Working towards open and sustainable capital markets in Europe that serve the real economy - next steps for the CMU

A contribution by The Dutch Authority for the Financial Markets (AFM)

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The Dutch Authority for the Financial Markets

The AFM is committed to promoting fair and transparent financial markets.

As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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Preface

The Capital markets union (CMU) is a flagship European initiative to strengthen capital markets in the EU. The CMU's main objective is free movement of capital to support economic growth and financial stability. CMU measures are aimed at deepening and integrating cross-border capital markets (increasing the size of markets, enabling more liquidity and efficiency, and providing protection from potential future shocks in the economy) and at reducing European (EU) dependence on bank financing by stimulating market-based finance. Many of the legislative proposals from the European Commission's Capital Market Union Action Plan from 2015[1] have been adopted by the European Council and/or European Parliament, such as those on prospectuses,[2] securitisation,[3] personal pensions,[4] and the European system of financial supervision (ESFS). Some of these legislative proposals have only been recently implemented, or still have yet to enter into force. Therefore, it is too soon to judge the success of these pieces of legislation.

Last year, the Ministers of Finance of France, Germany and the Netherlands launched an initiative to give an extra boost to the CMU. They set up a joint working group to report on recommendations for deepening the CMU. The working group's final report – which was published on 9 October 2019 - was intended as input for the new European Commission (EC).

Further development of the CMU could lead to more financing options for companies and investment opportunities for consumers. Further integration could increase market efficiency and will lead to more risk diversification, which should benefit EU consumers and EU companies, especially Small and medium-sized enterprises (SMEs). National capital market issues also often require an EU solution and the CMU is the ideal forum to provide such solutions.

The Dutch Authority for the Financial Markets (AFM) fully supports the objectives of the CMU and encourages the EC to continue its efforts to further strengthen the CMU by striving for liquid, transparent and accessible EU capital markets. A healthy financial system breathes with two lungs: 1. a robust banking system, and 2. resilient and diversified capital markets. It is key for the EU to keep working on stronger integrated capital markets in order to avoid over-reliance on the banking system. The AFM encourages the regulatory efforts taken so far.[5] However, Europe's financial system is still very much dependent on banks and the strong home-bias in bond and equity markets indicate that markets are not yet fully integrated.

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[1] The action plan covers six areas: (1) financing for innovation, start-ups and non-listed companies; (2) entering and raising capital on public markets; (3) facilitating long-term investment; (4) fostering retail and institutional investment; (5) facilitating securitisation; and (6) facilitating cross-border investment. In June 2017, the Commission published a mid-term review taking stock of the progress so far and adding new priorities to its CMU action plan (European Commission, 2017).

[2] Regulation (EU) 2017/1129

[3] Regulation (EU) 2017/2402

[4] COM/2017/0343 final - 2017/0143 (COD)

[5] MIFIDII, EMIR, CSDR, UCITS, EuVECA, ELTIFs, AIFMD, PR, STS, MAR, IFR, CRAR, BR and SSR

The current global disturbance, as a result of the outbreak of Covid-19, makes the case for a CMU even stronger. With markets being in turmoil the need for highly integrated markets, with deep liquidity and available unlocked capital flowing freely, becomes even more compelling.

The AFM wishes to contribute to the debate by sharing its views on the way forward. Given our role in the regulatory and supervisory framework we will focus primarily on supervisory aspects of the capital markets and issues related to investor protection, sustainable financial markets and pensions. **In this contribution we first set out our main priorities for the CMU, followed by annexes presenting some additional considerations.**

Recommendations

The AFM makes the following recommendations:

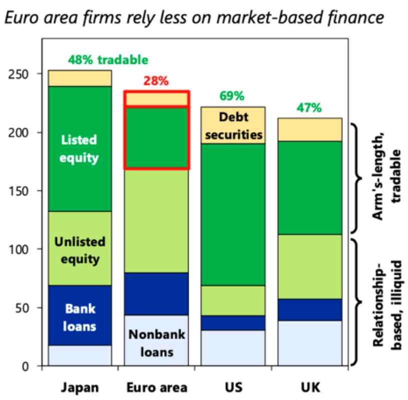
- **Chapter 2**: The AFM supports initiatives that preserve the EU as an open and attractive place for financial services companies to conduct business, also for companies outside the EU.
- **Chapter 3**: Given the AFM's positive experiences over the past six years, the AFM encourages the EC to ask ESMA to explore a European ban on inducements.
- **Chapter 4**: The AFM suggests that member states build up an adequate and sustainable pension system that will help retail investors to indirectly enter the capital markets by means of savings for their retirement. This will also strengthen the capital market union and increase funding options for companies across Europe. It would be worth exploring both public (pillar 1) and private sector options to improve pension adequacy in member states with less developed pension systems.
- **Chapter 5**: The AFM supports the work carried out by the European Commission under the EU Action Plan on Financing Sustainable Growth, encourages the convergence of regulatory standards, and calls for attention to the consistent implementation of such standards in the EU. Since transparency is key for the functioning of the financial markets, more and better reporting of non-financial information by companies should be encouraged.
- **Chapter 6**: The AFM encourages the EC to analyse both the positive and negative aspects of the current passporting system and to look for solutions that will empower NCAs to effectively protect investors domestically. If appropriate ESMA could also be granted additional powers to effectively enforce supervisory convergence in this area.
- **Chapter 7**: The AFM proposes to develop a standardised method of assessing the effectiveness and allocation of supervisory powers that can be used in the review of existing regulation and during the development of new regulations.

