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Restoring investors' trust in Europe's markets

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Ladies and gentlemen,

Firstly, I want to thank the BBA for inviting me here today to speak at one of the most important banking events in Europe. I am honoured to have the opportunity to share my views with you from the perspective of a securities and markets regulator. At first sight, my presence here may appear to have limited value for you as banking regulation and supervision is outside ESMA's remit. However, banks are important and active players in Europe's securities markets and many of ESMA's activities are relevant to them and their operations. It is therefore not surprising that banks, including those UK institutions represented here today, actively contribute to ESMA's work, for example through responding to our consultations and participation in our public hearings.

Trust

I would like to commend the BBA for selecting *restoring trust* as the central theme of today's conference. As we are all aware, trust is the cornerstone of financial markets. Those of you who have an interest in the history of financial markets know very well that trust lies at the root of the development of our securities markets. Public companies and stock markets, which have been so important for the development of our economies and the generation of our wealth, cannot exist without trust. In essence, the level of trust needs to be at such a high level that savers are willing to transfer some of their carefully saved income to another person, who they do not know personally, and who will use it to undertake a productive activity. Considering the many potential risks involved, it is remarkable that we have been able to achieve the level of trust needed for the functioning of large and complex financial markets.

Applying the concept of trust to the world of securities markets of today, it is clear that investor trust has been severely undermined. It is also clear that to let our economies grow again and to move out of the current difficult economic phase, investor trust needs to be restored. However, while losing trust can happen quickly, restoring trust is difficult and takes time.

In my view, two main factors have been responsible for undermining investor trust, one related to the overall condition of our economies, and one related to the performance of the financial services sector.

On the first factor, a lot of investors' distrust and aversion to risk is related to the current fundamental problems in our economies. If I can only use a few words, the core of these fundamental problems consists of the high indebtedness of banks and sovereigns and the strong link between these two groups. In particular the problems of indebtedness of Eurozone banks and sovereigns have resulted in high levels of risk aversion amongst investors.

I will refrain from adding to the impressive number of analyses and comments provided on these economic issues. However, as a securities markets regulator I would like to make just one remark. Growing our economies is one of the central themes in the current policy debates as it is obvious that without growth, solving the debt problems of the public and private sector will be extremely difficult. Europe's banking sector is very large both in relative and absolute terms compared with the US and emerging markets. EU companies rely more heavily on bank funding rather than funding based on securities markets. The current hope is that with a struggling banking sector, securities markets can to some extent take over the role of funding economic activity and growth. While I believe that it is important to think about policy measures which can help to improve securities markets as a source of funding, all these policy measures will not be effective without first solving the Eurozone's problems.

Let me now move to the second factor which has contributed to the undermining of investor trust. Investor trust is also low as a result of longer term problems in the financial services sector. Investors and financial consumers currently have very limited trust in the financial services sector. As always, this lack of trust is the result of various factors. First and foremost, investors and financial consumers have too many times experienced poor service performance resulting from a lack of transparency, promises of unrealistic expected returns, and unexpected hidden costs. In some cases, this has resulted in financial consumer scandals and the payment of large amounts of compensation to investors, a situation with which institutions here in the UK will be very familiar. The reputation of the sector has also been harmed by the poor behaviour of some financial sector executives and traders.

Regaining the trust of investors and financial consumers is primarily a task for the financial services sector. As I am convinced that a sector can only be viable in the long term when it is trusted by its consumers, it is also in the self-interest of the financial services sector to restore this trust. Regulation and supervision can support the industry in its moves towards regaining consumer trust and confidence.

Investor protection

Let me now take the opportunity to move from this high level analysis of investor trust, to how ESMA has contributed to rebuilding investor trust through a series of concrete initiatives aimed at strengthening the European framework for investor protection. In July 2012, for example, we published two sets of guidelines aimed at enhancing investor protection. One set concerns the suitability of advice under MiFID and the other deals with investment firms' requirements regarding their compliance function. As you are aware, before recommending a specific product, an advisor needs to take client information into account like the investment objective, his or her financial state of affairs, and the client's expertise and knowledge.

While we are on the subject of suitability of advice under MiFID, I would like to mention that inducements provided to advisers are an important factor leading to unsuitable products being recommended to clients. I firmly believe that the problem cannot be solved by yet more transparency alone. I fully support the ban on inducements in certain situations as included in the proposal by the Commission for MiFID. At a minimum we need to ban inducements in the case of discretionary portfolio management and when an advisor wants to use the *independent* label.

Getting the incentives right for providing good advice to clients is in all of our interests. Tackling poor incentives only via corrective measures like internal controls and external supervision can add costs and will too often fail to achieve the desired outcome. I therefore hope that the European Union will follow the example of some member states, including the UK, and move to ban inducements.

