International Capital Market Association

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Opening Remarks

Cyrus Ardalan

Chairman of the Board, ICMA

Good afternoon and welcome. It is a great pleasure, firstly, to welcome so many of you to Amsterdam for this 47th annual conference of ICMA. I believe the last time ICMA had its conference in Amsterdam was back in 1990. It has been really a very long time, and it is a great pleasure to be back here. It seems quite fitting to be in Amsterdam, as we reach the end of the post-crisis re-regulation process. I suspect that this city looks at the financial crisis with the calm of an old hand. After all, it was as early as 1637 that the tulip crisis gave us a salutary lesson in the dangers of asset bubbles. The subsequent success of the Dutch economy as a trading nation offers an example of how international trade and investment drives sustainable recoveries. In fact, many of you will know that the Dutch East India Company was one of the first businesses to issue stock. The roots of capital markets run deep here in Amsterdam.

I am delighted to see so many of you here. We have more participants this year than we have had in many, many years. I am genuinely pleased to see how this conference has become a forum for the full spectrum of stakeholders in the capital market to meet, consider key market developments and exchange views. It is also good to see that the opportunity for direct face-to-face communications between individuals is still thriving, even in these technologically connected times.

Last year, we met shortly after the election of the European Parliament. The new Parliament and Commission have moved quickly to set important new priorities and renewed urgency to restore growth in the EU. We, in capital markets, are right at the heart of this agenda. Our conference today focuses on this capital markets union project and the need to create an efficient, dynamic and multifaceted European capital market. This is a development that ICMA very much welcomes. After all, our Association has been at the heart of a market that has encouraged cross-border capital flows for over 50 years. We are very fortunate to have so many distinguished speakers from the public sector with us today, who will give us their perspective on the capital markets union. We will also be hearing from market participants about how the private sector can help with practical initiatives to make this happen, to anticipate the Minister’s speech.

There should be no illusions. Capital markets union is an ambitious and complex initiative. It involves a whole ecosystem and goes to the very heart of the intermediation process in Europe. While this initiative is important and timely, we are still in a long implementation phase of the post-crisis regulatory framework, measures which are designed to ensure stability and safe financial markets. I would like to stress my admiration for the work of lawmakers across the globe. This was the most ambitious legislative programme in living memory, undertaken at one of the most challenging periods in our history, and we are left with a remarkable and far-reaching body of law. I know that our political leaders will agree that important challenges remain. We have to establish the right balance between stability and growth objectives, and, more simply, we need to understand how all the various separate laws interact with each other. The industry has a responsibility to be part of this discussion. Some of these challenges will be touched upon by speakers and the various panels at this conference.

The programme, like our membership and the attendees who are here today, goes beyond what is happening here in Europe. The International Capital Market Association is exactly what the name implies. Today, we are particularly pleased, therefore, to welcome friends and colleagues from Asia.

Before we start our proceedings today with our first guest speaker, a word of thanks to the sponsors of the event, whose logos you see all around the hall, and special thanks also to the committee of ICMA's Netherlands region, who have worked tirelessly with us to put together this excellent programme that we have for you over the next two days, and, last but not least, have successfully conspired to bring us such wonderful weather, which is no mean feat.

Finally, as some of you know, this is my last conference as Chair, as I shall be retiring shortly from Barclays. I would like to say how much I have enjoyed being at the heart of this community and I am proud of what we have achieved. Our industry has come through a period of acute challenge, and we are now better informed, wiser and more stable as a result.

Now, it is my great privilege and pleasure to introduce our first keynote speaker, Jeroen Dijsselbloem, Minister of Finance of the Netherlands.

The Capital Markets Union: You Have to Make it Happen

Jeroen Dijsselbloem

Minister of Finance, the Netherlands

I. Preamble

Ladies and gentlemen, it is a great pleasure to join you today here, in Amsterdam, of course, which is a pleasure in itself. Over the last few years, the European financial landscape has undergone fundamental change, basically because it had to. It was clear from the crisis that the financial system had to become more robust and more stable. You know that change is necessary when banks can take down entire countries in their fall. There was a clear need to weaken the link between banks and sovereigns. In the aftermath of the crisis, banks caught their breath, strengthened their balance sheets and looked at credit applications more critically. It also became apparent that the European economy is over-reliant on banks for finance. Stronger and more diverse financing of the real economy is needed to create robust growth, jobs and solid investments. Capital is needed by all businesses. From small companies to huge conglomerates, innovative entrepreneurs must be able to finance their ideas and companies must be able to finance their growth plans.

II. Policy Initiatives in Outline

1. Overview

These are some of the reasons why we set up two landmark initiatives: the banking union and the capital markets union, and they clearly complement one another. The banking union has been set up to make banks more stable and to weaken the link between banks and sovereigns – in other words, to ensure that our banks are open for business again. The capital market union aims to cut the cost of rising capital and reduce a high dependence on bank funding in all 28 EU member states. In short, both initiatives increase the stability and growth potential of the EU economy. Banks should no longer be too big to fail. Taking away distortions, such as implicit subsidising of banks, will create a more level playing field between banks and other market players. This is also relevant to the capital markets union, because we have to unlock new and effective sources of investment in Europe's companies and infrastructure. Both the banking union and the capital markets union are policy initiatives, designed to help the real economy grow and make Europe more shockproof. There are big differences between them, and let me take a closer look at those.

2. Banking Union

The banking union was made possible by making the financial sector basically responsible for itself. Stricter demands for capital and leverage, CRD IV, the bail-in rules all cleared the way for a single supervisor. With the European Central Bank taking up this supervisory role last November, the banking union officially kicked off. The European Central Bank supervises all euro area banks, directly or indirectly. Before the European Central Bank took up this role, it conducted, as you know, a comprehensive assessment and a stress test of 130 of Europe's largest banks. This brought back confidence in our banking sector. Harmonised supervision enables us to apply similar standards to all banks, in recognition of the fact that many banks operate across European borders.

We are also in the process of establishing a fully-fledged European resolution mechanism, which should be fully operational as of 1 January 2016. This new mechanism ensures that, if a bank is facing serious difficulties, its resolution will be managed efficiently, at minimal or no cost to the tax payer and the real economy. The new bail-in regime is critical in this respect. Banking union makes banks safer, more resilient and ensures that common standards are applied. Thereby, we address the potential contagious links that we have experienced between banks and sovereigns.

3. Capital Markets Union

The capital markets union, however, is something completely different. It is not about institution-building. It is about creating the right conditions for European capital markets to function better, to help markets unlock investments for European companies and infrastructure. Of course, regulations are still necessary for more market-based finance. We are not starting from scratch. A lot of legislation has already been introduced over the last few years. Now, we have to make markets work more effectively and more efficiently. By identifying the remaining barriers and knocking them down, we are putting the ball into play, but it is you, market participants, who, in the end, have to score the goals for us.

4. Chronology

This means there is also a big difference in chronology between the banking union and the capital markets union. Banking union has been set up with remarkable speed, and is almost complete and up and running. The capital markets union, on the other hand, is more of a long-term project, requiring sustained effort over many years, but that should not stop us from making progress as soon as possible, and I am sure that Commissioner Jonathan Hill, who is with us today, will come up with an ambition and action plan this autumn.

Ladies and gentlemen, the banking union is an intricate collection of initiatives, focused on a single goal. The capital markets union is equally complex, but has a greater tendency towards improvisation. Banking union is more like the Beatles; and capital markets union is like jazz, but, still, like good jazz, the initiatives that make up the capital markets union have several themes. Let me address those themes.

III. Themes of Capital Markets Union

1. Better Access to Capital

The first theme I would like to mention is better access to capital. For this, we need to address remaining barriers to cross-border capital flows. European financial rules should be consistent across borders. This will enable investors to invest without hindrance across borders, and businesses to raise funds from a diverse range of sources, irrespective of their location. The review of the existing prospectus regime is the first step in this direction.

2. Broad and Deep Supply Side

The second theme is that we need to broaden and deepen the supply side. This requires increasing and diversifying the sources of funding. This means not only investors in the EU, but from all over the world, and not only big institutional investors, but also retail investors. It also requires an effective level of protection for consumers and investors. They also should have access to capital markets and they must be able to make well informed choices, decisions based on good insight into costs, expected returns and, of course, risks. Institutional investors should also have better access to capital markets, for example by eliminating unnecessary barriers to long-term investments. We also need to create a sustainable, high-quality securitisation market, relying on simple, transparent and standardised securitisation. This will enable the transfer of risks to investors that are able and willing to bear them. We very much support the development of alternative sources of finance, such as crowdfunding and credit unions.