1. Current state of the CMU

In September 2015, the EU launched an action plan on building a single market for capital: a Capital Markets Union. Together with the Banking Union (BU), the CMU could help to facilitate cross-border capital flows and sustain investment in EU Member States suffering major economic shocks, thereby strengthening the EU economy. The CMU aims to: 1) provide more funding sources for businesses, especially for small and medium-sized enterprises (SMEs) and thus to reduce dependence on bank lending, 2) to increase investment options for retail and institutional investors, and 3) to enhance cross-border investments. The original CMU action plan sets out 33 actions, which aim to establish the building blocks of an integrated capital market in the EU by 2019.

Five years on, the work on the CMU has raised awareness of the importance of market finance for Europe's financial system and the competiveness of its economies, but much remains to be done to facilitate a diversified range of financing resources.
European capital markets are still relatively small and are sharply divided along national lines. European businesses are heavily dependent on banks for their financing needs. A recent report published by the IMF shows that about 40 percent of EU households' savings are held as bank deposits, compared with 10 percent in the United States. Bank assets are 300 percent of GDP in the euro area, dwarfing the United States 85 percent of GDP but below Japan's 500 percent. Listed equities stand at 68 percent of GDP, well short of the United States' 170 GDP and Japan's 120 percent.[6] The IMF also reports that only 30 percent of the sector's financing comprises tradable instruments in the euro area, versus two-thirds in the United States (**figure 1**; source IMF (2019)). Another study conducted by the Association for Financial Markets in Europe (AFME) shows that 88 percent of companies' new funding came from banks and only 12 percent from capital markets in 2018. This is a 2 point decrease from the average 2013-2017.[7]

Figure 1: Nonfinancial Corporations' Funding Structure 2017 (% of GDP) (source:



Sources: Haver Analytics; and IMF staff calculations.

Also, the share for alternative funding sources, such as venture capital (VC) and private equity (PE), is still very limited in the euro area. CEPS reports that as of the end-2017, VC investments stood at 0.04% of GDP and PE investments at 0.44%. Compared to the US, VC and PE is much less developed in the EU, meaning that European companies receive far less access to early-stage equity funding than their US counterparts (**figure 2**; source CEPS (2019)).[8]

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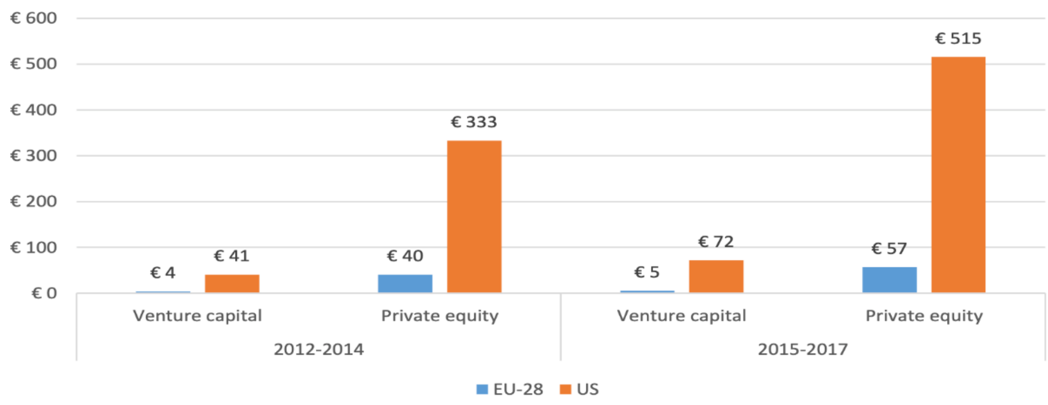
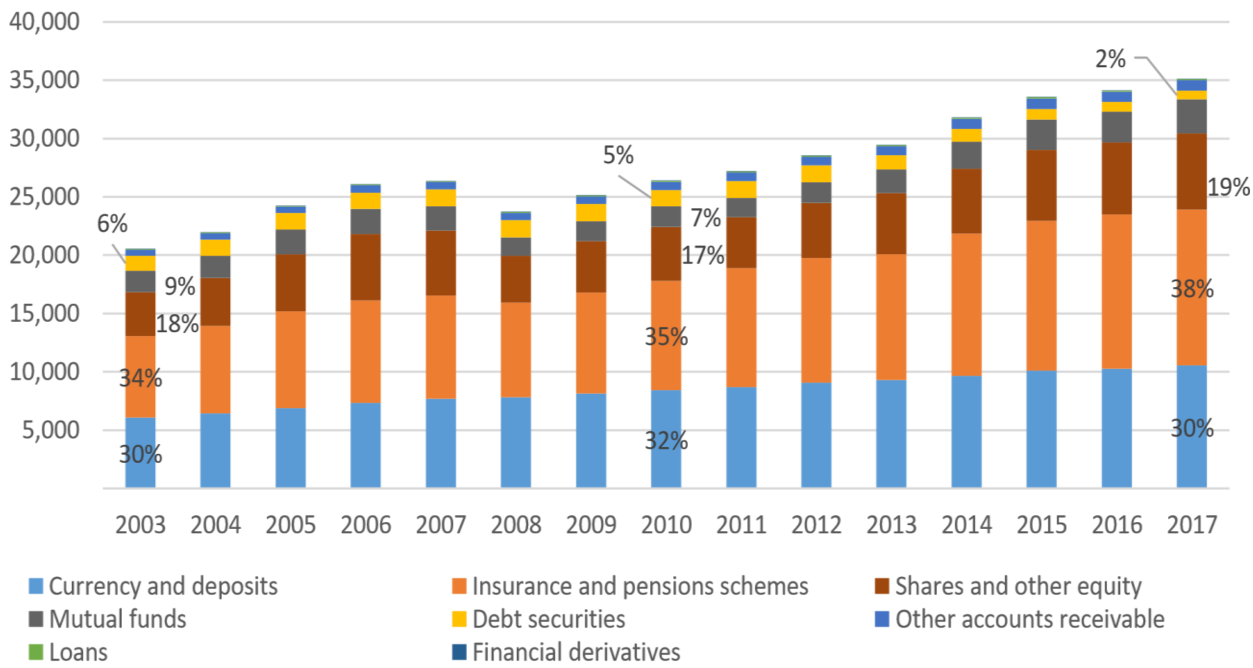
[6] IMF (2019), *'A Capital Markets Union for Europe'*, www.imf.org
[7] AFME (2019) *'Capital Markets Union - Key Performance Indicators (second edition)'*, www.afme.eu
[8] CEPS (2019), *'Rebranding Capital Markets Union A market finance action plan'*, www.ceps.eu

