Effective financial supervision in Europe: lessons learned and challenges ahead

ICMA -- The impact of regulatory reform on capital markets

Amsterdam, 21 November 2013

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Ladies and gentlemen, good afternoon.
Thank you very much for the invitation and to ICMA for organizing this timely meeting, which addresses important topics that the AFM has a great interest in. It is a pleasure to be here.

Indeed, this a period of major and impactful regulatory reform. The AFM very much appreciates having an open and frank dialogue with market participants regarding the regulatory agenda and its implementation. So, I greatly appreciate having the opportunity to share with you some of the AFM's observations regarding the topic of today: regulatory reform and its impact on capital markets.

Introduction

Five years ago, the financial crisis showed that there were major shortcomings in how the financial markets operated. At the same time significant flaws in the institutional framework of financial supervision became exposed.

You will recall of course the major shocks in the United States, like the bankruptcy of Lehmann and the bailout of AIG. The shockwaves also reached Europe with a large number of banks that had to be bailed out by their national governments. In the Netherlands, large financial institutions like ING and ABN AMRO had to be supported by the government or became entirely government owned.

While these rescue operations were of a prudential nature, the AFM as a market conduct supervisor also got its share of emergency measures, e.g. the emergency restrictions to short selling. As you may recall, legislation was passed in Parliament within a few weeks to provide a more structural legal basis for these measures. Many other countries in Europe also introduced national short selling restrictions. There was hardly any coordination at a European level to ensure an effective regulatory process or to safeguard consistent outcomes. These events clearly showed that the European coordination mechanisms for financial supervision had to be strengthened.

Now, half a decade later, we are in a position to start assessing the institutional reforms that have taken place. Some of the new regulations that were adopted in response to the crisis are in operation. Others will follow shortly. In the meantime, of course, the financial crisis entered a new phase with the sovereign debt crisis, which has led to yet more regulatory initiatives (like the Banking Union) and which also had an impact on earlier (credit crisis-related) regulatory workstreams that were still being developed. On top of all this, new scandals have emerged, particularly the Libor rigging, which threaten the delicate restoration of trust in the financial sector, and which also require a regulatory response.

Against this background, I would like to focus today on:
Firstly, the policy response that followed the financial crisis.
Secondly, where do we stand today?
And thirdly, some concluding remarks on the future of regulatory reform.

Policy response to the crisis

When assessing the regulatory reform agenda and the institutional reforms, one characteristic is that these continue to be sectorally organised. This is quite in contrast to the functional, cross-sectoral approach that we have successfully implemented in The Netherlands under the twin-peaks system. The twin-peaks approach is increasingly adopted as an effective way to organize financial supervision, most recently in the UK.

We believe that the sectoral, silo'ed, approach fails to capture the interconnected and complex nature of the risks to which consumers and investors are exposed. It also fails to reflect the complex structure of financial service providers. Many financial institutions are, after all, operating across bank/insurance/pension lines. They offer increasingly complex financial products. As a result, the traditional boundaries between credit, insurance and securities markets have blurred. Think of credit default swaps or investment-linked insurance products.

The current sectoral European regime confuses consumers and investors as well as financial market participants. They have to deal with different regimes of protection and transparency for comparable products or activities, while firms are confronted with overlapping, inconsistent or even contradictory compliance requirements. This creates an unlevel playing field across sectors and market participants.
Ideally, all regulation and supervision for consumer and investor protection should be cross-sector consistent with a uniform set of definitions, including scope. The current situation is rapidly becoming unworkable. For example, multiple directives regulate consumer protection, but they do so in slightly, or sometimes widely, different ways; and sometimes they overlap.

Examples of subjects of regulation that we believe should be consistent across sectors are: transparency, product governance, organizational requirements for financial institutions, competence requirements, remuneration, selling practices, and advice standards.
A cross-sectoral approach is particularly needed to improve the level of investor protection and to ensure that the rules are both more effective and more efficient. For that reason, we believe European policy makers should reflect on what the future European framework for consumer protection in financial services should look like.

Banking Union and market conduct supervision

Having these institutional discussions is an urgent matter, given the creation of the Banking Union and the Single Supervisory Mechanism (SSM). As you know, the sovereign debt crisis has shown the great risks stemming from contagion between the government debt markets and the banks. A deeper integration of banking supervision is needed to mitigate those risks. The creation of the SSM will have a great impact on financial supervision as we know it.