3. Strong Foundations

Thirdly, all structures that are built on wobbly foundations will come down in the end, and that includes our financial infrastructure, so we need a strong base. This is a fundamental precondition for well functioning capital markets. We have already poured the concrete for the foundations with the safeguards provided by MiFID 2 and EMIR. Now we have to develop an effective framework for the recovery and resolution of central counterparties.

4. Accessible Information

Fourthly, information should be easily accessible to all suppliers of finance, not just banks. Information should be easily comparable. Without adequate information, markets simply will not function properly. We should try to lower the information and transaction costs for investors in companies in need of finance, especially for SMEs. For this, we need to look to common minimum standards for credit reporting and assessment, as well as standardisation of credit quality information.

IV. Concluding Remarks

In our response to the Commission's green paper, we stressed the importance of the capital markets union project. As I said, I very much welcome the initiatives the Commission has taken so far. Commissioner Hill will present his action plan, and the success of this initiative will very much depend on the level of ambition with which it is pursued. The Commissioner can count on my support. Having said that, in the end, we can only create the preconditions for an efficient and sustainably capital market. Ultimately, to get a fully integrated single market for capital, we need private initiative, and I have no doubt that the private sector will take up this challenge. We have already seen the rise of various alternative sources of financing, from credit unions to crowdfunding, from private placements to venture capital. Technology will enable new forms of financial innovation, for business lending, payment systems, savings. Ultimately, new business models will arise that complement more traditional forms of finance. In short, market-based finance is on the rise, and the capital markets union is there to help it take off.

Ladies and gentlemen, during the first ever international football match between England and Scotland in 1872, the Scots introduced a new tactic. They started to pass the ball between each other, instead of dribbling on their own straight to the goal. This was an instant success and changed the game forever. The player who had the ball was no longer the only important man on the field, and, by introducing this new tactic, more players were brought into the game. You can all see the similarity here. By introducing a capital markets union, we are changing our tactics so more players can be brought into the game, into the capital markets. This will change the game, but, as in football, it is, in the end, down to the players to use technical and tactical possibilities to make things happen.

That basically means you, the market. You have to put it into practice, make more market-based financing possible for entrepreneurs, companies, multinationals, with better access to capital, with more diversification, sound information and a better infrastructure. That will lead us to more jobs, robust growth and solid investments for Europe. I thank you very much.

Cyrus Ardalan

Thank you very much, indeed, Minister, for your very comprehensive views, and also your very interesting analogies, which we can certainly bear in mind. With that, I come to our second keynote speaker. It is really a pleasure for me to introduce Commissioner Hill, who is the Commissioner responsible for financial stability, financial services and the capital markets union in the EU. His area is clearly core to everything that we will do and central to our mission, and we very much look forward to his presentation. Thank you.

Capital Markets Union: A Driver of Growth Across the EU

Lord Jonathan Hill

EU Commissioner, Financial Stability, Financial Services and Capital Markets Union

I. Preamble

Good afternoon and thank you very much. Thank you to Jeroen for his strong support. He talked about dribbling and passing the ball. I will try not to dribble and I accept the ball that he has passed to me. I think it is a good example of how we are all going to have to work extremely closely together on this project in the coming years. I am delighted to be here. Thank you for inviting me. Where better to be than in this city, with its great heritage, home to the oldest stock exchange in the world, to talk about the next steps for vibrant capital markets in Europe? I know that many of the issues that you are going to be discussing today fit exactly with the questions we have been looking at in our work to build a stronger single market in capital. I look forward, therefore, to your conclusions today, and I also want to take this opportunity to thank ICMA for the very thoughtful contribution that you have made to our green paper. I will come back on some of the specific points you raised in that later on.

First, I just want to start by saying a few words about how my work to build a stronger single market in capital, the capital markets union, fits into the overall approach of the European Commission, to set out what I am trying to achieve with it, who would benefit from it and how I think it can help drive growth across the EU.

II. Priorities of the European Commission

1. Jobs and Growth

I think it is fair to say that, with 24 million Europeans out of work, our top priority is jobs and growth. It is that which lies behind our new drive on free trade agreements and behind our new push to expand the single market in energy, in digital services and in my own area of capital markets. Bigger markets, more competition and more trade will help economic growth and generate more of the jobs that we need. That drive, which is one that I know chimes well with many people here in the Netherlands, sits at the heart of the new Commission's agenda.

2. Less and Better Regulation

We also have a new push, led by the Netherlands' very own Frans Timmermans, to regulate only where necessary, and he has set a cracking pace for us. This year, the Commission will introduce only one fifth as much new legislation as the previous Commission typically introduced in an average year, and we will be reviewing two and a half times as much of our existing legislation. Frans recently set out a new approach to regulation that should improve the quality of the new laws, through better impact assessments, and also to promote more effective reviews of existing EU legislation. I support him very strongly on that approach and I intend to bring it to bear in my own area of financial services, so there will be less new legislation in the future, more of a focus on bedding-in reforms of recent years and more of an emphasis on reviewing existing legislation.

3. Adaptation

Over the last five years, as Jeroen reminded us, we had to legislate at speed while the fires of the crisis were burning all around, and it was a remarkable achievement, in particular to create the banking union from scratch. There is no doubt, as a result of those reforms, that our financial system is stronger, better regulated and more resilient, so no one is putting into question the new framework that has been put in place. However, I do think that it now makes sense to step back and ask ourselves whether we managed to get everything right all of the time, to take a look at the combined effect of our legislation and to check whether we have always achieved the right balance between managing risk on the one hand and enabling growth on the other. I think that, if the evidence does show that the rules are not proportionate to the risks that they were originally intended to address, if they are not conducive to growth, then we should be ready to adapt them.

4. Availability of Capital

If the aim of the Investment Plan being championed by my colleague, Jyrki Katainen, is to help kick start growth in the short term, the goal of my work on the capital markets union is to encourage investment for the longer term. The background to it, I think, is well known. Despite efforts made over the years, EU capital markets remain underdeveloped. Our equity markets are only about half the size of those in the United States. It is also the case the Europe does not have a shortage of capital, so the question is: where is that capital going and to what extent is it feeding back into the economy?

In the US, around a tenth of household assets are tied up in bank accounts. Even in mature and well developed EU markets, that figure is closer to a third, and, in some EU markets, it is over a half. To give just one other example, medium-sized companies in the US receive five times as much funding from capital markets as they do in the EU, so Europe's capital can and should be put to more productive use. At its simplest, the purpose of capital markets union is to increase the availability of capital to the economy and to link savings more effectively to growth; to give businesses at different stages in their development more options for funding; to diversify sources of finance; to complement the traditional role of banks in the European economy, which itself will increase financial stability by spreading risk. We have all seen what has happened to lending in countries that are heavily dependent on bank financing in the aftermath of the crisis, including here in the Netherlands, so diversifying funding sources will help ensure that capital continues to flow as best it can in the good times and the bad, thus making our economies more resilient.

III. Benefits of the Single Market

1. Businesses

A deeper single market in capital will have a number of obvious benefits. Businesses would benefit by being able to raise finance more easily more easily and having more funding options open to them, both at home and cross-border. Even in parts of the EU where there is no shortage of bank lending, SMEs with innovative ideas and a higher risk profile often tell me that they cannot find the funding they need. This is a common theme wherever I go. I am sure all of us know of examples of European entrepreneurs and innovators who have moved to the United States for funding. Well, I want us to deliver that finance here in Europe, so that businesses have the choice to stay, to hire and to grow here in Europe.

2. Banks

Banks would benefit from capital markets union. One of our priorities is to build an EU market for securitisation. This will help free up banks' balance sheets so that they themselves can lend. Here, I see capital markets union as sitting alongside the vital role of banks in lending the economy, complementing what they do and making more finance available throughout the system.

3. Savers and Investors

People saving for their future, for their requirement, would be able to benefit from a wider range of affordable investment opportunities. Institutional investors, like pension funds and insurance companies, would benefit from our emphasis on supporting investment in long-term projects. Here in the Netherlands, where you have large pension funds and highly developed pension products, I know there is a lot of interest in the potential of a 29th regime for a European pension fund. Speaking about pension funds, I hope that the pension fund industry will be pleased with the decision that the Commission will adopt tomorrow to continue to exempt pension funds from the clearing obligations under EMIR for another two years, thus providing a greater degree of certainty, which the industry was understandably asking for.

4. Member States

All EU member states, I think, would benefit from their businesses having access to deeper pools of capital on better terms. I see this as a classic single-market project. It is for all 28 member states, and it is supported by all 28, and I have also had good backing for it from the European Parliament.

IV. Industry Input

My starting point is to build this strong single market from the bottom up. That is why we started with a green paper, to try to identify all the barriers and obstacles that currently exist. To do that, we needed input from member states, from consumer organisations, and, of course, from the industry, because I think it is the industry who knows best where the barriers are, where the shoe pinches, what is stopping them from investing in businesses across the EU. I am very clear that I want the capital markets union to be something that is developed with the industry, and not something that is done to it.