Figure 2: Average amount of invested by Venture Capital and Private Equity, EU-28 vs US (EUR Billion) (source: CEPS)



CEPS also reports that despite the significant increase in EU financial assets since 2003 a rather small proportion is channelled through the capital markets (**figure 3**; source CEPS (2019)). In comparison to the US, where 12% of the US household assets are held in cash and bank deposits, 30% of the total EU household assets are held in cash and bank deposits. On the other hand, European households invest an average of 21% of their assets in equity and debt securities compared to 41% in the US. Also, this composition of household financial assets varies considerably across member states. In some European countries a large proportion of the assets are held in currency and deposits, while others have invested a much larger proportion in Insurance and pension schemes.

Figure 3 EU-28 household financial assets (EUR billion) (source: CEPS)



Source: Eurostat.

To breathe new life into CMU, a group of high level experts was tasked by the Ministers of Finance of France, Germany and The Netherlands to propose a strategy to accelerate the integration of the European capital market five years after the launch of the CMU: the "*Next CMU high-level Group".* [9] Since 2015, geopolitical, social and economic developments have proved challenging, reinforced further by an expected Brexit. The Next CMU group concludes that these developments create a strong sense of urgency. In their report the experts highlight the following trends: 1) Shock absorption capacity: the EU needs more risk sharing mechanisms through the financial markets to increase its asymmetric shock absorption capacity, 2) Digital finance: like artificial intelligence and block chain technology, trigger significant opportunities to create pan-European access to finance and improve efficiency, 3) Aging population: 18% of older people in the EU remain at risk of poverty and social exclusion, 4) Funding: a more diversified funding system is needed to support citizens' and companies' needs, 5) Sustainability: society and the financial sector are becoming more aware of climate change, which could be a powerful transformation tool, 6) Competitiveness: removing cross-border barriers and encouraging consolidation of the EU market players will increase their competitiveness, 7) Brexit: Brexit will cause European markets to become more fragmented.

Following on from these developments, the Next CMU group recommends the following main objectives**:** *i) Adopting and promoting a capital market that offers savings products to serve citizens' needs and that allocates capital to value-creating investments in the real, innovating and sustainable economy. ii) Building/strengthening an integrated, competitive, deep and liquid European Capital Market, to maintain the EU as one of the world's top 2 financial centres.*

The AFM fully supports the ongoing work by the Commission on the establishment of a Capital Markets Union and believes the Next CMU high level Expert Group's recommendations form an excellent base for further policy discussions. In our role as a regulator we would like to highlight four topics:

1) An open and integrated European capital markets-facilitating cross-border financial flow and a Capital market that remain attractive for foreign investment. This is a necessary precondition to increase investment and financing opportunities and risk sharing.
2) Stimulating long-term participation by increasing direct and indirect retail participation.
    a. Given the AFM"s positive experiences over the past six years, the AFM encourages EC to ask ESMA to explore a European ban on inducements.
    b. Building up an adequate and sustainable pension system will help retail investors to indirectly enter the capital markets through savings for their retirement. Larger retail participation must go hand in hand with improved investor protection and transparent capital markets.
3) The role of Capital Markets in the transition to a sustainable economy. The transparency, level of standardization and the reliability of information on sustainable financial products

[9] www.nextcmu.eu

and more and adequate information on the sustainable performance of corporations is crucial for the efficient allocation of financial investments in a sustainable economy

4) High degree of supervisory outcomes, irrespective of where investors are located and from which country the product and/or service is offered. We ask the European Commission to consider the following options: 1) to evaluate both the positive and negative aspects of the current passporting system, and 2) to look for solutions that will empower NCAs to effectively protect investors domestically. If appropriate, ESMA could also be granted additional powers to effectively enforce supervisory convergence in this area.