I am convinced that banning inducements will contribute to the development of a viable business model with a high level of investor trust – although this will also require efforts to improve financial awareness among investors. I do understand that it will take some adjustments, both on the industry side and the investor side, to move to a new business model without inducements. Therefore, allowing sufficient time to all stakeholders to adjust before a ban is introduced would be reasonable.

I know that concerns have been raised that banning inducements might affect the competitive positions between banks and advisors or intermediaries. These competition concerns vary to some extent with the predominant distribution model. In some EU member states banks are the main distributers of financial products, while in other member states, like here in the UK, intermediaries and independent advisors are an important distribution channel of financial products. Whatever the distribution model, we should ensure there exists a level playing field between the various distributors.

Advisors and intermediaries, especially, have raised concerns about how a ban on inducements may negatively affect their competitive position. Banks can recommend products that they have originated and therefore there are no explicit inducements involved. However, there still can be conflicts of interest in this situation. When offering a range of products, advisors within a bank might be tempted to be biased towards their in-house products or to those in-house products with a higher benefit to the bank. To address this risk we should not only look at inducements, but also look at the remuneration of advisors and sales staff in financial institutions as I see inducements and remuneration as different sides of the same coin.

Consistent with that line of thinking ESMA published after the summer a consultation paper on proposed guidelines on remuneration policies and practices under MiFID. The guidelines aim to strengthen investor protection by seeking to improve the implementation of the MiFID rules on conflicts of interest, thereby preventing mis-selling of products.

The guidelines will apply to investment firms, fund management companies when providing investment services, and to credit institutions. Firms must ensure that they have appropriate remuneration policies and practices in place, bearing in mind the obligation on firms to act honestly, fairly and professionally in the best interests of their clients.

As stated earlier, during the last decades we have seen a number of mis-selling scandals affect the retail investor across Europe. A key factor identified as a driver for the promotion, recommendation and selling of unsuitable products is the presence of financial incentive schemes for sales staff that do not take account of the clients' best interests.

The proposed remuneration guidelines for MiFID investment firms are key to ensuring that the pay and incentive structures for sales staff and their superiors do not create false incentives when selling financial products to retail investors. The consistent application of ESMA's remuneration guidelines will help strengthen investor protection and achieve the same level of protection for Europe's retail investors no matter where they invest.

Before I conclude on the topic of investor protection let me mention that ESMA has also exercised its power to issue warnings to investors. In December 2011, ESMA issued a warning on the main risks involved in forex trading, and this September we issued a warning on using the internet for investment purposes, following an observed rise in complaints reported by national authorities.

Investor trust or investor protection is not a sufficient condition on its own to support well-functioning securities markets. There are at least two other elements which are also needed and which are central to ESMA's activities: financial stability and a single rule book for the European Union. Today I will not comment further on the first topic but just let me assure you that financial stability is fully embedded in ESMA's work. Traditionally, securities market regulators have had a stronger focus on transparency and conduct of business, while treating stability as the poor relation. While we still focus on transparency and conduct of business, we now also fully take into account in our work possible stability issues in securities markets. This additional perspective is very much needed with, for example, investment funds being heavily involved in securities lending and repo transactions, and market infrastructure such as CCPs being under the remit of securities regulators.

The single rule book

The single rule book is also essential for well-functioning European securities markets. Firstly, going back to the discussion on investor trust, as many investors conduct their activities across borders, it is important to ensure that they enjoy equal protection across borders. This requires a single EU rule book.

Secondly, the single rule book is beneficial to the financial industry as it reduces the costs of doing business across borders and helps to exploit economies of scale. I think it is no secret that the UK financial sector has in general been a strong supporter of a single rule book for the EU. This is to be expected as a strong financial sector at home is in a good position to compete at European level.

ESMA has worked very hard on the development of the single rule book for securities markets. Since September 2011 we have developed 51 draft regulatory and implementing standards and six sets of guidelines in areas such as credit rating agencies, short selling, high frequency trading, and alternative investment funds. I specifically want to mention the 40 technical standards that were developed for the implementation of EMIR. As you know, EMIR is the European regulation bringing OTC derivatives under regulation and supervision. ESMA delivered the final standards by the end of September in order to meet the EU commitment of the G20 to have rules in place for derivatives markets by January 2013. Later I will discuss in more detail some of the BBA's concerns regarding those technical standards.

I fully appreciate that all this regulatory activity to achieve a single rule book not only keeps ESMA busy, but also results in substantial implementation costs for the financial sector, at least in the short term. However, there can be no single market without a single rule book, and I am convinced that the standardisation of regulatory and supervisory practices across Europe will have major benefits for its financial services industry.

Let me now comment on two specific areas of the single rule book that are foremost in the minds of the industry at present: the technical standards for OTC derivatives and the guidelines for short selling.

