: What will capital markets deliver?

At present, capital markets have reached varying stages of development throughout Europe, and there remains a marked mismatch between supply and demand on a cross-border basis. The degree of (in) direct participation of retail investors and also the size/structure of the non-bank financial sector vary significantly across member states. The strengthening of long-term savings and investment channels through well-functioning, deeper and highly integrated capital markets remains a priority. Many factors – the central banks' stance on tapering, changing economic/financial conditions, evolving demographics, regulation and technological developments – will impact asset allocation in the coming years. What themes are likely to dominate the investment space? Does the current supply of products meet the needs of retail investors? Are institutional investors equipped for major market/regulatory/technological shifts? Do current rules provide adequate incentives for long-term, sustainable investment?



Ulrich Bindseil
European Central Bank



Rick Lacaille
State Street Global Advisors



Laurent Clamagirand
AXA Group



Martina Macpherson
Network for Sustainable Financial Markets

In the coming years, market participants are expected to better align their capital allocations with the long-term needs of the real economy. More transparency is needed and confidence in the financial sector must be restored. **Ulrich Bindseil** (presentation) stressed that efficient capital markets are best suited to finance real assets, and therefore further enable the transition towards more sustainable growth models. This is coupled with a renewed emphasis on the need to increase retail and institutional activity in the equity markets, i.e. initiatives aiming to 're-equitise' the investment culture. **Rick Lacaille** (presentation) emphasised that the demand for long duration and spread assets is huge but the pools of 'sticky' capital remain rather small. When it comes to the capacity of insurers and pension funds to engage in long-term investments, there are numerous constraints related to their balance sheets, the overall market conditions, prudential/accounting

requirements or tax regimes. **Laurent Clamagirand** (presentation) noted that Solvency 2 has been a major driver of asset allocation; reviewing the regulatory treatment of equity and accounting standards is necessary, in his view. Most importantly, institutional investors and asset managers should be equipped to seize the opportunities and tackle the risks arising from material sustainability/ESG factors (and maybe captured by prudential rules) in order to fulfil their obligations to end-investors. **Martina Macpherson** (presentation) indicated that ESG integration into various asset classes is moving steadily from niche to core investment strategies. As regards corporates, there are multiple reporting standards and valuation models, often leading to misalignment with investor expectations. On the investors' side, there are challenges related to fiduciary duty expectations and the lack of investment vehicles and appropriate benchmarks.



Reforming the derivatives markets: Is the puzzle complete?

The UK's withdrawal from the EU seems to have injected some energy into the ongoing reform process. Among others, the current proposals include provisions to extend the temporary exemptions from central clearing obligations for some end-clients and a more centralised supervisory mechanism within ESMA. Moreover, the existing prudential, operational, oversight and risk-management rules are being complemented with a recovery and resolution framework for central counterparties (CCPs). Is the continuity of the critical functions of CCPs guaranteed without an unlimited backstop? Are resolution colleges well placed to resolve CCPs? What role can ESMA play in CCP supervision and recovery and resolution in a post-Brexit environment? Are the Commission's proposals sufficient to make the derivatives markets Brexit-proof? Is there a need for transitional arrangements? And are additional reforms required to make the European derivatives markets more efficient without harming financial stability?



Haoxiang Zhu

MIT Sloan School of Management



Fabrizio Planta

European Securities Markets Authority



Daniel Maguire

LCH Group



Eric Litvack

International Swaps and Derivatives Association



Franklin Allen
Imperial College London

Despite the reforms in the US OTC derivatives market, multilateral trading is still sparse. Eliminating the bifurcation of liquidity should be a priority as it will increase competition and improve market quality. Basel III incentivised the dealer banks to innovate and reconsider their business models. **Haoxiang Zhu** (presentation) argued that trade compression should not be viewed as a complete substitute for mandatory central clearing. While EMIR certainly represents a regulatory milestone, **Fabrizio Planta** (presentation) indicated that the ongoing review offered the opportunity for warranted amendments. The current proposals aim to ensure further supervisory convergence, accelerate certain procedures and improve cooperation with responsible central banks. A new two-tier system for third-country CCPs, and those deemed systemically important (Tier 2) will be subject to stricter requirements. An area that requires attention

is avoiding the duplication of data reporting among ESMA, NCAs and the central bank of issue, which could create uncertainty in the market. In parallel, related issues with respect to an enhanced role for ESMA must be separately examined under the review of ESAs. **Daniel Maguire** highlighted that the industry embraced the post-crisis reforms, which have already delivered significant improvements. Nonetheless, the risk of fragmentation may materialise, namely by creating two sub-markets. **Eric Litvack** argued that reviewing, improving and recalibrating EMIR should largely be driven by the objective to encourage greater liquidity and access to risk hedging/transferring for end-users. Regarding the impact of Brexit, the easy option (i.e. location policy) may not be the best option. The hardest option (i.e. enhanced regulatory cooperation and supervision, transitional arrangements) could deliver better and more robust results.



2017 ECMI Best Paper: The failure of a clearinghouse: empirical evidence

Authors: **Guillaume Vuillemeys**, HEC Paris and **Vincent Bignon**, Banque de France

Academic Committee (Chair and Vice-Chair)

Andrei Kirilenko, Imperial College London and **Florencio López de Silanes**, SKEMA Business School



CCPs are becoming critical institutions in post-crisis financial markets, due to regulatory requirements to centrally clear all standardised derivatives. This paper provides the first detailed empirical analysis of the failure of a derivatives clearinghouse. Using archival data, the authors find three main reasons for the failure. First, the ill-constructed pool of investors consisting of unsophisticated and non-diversified retail investors. Second, the failure to contain the growth of a large position by its largest member, due to a misuse of the available instruments to manage risk. Third, risk

management wasn't as strong as it should have been when prices collapsed, and a large clearing member approached distress. As the interests of the CCP aligned with those of the defaulted member, the CCP engaged in risk-shifting behaviour. While better capitalised CCPs are desirable to reduce risk-shifting incentives near distress, the paper concludes that a governance structure that gives more weight to hedgers than liquidity providers, as well as well-designed default management schemes (i.e. default waterfalls) can significantly curb risk-shifting behaviours. The full paper is available [here](#).

