Speech, Gerben Everts, Board member of the AFM
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"EU Supervisory Model: Challenges and the way forward"

Bonjour Mesdames et Monsieurs! Je suis très heureux de participer a cette très importante conference aujourd'hui.

Introduction

As the large majority of you, today's audience, is providing the infrastructure, products and services on the capital markets of Europe, I am invited to address my view on these markets. More particularly, I'd like to share my view as a regulator on the current and future European supervisory model. A model that needs to fit, is fair and sustainable, and will allow companies to grow and prosper. Both on the sell and buy side. Both in France, as in all other important marketplaces in the EU.

I'd like to consider the following three questions: First, what are most important lessons we learned since the European Financial debt crisis vis-a-vis Supervision in Europe? Second, what are the most important threats for the current European Supervision model? Third, what adjustments are needed to sustain the EU model for the next 10 years?

The European debt crisis: Responses and (remaining) challenges

First, on the European Debt crisis. This crisis is one of the most significant economic events in the history of Europe. Dramatic in its essence. Since the onset of the financial crisis in 2008, the European economy has had to cope with a series of very negative shocks. The private sector has been in a deleveraging mode for nearly a decade. And also many governments had to make large fiscal adjustments to ensure their debts remained sustainable.

At the same time, a decade later, we're still standing. To counter the crisis, the European Central Bank successfully eased monetary conditions. Through various programs, including an asset purchase programme, known as Quantitative Easing. By lowering long-term interest rates, the asset purchases have helped to further loosen financing conditions for household and firms. Unprecedented actions that served its purpose. However, ultimately the rescue comes with a price. An enormous bill is tenderly redirected to future generations. Reforms are urgently required if we want to maintain at least some solidarity between generations and nations alike.

As regulators we have worked hard on revamping the European regulatory framework. We had to improve the resilience of the financial system. Regulators have forced banks to hold more capital and have deeper, more resilient sources of liquidity.

The establishment of the Single Supervisory Mechanism and the move towards a Banking Union has made the banking system safer in Europe. To tackle the systemic implications of individual institutions and infrastructures, authorities are putting in place better resolution regimes. This in order to prevent a trail of devastation if one systemically important entity fails to comply.

Measures are also being taken to contain the financial stability implications of excessive leverage. As banks have become less complex and more focused, they are lending relatively more to real households and real businesses and less to each other.

A series of measures is eliminating fragile forms of shadow banking while reinforcing the best of resilient market-based finance, like securitization of simple products. And improvements in the market infrastructure are simplifying the previously complex – and dangerous – web of exposures in derivative markets.

In addition, the revamping of the regulatory framework (like EMIR) has driven the shift of financial transactions to central counterparties (CCPs). I am sure many of you invested a lot of time and effort in the implementation on the ground. Perhaps with some second thoughts on added value. And of course, regulation is never ideal in one go.

However, I'd like to thank you for all efforts to collectively make the ecosystem of the capital markets in Europe more safe and sustainable. Market risks and failures will continue to become reality – but by building a stronger and better regulated ecosystem, we try to prevent that markets themselves will fail to function.

Another important initiative to stimulate the European Economy is the launch of European Commission's action plan for the Capital Markets Union (CMU). The CMU aims to stimulate investments through non-bank funding, creating new jobs and stimulating economic growth. Ultimately, the CMU will strengthen the competitiveness of European capital markets on a global level. If we want to keep the welfare we now have, we simply need economic growth and remain competitive. We cannot turn our back to this simple reality.

The action plan contains many initiatives, revisions and assessments and in my view 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 crisis.

Where are we now?

