‘Capital Markets United’

*AFME European Public Policy Committee, 4 November 2015 Amsterdam, the Netherlands*

*Gerben Everts, Board member of the AFM*

Introduction and outline

You invited me here today to discuss with you Commissioner Hill’s Action Plan for the Capital Markets Union. It is a work stream of significant importance. It will potentially have a substantial impact on the development of financial markets in Europe. It will - if implemented successfully - affect both market participants and supervisors. It will make Europe stronger, less dependent on bank financing and presumably less susceptible to financial crises.

His initiative reminded me of the Financial Services Action Plan at the very start of this millennium. FSAP was an ambitious plan of the former Dutch Commissioner Frits Bolkestein. Many in the room today are familiar with it. The FSAP created a more harmonised financial regulatory framework for the financial market within the EU with full support of Council, Parliament and industry.

At that time, I was working for the European Commission and was responsible for the coordination of the FSAP, writing the progress reports, preparing the updates for Council and Parliament and reaching out to the industry. Many of you were amongst those I met.

Since, we have an Internal Market for financial services and financial markets. However, it is not perfect; we are not there yet. For a true Internal Market, we need to have it supported by a Capital Market Union in Europe. We need to facilitate the regulatory shift which is needed if we want to be less dependent on bank financing for large and small companies alike. And we need to look at supervision.

Without converged and harmonised supervisory practices we potentially anticipate the third crisis in a row. A playing field where regulation is harmonised, but coordinated supervision is absent and a big stick to sanction those that do not behave does not exist, comes with a high price. We must have learned our lesson after the introduction of the Euro and the implementation of banking regulation. If we want to safe us a next crises and - more importantly - regain trust in the European Union, we must not turn a blind eye to supervision – again. I know this is difficult election-wise, but one needs to be brave and courageous to regain trust. And we should not be naive. The good functioning of the European Union is extremely important for the future wellbeing of all EU citizens.

Action Plan CMU – its relevance

Let me now turn to my thoughts on the relevance of the CMU Action Plan, along the lines of three important topics for the AFM as a conduct of business supervisor. Also, I would be very interested to hear your ideas on how the AFM could further improve its contribution to the establishment of a true Capital Markets Union in the EU.

It is clear that capital markets in the European Union are less developed compared to those, for example, in the US of America. The US is one market, while the EU offers as many as 28. This is simply a heritage from the past; no one can be blamed for that. While the US and EU economies are about of the same size, both European equity and debt markets are still far behind when compared to the markets in the US. However, looking forward, it provides an excellent opportunity.

As I mentioned in my introduction, we share in many parts of Europe an overreliance on bank finance and we suffer from an insufficient supply of financing alternatives. On top of that, the regulatory environment is fragmented. Hence, it is important that the Commission intends to take action in order to eliminate barriers that hamper the free flow of capital. As this is one of the fundamental principles of the European Union, we must seek the momentum. And it’s up to me as a regulator, and you as financial market participants, to support the Commission in that quest.

Particularly for the Dutch economy, deeper and more developed capital markets are key. The balance sheets of Dutch banks are heavily loaded with mortgages with Loan to Values above 100%. It will take some time before LTVs of the mortgage portfolio will decline to more sustainable levels that would facilitate securitization more easily and – as an effect - decrease mortgage interest rates instead of increase them due to higher capital requirements for banks.

Securitization is an important instrument for financial institutions in the Netherlands to free up their balance sheets such that they can continue lending to fund the Dutch economy. Furthermore, with relatively large institutional investors, pension funds and the like, our financial industry is heavily dependent on good functioning capital markets in Europe. Hence we recognise broad support for the Action Plan in the Netherlands.

Action Plan CMU – on content

On the Action Plan itself. The Action Plan contains many new initiatives, revisions and assessments. Most of them are still in a conceptual phase but with delivery dates within the next three years. Of course, the ultimate shape of the CMU is highly dependent on a number of factors, in particular the political situation within the Union. Although the Commissioner has taken a realistic, but ambitious approach, he could have gone further. Unlike the Banking Union, the Capital Markets Union will have to do without a single supervisor at the EU level.

It seems that the CMU will not instigate any substantial changes to the current structure of financial supervision in the European Union, while there is a market-driven logic for further centralization of European supervision. It is also clear that there are significant countervailing powers to such centralization, which are mostly institutional and political in nature.

The most important opposing force is the resistance of Member States to further centralization of capital markets supervision - or even ‘more’ EU in general. Individual Member States have their own national capital markets and they are sometimes unwilling to yield supervisory sovereignty to a more centralized entity. In my opinion, this is a missed opportunity. If we want to build a truly integrated capital market in the European Union, it should be accompanied by a single supervisor overlooking the entire Union.