The Banking Union is no less than a landslide in micro-prudential supervision. National prudential supervisors will have less room for manoeuvre in supervising their banking industry. A next step will be a European resolution framework for unwinding banks in an orderly manner. The banking union will mainly be of a prudential supervisory nature, with the enforcement of the Capital Requirements Directive (CRD) at the core of its mandate. But it also raises wider questions regarding the future of European supervision.

I believe that one important question has not been fully explored in the debate regarding the SSM, namely: what will be the role of market conduct supervision in Europe? The recent crises have shown that both financial stability and consumer/investor problems can find their origin in market conduct of financial market participants. In the Netherlands we have learned that the hard way when one of our consumer banks went bankrupt as the consequence of a conduct problem. Internationally, we have seen this on a much larger, and much more impactful, scale with the irresponsible creation and miss-selling of structured finance instruments. This was behavior which stemmed in large part from inappropriate incentives and the exploitation of excessive information asymmetries that existed both in the market at-large and at firm level.

The lesson that we can learn from these recent experiences is that a bank's viability cannot be measured solely by assessing its buffers, balance sheet ratios and other quantitative criteria. A healthy bank is first and foremost a bank that has a sustainable business model and which treats both its customers, investors, and other market participants fairly. We therefore think that, in addition to supervising the European banks from a prudential perspective, effective and consistent oversight from a market conduct perspective is also needed for the Banking Union to be effective.

Financial stability supervision from a conduct perspective

At a national level, the AFM is seeking to put these lessons learned into practice in our approach to financial stability supervision, together with our prudential colleagues at DNB.

The AFM joined DNB and the Dutch Ministry of Finance as a member of the Dutch Financial Stability Committee, which addresses developments which are important for financial stability. Together with DNB, the AFM seeks to ensure that the financial system operates on the basis of a manageable and transparent level of risk. As a business conduct supervisor the AFM focuses on the stability of trading infrastructures, the conduct of market participants and on the transparency of systemic risks in general.

What other areas could benefit from centralized European supervision?

Currently, only the supervision of credit rating agencies (CRAs) and Trade Repositories (TRs) is directly mandated to ESMA. The reason for granting these tasks to ESMA is the pan-European reach of the supervised entities. Their activities are not restricted to particular member states but have an impact on the capital markets Europe-wide. However, it is easy to name other areas where the same arguments would apply, such as supervision of market abuse, of audit, and of financial reporting. Enhancing cooperation in those areas would definitely serve the interests of market participants. It would lead to more convergence in interpretation of rules and more coherence in the day-to-day supervision. I believe it also leads to better supervision from the perspective of investors, consumers and markets.

Who should be the supervisor?

Who should be responsible for European conduct supervision? We would prefer an independent yet fully accountable body, not only independent from political interference, but also independent from the ECB's interests as central bank and monetary authority. From our perspective, it would seem logical to redesign ESMA into an independent European conduct-of-business supervisory authority along the lines I mentioned.

Risks and opportunities in some European regulatory projects

We tend to see further European integration as a positive development, where this leads to more consistent regulation and more effective supervision. However, we also see some risks that some of the European rules will be ineffective or may lead to unintended consequences. Let me illustrate a couple of these risks first before I turn to the more positive side.

a. Risks

The main reasons for concerns are related to the quality of European regulation and the risk of a 'ticking-the-box'-mentality:

- The large number of new and complex European rules are created under severe time pressure, which leaves limited time for reflection, adequate consultation and calibration when drafting and implementing these rules;
- The sectoral design of the rules, which adds to their complexity. Also it may create inconsistencies, gaps and overlaps between rules that apply to different (but comparable) financial activities and products;
- The philosophical differences of opinion between European jurisdictions on how to appropriately regulate the financial markets, and the different approaches to financial supervision in practice;
- The increasing number and complexity of European rules make compliance with these rules more difficult and costly. Smaller firms may find it hard to comply with the large amount of new and complex rules and reporting requirements, which come on top of higher capital requirements. As an unintended consequence, this may lead to more market concentration and less competition, as a consequence limiting consumer and investor choice.

b. Opportunities

On the other hand, we see the benefits of the harmonisation of regulation and supervision. The AFM is very much in favour of strong cooperation mechanisms in Europe. That is why we actively contribute to the workstreams of ESMA, EBA, EIOPA and the ESRB. These newly established institutions have realized some major achievements in their first three years of operation, especially in the field of creating a Single European Rule Book.