So after a dark decade, it seems there is light at the end of the tunnel. First, there are some signs of rebound in activity. Global GDP growth is projected to pick up modestly to around 3.5 % in 2018, from just under the 3% in 2016. Business confidence has improved, the recent fear of deflation is no longer the talk of the town and there is an improvement in employment.[1] In the aftermath of the US elections, market sentiment has shifted considerably, reflecting expectations of higher economic growth and inflation in the US. Perceptions of a regime change in the US have

[1] Source: BIS quarterly review, March 2017, OECD Interim Economic Outlook, March 2017.

triggered what is being called a "great rotation" out of bonds into other asset classes. With a strong emphasis on lower taxes and fiscal spending, increased protectionism and deregulation of markets. The well-known ingredients for a Financial Soufflé. Which might be extremely tasty – if done well. If not, it can be a sticky mess as well.

Another trend is the rise of market-based funding. The broad measure of the market-based funding market in the EU, comprising total assets of investment funds and other financial institutions, amounted to €40 trillion at the end of the third quarter of 2016.[2] What you call a market with significant size.

Challenges

The question comes up: is the market now stable and sound? Although improvements were made, the answer is negative. There is a risk of complacency and self-delusion:

1. What we can see is that low interest rates and excessive risk taking have contributed to very high asset valuation, compressed risk spreads and term premiums. This stimulated the growth of the non-bank-sector, boosting leverage and homogeneity. This is clearly a risk going forward.
2. Global long-term interest rates remain at historically low levels. This means that if recent policy trends continue, there is an ever growing scope for further increases and sizeable valuation losses for long-duration fixed income investors.
3. Long-term interest rates may also lead to a re-emergence of market concerns about public and private sector debt.
4. Furthermore, one has to anticipate guaranteed losses for fixed income products over the full life-span of existing and newly sold products. How to explain that as an asset manager to the ultimate owners? What will be your added value, if the only added value is a loss guarantee on this trench of the asset mix?
5. The interconnectedness between market based financing and financial institutions due to financial engineering is a risk. A lack of information and disclosure on procyclical elements, leverage and liquidity risks impede systemic risk monitoring.
6. More generally, political fragmentation could undermine reform efforts at the national level and pose challenges for the governance of the EU.
7. And last but not least, without converged and harmonized supervisory practices, we potentially anticipate the third crisis in a row. A playing field where regulation is harmonized, 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 the banking union, we must not turn a blind eye to the need for converged and strong supervision again!

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[2] Source: ESRB

The way forward

As the financial crisis has showed us that supervision is important, I want to take a closer look at the current European supervisory structure and the efforts to improve this structure. The European Supervisory Authorities (the "ESAs": EBA, EIOPA and ESMA) are an important cornerstone of the institutional supervisory framework in Europe. They were created in response to the financial crisis. Their mandate is to contribute to developing the Single Rulebook, solve cross-border problems and promote supervisory convergence.

The European Commission started a public consultation on the operations of the ESAs last month. The focus of this consultation is on four broad categories of issues: 1. Tasks and powers of the ESAs; 2. Governance; 3. Supervisory architecture; and 4. Funding. In my opinion, the ESA Review is a very good document. I can highly recommend it to you – to read and to respond to it. As the scope of the ESA Review is very broad, I can only discuss a few elements with you this morning. I will focus on supervisory convergence, direct supervisory powers and the supervisory architecture.

Supervisory convergence

ESMA and the other two ESAs have worked hard in the six years of their operation at creating a single European rulebook for the capital markets. The biggest challenge in the years ahead 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 - peer learning, developing best practices, common interpretations and joint supervisory priorities. 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. The ESAs need to step up their peer review work.

Let us take ESMA as an example. The last few years, ESMA has been very busy with drafting level 2 regulation for Market Abuse and MiFID II. Most of this work is finished by now. Consequently, ESMA will have more resources to focus on supervisory convergence. ESMA already uses several instruments to achieve supervisory convergence such as guidelines, Q&As, opinions, best practices and the instrument of peer reviews. The ability to conduct peer reviews is in my view one of the most important instruments for promoting supervisory convergence and to contribute to the quality and consistency of supervision in the EU.