2. A truly integrated and open EU capital market

The integration of the European capital markets is challenged by the creation of new barriers. While everyone seems to agree that we need to push for further integration, we note that in certain areas new barriers are being created which could have a negative impact on the efficiency, liquidity and accessibility of financial markets.

The Capital Markets are in effect a diverse ecosystem comprising a variety of different firms and actors. It is a diverse financial ecosystem with trading venues, liquidity providers, brokers, retail and institutional investors, benchmark providers, and so on. It is essential that new rules and regulation cater for such a variety of firms, otherwise they will act as a barrier to the smooth and efficient functioning of the financial ecosystem. A well-functioning capital market union with an appropriate set of regulatory rules will offer companies a true alternative to bank-based financing, creating a healthy form of competition with the Banking Union.

One of the aims of MiFID II and EMIR is to make trading more transparent by moving it to trading venues, for example. Adequate and transparent price formation is essential for the proper functioning of these markets. It is a requirement under MiFID2 that platforms have a certain amount of liquidity in order to facilitate the price formation process. Proprietary traders often fulfil this role. Together with many other investment firms, such as asset managers, they make up the 'ecosystem' needed for well-functioning capital markets. The AFM welcomes regulatory initiatives such as the Investment Firm Regulation/Investment Firm Directive; a new regime for capital requirements tailored to the business model risks of investment firms.

The availability and accessibility of trade data to retail and institutional investors could be further improved through the establishment of a non-profit, post-trade consolidated tape for equity instruments.

It is key that the European capital markets remain open and attractive for financial services companies from countries outside the EU. The interaction between European capital markets and the global capital markets is important and will become even more so when the UK leaves the EU. EU capital markets should be an attractive destination for investments from countries outside the EU. They should remain accessible for third country actors such as asset managers and market makers without compromising the integrity of the Single Market. One way this is organised is by way of equivalence regimes, which are part of the varied EU Directives and Regulations. The basis for such regimes is that regulatory and supervisory standards in the third country are deemed to be of the same standard as those in the EU. However, the different equivalence regimes currently vary widely. In our view the equivalence regimes should strike the right balance between a level playing field and an open and attractive European Capital Market.

3. Stimulate retail participation in European capital markets

There is a significant need as well as high potential for the increased participation of retail investors in EU capital markets. As mentioned in the previous chapters, EU investors' overall participation in capital markets is relatively low. However, the demographic changes across the Union require larger retail participation. At the same time, retail participation increases the opportunities for SME funding.

A key element to achieving stronger participation among retail investors in capital markets is to provide them with more cost effective, simpler financial products and fair advice. As indicated by ESMA in its study on the performance and cost of retail investment products in the EU, there are currently large differences in the regulatory framework in the area of product and advice costs across the Union, mainly due to national discretion.[10] Furthermore, since the financial crisis a lack of trust has continued to deter consumers from engaging in the EU capital markets. Improving advice and making products simpler and more cost effective is a fundamental step towards restoring that trust of the EU's citizens in the financial services industry.

In order to increase the level of investor protection, the Netherlands introduced the ban on inducements six years ago. Inducements, also known as 'commissions', 'provisions', 'retrocessions' or 'kick-back fees', are payments by third parties to distributors or advisers related to their provision of portfolio management, execution only services or investment advice services to its underlying clients. As laid out in legislation, the underlying principle for prohibiting inducements is that investment providers must act in the best interests of their clients.

In the Netherlands, the ban on inducements has encouraged the introduction of more cost-effective investment products and has reduced conflicts of interest in advice. This is reflected in – among others – two recently published independent studies: the Morningstar Global Investor Experience Study 2019: Fees and Expenses on Funds and ETFs in which the Netherlands earns a Top Fees and Expenses Grade (third time in a row) as a result of "investor-friendly regulations that prohibit front loads and trailing commissions"[11], and in ESMA's first Annual Statistical Report 2019.

Another consequence of the inducement ban is the increasing differentiation between service concepts. Customers previously had two main choices: doing everything themselves - 'DIY investing' or 'execution only investing' - or seeking bespoke advice. These days customers have more choice. Increasingly, service concepts that offer significant additional value compared to DIY investing are being introduced. Examples include 'guided execution only' and more cost effective portfolio management propositions, without being as comprehensive and expensive as bespoke advice. The AFM trusts that the ban on inducements allows innovative technology developments, which have been visible in the Netherlands through the fast growth of robo advice concepts. This

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[10] ESMA (2019), *'ESMA Annual Statistical Report 2019, Performance and costs of retail investment products in the EU'*, www.esma.europe.eu

[11] Available at: www.morningstar.com

form of investment management is more cost efficient than bespoke advice and is often available from as little as EUR 1000 upwards. As with traditional advice, robot advice and portfolio management through robot advice also need to treat customers fairly.

The ban of the inducements has also increased competition between product manufacturers. This is in part because distributors are incentivized to offer passive products without retrocession payments next to the active segment, also without retrocession payments. The Netherlands is also seeing stronger growth in passive products than many other European countries. These lower costs are reflected both in the aforementioned ESMA Report and the Morningstar Study. Annual consumer surveys conducted by the AFM show that in the three years following the introduction of the ban the percentage of consumers receiving financial investment advice remained fairly stable (a decline of 3 percentage points), while the provision of (online) portfolio management services grew (by 10 points). The inducements ban has also improved the quality of advice because of the aligned interests of advisors and investors.