There are already several areas of supervision that could quite easily be transferred from national to European level, for example supervision on the financial markets infrastructure such as in the field of clearing and settlement, CCPs and CSD’s, as well as trading platforms, but also supervision on audit firms, financial reporting and market abuse. Although small steps have been taken in the past years, such as the creation of the European Supervisory Authorities, we have not seen a big bang in the area of capital markets as we did see in the Banking Union. And, like a stated at the start, it is better to recognize this need for strong supervision in anticipation than ex-post of a next crisis.

Now I will reflect in more detail on what is actually in the plan. I will elaborate on three topics that are of special interest to the AFM and that will come up in the short term. First, one of the most important elements of this CMU Action Plan: an ambitious revision of the Prospectus Directive. The second topic is the securitization proposal given the importance of this instrument for the funding of Dutch banks. The third topic is the important role of ESMA in strengthening supervisory convergence.

However, the CMU debate should not just focus on jobs, growth and investment. As we stressed to Commissioner Hill when he visited Amsterdam, confidence of investors is an essential building block of the Capital Markets Union as well. As such, an appropriate level of investor protection should be included in the objectives of each initiative within the CMU. It is a balancing act – like many other topics under our supervision.

*Prospectus*

On the revision of the Prospectus Directive, it appears that the European Commission will present an ambitious proposal. SMEs must be provided better access to the capital markets. Some of the regulatory burden on issuers must be relieved. At the same time some of the other issues that may be currently impacting the Prospectus Directive are reflected upon.

These are all good intentions, which deserve support. However, the original goal of the Prospectus Directive is to inform investors; enabling them to assess the assets and liabilities, financial position, profit and losses, the prospects of the issuer and of the rights attaching to the securities. It is important to emphasize that this information is supposed to be provided in a comprehensible form, but achieving this goal is a challenge for both issuers and national regulators. Whether investor protection is being hampered is too early to tell, but it deserves careful attention – now and in the future.

What we recognised based on our supervision on prospectuses is that different stakeholders have different interests in relation to prospectuses. For example, frequent issuers see prospectuses as a ‘compliance’ document. This encourages issuers to include a great deal of additional information and disclaimers in the prospectus. They want to avoid liability. However, this may not always be helpful if the goal of a prospectus is focused on the informational value for investors. Investors may be overwhelmed by the sheer amount of information. These issuers may not see the need for any changes to the Prospectus Directive.

We all know that many prospectuses are not read and others not in full. Many retail investors may seek the information necessary for their investment decision outside of a prospectus, for instance in more glossy brochures. Nevertheless, there are prospectuses that appear to be relatively well read. This is especially the case in relation to prospectuses relating to SMEs, shipping, property transactions, smaller investment funds and IPOs. This might be a message contrary to popular belief that prospectuses are never read. This is not true. It is true, however, for particular prospectuses, such as those relating to debt securities and structured products. These prospectuses are often not the source where investors will find the information necessary for their investment decision. There is certainly room for improvement. Our experience is that for instance many smaller issuers often have difficulty meeting the requirements included in the Prospectus Directive. To reflect on the access to our markets for those smaller issuers is an issue which is rightfully addressed in the CMU Action Plan.

One of the challenges for the European Commission, the European Parliament and the Member States is how to deal with the interests of the different stakeholders. Regulation and reaching compromise is an art in itself. This being the case, stakeholders - including you - need to recognize that the Prospectus Directive serves many interests, including some interests that may occasionally conflict. It is my hope that the revision will lead to both better access to the capital markets for issuers, reduced burdens for issuers in the long term and improved investor protection.

*Securitization*

This brings me to another important element of the CMU action plan, securitization. In the past, Dutch banks have often used securitization to fund Dutch mortgages, while other jurisdictions have relied on covered bonds for secured funding, for example. The legislation post-financial crisis demonstrates a relatively gentle treatment of covered bonds, while securitization has been treated as a dangerous instrument regardless of how it is used.

The AFM believes that this imbalance needs to be addressed and adjusted. Not only because securitization can be a useful means of providing financing for the European economy, but because not all securitization is inherently dangerous. As regulator we have to develop a culture in which for our internal considerations we always stick to the facts and ignore biases in our people’s thinking or reflections of non-factual sentiments. Many of you may already be aware that for instance Dutch Residential Mortgage Backed Securities have performed well throughout the financial crisis, despite the high loan-to-value ratios of many Dutch mortgages. Furthermore, market players in the Netherlands have been working to ensure that investors have sufficient information to make their investment decision. This is encouraging to us since this is a message influencing the sometimes too negative sentiments of some other regulators in Europe.

The Securitization Regulation is currently being discussed in the European Council and the hope is that a general approach will be ready by the end of the year. This draft should help to create the conditions to revive the securitization market after the market conditions have changed. The momentum is now; it is economically interesting to use securitization under careful conditions of simplicity, transparency and standardisation. These conditions are needed as we do not want the repackaged bad loans back on our markets. The AFM has noticed that market parties’ chief concern appears to be the structure for the supervision of the criteria for simple, transparent and standardised securitization, otherwise referred to as the ‘STS Criteria’. We must reflect on that carefully, I agree.