Supervisory convergence becomes even more important in the next two years when we are dealing with Brexit. The decision by the UK to leave the EU may lead to supervisory convergence risks among national supervisors. Market participants may seek to relocate (part of) their activities from the UK to the EU before March 2019 in order to make sure to continue benefiting from the European passport and unrestricted access to the single market. This may lead to increased competition between Member States to attract business from the UK. It is not difficult to predict that in the absence of enhanced supervisory cooperation the risk of regulatory arbitrage is just around the corner. It is therefore important that ESMA and the NCAs develop a common convergence framework to address the arbitrage risks in some essential areas of the European capital markets.

What is ESMA doing on Brexit? ESMA is currently working on a general opinion on cross-cutting issues along with three specific thematic opinions which will be published before the summer. The general opinion will cover issues such as how NCAs should ensure on-going effective supervision of re-located activity, in particular when certain functions are subject to outsourcing and delegation. The three specific opinions will address in more detail the areas of asset management, investment firms and secondary markets.

In my opinion, these efforts by ESMA to strengthen supervisory convergence in response to the Brexit are very important and absolutely necessary. It touches upon the very nature of the existence of ESMA. If we cannot get our act together and come to common positions, this would mean a step backwards in terms of integrated European supervision.

Direct supervisory powers

The biggest challenge in the years ahead is consistent implementation and supervision of the single rulebook. There are various methods to tackle this challenge. For instance by developing best practices, common interpretations, joint supervisory priorities and supervisory convergence. A more radical solution is further centralization of European supervision. In order to achieve this goal, the EU could start with the areas that are most promising and produce most potential gains. The most likely candidates are areas where the business is principally European and of a cross border nature. Supervision on a European scale is very likely to lead to an increase in efficiency or effectiveness here. In addition, the current EU Passport system could be evaluated and where possible improved, however without deterioration of the current benefits like free movement of goods and services.

There are significant countervailing powers to such centralisation of supervision. 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. Of course, this is an evolutionary process and should be done step by step. In the current situation, ESMA only has direct supervisory powers for credit rating agencies and trade repositories. Other areas where direct supervision at a European level could be considered are clearing (CCPs), data reporting (DRSPs) and for the mid/long term also financial reporting. More direct supervision at the European level could help to overcome market fragmentation and benefit the integration of the capital markets.

In this context, Brexit may be a blessing in disguise. Now that a champion of national sovereignty will be leaving the EU soon, the opposition to more direct European supervision will lose a key supporter. It also gives the opportunity for the EU-27 to show how dedicated we actually are with regard to a real Capital Markets Union and ESMA as a strong European supervisor.

Supervisory architecture

The current institutional framework of the ESAs mirrors the traditional tripartite nature of the financial industry (banking, insurance/pensions and securities). It is questionable however whether this institutional framework is still aligned with how the financial markets have evolved over the last ten years and whether this structure is the most effective one for the next decade. Financial markets have become more interconnected, products have become more complex, financial innovations and new technology pose a challenge to the traditional financial industry. In this environment, we need to evaluate whether the current supervisory framework is still the best one for the near future.

Concluding remarks

In conclusion, my recommendations for the way forward are:

- if we want to maintain our welfare, we need economic growth and be competitive as EU markets;
- if we want markets and market players – both buy and sell side - to prosper in a sustainable way, we need to prevent a third crisis;
- therefore we need good regulation and good supervision and prevent the pendulum to swing back and erase the lessons learned;
- we can only take a step closer towards a CMU if we strengthen supervisory convergence and tools like peer reviews;
- more centralization of European supervision will boost ESMA's credibility as a EU supervisor;
- and last but not least, we need to enhance the cross-sectoral dimension of European financial supervision by aligning the institutional framework with how markets have evolved. I invite all of you to respond to the Commission's important consultation in the upcoming month.

Je vous remercie pour votre attention et je vous souhaite une bonne continuation de cette conférence.