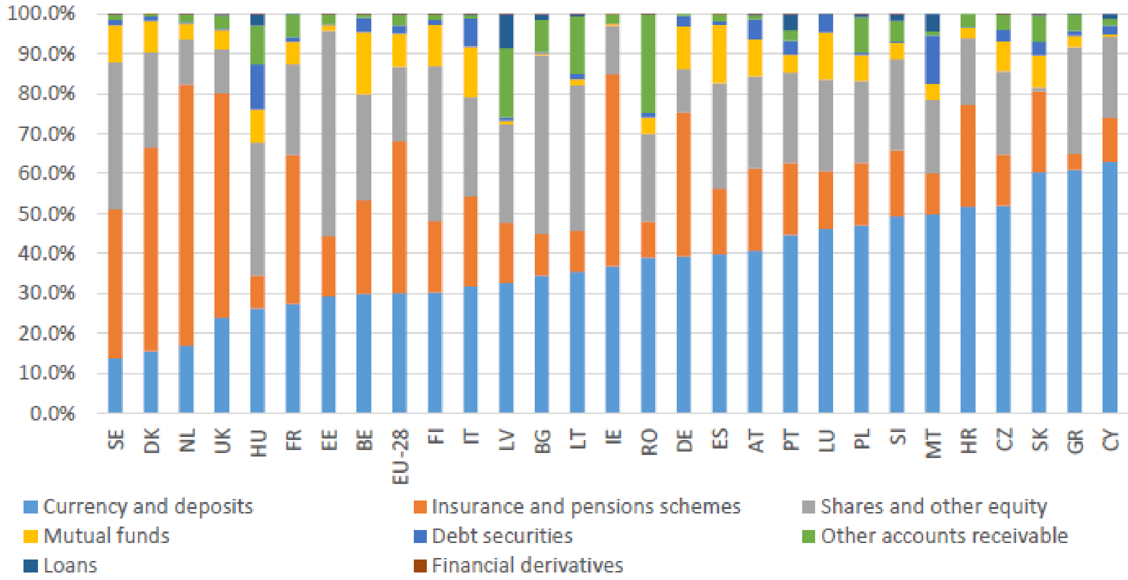
To sum up: while MiFID II introduced more transparency to the European Capital markets, the divergence of costs around investments in the Union is still very high. However, lower fees stimulate retail participation. A ban on inducements leads to lower costs and firms are incentivized to act in the interest of the retail investor and provide a more cost efficient, diverse offering. This strengthens the capital market union and increase funding options for companies across Europe.

Recommendation: Given the AFM's positive experiences over the past six years, the AFM encourages the EC to ask ESMA to explore a European ban on inducements.

4. Pensions

There is a positive correlation between a developed asset management sector and capital markets. Countries that have developed insurance and pension schemes generally also have a more developed capital market. Currently, the composition of household financial assets varies considerably across member states (**figure 4**; source CEPS (2019)). In the EU, household financial assets are driven mainly by holdings in cash and deposits together with investments in insurance products and pension schemes.[12]

Figure 4 EU-28 household financial assets across member states (end-2017, % of total financial assets) (source: CEPS)



Source: Eurostat.

Taking a closer look at pensions, we see a diverse landscape in Europe. This ranges from industry-wide collective pension funds to extensive pay-as-you-go systems (PAYG system) and pension systems dependent on individual contracts. In the second pillar, the EU has set rules for minimum harmonization in the shape of the IORP directive. In a more far-reaching move, the EU has adapted the PEPP regulation which gives shape to the third pillar pension system in European member states. The PEPP regulation is accompanied by opportunities and challenges.

The PEPP regulation gives consumers in Member States with a less developed pension system the opportunity to start saving more for their retirement. Member States that have predominantly a PAYG system could also use the PEPP regulation to shift towards more capital based pension savings. And even for Member States with a capital-based system, this could offer opportunities for some consumers that are not covered by their mandatory pension system. The EC expects PEPP products to add a substantial amount of pension savings. These savings will typically be long term in nature and can be invested in the capital market. The PEPP regulation will also allow for PEPP providers to extend their business to other Member States and to export pension expertise from one Member State to another.

[12] CEPS (2019), *'Rebranding Capital Markets Union A market finance action plan'*, www.ceps.eu

While it is hard to predict how PEPP products will take off, there are some challenges ahead. The first is in persuading consumers to save for their pension on a voluntary basis. The behavioural challenges for consumers to look into the long term, especially when this might span decades, are well documented in various studies. The PEPP providers could learn from the incentive mechanisms and nudges that are in place in other markets or in the second pillar in certain Member States. Additional challenges lie in the different fiscal regimes between Member States, which might hamper the portability of the PEPP product. Other differences between Member States stem from social and labour law which might impose requirements on PEPP products. Perhaps the biggest challenge right now is the low interest rates which have substantially increased the price of a pension income, making capital-based pension rather unattractive.