Technical Standards for OTC Derivatives: EMIR

The European Markets Infrastructure Regulation or EMIR, on the regulation and supervision of OTC derivatives, has far reaching consequences for financial markets by moving to central clearing of OTC derivatives and transparency on all derivative transactions.

Preparing the implementation of EMIR in the EU is an important part of ESMA's work, and to meet the end of September deadline for the draft technical standards the relevant team in ESMA has worked night and day. Despite the tight deadline, we have been able to organise two rounds of consultation with market stakeholders.

In these consultations, the feedback from the BBA and UK banks focused especially on the topics of indirect clearing, margin requirements, and collateral and investment policy requirements.

On indirect clearing, a key concern was the obligation for clearing members to provide indirect clearing services on reasonable commercial terms that are publicly disclosed. ESMA accepts that a mandatory requirement could have unintended consequences and has removed the obligation but emphasises the need, in line with the legal text of EMIR, to ensure that indirect clearing services are available on reasonable commercial terms. ESMA has also revised the disclosure requirement to strike an appropriate balance between transparency and commercial secrecy.

Another key concern with the indirect clearing proposals was the proposed segregation and portability requirements, in particular where they conflict with national insolvency regimes. ESMA has revised some aspects of the technical standards to better align them with the situation for direct clients and ESMA recognises the concerns about conflict with national insolvency regimes. However, we need to ensure that indirect clients can benefit from protection equivalent to that for direct clients.

I would like to stress that we have changed some indirect clearing proposals to reflect the feedback received but ESMA will be closely monitoring the effectiveness of these arrangements. If in practice indirect clearing is not sufficiently facilitated, ESMA may need to revise its technical standards in the future.

On the topic of margin requirements in the case of central clearing, a number of respondents considered ESMA's proposals to be overly prescriptive. ESMA has revised its technical standards in some areas but generally considers them appropriate and consistent with international standards. ESMA's requirements are also in line with current best practices in Europe. As EMIR introduces a legal obligation to clear through CCPs, it is essential that they are robust and are subject to sufficiently stringent prudential requirements.

On the other hand, on the topic of the collateral and investment policy requirements, respondents commented that ESMA was not sufficiently prescriptive, suggesting that ESMA should narrow the scope of permissible instruments. We think that in many cases that would conflict with EMIR. However, ESMA has amended its draft standards to introduce some further prescription but generally considers its proposals appropriate. ESMA recognises the importance of setting sufficiently stringent prudential requirements but we need to strike the right balance between the safety of CCPs and the overall availability of collateral.

As a concluding comment on EMIR I should mention that we did not yet finalize the technical standard relating to the issue which transactions outside the EU should be subject to the EMIR requirements. As you will understand, this is an area where we need to coordinate with our counterparts outside the EU before consulting specific proposals.

Let me assure you that in these international discussions we take the approach that we should avoid breaking up a global market in a number of local ones for the simple purpose of applying our domestic rules. Europe has a long experience in relying on each other's regulation and supervision and in assessing the equivalence of third country systems. These concepts allowed European financial market to grow significantly and if we want the global markets to grow as well, we would need to extend these principles at international level.

Short selling regulation

Let me now move on to the second specific topic of the single rule book that I want to address: the Short Selling Regulation. As you know, the Short Selling Regulation, adopted in March 2012, contains an important exemption for market making activities but does not envisage any implementing regulation to specify details on how to apply this exemption.

Therefore, ESMA decided to launch a project to develop guidelines aimed at ensuring that the application of the exemption would be as convergent as possible across the different European jurisdictions. This was done again with the objective in mind of a level playing field across the EU. To achieve this we launched a consultation in September and are currently analysing the responses. We know that the timing is tight and not ideal, as many firms are already applying to take advantage of this exemption. However, it is important to shape those guidelines correctly, to avoid either unintended consequences that could reduce liquidity in some markets or blanket exemptions that would make the Regulation void. I know that some aspects are controversial for some firms in some products and we hope to strike a fair balance in the final guidelines, obviously taking full account of the text of the Regulation itself.

Let me conclude on the topic of the single rule book and single market with some general optimistic messages. We nowadays hear many concerns about the European financial integration process being halted or even reversed as a result of the crisis, especially in the banking area. However, perhaps surprisingly, for securities markets, I have a positive message on the crisis and its effects on economic integration and the single market. While there is variation in the various subsectors of securities markets, the current overall development is still in the direction of more integration across the EU's securities markets.

I would like to especially mention the European dimension of market infrastructures. The current new waves of institutional changes are a positive development for integration in the area of market infrastructures. The legislative changes as a result of EMIR and CSD, which will improve the EU level playing field for market infrastructures, give a strong stimulus for market infrastructures to consider new strategic options pointing to integration across national and even regional boundaries.