We have had well over 400 responses to the green paper on the green paper aspects of the capital markets union alone, and we are busy working through them. That will help us identify what those biggest barriers are and then work out how to overcome them, one by one, step by step. It is going to be an ambitious project and it will require sustained effort over time. It is more of a marathon than a sprint, but the need for that long-term effort goes hand in hand with the requirement for a very quick start. That is why we are moving forward as fast as we can, with early measures on securitisation, on reviewing the prospectus directive, for both of which I have received strong support, including, as we just heard, from the Dutch Government.

V. Focal Areas

1. Access to Finance

I thought I would single out four areas where we are concentrating our efforts. The first is on improving access to finance. In some countries, fewer than a third of SMEs get the credit that they ask for, whereas, in others, that figure is more than 80%, so we want to make it easier for creditworthy companies to be able to get the financing that they need. That is why we are looking at how we can reduce barriers to accessing markets, through lowering burdens in the prospectus directive, and we are also looking at what we can do to make SME credit information more accessible to potential investors, but without tying up those SMEs themselves in a new tangle of red tape.

2. Diversity of Finance Sources

We want to diversify sources of finance by unblocking barriers to new channels of financing reaching our companies and our infrastructure projects. That is why, along with the ECB and the Bank of England, Basel and IOSCO, we want to get the market for securitisation going again in Europe, creating a framework for highly transparent, simple and standardised products. Despite losses on European securitisations being very low, our markets remain at just one third of the level that they were before the crisis, so the door will remain firmly shut on the bad old ways of the past that we saw in the United States, but progress here could make a big difference to long-term investment, by broadening the investor base to include more long-term investors, such as insurers and asset managers.

Another area we are looking at is how we can improve the ecosystem in Europe for venture capital. If our venture capital markets were as deep as those in the US, as much as €90 billion extra of funding would have been available to finance companies between 2008 and 2013, so we need to look again, not just at the rules for EU venture capital funds, which we intend to do, but also the wider picture for equity financing in the EU. I am sure that many of you here agree we also need to explore the potential offered by crowdfunding and other areas of financial innovation, where new funding models are emerging. If savers are going to invest more, we need transparency; we need choice; and we need competition. In the coming months, I will be launching a green paper on retail financial services, in order better to understand how we might be able to help consumers have access to more products, better services and lower prices. Again, I very much welcome the Dutch Government’s thinking in this area.

3. Long-Term Investment Flow

We want as well to help investment flow for the long term. While I do not believe it is for policymakers to force markets to behave in the particular way, I do think there is a role we can play in supporting market activity. For example, insurers were given a number of incentives for long-term investment in the detailed rules under Solvency II last October. That, I think, shows a useful way forward, but there is more work that I believe we could do here, and I have asked EIOPA to look into these issues and to report back to me on the scope for further action by the end of June.

On a topic close to your own hearts, we are keen to exploit the potential for private placement as a source of funding for large and mid-size companies to borrow from institutional investors. These markets work very well in the United States, but they are working less well in Europe. Three-quarters of the €20 billion or so that is sourced in this way in Europe is concentrated in just two countries, Germany and France. I am keen to boost this funding channel in Europe. I was very encouraged by the Pan-European Corporate Private Placement Guide that ICMA published back in February, not least because I do not think we always have to reach for legislation as a first option. Now that a few months have passed since it was first published, I am very keen to know what progress has been made, what concrete projects have been developed as a result and when we might be able to see the first successful issuances under the regime.

4. Legal and Supervisory Aspects

We asked specifically about private placement in our consultation on the CMU. Most respondents advised us to be careful about regulating and to support market-led initiatives. What they said is that where they would like to see EU-level action is with regard to taxation, interactions with other pieces of legislation and some harmonisation and clarification with regard to the application of withholding taxes on private placements in EU member states. We are still at an early stage in our analysis, but we will certainly reflect on the feedback that we have had from ICMA and from others when considering our next steps.

The green paper also raised well known issues relating to securities law, to tax and to insolvency, where differences sometimes exist for good reasons, but they also can act to deter investment and create uncertainty. It also looks at the question of supervision, where the success of any reforms will depend on the consistent implementation of the rules and where the European supervisory authorities have been helping to promote supervisory convergence.

VI. ICMA Concerns

1. Cross-Border Collateral

I am just going to touch on a couple of other issues that ICMA have raised specifically, which we have been looking at in the green paper. The first is the cross-border use of collateral. I know that recent papers from you have gone into some depth on the importance of collateral in underpinning the functioning of capital markets and it is widely accepted that the overall demand for collateral has increased in recent years. Just to say that I fully share your view that we need to be very careful with financial regulation around the movement of collateral, so as to guard against potential systemic risks, without impeding the working of the markets, so we will give this careful thought as we prepare our next steps.

2. Credit Unions

The other issue to raise is about credit unions, which is something that a number of people have brought up over the last day, here in the Netherlands. These are an established part of the financial system in a number of member states, like the United Kingdom and Ireland. These schemes, which are often community-based, offer, I believe, a valuable additional source of funding to the economy, particularly for small businesses. They are certainly something I welcome, particularly in the context of our drive, through the capital markets union, to support improved access to finance for small businesses. I am pleased, therefore, that the Dutch authorities are in the final stages of completing a new regulatory regime for credit unions.

As part of that, I have been asked whether it would be possible for the Commission to exempt credit unions from European banking law. This has been raised with me by Dutch parliamentarians and, again, just before we came here, by Minister Dijsselbloem. Given the small size of these credit unions, the limited financial risks that they pose and the fact that the medium-sized and large credit unions will be subject to specific prudential and supervisory regimes, I can announce that the Commission is certainly sympathetic to considering this exemption for Dutch credit unions. The next step will be to send the Commission a request and all the details that we need on the design of the Dutch credit union system. Then I will instruct my officials to move forward with that as soon as we can.

VII. Concluding Remarks

Rolling forward a single market in capital is also, I believe, an opportunity for the financial services industry to demonstrate again how it benefits the wider economy. The nature of the recent crisis has encouraged the perception of financial services only as a source of problems, whose resolution had to be borne on the shoulders of wider society. My view is very simple: that I believe the whole economy needs a thriving financial services industry. I want that to be apparent again, so that people will see jobs and wealth being created by the flow of investment from the industry. The industry, I think, will need to respond to that challenge by demonstrating leadership and a clear set of values, as it goes about its business.

I also want to ensure that the capital markets union project is one that benefits all 28 member states, not just those with well established capital markets. Money should be able to flow to companies and projects, regardless of where they are located in the EU. Equally, those countries that have developed expertise and experience in specific financial sectors, as here in the Netherlands, should be able to build on that across a market of 500 million people, for Europe's financial centres to demonstrate their value, not just to their own customers and investors, but to the whole of Europe.

I hope that you will all agree that we have a great opportunity now to build a stronger single market in capital, with all the benefits that that would bring for the European economy. In September, I will be publishing an action plan, which will set out a clear way ahead on the CMU. Alongside that, we will publish proposals on securitisation and on the prospectus directive, so we will be moving fast and with a great sense of urgency. Although it is nearly 60 years now since the Treaty of Rome first set out a commitment to the free movement of capital, I do think that, today, we have a fantastic political opportunity to make a new attempt to tackle some of those old challenges. That is an opportunity that, with your help, I intend to seize. Thank you.

Cyrus Ardalan

The vision that you have outlined, Lord Hill, of a capital markets union I think is very much consistent with the views that we have as an institution. As you have put it, the onus is very much on us to work very closely with the Commission and others, particularly in respect of the elements of the action plan, which will be coming up shortly. With that, it is my privilege to introduce our third keynote speaker, Klaas Knot, the Governor of De Nederlandsche Bank, the Central Bank of the Netherlands, who will provide us with an alternative view, looking at the capital markets union from the perspective of the central banker.

How Capital Markets Union can Bolster Monetary Union

Klaas Knot

President, De Nederlandsche Bank

I. Preamble

Mr Chairman, it is excellent to see Mr Dijsselbloem and the Commissioner, Lord Hill. Esteemed ICMA members and conference participants, thank you also for the opportunity to share with you my views on this important project of the European capital markets union. Before delving into them, let me first express my full support for the views that have already been expressed by the two previous speakers. I too very much welcome the initiatives by the Commission, geared towards the further development and integration of European capital markets. I am confident that, through the harmonisation of regulation and through the introduction of common standards, we will be able to unlock important new sources of finance in productive ways that will also increase the resilience of the European economy, going beyond the traditional financing channel of banking.