A different approach would be to strengthen the capital based second pillar in individual Member States. Various Member States already have substantial second pillars with strong incentive structures which force consumers to save for their retirement, ranging from mandatory participation to auto-enrolment to large fiscal incentives. The involvement of a natural partner in the employer means that this could reach a large number of consumers, allowing the pension providers to exploit economies of scale. Those structures may well serve as an inspiration for other Member States, as they could help retail investors to indirectly enter the capital markets through savings for their retirement. This will also strengthen the capital market union and increase funding options for companies across Europe.

Recommendation: While we fully acknowledge that pensions and tax regimes are national prerogatives, the AFM recommends that Member States build up an adequate and sustainable pension system that will help retail investors to indirectly enter the capital markets through savings for their retirement. This will also strengthen the capital market union and increase funding options for companies across Europe. It would be worth exploring both public and private sector options to improve pension adequacy.

5. Sustainable financial markets

Fostering more sustainable private investments has been identified as a key priority of the Capital Markets Union's mid-term review. The Action Plan on Financing Sustainable Growth launched by the Commission on the March 8, 2018 lays out a roadmap to deliver on this commitment. Its key actions include establishing a clear and detailed EU classification system – or taxonomy – for sustainable activities, introducing disclosure obligations on how institutional investors and asset managers integrate environmental, social and governance (ESG) factors into their risk management processes and creating a new category of benchmarks comprising low-carbon and positive carbon impact benchmarks. These actions will contribute to provide investors with better information on the carbon footprint of their investments.

Capital markets play an important role in the sustainability transition. It is important for investors in green products that they have access to sufficient and reliable information about the risks arising from sustainability. The development of standards for what may be called 'sustainable' reduces the risk of 'greenwashing' (the improper use of the term 'sustainable'). Investors will then be more inclined to participate in sustainable products. On the one hand, this will lead to new financing options for sustainable initiatives and, on the other, to new and reliable investment opportunities.

Transparency is essential for the functioning of financial markets and could be further improved by transforming the non-binding guidelines on reporting non-financial information into binding and enforceable legislation. Investors increasingly require information on more than the financial performance of companies alone. With integrated reporting, companies present relevant financial and non-financial information in an integrated report for investors and other stakeholders to use in their investment decisions. Transparency about non-financial information is an important precondition for the realization of international sustainability goals. Since better availability of information to investors can lead to capital flows into companies, this could result in a valuable contribution being made to the transition to a sustainable society and economy.

More and more investors and issuers are interested in sustainable financial products and financial institutions are developing an increasing number of financial products and services that address sustainability. For example, the market for sustainable bonds has grown rapidly in the past couple of years. Since the issuance of the first green corporate bond in 2007, the total volume of sustainable bonds issued exceeds USD 500bn today (based on CBI data). From 2014 to June 30, 2019, 73 sustainable bonds were issued under AFM supervision with a total nominal amount of €45.6bn. This includes the debut green bond by the Dutch State Treasury agency of € 6bn by mid-2019. This bond is the first green sovereign bond ever to be given an AAA rating.

The transparency, level of standardization and the reliability of information on sustainable financial products are currently inadequate. For instance, even though ESG ratings are becoming increasingly relevant, credit rating methodologies have not yet fully integrated environmental factors.

The moment that an ESG rating is lowered, at the time of writing, has no repercussions for the product's credit rating and sustainability label. Furthermore, without clear uniform definitions and criteria, issuers will be tempted to lower the threshold of sustainability criteria to meet the growing demand of investors (greenwashing). This could be detrimental to the reputation of and confidence in sustainable financial products, and could weaken the growth and potential of this market.

By improving the quality, availability and accessibility of information on 'sustainable' financial products and by applying standardized ratings on these products, the risk of greenwashing can be diminished and more capital may be unlocked from conscious investors. It will provide investors with new and reliable investment opportunities. Not only that, by securing investments for financing sustainable projects, it will also support the transition in line with the Sustainable Development Goals and the Paris agreement. In this respect, we fully support the Action Plan on Financing Sustainable Growth.

Recommendation: The AFM supports the work carried out by the European Commission under the EU Action Plan on Financing Sustainable Growth, encourages the convergence of regulatory ESG standards, and calls for attention to the consistent implementation of such standards in the EU. As transparency is key for the functioning of the financial markets, more and better reporting by companies of non-financial information should also be encouraged.

6. The EU passporting regime

Attention must be paid to issues related to the cross-border supervision of retail financial services and to the passporting regimes in particular. Technological developments have made it easier for parties to distribute their products or services to investors in other Member States. As a consequence, there has been a rapid increase in the cross border distribution of financial services and products. The EU passporting system for banks and financial services companies enables firms that are authorized in one EU or EEA state to offer their products or services freely in any other member state without additional authorization requirements. As a result, the range of products available for retail clients has expanded, which is a very positive development. However, the combination of the above has also led to 'jurisdiction shopping'. It is a tremendous challenge for supervisors to enforce all EU regulation with the same level of intensity. As a consequence, financial services companies can look for the jurisdiction that applies specific requirements less intrusively and apply for an authorisation there, with the main intention to passport services to other EU Member States. This clearly imperils the protection of investors that are engaged in cross-border transactions.