In order to illustrate my preceding remarks regarding European regulation, I would like to touch briefly on some current European regulatory projects:

Benchmarks and market abuse regulation

The recent manipulation of financial benchmarks such as Libor and Euribor has shown the importance of up-to-date and consistent international regulation. In a legal sense, the existing market abuse rules did until now not prohibit the manipulation of benchmarks. Yet nobody will question the importance of the integrity of the benchmark setting process. The manipulation of Libor and other financial benchmarks has done tremendous harm. Financial benchmarks are crucial for the pricing of financial instruments such as derivatives and structured finance products, and they exert a direct influence on the value of the underlying financial instruments and other contracts for which they are used as a reference. The manipulation of Libor revealed both the importance and the shortcomings in the process of benchmarks setting. As you will know, a major Dutch bank was involved in the Libor case. The understandable commotion about this in the Netherlands is a vivid illustration of the harm improper behavior can cause to financial firms and to the trust in the financial sector more generally. It also illustrates the need for constant alertness, within firms themselves, at the level of policy makers, and amongst financial supervisors.

In order to come up with European regulation, the European Commission put forward a proposal for regulation of benchmarks. At this moment it is uncertain when this proposal will be implemented. The European legislative process has just started. Meanwhile, principles have been developed by IOSCO and EBA/ESMA, in order to enhance the integrity, reliability and the oversight of benchmarks in the period before the implementation of EU regulation. As a member of ESMA and IOSCO the AFM played an active role in the creation of these new guidelines related to the benchmark-setting process. We support both sets of principles and have put effort to assure that the principles are consistent with each other. We will continue to monitor the EU rulemaking process closely to make sure that this regulation will be effective.

Also, changes will be made to the Market Abuse regulation that will allow future manipulation of benchmarks to be considered Market Abuse. This will give the European securities regulators effective enforcement tools. With the new Market Abuse regulation coming in place in 2016, a more uniform and stronger framework to preserve market integrity and to avoid potential regulatory arbitrage will be shaped. From that moment, market abuse will be a criminal offence in all member states. The new market abuse regime introduces minimum levels of criminal sanctions on the most serious market abuse offences, which have to be transposed into national criminal law in the member states. Criminal sanctions will help to improve deterrence and will facilitate the cooperation of law enforcement authorities in the Union.

Prospectus directive and PRIPS

When looking at certain developments relating to the revised prospectus directive and the PRIPS directive proposal, our concern is that too little attention was paid at the European level to the effectiveness of these new rules. Let me explain.

To make it easier for an investor to compare various types of securities, the revised prospectus directive provided for certain new rules. According to these rules, the summary of, for instance, a prospectus must contain key information prepared in a specific format. These rules must be complied with since a few months. It has not yet been investigated whether these rules have the desired result. It is unknown whether investors have access to this so called 'issue specific summary' and whether they use it to make an investment decision or whether they use it to compare various types of securities. Nonetheless, we understand that the European Parliament now already intends to broaden the scope of the PRIPS directive in a way that, in addition to the issue specific summary, a 'key investor information document' (KIID) must be prepared when offering securities. The AFM is of course in favor of providing investors with key information. However we think that it should be investigated whether the two set of rules have the desired effect. The AFM queries whether the key information document can give the key information of the product offered and insight in its comparability with other products at the same time.

Concluding remarks

Let me conclude. The financial crisis has led to a virtually unparalleled number of regulatory reforms. With these reforms, we should use the opportunity to build a strong and future-proof system of European market conduct supervision. In doing so, we need to create rules that have proper safeguards for market integrity and investor protection and at the same time promote a level playing field. The wider objective of the reforms is to have orderly functioning capital markets that serve the real economy in allocating capital aimed at productive activities and redistributing financial risk. Financial institutions and other market actors should conduct useful activities that carry transparent and acceptable levels of risk. The costs of excessive risk-taking behavior should not be shifted to society. If the requirements of efficiency, transparency, integrity and stability are satisfied, then the capital markets can be relied on to contribute favorably to economic growth and prosperity.