II. Financing Channels

1. Reliance on Banks

It is true, as was already indicated, that, in the euro area, small and medium-sized enterprises still depend very much on the bank lending channel. This implies that business investment in the euro area also depends on the availability of credit. This creates vulnerabilities within the European economy, for example when banks themselves are in the process of deleveraging in order to strengthen their balance sheets. The European bank-based financial system is often contrasted to the situation in the US, which is presumed to be more market based. I should note that this difference is a bit more nuanced than is often acknowledged, for, in the US as well, SMEs are similarly dependent on bank financing, in particular the smallest of firms. To the extent that the smaller firms do access the capital markets, this is mostly confined to specific sectors. A well known example, of course, is the Silicon Valley industry, start-up tech companies that are able to attract large sums of financing from venture capitalists.

2. Complementary Sources of Finance

This refinement notwithstanding, in general, it has been shown that well developed capital markets can complement bank financing. Economic research confirms that this can actually improve economic performance. The Minster has eloquently explained how this would apply specifically to the European economy, and he has set out how the capital markets union relates to the recently-established European banking union. In my address, I want to focus on yet another perspective. I will give you my views as to why I think that the completion of a true European capital markets union is also beneficial from a monetary policy perspective, for there are several reasons why better developed and integrated capital markets can make the lives of European central bankers much simpler.

III. Benefits for Monetary Policy

1. Transmission of Decisions

As you know, the Governing Council of the European Central Bank aims to maintain price stability in the euro area as a whole. To achieve this, we conduct monetary policy. Based on the outlook for inflation, we set our interest rates, our policy rates, to steer overall financing conditions for households and firms in the euro area. The homogenous transmission of monetary policy decisions throughout the financial system enhances the appropriateness of our decisions, for the euro area as a whole as well as for individual member states. That is why monetary policy profits from a level playing field in financial markets across countries.

Note that I do not intend to suggest that all economic agents should be able to borrow under exactly the same conditions. Actual financing conditions for households and firms are to be determined by the market, and not by the ECB, and these should appropriately reflect differences in earning capacity and risk. This is, of course, exactly what went wrong in the run-up to the financial crisis: lending rates converged throughout the euro area and no longer reflected actual underlying risks. Several potential explanations have been put forward for this. One reason often mentioned is the search for yield as a consequence of the low-interest-rate environment, or the fact that the no-bail-out clause in the EU treaty was not perceived to be as credible as some would have liked. Yet another explanation is that gaps in banking regulation were the primary cause of the mispricing of risks in the run-up to the crisis. In my view, all these three explanations, and probably a few more, have been relevant. In fact, these factors are likely to have reinforced each other.

2. Harmonisation

In a similar vein, I also believe that a lack of harmonisation in regulation and common standards in euro area capital markets can be viewed as a further aggravating factor, for heterogeneity and inconsistencies in regulation can obscure how losses will be distributed once financial risks materialise. This, in turn, can exacerbate mispricing of risks in financial markets. I think this is a key issue that the Commission agenda on capital markets should address. In my view, one of the obstacles to be tackled is the lack of harmonisation of insolvency laws across countries. Unfortunately, in the Commission’s early proposals, initiatives to that effect do not feature very prominently yet, but I nevertheless believe that it could be a very effective way for the capital markets union to contribute to a consistent pricing of risk across countries, for it will help to ensure a homogeneous but risk-consistent transmission of our policy decisions.

3. Efficacy of Policy

Capital markets union, I would say, can deliver much more than just that. It can also greatly increase the efficacy of monetary policy. Common to all monetary policy decisions is that their transmission through the real economy is sluggish and can sometimes be incomplete. For example, the extent to which banks are able to lower lending rates following a rate cut depends on many factors beyond the control of monetary policymakers. One could think of the level of competition in the banking sector or the health of bank balance sheets. A successful capital markets union will open up entirely new channels for the transmission of monetary policy to the real economy, making central bankers much less dependent on a single sector for the transmission of its policy decisions. In that sense, central banks can diversify the channels through which they can influence the real economy, adding to its effectiveness.

4. Diversity of Finance

Note that economic agents can also benefit from capital markets union in a very similar way. Household and firms can also diversify their dependency on finance, if alternative sources of finance are in abundance, making them less vulnerable to the risks stemming from a single sector. A well diversified financial structure increases the resilience of balance sheets of households, corporations and shops, and it increases the resilience of the economy as a whole. When an economy is better able to cope with external shocks, monetary policy is no longer distracted from pursuing its primary remit, and that is delivering price stability.

5. Resilience to Shocks

The latter is even more relevant for monetary policy in the monetary union. Structural differences between national economies imply that the euro area economy is exposed to asymmetric shocks. Private-sector risk sharing across countries can greatly enhance the smooth transmission of such shocks throughout the area, and that is exactly what capital markets union also seeks to accomplish: an increase in the cross-border holdings of financial instruments to enhance risk-sharing across the euro area, thus improving the functioning of the monetary union.

However, the capital markets union is also no silver bullet. Clearly, its introduction does not absolve us from pursuing prudent policies in other areas too. Moreover, it will also take a lot of time before we can reap the full benefits of capital markets union. There can be no doubt, though, that it will prove to be an important complement to the banking union in enhancing the functioning of our monetary union.

IV. New Challenges

1. New Monetary Instruments

At the same time, capital markets union will also bring new challenges and new risks, for example as a result of the shift in the relative importance of the transmission channels of monetary policy. Interest-rate decisions may transmit differently to the real economy through markets than they do through the banking sector. This calls for careful analysis, and possibly a reassessment of the effectiveness of our current set of monetary policy instruments. These instruments are currently primarily geared towards the banking sector. However, to be able to also influence financing conditions beyond the banking sector, we may need to introduce new, more capital-markets-based, instruments.

2. Shadow Banking

Another possible consequence is that risks may shift to what is often referred to as the shadow banking sector, a sector that is currently clearly less transparent and less regulated than the traditional banking sector. It is yet unclear what could be the financial stability ramifications if such a development were to occur. In any case, it would warrant enhanced monitoring of the developments in that sector. One could even argue that a more formalised supervisory framework should be put in place. Finally, it could be conceivable that macro-prudential policy measures would have to be applied beyond banking as well.

3. Complex Instruments

As for the potential risks associated with developing capital markets, let me highlight one more issue. Some might worry that, by developing financial markets, we will again see the introduction of complex financial instruments, the type of obscure instruments that, according to many, were the root cause of the financial crisis. Here, I would like to reiterate, and reiterate quite firmly, that this is clearly not what I envisage. Rather, the goal of the capital markets union is to create a level playing field, by introducing simple standards that improve transparency. Only then can the capital markets union foster financing flows that support economic growth in a sustainable fashion.

V. Concluding Remarks

Dear participants, let me wrap up. I presented to you a central banker's view on capital markets union and why I think this is a very important initiative. Today, the discussion on capital markets union is still very much at an early stage. The agenda is being set as we speak. Having an exchange of views on such an important topic with esteemed members of the capital markets community could not have come at a better time. Therefore, I very much look forward to your discussions later today. I am confident that this conference will yield important insights and new ideas that will bring us closer to completing this important pillar of economic and monetary union in Europe. I thank you for your attention.

Cyrus Ardalan

Many thanks, Governor. I think that was really a fascinating presentation and certainly highlighted areas that many of us have not been focusing on, namely the impact of credit pricing efficiency on stability in Europe, the transmission mechanism and asymmetric shocks. With that, thank you very much indeed to those speakers. We are very grateful for the presentations. We move on to the next item on the agenda, which is a panel on credit market union.

Panel: Capital Markets Union

Moderator:

Cyrus Ardalan, Chairman of the Board, ICMA and Vice Chairman, Head of Government Relations and Public Policy, Barclays Bank plc

Panellists:

William Connelly, Chief Executive Officer, ING Commercial Banking

Bertrand de Mazières, Director General, Finance, European Investment Bank

Daniel Trinder, Managing Director, Global Head of Regulatory Policy, Deutsche Bank

Cora van Nieuwenhuizen, MEP, the Alliance of Liberals and Democrats for Europe

Cyrus Ardalan

Having listened to those three presentations, I do not think we could be in a better position to have a panel discussion on capital markets union: three very different but all very interesting perspectives on capital markets union, what it means, what it will provide, etc. One point common to all, and which I think we all share, is that this is a very serious and significant initiative on the part of the European Commission, one which is being taken very seriously and viewed as something that could have a pretty dramatic impact on the future. It is significant in two respects. First, it reflects a significant shift in the focus of the Commission, from focusing on stability to focusing on growth. It comes out through all three presentations that that is very critical. Secondly, it reflects that a key element in that shift from stability to growth is the capital market, and that is central to your view. We are now, in many ways, in the centre of what is being proposed. That is, in some ways, very nice, but also puts enormous responsibilities on us as an industry and as an association. It is also clear that this is a highly complex and multifaceted issue, and has many different aspects.