The passporting regime has more implications. In some pieces of EU legislation Member States are allowed to opt nationally for a higher level of investor protection. Although the use of these "Member State options" might lead to a patchwork of divergent legislation across Europe, the AFM is supportive of this type of minimum harmonization as it can guarantee a higher investor protection standard at a national level. At the same time, market participants use their European passport to circumvent more stringent national rules or requirements. By using their passport they can distribute products and services from one (home) Member State to other, host, Member States. This is despite the fact that these 'exported' products or services may be deemed to be ill-suited for consumers by the host Member State. The supervisor of the host Member State may not be able to use the national enforcement powers in their remit to act against such parties and are in fact dependent on the supervision of the home Member State. However, the home Member State may not have the incentive or legal tools to act against these activities, which are not deemed to be illicit in the home jurisdiction. This could therefore lead to the distortion of level playing field within the host Member State, since domestic market participants will be subjected to the more stringent national rules.

The AFM encourages the EC to analyse both the positive and negative aspects of the current passporting system and to look for solutions that will empower NCAs to effectively protect investors domestically. The issues related to jurisdiction shopping need to be addressed. A more uniform approach to passporting should be addressed. For instance, financial services companies could be required to only apply for a license with passporting rights within one (not multiple) member state in which their activity is "material" and not merely passported from. Clear guidelines should be developed to enable supervisors to establish when firms are considered to be materially active in a Member State. Another possibility, in addition to the breach of union law procedure, is that ESMA could be given additional powers to support a home supervisor with its supervisory tasks in addition to the binding mediation procedure in Article 19 of the ESMA

Regulation. In cases where the home supervisor is unable to take adequate measures against malignant parties in time, ESMA can then intervene, for example. Currently, ESMA is currently looking into the possibility of creating a centralised register listing all market participants with EU passports. The register should only include passport registrations which are actually used by the market participants. This is an important step into the right direction, but needs to be well developed in order to be effective. For instance, it should be clear for the participants and supervisors what the conditions are for the registered passports, there should be a well-built IT-infrastructure for the register and a clear description of ESMA's role.

Recommendation: The AFM encourages the EC to analyse both the positive and negative aspects of the current passporting system and to look for solutions that will empower NCAs to effectively protect investors domestically. If appropriate ESMA could also be granted additional powers to effectively enforce supervisory convergence in this area.

7. Centralised supervision

To build a truly integrated capital market in the European Union, Europe needs to establish a single Capital Markets Supervisor for markets of a cross border nature. Although there will always be room for improvement on pieces of legislation, we believe that the integration of supervisory tasks within one single supervisor would be a real leap forward. Although the ESA review has led to new supervisory tasks for ESMA, the CMU is in this respect still clearly lagging behind the banking union, which has established a Single Supervisory Mechanism. Of course, this is an evolutionary process that should be taken step by step, but it would be a missed opportunity if this were not put back on the CMU agenda.

Supervisors worldwide are facing the enormous challenge of getting a grip on the fast-changing capital markets. The financial sector and its ecosystem are transforming radically, mainly in response to technological developments. As the system changes, the challenges and risks change with them. They have become broader in scope.

Individual supervisors will not be able to deal with the challenges by themselves. As the capital markets operate increasingly cross-border, the problems will also become cross-border by nature. Supervision on a national level is insufficient since violations and fraud often take place in multiple markets. Europe has made giant steps towards a single rulebook; the main supervisory challenge now is its consistent implementation and converged supervision. There are various methods to tackle this challenge. By developing best practices, common interpretations, joint supervisory priorities and supervisory convergence, for instance. However, supervisory convergence has its limitations. It will not make full use of the potential efficiency and effectiveness gains, and nor does it eliminate the risk of regulatory arbitrage. The ultimate convergence will be in the form of centralizing supervisory powers.

Centralised supervision could help to reduce market fragmentation and contribute to a better functioning and more integrated European capital market. It will be a tremendous boost to the CMU since it:

- Counteracts regulatory arbitrage.
- Efficiently and effectively addresses cross-border problems
- Efficiently pools technical expertise (no need to build up expertise in multiple jurisdictions)
- Provides for a holistic overview of market data
- Avoids supervisory overlaps across jurisdictions
- Creates a one-stop shop for market participants
- Leads to economies of scale, especially in IT investments.

In general, the allocation of supervisory powers should reflect the cross-border nature of the capital markets. Some progress has been made through the reform of the ESAs, and by granting ESMA more direct supervisory powers on Data Reporting Service Providers and European critical

Benchmark administrators. As has the reform towards more robust European supervision on Central Counterparties.

The review of existing regulations such as MIFIDII/MiFIR and the AIFMD and the development of new regulations offer natural opportunities to evaluate the effectiveness of the current allocation of supervisory powers. The AFM encourages the EC to continue its efforts in this area and suggests making this a standardised assessment in the review process.

Supervision on a European scale is very likely to lead to an increase in efficiency and effectiveness. To assess what would be the most appropriate supervisory method or authority, criteria should be identified to help the European legislator assess the level at which supervision should be implemented. The following criteria could be taken into account:

- Are the activities/services cross-border?
- Are the risks cross-border?
- Are the rules harmonized?
- Is there a risk of regulatory arbitrage?

If a specific area ticks all the boxes, there is no compelling reason not to centralize supervision from a technical supervisory perspective. This would, in our view, logically lead to central supervision on firms, such as Central Counterparties, Transaction Reporting, Central Securities Depositories and all Benchmark Administrators. Based on these criteria it currently seems unlikely that supervision on the retail markets needs to be centralised.