The City and the European Union

Concluding on the topic of the single rule book and single market I would like to emphasise that this concept needs to include all 27 member states of the EU. In this context, I think it is worthwhile briefly reflecting on the topic of the City and the European Union. This topic is sometimes charged with too much emotion which causes us to lose sight of the facts of the matter.

The UK is Europe's largest securities market and as a result a very important contributor to the activities of ESMA, both through the participation of the UK FSA – one of this afternoon's speakers Martin Wheatley sits on both our Board of Supervisors and Management Board – and the contribution of the UK financial services industry to our consultations, securities markets stakeholder group and consultative working groups.

The recent steps towards further integration of the Eurozone, for example with the proposals for a Banking Union, have raised the issue of the effects of this stronger integration on non-Eurozone member states and most notably the UK. While this is a valid debate, I want to emphasise that for large parts of the financial markets the distinction between Eurozone and non-Eurozone member states has very limited relevance. For example, market infrastructures, investment firms, and investment funds span the Eurozone and the non-Eurozone and in all the directives, regulations, technical standards and guidance that are within ESMA's scope, the Eurozone/non-Eurozone distinction hardly ever plays a role.

In other words, the rationales for developing a single rule book, consistent supervision and a single securities market are not affected by the integration of the Eurozone. We should remain focused on the economic benefits of the single market in securities for all 27 member states and jointly continue our important work of achieving a single rule book and a consistent approach to supervision.

As I near the end of my contribution this morning, I would like to make some brief remarks on two topics that I suspect are of interest: interest rate benchmarks, and credit rating agencies.

Interest rate benchmarks

Much has been said already about LIBOR and the involvement of the BBA and UK banks. The theme of this conference, *regaining trust,* illustrates the impact of the activities which occurred in relation to LIBOR, and beyond this I will not make any further comment on the specific topic.

However, as we are all aware, there are many other interest rate benchmarks issued and used in the EU. In addition to the well-known Euribor rate, there are dozens of other interest rate benchmarks. Therefore, ESMA, together with the European Banking Authority (EBA), is carrying out work in relation to interest rate benchmarks, and has begun work on a number of areas. Firstly, we facilitate the national investigations regarding Euribor, where national authorities will be in the lead. However, EBA and ESMA will need to ensure that information is exchanged and activities are coordinated. Secondly, a review is being conducted of the Euribor system, covering the rate setting system and the submission process. Thirdly, guidance is being developed for benchmark providers and market participants focusing on transparency, conflicts of interest and controls. This work will complement and contribute to the possible forthcoming European Commission work in this area. We will of course ensure that this work will also be coordinated with our international counterparts as some interest rate benchmarks are used world-wide.

Securities markets regulators are used to the application of benchmarks in financial markets. Many investment funds use benchmarks, or indices, and ESMA has for example done work in 2011 on requirements for indices used by UCITS investment funds. This work has resulted in additional requirements, as set out in our recently published guidelines for UCITS funds, which include additional transparency obligations regarding indices and ensure that investment funds cannot use indices which are solely constructed for one individual investment fund.

Having experience of regulating investment funds, and without prejudice to our forthcoming work, I was struck by a remarkable characteristic of interest rate benchmarks, which is the lack of transactions and therefore no active market. This makes interest rate benchmarks much more susceptible to manipulation and this needs our full attention in any policy response.

Credit Rating Agencies

Our supervision of Credit Rating Agencies (CRAs) attracts a lot of interest from banks across Europe including the UK. Earlier this year UK banks expressed their concerns about the endorsement procedure which allows the use of ratings issued outside the EU. While we were fully aware that not endorsing ratings from outside the EU might have resulted in very serious problems, we also needed to ensure that non-EU ratings meet the same requirements as EU ratings. This is essential to protect the interests of European investors and to achieve a level playing field.

Looking back it is comforting to see that the most important third countries meet the EU requirements and that the vast majority of ratings from third countries can be used for regulatory purposes in the EU.

Additionally, I would like to recall that earlier this year we announced that we had started a review of the bank rating methodologies at the largest CRAs. This focus on bank ratings is warranted as CRAs have been revising their rating methodologies as a result of the financial crisis and new insights have been obtained into the relationship between banks and sovereigns. In addition, the increased focus on banks by the CRAs needs to be reflected in their allocation of sufficient and appropriate analytical resources to support the heightened level of activity in the area of bank ratings. We expect to report on our specific review of the bank ratings around the year end.

Conclusion

Let me conclude this morning by once again thanking the BBA for allowing me, an interloper from the securities markets and dare I say "Europe", the opportunity to share my thoughts on ESMA's work. I believe that building a common rulebook and supervisory approach across all the EU's member states will enhance investor protection and promote stable, well-functioning financial markets.

It is my hope that the combined efforts of regulators, in the shape of ESMA and national authorities such as the FSA, and a financial industry seeking to rebuild relations with their clients will ultimately restore investors' trust in our financial markets.

Thank you for your attention.