With that, today's panel, I think, should be a very interesting opportunity for us to explore these issues in much more detail. I have four very distinguished panellists who bring diverse perspectives to this project. I will make a very quick introduction.

- Bertrand is the Director General of Finance at the European Investment Bank. He has had a very distinguished career in the public sector and he brings a very interesting public-sector perspective, but also a markets perspective, given the role of the EIB in markets.

- Cora van Nieuwenhuizen is Member of Parliament for ALDE. She is on the Economic Committee and is rapporteur on the benchmarks dossier, so playing a very important and key role in Brussels on issues of great interest and importance to us.

- William Connelly is the CEO of ING Commercial Banking, a member of the management executive team, and brings a commercial banking perspective.

- Finally, Daniel Trinder is Managing Director and Global Head of Regulatory Policy at Deutsche Bank, one of the leading investment banks globally, and certainly one of the leading investment banks in Europe, in addition to being a universal bank, so he can bring an interesting perspective.

We have a set of three questions we would like to explore. We will go through each one of them in turn, and, at the end of each question, we are going to give you an opportunity to express your views on the topic that we have discussed and look at the results of that. The first is: why do we need a capital markets union in Europe? After all, Europe has been around a long time, so what has changed? Why is it so important that we should be focusing on capital markets union? What does it entail? Is it just a short-term response to a problem we have had for a couple of years? Is it a more structural sector issue? Is it a product issue? What is it all about? I would like to have all four participants discuss that. Perhaps, Daniel, you can kick off.

Daniel Trinder

I was going to make three observations, one of which, around being too reliant on one source of finance, was covered by two of our guest speakers. I will make one point on the statistics around how much Europe relies on bank funding at the moment. If you look at how banks like Deutsche are involved in markets, through market-making and facilitating client trades, that is not going to get easier going forward. You have a lot of challenges in the European banking landscape. You have the cost of capital for most banks now touching on above the return on equity. You have a lot of regulations, albeit good, such as the AQR or leverage ratio, coming in, which, again, are going to be challenging for banks to fulfil.

That is the banking aspect. I also think, if you take the economic numbers around savings and attracting investment into the EU, Europe does a very bad job at selling itself outside the EU. It is hard enough for people within the EU, often, to understand how Europe functions, but it is confusing for investors looking to invest into Europe.

The third point, just at a macro level, would be that, for many of the companies that require finance, historically, bank finance may have been the right form of finance for them to be relying on; that is often now not the case and it is better if they look at other options available to them going forward. That is where capital markets can deliver. If you look at some of the really big success stories in the US about some of the companies that did not exist 20 years ago – Google, for example – they are not relying on bank finance. It is other forms that have created them.

William Connelly

From a pure bank perspective, our observation is that, as a result of the crisis, certainly there has been regulatory change and it has been good. We have seen that banks now have stronger capital ratios; we have improved liquidity; in our case, we are now supervised by the ECB. We have much more robust recovery and resolution plans. However, there have been two consequences of this that do affect this discussion. One is that banks have deleveraged, and therefore we are not able to fulfil the full role that we played before the crisis.

Secondly, which is something you will all be familiar with, there is much less liquidity in the market. When I refer to liquidity in the market, I have to distinguish between two very distinct markets in Europe. One is investment grade. I certainly believe that investment grade companies and entities have full access to the market, and, as a matter of fact, it is probably the best time that they can remember as an issuer to the markets. For those that are non-investment grade, these are companies that maybe do not have the size, maybe have lower leverage, may be SMEs of mid-corporates. Clearly, the pricing and ability to access capital markets are very different from the first category. In that regard, I believe that the capital markets union can play a very important role, because it is in that area where I think the most benefit can be acquired. This requires a bottom-up approach, from us, the market participants. There is a lot we can do to facilitate the process. We have heard Commissioner Hill indicate that he wants proposals from us in terms of how we can do it better, and I think we should take opportunity.

Equally, there is a top-down requirement. You are all familiar with the themes. We need better harmonised tax treatment; we need better harmonised accounting, particularly when we think about MiFID 2 and the implications of that; and we need public filings to do with providing securitisation, covered loans and bonds to go through. We need a better framework that allows market participants to pursue these opportunities. If I look at the opportunities, it is also an observation that much that has been debated until now is regarding issuers. I think a well functioning capital market requires not only issuers but the investors to be aligned, and the role of intermediaries, ourselves.

I come back to a point that I raised earlier. In both the investment grade and non-investment grade markets, I am concerned about the increased lack of liquidity. The ability of banks to fulfil the role they have played in the past is not there. To the extent that there is liquidity, it is in many cases provided by hedge funds and shadow banking, which is not something I would have comfort in if I were the central bank. Certainly, when you look at the consequences of new regulation coming in, for instance, a retail investor has to be able to invest €100,000. I struggle to reconcile a retail investor and €100,000. We can also see the impact in terms of QE also squeezing out private investors. QE is a good thing and we know why it is being done, but there are consequences there, and we see more coming.

We see the banking structural reform. We see certain aspects of TLAC coming our way. FTT is coming also; there is a continued debate there. There is the fundamental review of trading books. In our view – and this follows what Commissioner Hill said – yes, there has to be regulation; there has to be a framework, but it is not a matter of adding new initiatives on top of others; it is a matter of making sure that the framework that is set is clear, robust and aligned with all three participants in a capital market.

There have been many comparisons done with the US, and I think we have to move away from that debate. The US, first of all, has different accounting standards. For instance, as you all know, mortgages do not stay in banks; they tend to go to public entities. The common language is a big benefit. The role of retail investors is also very different. People much more actively manage their own pensions than they do in Europe, and therefore, by definition, they are not curtailed, for instance, by a $100,000 limitation.

We, as a bank, are certainly encouraged to see that the Commission has taken a more active role. We do agree that this is a journey; it is not coming in overnight, but it is a balance that is required between ourselves, the market participants, and top-down initiatives coming through, but there has to be, in my view, a key component, which is addressing the matter of liquidity. That will then create what is the stated goal: a more robust economy and financial system, and support jobs and growth.

Cyrus Ardalan

It is an interesting point. Deleveraging has caused the problems for some sectors, like SMEs, which are not getting credit. The range of products that we have may not be adequate. How do you see this from Brussels, from your perspective? What are the key elements that need to be addressed or key factors that we need to address in capital markets?

Cora van Nieuwenhuizen

Of course, after any crisis, there is an instant reflex in politics to come up with new regulation. That is exactly what happened in the last few years and exactly what we are looking at now. It is a pity that Commissioner Hill is not here anymore, but he has to come up with this mandate with over 400 delegated acts. If we are talking about detailed regulation, you are really facing that. I agreed with what he said, in that we need jobs and growth. Well, governments do not create jobs; businesses do, so what we should do is get out of their way and give room for companies to grow.

I meet a lot of entrepreneurs, and they always come with the same single problems. For example, everybody who wants to sell their products all over Europe has to deal with 28 different systems of VAT. The Council cannot even agree on the form – I am not even talking about the rates – to use for VAT administration. It is also a pity that Mr Dijsselbloem is not here anymore, because I would really urge him to make progress in the Council on more harmonisation. It may not be that difficult.

I agree with what has been said already: SMEs provide most of our jobs, so we really need to have more attention on SMEs. I am very much in support of what the First Vice-President of the Commission, our own Frans Timmermans, is doing in his proposals for cutting red tape, but I would prefer the approach that Prime Minister Modi of India has taken. He has said not only, ‘We have to cut red tape’, but he also said, ‘We have to replace it with red carpet for our businesses.’ Basically what we should do in the capital markets union is rolling out the red carpet for businesses. Make things easier; make them feel welcome in our countries. A lot of that is still not functioning very well.

For me, in the Parliament, I want the focus to be on making things easier. For example, next week in Strasbourg, the Parliament will be voting on the shareholder rights directive. I do not know if you have read it, but, in my opinion, this is exactly the wrong example, because it is way too detailed and way too rigid. If you want to have alternative financing to banks, one of the alternatives could be for some SMEs to go and get listed. Well, if you read the shareholder rights directive, they will not even think about it anymore. I think we really should be focused on rolling out the red carpet.

I also have the privilege of being the rapporteur for MiFID on my group. Well, that is also a very bad example. As I was discussed with my neighbour, as a Christmas gift from ESMA, I got 1,800 pages about MiFID. That was not really what I wanted to read under the Christmas tree, but it also shows that it is too complicated. We have to get back to the simple principle that it has to be workable and pragmatic.

