European Securities and Markets Authority

Date: 12 May 2015
ESMA/2015/854

Priorities of a Capital Markets Union

Luxembourg Stock Exchange Day

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Ladies and gentlemen,

I am delighted to speak today at this important event of the Luxemburgish financial sector. It provides an excellent background to talk about the priorities of the Capital Markets Union or CMU. Over the past decades Luxembourg has successfully developed its non-banking sector and the stock exchange is a key part of that success. Also, it is very timely to speak about the development of capital markets considering this week's deadline for the consultation on the Commission's CMU Green Paper. Hence, in my contribution I can give you some first indications of ESMA's reaction to the consultation. But before I continue on the topic of CMU, let me first take a step back.

Unusual things are happening in the European economy. The European Central Bank (ECB) embarked on a massive *Public Sector Purchase Programme* to fight deflationary risks and achieve price stability. Other EU central banks have cut their interest rates below zero, and former crisis countries, like Portugal, are experiencing negative sovereign bond yields in secondary markets. Deflationary pressures remain which is an implicit sign that investors do not believe that the future is looking bright.

How can we get things right again? Monetary policy alone is, and will not be, sufficient and should be supported by policy initiatives introducing structural reforms. Increasing the role and performance of capital markets should be an important part of these structural reforms.

Europe’s current biggest challenge is the quest for economic growth to ensure our welfare and to maintain our position in the global economy. We need to meet this challenge against a background where all across Europe, the European Union (EU) is rather seen as part of the problem than part of the solution. Therefore, our measures need, more than ever, to be concrete and practicable, encompass the entire membership of the Union and contribute to economic growth. The development of the CMU is of strategic importance in that respect.

The crisis has hit Europe and many other parts of the world severely. It has made us – not surprisingly – more risk averse. But, ladies and gentlemen, economic growth needs the willingness to take risks. Not the type of risks associated with exotic financial instruments but the kind of risks that allow entrepreneurs and investors to innovate, to start new projects and businesses, to generate new revenues and jobs. And to do so, companies need capital which is not always available within the banking sector as it has too often been crowded out by the increased absorbing of government bonds by banks[1]. Also, bank funding typically implies debt funding, while our heavily indebted private sector would benefit from more equity funding. The latter is available in the non-banking sector.

Europe needs to develop alternative funding channels to ensure that the benefits of capital markets and non-banking institutions are maximised for the real economy. Therefore, the European Commission – rightly, in my opinion – launched the initiative to establish a CMU, building further on the EU’s longstanding tradition of integrating the capital markets of its 28 Member States.

Before I move on let me briefly comment and focus on the development of alternative funding channels. As I have stated earlier, policy makers and regulators should ensure that the regulatory framework provides for various funding channels and that they can function well. However, it is up to market participants to actually select the preferred channel depending on the funding and investment problems they are faced with. In simpler words, we should refrain from identifying in advance a *champion* among the funding channels or giving the impression that there are risk free investments.

I would like to comment on two specific funding channels. First, regarding securitisations, I

[1] Ivashina, V. and Becker, B. (2014) *Financial Repression in the European Sovereign Debt Crisis*. Working Paper Harvard Business School

would like to emphasise that this channel has been changed fundamentally in response to the financial crisis. These changes include for example *skin in the game* for those who originate securitisations, more disclosure to allow investors to assess the credit quality of the underlying loan portfolios, and the introduction of regulation and supervision of Credit Rating Agencies by ESMA, which should result in increased quality of securitisations ratings. Hence, any further changes to securitisations should build on, and be consistent with, the regulatory reform already underway for securitisations.

The second funding channel I would like to comment on is crowdfunding. While in absolute terms this is a small funding channel, we all know that technology developments are quite unpredictable and we need to be prepared if this channel becomes, to use the applicable jargon, a disruptive innovation fundamentally changing capital markets. On the basis of ESMA's analysis it is clear that many current crowd funding initiatives are developed outside the existing legal requirements. While understandable, this has negative effects both for investors and crowdfunding platforms. We think that appropriate regulation could better ensure investor protection and offer better development possibilities for crowdfunding platforms, for example by allowing the passporting of their activities to other EU Member States. Let me now go back to the general CMU topic.

CMU has become a buzzword, being talked about in the financial community all across the continent. But how can we make it work? We should be realistic. We will not be able to establish a full Capital Markets Union within five years from here – nor do we have the time to wait until then. We cannot wait any longer, the time is now. We should prioritise a limited number of areas on which we can make progress quickly, bringing tangible results across the EU. Indeed, the Matthew-effect glimpses around the corner and we need to avoid that Europe's big financial markets only become bigger without any progress for the smaller financial markets.

