

Regulatory measures to prevent another crisis CFA Institute, National Bank of Belgium, Brussels

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Ladies and Gentlemen,

I am delighted the CFA Institute invited me to speak to you at this conference today. It gives me the occasion to share with you some thoughts on how we, as securities regulators, work to improve financial stability in the EU. But I also take this as an opportunity to familiarise you with the progress we made since the creation of ESMA three years ago, with implementing regulatory measures and EU supervision, in response to the financial crisis.

I am also very pleased to see Sheila Bair speaking today. Firstly, her participation underlines that our efforts in this area greatly benefit from an international perspective. Secondly, it also underlines that our approach needs to go across the various sub-sectors of the financial system. We all know that Sheila Bair has extensive experience in banking supervision. But earlier in her career she also gained broad experience in other parts of the financial system, including in securities markets.

I think the title of this event captures quite well the main motivation of the regulatory work in recent years: establishing a more safe, sound,

transparent and responsible financial system. But it's not only about "preventing" another financial crisis; it is also about limiting the consequences to taxpayers, the economy and society as a whole when a financial crisis occurs.

However, such financial markets reform needs to be considered at the global level. Already back in 2008, the G20 established the core elements of a new global financial regulatory framework, which once fully implemented, will make the financial system more resilient. The G20 provided regulators with a roadmap where no financial product, no market and no territory with potentially systemic impact should remain without appropriate regulation and effective supervision. ESMA has played an important role in the implementation of the G20 commitments for securities markets in the EU. In order to ensure that our work is coordinated at an international level, we engage directly with our international counterparts and with a range of international bodies including the Financial Stability Board, the Committee on Payments and Market Infrastructures, the OTC Derivatives Regulators Group and IOSCO.

In the following I would like to cover three items that seem relevant to me:

- (1) How regulation and supervision responded to the crisis;
- (2) The implementation of the new regulatory framework; and
- (3) An outlook on current and future risks, as well as on the opportunities offered by the proposal for a Capital Market Union (CMU).

1) Comprehensive response to the crisis across all areas within the EU and globally

In this first part of my speech, I would like to look back at what has been achieved on the regulatory side and how this has already improved financial stability. Most of the G20 commitments have passed the legislative phase and are now implemented in many jurisdictions. Let me give you three examples of major steps undertaken in the EU in response to the financial crisis regarding securities markets:

- **i) OTC derivatives/ EMIR.**

EMIR is one of the most prominent EU responses to the financial crisis. OTC derivatives played a major role in the financial crisis. It became apparent that a regulatory framework was needed to increase the transparency of derivatives, apply central clearing, and impose collateral requirements on bilateral transactions to cover market and counterparty risks. These are exactly the issues that the use of central counterparties (CCP) and the exchange of margins address. All EU CCPs are now in the process of being authorised under EMIR, six trade repositories are up and running to provide transparency on EU derivatives trades and ESMA has already decided how interest rate swaps will need to be centrally cleared;

- **ii) Securitisations/ credit ratings**

Prior to the financial crisis, securitisations had become too complex and together with far too optimistic ratings issued by CRAs, contributed to the spreading of the financial crisis. Requirements for improved transparency around securitisations have been agreed since and are currently being implemented. The "skin in the

game” rule under the AIFMD also aims at creating the right incentives and limits conflicts of interest: as alternative funds must not be exposed to any securitisation unless the “originator, sponsor or original lender retains a net economic interest of at least 5%”.

In addition, the three European CRA Regulations issued in the past years introduce a wide range of measures regarding credit ratings, including bringing CRAs directly under supervision of ESMA. This will help to reduce the reliance on credit ratings and alleviate the “cliff effects” through which downgrades can amplify a financial crisis. The supervisor of CRAs is well-developed and ESMA will soon publish the results of a thematic review into the monitoring of structured finance ratings by CRAs;

- **iii) Hedge funds**

Hedge funds were not regulated prior the financial crisis. But the AIFMD creates a comprehensive framework for the supervision and prudential oversight of alternative funds and private equity in the EU. Not only does it increase the transparency for investors, but it equips national supervisors, ESMA and the ESRB with the information and tools necessary to monitor and respond to risks to the stability of the financial system that could be caused or amplified by the activities of alternative investment funds, for example through excessive leverage.

All these ambitious reforms were possible because we reached fairly common views at the global level. The developments that I just described mirror equal regulatory developments in North America and Asia. However, while globally agreeing on regulatory reform is a big step

forward, the consistent implementation is an equally important step. That said, we are only half-way there and we now need to ensure that the regulatory reform is properly implemented and the financial sector changes its practices as intended. Therefore, while in the first part of this speech I described some of the new rules to make the financial system safer, in the second part, I will focus on their implementation.