ESMA is best equipped to take up the role as the single capital markets supervisor. It has proven to be a credible supervisor of Credit Rating Agencies and Trade Repositories. Of course, a change in responsibilities should be reflected in the governance of ESMA. We envision a more independent role for ESMA in its supervisory decision-making. It will also be crucial that ESMA receives the necessary resources and manpower to take up these responsibilities. Lessons can be learned from the staffing of the ECB/SSM. For ESMA to be successful it will be key that ESMA works closely together with national authorities, and leverages on their expertise and knowledge. A model where ESMA gradually grows towards being a stand-alone supervisor could be considered.

Recommendation: The AFM proposes to develop a standardised method of assessing the effectiveness and allocation of supervisory powers, to be used in the review of existing regulation and during the development of new regulations.

8. Annexes

8.1 Technological innovation

The two most striking technological developments that could have a huge impact on our capital markets are Artificial Intelligence and Distributed Ledger technology. Artificial Intelligence: We are already familiar with trading based on algorithms through high-frequency trading. But this technology can of course be used in many more areas. Since the advanced use of this technology is still in an early phase, it is important to understand how it works and how it is used. Subsequently, an appropriate policy framework with the right checks and balances could be considered, as was the case with high-frequency trading. In this contribution we take the opportunity to encourage international bodies (IOSCO, FSB, ESMA etc.) to continue their explorative and investigative work in these areas.

Distributed Ledger Technology (DLT): This has the potential to unlock funding opportunities for SMEs, but needs to be supported with proportionate regulation without compromising investor protection and market integrity. The application of DLT may open up opportunities for the funding of small-scale business activities, provided the cryptos represent clear and enforceable rights, as is the case with shares and bonds. The AFM and DNB recommend amending the European regulatory framework for corporate funding to enable the use of cryptos that are comparable to shares or bonds. This requires proportionate rules for (secondary) trading as well as amendments to the rules for custody and settlement in order to prevent them from unnecessarily reducing the benefits of blockchain technology. Since countries recognize the potential of the tokenization of assets, some have developed their own response. Although the adequate action of individual governments are appreciable, a fragmented approach is not in line with the ideas of the CMU.
In addition, legislative amendments are required to remove unnecessary obstacles to the application of blockchain technology underlying those cryptos that qualify as a security. Requirements relating to clearing, settlement and custody must offer flexibility to merge these activities with blockchain technology.

With respect to the definition of security, we recommend creating the necessary space in European legislation to allow supervisory authorities to adopt a substance-over-form approach when qualifying existing or new corporate funding activities. The new funding models that have emerged with the rise of Initial Coin Offerings (ICO) and Security Token Offerings (STO) show that there is limited space to apply capital market requirements under the current national and European regulatory frameworks. As a consequence, service providers can simply set up their ICOs without being subject to supervision and at relatively low costs. We believe that this undermines the MiFID framework.

8.2 Securitisation

One of the major building blocks of the CMU is a framework for securitisation. The idea behind this is that developing (or redeveloping) a securitisation market will help create new investment possibilities and free up liquidity at banks, thereby providing an additional source of finance, especially for small and medium-sized enterprises and start-ups. A high-quality securitisation market will improve the financing of the EU real economy, enhance private risk sharing and ensure investor protection through more transparency.

Regulators have sought to stimulate the market for securitisations and provide incentives for both issuers of securitisations as well as investors in securitisations. The market for securitisations was heavily affected by the financial crisis of 2007 because of the role securitisations played in the US subprime mortgage crisis. Volumes plummeted and market confidence in securitisation products evaporated. The securitisation market in the EU had dried up and an important source of liquidity or funding was not being used optimally or at all. Therefore, to restore market confidence and stimulate the use of securitisations, the Securitisation Regulation ("SECR"; in force since January 1, 2019) was developed and amendments were made to the capital requirements regulation ("CRR"; Regulation (EU) 2017/2401).

We do not believe it likely that the market for securitisations will ever return to pre-crisis levels, but we expect the market for securitisations to develop further once all RTS have been finalised and uncertainty on some of the due diligence requirements has been resolved. Today's market for securitisations has not returned to the same level as before the crisis. We see some increased volumes compared to the previous years in the Netherlands as well as in the rest of Europe, but this is rather limited and both issuers and investors seem rather hesitant. However, it is a slightly too soon to draw firm conclusions at this stage, since the regulation has only been in place since 1 January 2019 and many RTS and guidelines are still not complete. Market participants therefore experience a lot of uncertainty regarding the final requirements and this explains their reluctance.

The requirements on transparency and due diligence are much stricter for securitisations than for Covered Bonds (CoBos) and this could be one of the reasons that market parties see securitisations products as less attractive than CoBos. The different risk profiles for these products do not fully explain the different requirements in his area. Although both regulations have been developed only recently it could be worth looking into whether converging these two regulatory frameworks, including their capital treatment, would result in a more effective impulse for the securitisation markets in Europe. Also, signals from the market tell us that the lack of an STS framework for synthetic securitisations is a barrier for the development of SME securitisations, which was the main reason for this new legislation.

The Dutch Authority for the Financial Markets
T +31(0)20 797 2000 | F +31(0)20 797 3800
PO Box 11723 | 1001 GS Amsterdam
www.afm.nl