I am sure you all agree that we, as politicians, are very good at listening, but mostly to ourselves. Commissioner Hill said he wants to listen to you. Well, I hope he does. Of course, there is the green paper, but I would urge you all to come up with different proposals, because, as far as I am concerned, there is only one government body that is really listening to businesses, and unfortunately that is the NSA, and that is not the kind of listening that we want to have, so please keep asking for more.

Cyrus Ardalan

Thank you very much, Cora. That is very sobering. Essentially, what you are saying is that we need a capital markets union in order to address all these factors, which are the real factors preventing companies from growing and doing what they need to do. I think a lot of people would share that view. Bertrand, you are looking at it from the perspective of a major issuer in the capital markets.

Bertrand de Mazières

As an issuer, what does it mean and why do we need a capital markets union? I must say that, when you asked me the question in advance of this panel, I thought I would tell you a story. It is a story I was hesitating a bit to tell, because it deals with the access of retail investors to the bond market, which usually attracts a big yawn. However, I am quite encouraged to tell the story all the same, because I noticed that both Mr Dijsselbloem and Commissioner Hill mentioned access of retail investors to markets, which they saw as one of the important items for the future.

Indeed, it is right. The EIB, as a large public issuer in Europe, tries to be a bit forward-looking and in the vanguard of practices in Europe, so, when the prospectus directive was implemented, we tried twice, in 2006 and 2007, to make public offerings across the entire EU. Actually, the first time, we were not so daring. We tried that only for the retail markets of members of the eurozone. Then, the second time, in 2007, we tried for all 27 markets. I must say, it was a success in a way, because it was also the inception of the green bond issuance that is one of the major successes of Europe, and we will certainly get back to that later on in discussion, but it was also an immense frustration.

Why was that? We had a passport with the prospectus directive, but we discovered that, beyond the passport, we needed 27 visas, and, when I say 27, you multiple it by three or four, because, in each member state, you had to get the authorisation and abide by special regulation set by the regulator regulating the markets, the supervisory authority, you name it. We discovered that, for example, in some countries, we needed to translate the prospectus in different languages, because some countries have more than one national language. That is fine, but not if the translation is done by a slow translator who generally does not have a clue about what he is translating.

As another example, in some countries, when a prospectus is registered, you have to publish, in a widely circulated newspaper, a notice on the prospectus, but you have to circulate that on the day of the listing of the prospectus or on the day after, not two days after. Otherwise it will fail and you cannot do it. There are all kinds of examples like that. Some regulated markets ask you to go through specific procedures and so forth. In the end, we never repeated the experience. To my knowledge, not even one other issuer in Europe tried to do a public offering all the way across Europe.

You may ask, 'Why bother?' Well, there is research from the United States, concluding that the fact the Treasury can access the retail investor translated very easily into several basis points of economy. Given that the benchmark is the anchor of all the other interest rates, it means that the entire economy of the United States gets a few basis points of economy, thanks to a good retail market access. It is also a very good experience, because it shows that, basically, at the moment – I do not think it has changed since 2007 – this market functions under a series of layers of regulation that end up in a very complicated system, so we should certainly do something about this.

Cyrus Ardalan

That is very clear, thank you. With that, I would like to ask you all to pick up your iPads. We have put a question, which is the first question we have been addressing: why do we need a capital markets union in the EU? You have four options and 14 seconds, I believe, to express your views; otherwise the iPad will blow up or something.

[*Votes cast*]

To promote deeper and larger capital markets in Europe is at 53%, so it is less of a question of basis points, and much more providing the depth, which I assume is both in terms of the types of products and the volume of lending that would be provided. That is interesting. Thank you.

With that, I would like to move on to our second topic: what does a capital markets union mean? I would like to focus the discussion on Daniel and Bertrand for this one, and then we will come back to the full group for the last question. Daniel, what are your thoughts on that? Does capital markets union mean setting up an SEC in Europe? Is it something different?

Daniel Trinder

The SEC are trying to work out themselves what a capital markets union in Europe is. To be honest, I do not think it is anything particularly new. Lord Hill mentioned that it is almost another attempt. If we go back to the Lisbon Treaty, the financial services action plan of 1999-2004, and the 42 measures that the Commission introduced, many of those had the same goal in terms of creating a capital markets union. In fact, for those that spent too long at university doing economics, one of the conditions for monetary union is the Mundell–Fleming assumption, about the need for that capital market flexibility, so I do not think it is anything new.

Bearing down on what I think it means, if you take the issue of standardisation, national discretion or gold-plating, there is clearly a whole category there. Politically, people need to remember why there are national discretions or gold-plating: because the political process in Europe is always going to lead to some differences. I mention just one example there. Lord Hill gave these figures around the private placement industry. I think what he did not mention is that a very large chunk of the funds raised in the US private placement markets is raised by European blue chip companies. One of the reasons why they do that, if we take one Scandinavian country, is because there are requirements that are not in EU law but additional requirements that mean it takes them about an extra three months to raise capital, and they need to spend about €300,000 on additional ratings or legal opinions. That is one category.

The second category I mentioned is: do not forget the market-making functions of banks. They are under immense pressure. Many banks are withdrawing from many markets. Deutsche Bank got out of single-name CDS in the last half year. Standard Chartered has got out of equities full stop. That will continue. The main number here is on the depth. If you break that down, on the private placement regime, that is needed in Europe. There needs to be a single, harmonious regime, not just for European investors but for international investors to invest into Europe.

There have to be targeted changes to insolvency law. Yes, it is politically difficult, but, again, from an investor perspective, many of the funds that came in straight after the crisis, so-called distressed debt funds, did not touch those regimes where the insolvency rules just made it impossible for them to invest. They went to countries like Ireland. The restructuring procedures around the insolvency laws are very important for Europe to sort out for that reason.

There has to be some sort of encouragement of equity culture in Europe. That means, unfortunately, the Council are going to have to look at some of the tax issues around the dead equity, cost of capital and withholding tax. There are massive differences in disclosure requirements across Europe. If you look at the raft of measures coming out – EMIR, the regulation part of MiFID, the securities financing transactions regulation, which is not complete, and also some of the ECB requirements on top of that – there are massive conflicts across them. It does not make sense and makes it very difficult for investors to work out.

I have two more. The Commissioner mentioned the collateral issue. I chaired an ICMA conference in Brussels last year, with representatives from the Commission, the Basel Committee and the ECB. I think they mentioned 11 or 12 bits of EU regulation that hit the collateral world. That is very hard. Collateral highlights this: you trap liquidity a lot where there is actually not much liquidity. You have conflicting bits of regulation going in different ways, and what is hard is, if you try to meet your leverage ratio, it has implications on liquidity and vice versa, essentially.

The last one is on securitisation, which was also mentioned. It is for bank balance sheets, as the speakers said, but it is also for the small firms as well. For blue chips, it may not matter so much, but these are the things that are packaged together, whether it be credit cards or small firms' loans. It is also for them in terms of their financing. For me, that is what it means.

Bertrand de Mazières

What can capital markets union mean? I am not going to repeat any of the very good ideas that have been said already. We listened to very good ideas at the beginning of this afternoon. However, I think that, certainly as a starting point, there is a necessity to reassess the cumulative impact of the regulation, especially the regulation that has been developed since the crisis. I think there is a willingness to reassess the impact of the regulations here; I can hear that from the EU authorities. I am not sure it will translate automatically into less regulation.

Again, my example of the attempt at using the existing EU templates shows the fact that it does not work. What it certainly means is that we need more convergence in the regulation. We are lacking convergence. We are too fragmented in the way the EU regulation is applied. I am quite interested in what you said about the excessive complexity and the detailed nature of the directive. It is a very good point. On the other hand, I think that, sometimes, the room left to member states for national implementation is much too wide, so we have to find a way to write less detailed, more policy level text at the Commission level, but also leave less room for national implementation. At the moment, we are suffering from too large divergences from one authority to another.

What could it also mean, perhaps? It could mean some slight changes in the way the EU authorities function. For example, I wonder whether they could not give more room to the notion of accepting developments that are the result of enterprises by market participants. Instead of wanting to be 'the regulator' everywhere, just be satisfied with acknowledging and validating, saying out loud, 'Okay, the template you have established is fine for me and the implementation of this template by market participants is correct.' Some sort of lighter way of regulating would be a good idea.

We tried that when I was Chief of Staff of a regulatory agency in France at the turn of the century, one of the two regulatory agencies that merged into the current French Financial Markets Authority. At the time, we tried that. We had – and it was specifically provided for by the European legislation – the possibility to publish our acknowledgement and approval of templates developed by the market. I know, because I have this experience, how we can fail, as it were, because, in the end, there is the risk that the validation becomes as complicated and as cumbersome as the mechanisms of direct legislation, so it has to be light in the way it is done.