Market parties’ concern relates to the fact that the Securitization Regulation includes *ex-post* supervision of the STS Criteria. As such, market parties themselves will be required to assess whether securitization meets the STS Criteria. We have to be careful that this will create unintended uncertainty for the investor, and as a consequence may lead to the Securitization Regulation not being successful in ensuring the viability of securitization as a funding tool. An issue closely linked with the lack of *ex-ante* supervision of the STS Criteria is the lack of a single regulator that is responsible for the STS Criteria. I know that amongst you there are institutions which are afraid that this will create legal uncertainty concerning how the STS Criteria will be interpreted by different regulators. This could theoretically lead to situations in which a national regulator in one Member State would consider a securitization to meet the STS criteria, while a regulator in another Member State would reach a different conclusion. This would not serve the Internal Market well.

While I think that these arguments make sense, there are also interesting counter arguments. The most important counter argument is that investors should not blindly trust regulators or third parties to evaluate securitizations, but instead rely on their own analysis. To me, the interesting question is how we can structure the supervision of securitizations in order to provide market participants with legal certainty, while still mitigating moral risk due to overreliance on national regulators or third parties. It will be interesting to see how this issue will be dealt with in the final proposal. I am sure you are as curious.

*Role of the European Supervisory Authorities in the supervisory convergence*

This brings me to the last part of my contribution, the necessary institutional reform. As I mentioned earlier, the amount of institutional reform under the CMU will regrettably be minimal. However, the Commission will look into a stronger role for the ESAs, and in particular ESMA, in the area of supervisory convergence. But what do we actually mean with ‘supervisory convergence’?

To deliver a well-functioning and integrated Capital Market Union unnecessary legal or supervisory barriers for cross-border funding need to be removed. In recent years, as a reaction on the financial crisis many regulatory initiatives have been launched. These initiatives were aimed at creating a single European rulebook for the capital markets. But more needs to be done. The biggest challenge now is the consistent implementation and supervision of the single rulebook in the different Member States: supervisory convergence. Supervisory convergence is about achieving similar supervisory outcomes by for example developing best practices, common interpretations, joint supervisory priorities etc. The same rules and interpretations must apply across the EU. But supervisory convergence is also about looking each other in the eye and taking strong action in order to ensure that practices are corrected where serious or persistent divergence is detected.

ESMA already plays a pivotal role in this area and will step up its activities in the coming years. There is a lot of pressure on ESMA to deliver all the Level 2 regulatory technical standards and technical advice. But this pressure will decrease and ESMA will have more resources to focus on supervisory convergence. ESMA does already use several instruments to achieve supervisory convergence such as Q&As, opinions, best practices and - specifically mentioned by the Commission - the instrument of peer reviews. The ability to conduct peer reviews is in our view one of the most important instrument for promoting supervisory convergence. By assessing each other’s supervisory approaches and establishing good practices, peer reviews contribute to the quality and consistency of supervision in the EU.

But what if the outcome of a peer review shows that a national supervisor needs to change its supervisory practices or has not fully implemented EU legislation? ESMA has several possibilities to address such an issue, for example by making the outcome of a review public, ‘naming and shaming’, or even to start a so-called Breach of Union Law procedure. But for each of these specific situations, where ESMA needs to ‘sanction’ one of its members, we face a problem within the governance of the ESAs. In the current set-up of the ESAs, the ultimate decision-making body is the Board of Supervisors composed of the Chairs of the national competent authorities. In case ESMA staff finds a so called Breach of Union Law by one or several of its members, it’s the national competent authorities themselves that have to take the decision whether to sanction one of their fellow Board Members. Since changes to the governance of the ESAs can only be done by amending the founding Regulations, this is where the European Commission comes in. A White Paper covering this issue is scheduled for mid-2016 and I’m looking forward to the Commission’s proposals.

Conclusion

Let me conclude. It’s clear that Commissioner Hill’s action plan will have an impact on all of us in the years to come. The plan deserves broad support. But at the same time, and just as important, we are still busy implementing the legislative initiatives from the former Commissioner Barnier. One of the key pieces is of course the revision of MiFID and the Level 2 work by ESMA. We need to see to it that the amount of regulation will remain digestible, both for us regulators and for you, the industry.

Therefore, in the process of creating new legislation, it is important not to do this in isolation but in connection. Of course, the regulatory framework is set by the co-legislators in the EU. They should remain in the driving seat and be responsible for the outcome. However, there are different ways to reach the goals of specific regulations. Listening to the industry in the development of technical standards is necessary. In the end, Europe wants to have regulation in which regulatory goals are achieved on the most effective way. Regulation that works on the ground. Hence we need to remain connected and act in unity - where possible. I will now open my ears and listen to your views on this important regulatory agenda. Thank you for your attention.