2) Making the new regulation work in practice

Now that we have new regulations in place, it is for supervisors to make it work. At the EU level three European authorities and the European Systemic Risk Board were given birth in 2011 to establish a consistent regulatory and supervisory framework to improve cross-border cooperation and to identify and respond to systemic risks. ESMA, as one of the three European authorities, was tasked with ensuring financial stability in securities markets. But I would like to emphasise that the financial stability perspective is quite new for securities regulators, who traditionally focus on transparency and conduct of business. As a result, their focus has been very much on individual supervised entities or markets, and paid limited attention to the possible interconnectedness between supervised entities and markets.

With hindsight it is surprising that before the financial crisis securities regulators had no or limited responsibilities for stability issues. As we all know, securities markets can generate risks to the stability of the system. I just talked you through the role CRAs, OTC derivatives and securitisations played in the financial crisis. However, there are also

other obvious areas in securities markets which can create stability risks, such as algorithmic trading on exchanges or efficient portfolio management techniques used by asset managers, involving securities lending and repo transactions. Also, central securities depositories need to function well in order to ensure a stable financial system.

This new role for securities regulators to also look at stability will benefit from unprecedented data collection and exchange, in which we do not have a long tradition. Since nearly all new pieces of legislation have extensive requirements to provide data to the national and European regulators, we have to build up this new expertise and add a quantitative dimension to our work. Moreover, we have to assess on an on-going basis whether there are still unknown areas in the financial system that would benefit further regulatory insight and bridge remaining data gaps.

Let me give you a glance of the challenges and opportunities these new regulatory datasets will entail:

In the EU, the implementation of EMIR and AIFMD respectively will significantly increase the availability of harmonised data regarding OTC derivatives and alternative funds, including some crucial information from a financial stability perspective such as funds' use of synthetic leverage. Such information will help to identify potential "super spreaders" of financial contagion, namely being the most interconnected market participants. In June 2014, ESMA already published a working paper¹ that showed that the EU CDS market was highly concentrated, with the vast majority of market participants being exposed only to a few others.

¹ ESMA (2014), Monitoring the European CDS Market through networks: Implications for contagion risks, No. 1, 2014.

The ESMA paper underlined the systemic role of some large banks, but it also pointed to the importance of some non-bank participants.

Probably the biggest contribution to improved data availability will come from the implementation of MIFID II. It will broaden the range of instruments for which market participants will be required to store or report data, which in turn will extend the data set available to competent authorities, including identifiers which will enable regulators to detect the trader executing a specific transaction, the algorithm used, and the client on whose behalf the transaction is conducted. This will lead to significant changes both in the way firms report to competent authorities and in the way supervisors monitor market participants.

While I am fully aware that all these new data requirements come at a cost, to both market participants and regulators, I am convinced that these data are inevitable for identifying and responding to stability risks in securities markets. We cannot do our work while being in the dark about what is happening in financial markets. Compared to our colleagues in banking and insurance supervision, we are only about catching up from a situation where we had the least intelligence on our parts of the financial system. As more and more data are becoming available, it is our responsibility as regulators to work together with market participants to improve the quality of these data and that we properly use it in our supervisory activities. I can assure you that since ESMA was created in 2011, we have invested significantly in our capabilities to analyse data and identify risks.

As I mentioned earlier, it is also our responsibility to point to possible gaps in our data on securities markets. In that context, one area where

we need to further progress is information on securities financing transactions. These transactions, like repos and securities lending, very much increase the interconnectedness within asset management and with other parts of the financial system. I therefore very much support the European Commission proposal regarding the reporting of these transactions to trade repositories.

3) Outlook on current and future risks and future supervisory developments

So far, I focused on our new stability mandate and the new legislation and the way we intend to make it work. Let me now move on to giving you concrete examples of current risk issues where strengthened supervisory powers or a better use of extensive datasets can be of particular relevance. I would like to focus on examples relating to OTC derivatives and asset management but will refrain from a comprehensive overview of risks in securities markets: those interested such comprehensive assessment, I invite to study ESMA's most recent Risks, Trends and Vulnerabilities Report². I will then conclude by saying a few words about the opportunity presented by the Capital Market Union.

First, now that regulation gives a more central role to **market infrastructures like CCPs**, some challenges remain. EMIR provides many benefits for the market in terms of risk management and netting, but it will also increase risk concentration within CCPs. This is the reason why regulation already requires that resources are maintained to offset the default of members under extreme but plausible circumstances such as fire sales and rapid falls in liquidity.

² ESMA (2014), Trends, Risks and Vulnerabilities, No. 2, 2014.

But we need to go even further: the failure of a CCP is a very low probability. But it cannot be fully excluded and it would have quite severe consequences for the market. While it is difficult to compare CCPs with banks, as their business models are fundamentally different, it is clear that the systemic impact of a failure of a large CCP would equal, or even exceed, the systemic impact of the failure of a large international bank. Therefore, defining an appropriate recovery and resolution framework for CCPs is now the main forthcoming regulatory challenge. Proposals are currently being prepared at the global and EU level. Several key questions remain to be solved in this perspective, notably clarifying when recovery and resolution should be triggered, the tools that may be used in each situation and the nature of the resolution authority. It is of utmost important that we speed up the process of having a recovery and resolution framework in place as soon as possible. With the move towards central clearing, CCPs are becoming more and more systemically relevant. Not having the recovery and resolution framework in place now is like letting ships leave for their maiden trips without any lifeboats on board.