DLT and its applications: Revolution or evolution?

Distributed ledger technology (DLT) is still at an early stage, but more solutions will come to the market in the next five years and be subject to 'business' proof-of-concept testing. In particular, the financial services industry needs to address longstanding operational inefficiencies and find ways to enable further simplification, standardisation and transparency. Most benefits are expected in the areas of trade and post-trade. Nonetheless, there remain many questions about the robustness, accessibility, interoperability, governance and the risk-management framework. In which segments is DLT most likely to bring about major benefits and achieve the necessary scale? How can be the potential risks introduced by DLT be mitigated? Will DLT lead to further disintermediation in the financial sector? How does DLT interact with the existing EU regulatory framework for securities markets (MiFID 2, EMIR)?



Angela Walch

St. Mary's University, Texas



Jan Bart de Boer

ABN AMRO Clearing



Tom Casteleyn

BNY Mellon



Simon Toms

Allen & Overy



David Ostojitsch

Association for Financial Markets in Europe

DLT has been linked to various segments of the capital markets, such as clearing and settlement activities, securities issuance and trading, fund management/distribution, record of ownership and safekeeping of assets, transaction and securities data reporting. **Angela Walch** (presentation) emphasised that while we are moving beyond the DLT hype, many misunderstandings and overstatements persist. A critical and relentlessly practical approach to how we design and use the technology is mandatory. Most of the changes witnessed in capital markets over the last decade were driven by regulation and/or technology. For **Jan Bart de Boer**, there is no reason to believe that market participants implementing DLT will not have to comply with the existing regulatory framework. Radical changes to incumbents' business models might not happen as soon as expected. For **Simon Toms**, regulation and governance are key. Some important

questions are yet to be answered: what happens when DLT goes wrong; how do we get our records back; if there is a dispute, where do we litigate that dispute and which law applies? DLT could be used in-house to improve certain operational processes and resilience but also to create, transfer and prove ownership of assets in a centralised network. **Tom Casteleyn** sees a clear opportunity, especially for those asset classes where there is no centralised infrastructure market yet (i.e. gold, corporate/syndicated loans, trade finance). Nonetheless, a critical mass of market players and interoperability is essential for the DLT to take off. Taking big 'chunks' of capital markets activity and putting them on the DLT might not happen in the short to medium run. For these reasons, the disruptive forces of the DLT may be more incremental than revolutionary or fully transformational.



Closing speech



Ugo Bassi
European Commission

CMU is a pro-growth, pro-business, pro-jobs project that aims to rebalance the financing structure in Europe and create new opportunities for all types of investors. The objective is to deliver on as many actions as possible before end-2019. The next Commission will certainly continue to support the CMU project. As concerns the Review of ESAs, there are areas that could benefit from centralised supervision at ESMA, such as the approval of certain prospectuses, benchmarks, Europe-wide CCP or any type of purely European product. When it comes to FinTech, targeted interventions are needed so that developments continue to take place in a more controlled manner. To this end, the Commission will issue an Action Plan on FinTech. A first example will be in the area of crowd funding. Another top priority on the agenda is sustainable finance.

The transition to a low-carbon, climate resilient and circular economy requires the full backing of private investors. In particular, the EU has committed to implement the Paris Climate Agreement in a firm, determined and rapid manner. More and safer corporate bonds would allow companies to diversify their funding sources. Nonetheless, a number of concerns need to be addressed, in particular making issuance easier for companies, increasing access for investors and ensuring liquidity, transparency and stability in this segment. As for the public equity markets, high costs and excessive regulatory burdens often outweigh the benefits. Small and targeted adjustments to the existing rules should encourage SMEs to go public. This is particularly relevant for the success of the SME Growth Market.



Final remarks



The future of Europe's capital markets is uncertain in the face of policy, market and technological developments.

In the wake of the financial crisis, the Juncker Commission set the ambition of further aligning the different markets in Europe and allowing for better risk-sharing mechanisms.

Three years on, it is clear that it remains a useful project, but is probably also a distant objective. Asset allocation patterns in Europe continue to be very diverse. Political events in the most developed European capital markets will create additional barriers. Global technological developments raise big governance questions and market supervisory structures are evolving in a more ad hoc way, rather than being clearly structured.

For ECMI, this means that much remains to be done to monitor these developments and remind policymakers of the inefficiencies in Europe's capital markets.

Karel Lannoo

CEO, CEPS and General Manager, ECMI



About the European Capital Markets Institute



Mission statement. ECMI conducts in-depth research aimed at informing the public debate and policy-making process on issues relevant to capital markets. Through its various activities, ECMI facilitates the interaction among policymakers, market participants, and academics. ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels.



Core activities. The exchanges among various stakeholders are fuelled by the work done by its researchers, such as opinion pieces, commentaries, policy briefs, research reports, working papers, event reports, statistical package. In addition, ECMI organises seminars, workshops, conferences, task forces that offer multiple networking opportunities. ECMI also undertakes studies commissioned by the EU institutions and other organisations, and publishes contributions from high-profile external researchers.

Membership and governance. The membership is open to private companies/associations, regulatory authorities and academic institutions. The board members provide the strategic direction, supervise the management team and the financial soundness of the institute. The research staff works on the basis of an independent agenda; they are assisted by the members of the academic committee.

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