The fact of being not as thorough in legislation could give the EU authorities the opportunity to validate for a limited period, and that would be fine, just to say, 'Okay, for the next five years, what you write under private placement' – for example – 'is fine with me, but I reserve the right to review, to legislate or to change my mind in five years, of course without any effect on what has been done under the previous process.' This is the kind of thing that maybe the Commission could consider. The Commission could also consider thinking more about guidance instead of direct regulation, inviting economic actors to engage in such-and-such activity that would validate some developments.

Cyrus Ardalan

Thank you very much, Bertrand. Let us conclude this session and again go to our iPads. You have four options. What does capital markets union mean? Is it better and less regulation; a single

European supervisor; more pan-European markets on the model of the euro-bond market; or greater access to funding from a wider group of European counterparts? Let us go ahead with the vote.

[*Votes cast*]

The results are: better and less regulation, 8%; a single European supervisor, 7%; more pan-European markets, 20%. The vast majority are very clear that it means greater access to funding from a wider group of European counterparts. It is really creating an ecosystem that allows small size companies, or even larger size companies, that do not have access to the type of financing they need, be it long-term or equity financing, to be able to access it. It is really developing an infrastructure that broadens the supply and type of products available in the market. That is what it means. That is interesting.

That is a good way of moving into our last question, which ultimately is the defining question. Lord Hill called us all to action: ‘Look, it is bottom up. It is all about the industry coming up with ideas.’ I think we are all on the same page as to the importance and the need for moving ahead with capital markets union, but the question is: what do we have to do to achieve this? This has a number of dimensions. One is that there are legal, fiscal, infrastructural and product issues. Where do we start? There are long-term and short-term issues. There is some low-hanging fruit that we can take, as Lord Hill mentioned. We have identified the prospectus directive, securitisation and the private placement directive. Then there are much more long-term things that might have a much more profound impact and will take time to do, to do with bankruptcy laws, fiscal incentives, etc. There are issues of complexity and consistency, which have been mentioned in our discussion.

At the end of the day, I do not think it is particularly helpful for you to come up with a list of 2,000 things to do; we are not going to get very far, so what I would like to do is each take three or four, maximum, areas that you would recommend be the focus for the immediate future if we are going to really make a difference in this whole project.

Cora van Nieuwenhuizen

We should be realistic about what is feasible in the near future and what is really long term. If we are talking about bankruptcy, insolvency, the differences between the 28 member states are that big and it will take a long subsidiarity discussion. I do not think that would be on top of the list. Of course, the prospective directive is one that can be taken up really quickly, but I think we also all agree that we are not going to change the world and solve the problem through the prospectus directive by itself, although it is important.

I really think we should try to take up securitisation as the next thing to work on. That is what the majority of SMEs could use as an alternative to what already exists. The prospectus directive is wonderful, but most of the SMEs are not going to use it anyhow. To be a bit more optimistic, you said we had the same discussions back in the 90s. That is true. I am also in the Special Committee on Tax, and, last week, we had a meeting with Mario Monti, discussing that the same problems were discussed in the 90s on taxation and tax avoidance. However, a big difference now is that we feel more of a sense of urgency, because, if we are looking at the rest of the world, Europe is losing competitive power, so we simply cannot afford to postpone things anymore. We really have to take up the work.

That is the reason why we could succeed this time: we really have to succeed, because we are losing it every day, every month. I am also Vice Chair for the Delegation to India, so I have a lot of contacts in India. They are moving very quickly, so we cannot afford to not take up the challenges.

Cyrus Ardalan

Thank you. Securitisation is obviously a very key one. What would be your second area of focus?

Cora van Nieuwenhuizen

Crowdfunding has been mentioned. That is on a very small scale. We also have to discuss more about credit unions and other alternatives that there are. Mostly, when I meet bankers, they are very afraid of shadow banking; they are probably the most afraid of shadow banking of all people, and I can understand that, but we have to face the world and see what is happening, with Google payments and what Facebook is doing. One of the big discussions that we are going to have in the Parliaments, and in all national parliaments as well, I think, is who owns the data of companies and of individual consumers. That will have an impact on all our business models, I think.

William Connelly

I quite agree that we might have to manage expectations. There are a number of things in the short term that I do think could have an impact; you mentioned securitisation, and some of the things mentioned by Commissioner Hill. For banks, certainly a concern is, as I have raised, liquidity. Regulators have to distinguish between when it is facilitation that we do to support and encourage new issues, and that can be a medium-sized IPO, to make sure that there is facilitation, and when it is proprietary trading and the risks that that brings across. It is a very difficult debate that we have had, trying to distinguish and explain the difference between the two. It is all viewed as proprietary trading and therefore evil and therefore not to be done, when, actually, there is value there.

In the more immediate term, certainly harmonisation is required. We are very active not only as a major eurozone bank, but we are active in the US, both in terms of lending as well as capital markets. One thing that is apparent is that the US commercial code, particularly in cases of bankruptcy or difficult situations, is extremely efficient. You know exactly what you are getting into. That is not the case in Europe. In some cases, in some countries, it works well; in other cases, you can be years locked in a difficult situation with no resolution. That makes it much more difficult to support and encourage business. A harmonisation of the things that we have mentioned, and also the whole commercial code in which we operate, I think would make a huge positive impact in terms of the longer term for European capital markets.

Daniel Trinder

The difference here is I think there is the political goodwill. I never thought banking union would get completed as quickly as it did, and I think some of that has spilled over to addressing some of the economic problems that Europe has. In some senses, we are attacking the low-hanging fruit. It is not low-hanging because it is necessarily the easiest to reach; it is low-hanging because of where it is in the process, so it is securitisation or the prospectus directive review, etc. With securitisation, that is where you start to see the benefits most quickly, and then I think people will start to realise much more the economic benefits of it. Politically, it takes some pressure off that may exist. If there is no action in a couple of years, people might start to question the approach and say there is much more regulation required.

We have a series of very difficult medium-term issues. We just mentioned insolvency and tax issues. The timetable is slightly different, but the political will is there, so you need to start that process now to get change, but you also need to be ambitious in the process. If you are not ambitious, you get nothing.

Bertrand de Mazières

First of all, there are reasons to be optimistic. The speeches we have heard this afternoon are reasons to be optimistic. There are things that are being put to the market now. For example, I am thinking of European long-term investment funds, this piece of the EU legislation that I can tell you the EIB is willing to put into action as quickly as possible. The idea that not everything will be possible, at the same time, is quite important. If you look at the example of the United States, first of all, we are speaking today about capital markets, with an 's', not a capital market without an 's'. That is the situation in Europe. Even in the United States, they have a functioning capital market union with a lot of diversity in their legislation. They do not have uniform legislation of insurance companies, for example. Their corporate law is quite diverse, so we do not have to do everything at the same time. What I think is certainly expected from the EU authorities is a clear indication of an order of priorities.

When I am speaking of the EU authorities, I am speaking not only of the Commission but obviously of the representatives of the European people and the Council, and also sometimes of the institutions such as the ECB or the EIB as well. What could these institutions do? If I had a wish list of where to start, I would certainly consider that one has at last to finish the job in the field of financial markets infrastructure. We are almost there, but it is very frustrating. I do not know how old the Giovannini report is. I fear to tell you how old it is, but it is not yet fully addressed. We are not far from that, and I think that a very good start of the capital markets union policy would be for the Commission to jump-start the final solution and make platforms for trading across the EU an internal priority.

Otherwise, what could be done, if I had this wish list? Again, speaking about the EU financial market infrastructure, I would like the Commission to act relatively quickly on the establishment of pan-EU information systems, for example of data dissemination. For example, why not have a standardised public corporate filing in Europe? Why not even have an EU-generated low-delinquency information system? These are things that are actually relatively easy to conceive and would provide a huge step forward in terms of unifying the risk assessment across capital markets in Europe, and that is an essential part, I think, of capital markets union.

Then I can become a bit more inventive and daring. For example, I spoke about this idea that the Commission could use more validation and expression of satisfaction with developments in particular areas. There is one field where the Commission could apply that. I am thinking of this field not only because the EIB has been at the vanguard, but also because it is really a field where Europe, at the moment, has the initiative in the world, which is green finance. The Commission could simply say, for example, 'There are green bond principles, and these principles are fine and we support them. We invite the entire community to apply them.' The Commission could even support the translation of these guidelines into policies by private institutions. For example, I am thinking of pension funds; they could invite these funds to invest in securities that abide by these principles.

There are these relatively easy things where Europe has done things already, markets have been particularly active and the Commission could relatively easily move forward and invite markets to take further steps. I could be even more daring and think of the Commission, instead of trying to invent new taxes that will be applied only in a few countries and one more layer of complexity, trying to unify views on tax harbours, which is easier to do than to increase tax. Why not develop some sort of tax incentive for green and socially responsible instruments? That would be something also to look at. It sounds daring, but that would be an act of unification, and it is not so zany, because it is what the SEC more or less is doing today. The SEC is imposing that listed companies in the United States will report on social risks and social responsibilities.