Let me focus in the second part of my contribution on two areas where, in my opinion, progress is especially important to move forward towards a CMU:

(1) We need investors to participate in the CMU; and
(2) We need a European-wide comprehensive supervisory approach.

As the EU's financial markets regulator, ESMA's activities in the years to come will be very

much intertwined with the development of the CMU. Therefore, in both areas I will also touch upon the role of ESMA.

Investor participation in the CMU

A successful capital market requires active participation by investors, including retail investors. The frequently used example of a better balance between bank funding and markets funding is the United States of America (USA). Just to share a statistic with you: participation of households in US securities markets has strongly increased in the past 30 years from about 45% to about 65% of all households. While there are national differences, participation of EU households in securities markets is typically much lower. For example, the average direct financial holdings of European households in securities markets only amounts to about 20%. To put it bluntly, Europeans prefer to keep their savings in deposits. However, this preference can be expected to change as households will more often have to take care of their own pension arrangements.

Let me get back to my earlier statement that we need to take risks. As a regulator, I am of course the first to point out to the higher risks for households when they invest in securities markets compared with saving via deposits. However, we all know that households allocating their long term investments to deposits will miss badly needed investment returns. In the long term, households investing carefully in securities markets will be better off than keeping their savings concentrated in deposits. This is no magic trick. It goes back to my earlier point that for economic growth we need more risk-bearing capital and investors will be rewarded for providing this. Of course, we all know that there are risks in financial markets, and especially retail investors need to carefully consider these risks.

Therefore, a high level of investor protection is essential for a successful CMU. Only when investors feel sufficiently protected will they be willing to enter financial markets. Hence, the importance of a solid single rulebook applied in a predictable way across the EU. I will talk about that later when touching upon the need for a comprehensive supervisory approach in the EU.

Restoring investors' trust is primarily the responsibility of the financial sector, however, regulation and supervision should support this process. While the early phase of the regulatory response to the financial crisis focused on stability and prudential objectives, later

on important regulatory measures have been agreed, like the revised Market in Financial Instruments Directive (MIFID II/MIFIR) and Packaged Retail and Insurance-based Investment Products (PRIIPs), which should ensure a significantly safer environment for investors. In particular, the more holistic approach to investor protection, including the new product intervention powers under MiFID II, should reinforce and further harmonise the level of protection of investors across Europe.

PRIIPs will add to investor protection by providing a framework for establishing consistent and high-quality disclosure for retail investors across the financial sector. It captures investment funds, structured products and insurance-based instruments. The Key Information Document (KID) it introduces – one the most tangible results of the three European Supervisory Authorities – will be limited to three pages in length and has to contain sufficient information to allow consumers to make informed decisions and to compare different offerings. That information will have to be presented in an accessible and consumer-friendly way, otherwise investors simply will not read it. Given that the KID will be used by millions of consumers across the EU on a daily basis it is only right that consumer input will be a key driver for what the final document will look like.

And that brings me to a topic that I know is of particular interest to the audience here in Luxembourg: Undertakings for Collective Investment in Transferable Securities (UCITS). We all recognize that UCITS is a strong and robust regulatory framework, and that it has been successful as an international brand. More than 25 years after the first UCITS was created, it is important to look at what has made the framework a success and what can help to maintain that position in the future. Let me be clear –it is not the role of ESMA, or of regulators generally, to promote particular firms, sectors or products. However, when we know that a product exists that has been carefully developed over a number of years, provides strong protection to retail investors and at the same time happens to be a successful European export, we should do our best as policy makers to foster and encourage that product.

Let me touch upon some more concrete proposals which I believe could further contribute to investor protection and to the further development of a pan-European asset management sector benefitting investors:

(i) Today, investors already benefit from a detailed set of rules on remuneration and cost disclosures via the UCITS KIID. However, we need more than transparency alone. There are still widely varying practices on the substance of what are common costs and expenses of retail investment products for investors across the EU. Hence, further harmonisation of those costs and expenses should be considered;

(ii) Experience has shown the difficulties of disclosing comprehensive and relevant information on costs in a table or a summary cost indicator. I think it would be in the industry's interest to complement the information on cost disclosure via setting up reliable on-line calculators or central databases on the costs of these funds;

(iii) We have seen national authorities introducing additional requirements for UCITS and Alternative Investment Funds or AIFs; this clearly hampers their cross-border marketing and passporting. We need to specify the type of add-ons that national regulators can introduce, if any. We should also clarify the division of competencies with regard to the rules of conduct for UCITS management companies that have established branches in a host Member State to manage UCITS; and

(iv) Finally, we can take one more step to improve cross-border marketing of funds. UCITS IV simplified successfully the procedure for cross-border marketing by introducing regulator-to-regulator notifications and clarifying the role of each national regulator. Today, any updates to the document provided to the national regulator of the host Member State at the time of the notification have to be communicated by the UCITS itself. I believe that the notification procedure would be more efficient if regulators would share the updates to the documents between themselves.