In addition, concerns were also raised regarding potential pro-cyclical effects of EMIR. More specifically, CCPs tend to increase margin requirements and haircuts during times of stress which, in turn, could lead to asset price declines and further margin calls, thus fuelling negative feedback loops. This issue is explicitly recognised in EMIR and should be taken into account by CCPs when calculating margin requirements and haircuts on collateral. That said, the practical implementation of this requirement now needs to be monitored.

Second, **potential risks that the asset management industry poses to the functioning of the broader financial system** have recently attracted the attention of a broad range of policy makers and regulators in financial markets. The work done in the FSB and at national level in the past years has given us concrete criteria of systemically relevant banks, how to identify them, how to regulate them and ultimately, how to resolve them. Now we have to assess whether there are equivalent systemic risks in asset management and if so, how to address them.

ESMA follows closely the work done at the global level by the FSB and IOSCO, regarding the designation methodology of systemically important funds. The initial analyses focused on the possible stability risks of large individual asset managers but rightly so this focus has shifted towards the stability risks embedded in certain activities and practices in asset management such as the use of leverage or security financing transactions.

I very much support this shift as it better takes into account the specific characteristics of the asset management sector which differs significantly from banking and insurance activities. Asset management firms manage assets on behalf of their clients, who generally agree to bear losses and gains. However, this does not mean that the stability risks in asset management are lower than in other parts of the financial system, but we need to address those risks taking the specific characteristics of asset management into account.

ESMA seeks to add value to this discussion. For example, the activity-based perspective is reflected in our policy work with our guidelines regarding securities financing activities by UCITS investment funds,

which apply regardless of their size. Also, we are currently working on a research project to identify systemically relevant hedge funds based on their capability to drive market trends thus also eventually designating which funds or strategies have the highest potential to destabilise markets.

The second main risk in asset management is related to the unusual current economic environment with extremely low interest rates. These low interest rates have resulted in so-called search-for-yield behaviour and a compression of yields across high and low risk investments. In more mundane words, there is an increasing risk of over-valuation of shares and bonds in asset management.

There is a widening gap between the ever increasing valuations and the very weak underlying economic fundamentals. While all involved – investors, industry and regulators – should try to reduce these risks as much as possible, we should also recognise that they are difficult to control. With extremely low interest rates, investors are inevitably less disciplined in their assessments of the risks attached to investments. It is the negative side-effect of the medicine used to cure problems in other parts of our financial system.

Last but not least, I want to mention **the creation of a Capital Market Union**. To stimulate investments and growth, many EU policy makers and regulators have raised the desirability of moving from a bank-dominated financial system to a system with more diverse sources of funding. Needless to say that ESMA strongly welcomes this initiative and is looking forward to contributing to achieving a truly integrated capital market in the EU.

Greater diversity in financing is needed in order to foster EU economic growth. European SMEs are particularly exposed, as they historically have strongly depended on bank funding. This is an issue for the EU economy, as traditional sources of financing remain subdued. Notably, banks are still undergoing a necessary process of structural change, and have been reducing their lending. A more diversified system with greater involvement of institutional or non-bank investors and higher shares of direct capital market financing is needed to fill the funding gap.

The CMU is now a concept under construction and I am looking forward to the proposals from the European Commission. In my view the CMU is about the accelerated integration of EU capital markets encompassing all 28 Member States. How can this accelerated integration be achieved? Let me just briefly mention the four building blocks:

- (1) greater diversity in funding;
- (2) increasing the efficiency of capital markets;
- (3) strengthening and harmonisation of supervision; and
- (4) increasing the attractiveness of capital markets both for EU investors and for investors from outside the Union.

Some say this new policy agenda is at odds with the policy response to the financial crisis. Without going into all details, I just want to emphasise how important a truly integrated capital market will be to achieving the stability objective. The report which provided for the EU response to the financial crisis, the so-called Delarosiere report³, very much argued that the fragmentation of the EU capital market, and the related un-level playing field and the risk of regulatory arbitrage, was one of the main causes of the financial crisis in the EU. It is clear that the CMU should contribute to reducing fragmentation in the EU's capital market.

Conclusion

Ladies and gentlemen, we have come a long way since we all decided that the financial system needed changing in order to prevent another crisis. This work is still on-going, but I am confident that what has been accomplished so far already made financial markets safer. Now we have to make this system work and to use the tools, the data and the powers that were granted to regulators. It is probably more than ever that we need safe and well-functioning markets to support the economy. Although I am quite certain that the financial system will be tested again in the future, I am also convinced that it will stand firmer than in the past.

Thank you for your attention.

³ High-Level Group on Financial Supervision in the EU (2009).