European-wide comprehensive supervisory approach

Let me now move towards the last, but by no means least important, part of my intervention today. This is an area in which the three European Supervisory Authorities can play an important role and which is one of ESMA's key strategic objectives for the years ahead: supervisory convergence.

Giving the breadth and complexity of the single rulebook, regulators need to make many choices regarding their supervision, including the interpretation of the rules and the intensity of supervision. Diversity in these choices will have the result that the single rulebook will not in fact be seen as such by investors and market participants. This is not an academic debate or power game between regulators but has important practical implications. Any investor or

company that has been active in different countries will without doubt underline the importance of applying, supervising and enforcing basic technical rules consistently.

Effective supervision of financial markets is not an easy task. What is sound practice in a specific circumstance is not necessarily evident, and requires professional judgment. As I well know from my experience both as a national and European regulator, even within one authority it can be a challenge to ensure that different supervisors treat similar cases in a similar way. It needs no further explanation that consistency between NCAs is much more difficult to achieve.

Currently there is substantial room for increased convergence of supervisory practices and approaches among NCAs. In that context I should mention our recently published peer reviews of national supervisory practices regarding *Best Execution* and *Clear, fair and not misleading information*. Both topics concern requirements which are very important for the functioning of securities markets and the protection of investors, and the reviews show substantial divergence between national regulators. We have changed our peer review methodology to get a more candid view of such divergence by introducing extensive on-site visits to national authorities. I should mention here that Jean Guill, Director-General of the Luxembourgish CSSF and Chair of ESMA's Review Panel, played an important role in the development of this new methodology.

The reasons for supervisory divergence are many. The economies, market structures and business practices may differ, leading to different supervisory practices. The resources national regulators have available, also in relation to market size, differ quite substantially. Regulatory and supervisory philosophies, objectives and techniques differ between countries.

Supervisory convergence does not mean that we should aim to converge to a one size-fits-all approach. It does mean that we promote the consistent and effective application of the same rules and using sufficiently similar approaches for similar risks.

Our overall aim is to achieve high, consistent standards of supervision throughout the EU. However, it would not be realistic to aim for full convergence in the period 2016-2020 and full convergence may not be needed in all areas to achieve our objectives. Therefore, ESMA will identify a select number of high priority areas on which we will focus our convergence

activities. In addition, we need to carefully think which convergence tools we will use to address supervisory convergence. We have a broad range of tools at our disposal, including for example peer reviews, mediation, a formal procedure on breach of Union law, providing opinions on national supervisory practices, and publishing Q&As to clarify our views on the practical application of legislation. The effectiveness of each convergence tool will vary depending on the problem at hand. Hence, to summarise, the success of our convergence activities will depend on the selection of areas subject to our convergence activities and the selection of the right instrument.

Let me conclude the convergence area with two remarks. First, convergence activities do not necessarily result in clear and tangible results in the short term. Only over time, and with the continued dedication of resources to convergence activities, we will observe that European supervisory practices will move closer to each other. Second, while we can already use a broad range of convergence tools as envisaged in ESMA's founding regulation, our toolkit can be further improved. Areas of such improvements include clarifying the possibilities for ESMA to ask for information and data from national authorities for convergence purposes and that all peer reviews will be made public.

Before concluding, let me raise one more topic related to supervision. EU supervision should not only converge, it should also focus on the right issues. For that, analysing risks both at national level and EU level will be essential. As you know, securities regulators have no long tradition of gathering extensive data to support such risk analyses. Rightly so, in response to the financial crisis, the opportunities to gather and assemble data on EU capital markets have expanded rapidly. I know some stakeholders have expressed their concerns about the extra costs this entails. However, we cannot supervise in the dark. I fully understand that both ESMA and the national regulators have the clear obligation to do their utmost to ensure that these new opportunities result in high quality data providing insights on the risks in securities markets. In that context I can assure you that the combination of data, IT and analytical capabilities is a very important element of ESMA's strategy.

Ladies and gentlemen, it is time to conclude. We cannot underestimate the importance of developing non-bank financing further to stimulate our economy, to ensure economic growth, jobs and our welfare. The experience of Luxembourg, one of the EU's biggest financial centers and the country with the highest GDP per inhabitant of the EU, embracing open markets and alternative financing, will no doubt serve as an example in the debate. The

Capital Markets Union is needed. We need to make progress, more than ever. But this will not be possible without clear prioritisation and moving forward on two essential elements: first investor participation and second the need for a European-wide comprehensive supervisory approach.

Let us work on that together. Thank you.