Cyrus Ardalan

That is very interesting. A number of common elements have come through very clearly, and securitisation seems to be top of virtually everybody's list. There is the whole question of infrastructure in the broader sense, from information to other aspects of infrastructure. Long-term investments are very key. Harmonisation in general is probably more long term, but very fundamental if this is going to happen. Cora mentioned credit unions, which leads to the whole question of looking at the other channels of intermediation that are out there and trying to get them to work more effectively than they have. Let us not neglect them; quite on the contrary, let us try to support them. Green bonds are another very interesting alternative.

Let us vote quickly on this one. We have three options. Very quickly read through those, and then let us go ahead and vote.

[*Votes cast*]

Again, there seems to be a majority for one, which is addressing the structural barriers: market infrastructure, collateral rules, taxation and insolvency regimes. That is followed by support for self-regulatory industry initiatives, which is interesting, and then a comprehensive review of the EU financial rules and regulation. It is interesting because it properly reflects where the real meat is, but it is a trade-off. If there were no constraints, this is exactly what you would do, but, if there is a constraint that means it will take 10 years to do that, is it what you want to do? That is the dilemma that the Commission faces, and I think it is the dilemma that we are all going to be facing. One of the key issues that needs to be managed very carefully, as has been said by the Commission and everybody else, is managing expectations. What is the glide path on this?

Thank you very much for your time and your contributions; and thank you for participating.

[*Break*]

Martin Schleck

Welcome back, everybody. We move into the second segment of our conference. It gives me great pleasure to welcome a very prominent figure, Dick Sluimers, who is the CEO of APG, one of the world's largest fiduciary managers, to come and share his thoughts with us. He has a long, distinguished career in both the public sector, with the Ministry of Finance, and in the private sector. He was formally the Chairman of ABP and has also a number of board mandates and trustee mandates with both private sector and also educational establishments. Without more ado, welcome. Thank you very much for coming and speaking to us today.

The System is not Stable

Dick Sluimers

Chief Executive Officer, APG

I. Preamble

Thank you, ladies and gentlemen. When I have the honour to address such an audience as you are, I always look to the names and the companies that are gathered here, and I can honestly say that I was very much impressed by so many financial specialists and economic experts.

II. Destructive Power

I did recall a story once told by a very good friend of mine who, in his heyday, was one of the key advisers of Mikhail Gorbachev. He told me that, when Mikhail Gorbachev was elected in the Politburo – elected in the Russian way, with 99% of the votes – he had been brought to stand on the balcony of the Lenin Mausoleum to see the first May parade. He said Gorbachev was standing there on the balcony, next to him Marshal Grachev, the Minister of Defence. He saw this enormous parade, going on for hours and hours, and Gorbachev was watching.

Suddenly, something very strange happened. There was a big gap in the parade; actually, there was nobody at the racetrack, except for one person. A guy, walking with his briefcase, just by himself, passed by, waved to the whole Politburo, and they all seemed to know him, because they waved back, and then the whole parade resumed, and, again, all the missiles passed by. My friend told me he asked Grachev, ‘Grachev, tell me, who in Heaven’s name is this man?’ Grachev said, ‘Well, my dear friend, my dear comrade, that is Boris Antonovich Baryshnikov. He is head of Gosplan. He is our Chief Economic Advisor.’ ‘But, Grachev, tell me, if he is our Chief Economic Advisor, what the hell is he doing all by himself in a military parade of the Red Army on the Red Square?’ Then Grachev said, ‘That, my dear friend, is to remind all the people in Russia that the destructive power of one Chief Economic Advisor is much greater than the whole of the Red Army.’

III. Sources of Instability

1. Overrated Economic Modelling

Ladies and gentlemen, the title of my speech is, not surprisingly, maybe, after this introduction, that the system is not stable. I tell you, last week, in the Tuschinski, a big theatre in Amsterdam, we had the premier of a movie called *Boom Bust Boom.* It was made by a Dutch professor called Theo Kocken and Monty Python icon Terry Jones. The movie is a humorous and sometimes hilarious description of various economic developments. Recurrent themes are the overrated belief in economic modelling and the persistence of financial crisis, like the tulip-mania in the 17th century in Holland, the railway-mania in Britain in the 19th century and the Wall Street Crash following the Roaring Twenties in the last century. Notwithstanding the funny character of the movie, its message is rather serious. For me, it all boils down to the notion that the financial system is not stable. In the movie, we see interviews with well known economists like Robert Shiller, Daniel Kahneman and Paul Krugman, who explain, in their own words, why financial systems have been and will always be unstable. The message is not new.

2. Euphoria

The movie is just another way of illustrating existing economic wisdom about financial crises. John Maynard Keynes already pointed out the extreme instability that is characteristic of a highly developed capitalist economy. He saw the violent psychological swings in mood among entrepreneurs as the basic source of instability. John Kenneth Galbraith, in his book, *A Short History of Financial Euphoria*, also traces financial bubbles through several centuries and argues that they are inherent in a free-market system. According to Galbraith, financial memory is notoriously short. What currently seems to be a new financial instrument is inevitably nothing of the sort. The world of finance – that is you – hails the invention of the wheel over and over again, often in a more unstable version.

3. Highly Integrated Markets

The financial crisis of 2008, which took many economists by surprise, seems to confirm these theories. We know that financial bubbles do exist, and yet they often take us by surprise. It looks as if there is a form of collective irrationality in the system that seems hard to escape. Yet, for me, the recent financial crisis is different in two important respects. First of all, due to technology, we now have highly integrated financial markets. In the good old days of Keynes and Galbraith, the problems in the US housing market would have been a problem of some shape in the US, maybe leading to one or more bankruptcies of some local banks before somebody in Washington realised that their housing programme was a little bit too generous. In the world of today, though, this is quite different, because, as a result of securitisation and the worldwide reselling of mortgages, many international financial institutions were also hit. This turned a national housing problem into a worldwide credit crisis.

I think there is a reason to believe that this instability will increase even further in the near future, with the technological advances and concurrent disintermediation of recent years. Look at the success of services like Bloomberg and Airbnb, who make these integrated financial markets change at a very rapid pace. As a consequence, there is considerable risk that policymakers and regulators are regulating the world of today and not, ladies and gentlemen, the world of tomorrow. Risk will not disappear by making regulation stricter. It will inevitably appear somewhere else in another form, like an air cushion, underpinning, time and time again, that the instability of our financial system is there.

IV. Unintended Consequences

1. Regulation

What are the consequences of this? Because of the limited time I have, let me focus on some elements of financial regulation. What are the consequences for financial regulators and policymakers, knowing that instability is part of the system? Now, it would be easy for me to reply that we simply need less regulation and to let risk prevail. That is not what I intend. Regulation is necessary. We need to prevent fall. We need transparent information and a level playing field. We need to address these in the free-market system. My plea is simply that regulators and policymakers should be diligent in designing all kinds of regulation promoting stability, because regulations tend to cause unintended side effects, and these side effects might become, by themselves, the source of new instability.

2. Interest Rates

Let me give you some examples in the financial sector related to interest rates. I am not going to talk about the low interest rates, although the effect of the quantitative easing programme would be an interesting example of the collateral damage that can occur from financial regulation. What I would like to discuss is the danger of rising interest rates and the possible side effects that can occur as a consequence of financial regulation. Let me elaborate on this. Central clearing obligations from the European EMIR regulation make regular interest-rate-hedging activities more expensive, mainly because of the margin obligation. At the same time, we see that the repo market becomes thinner and thinner because Basel III is setting a leverage ratio obligation for banks.

The two separate measures may have their logic. In order to curb speculative strategies, for example, by high-frequency traders, strict daily margin calls may be a good thing, and improving the balance sheet ratios of banks also has a logic from a financial stability point of view. However, applying the daily margin-call obligations to pension funds is little bit less obvious, because they have long-term investment strategies and, by law, only establish derivative positions for liability-hedging purposes. If the stronger regulations for banking apply to pension funds, which will have less and less access to repo transactions for their market calls, then liquidity risk becomes a serious and, I would say, necessary issue.

3. Pension Funds

EMIR regulations are intended to reduce risk in the financial system by making life harder for speculative traders. However, these changes also make derivative products more costly. Therefore, an unintended side effect could be that it becomes less attractive for pension funds to use these products in their regular liability-hedging activities, therefore ending up in more risky positions.

The adverse effects of EMIR for Dutch pension funds could be aggravated by prudential regulations in the Netherlands. The so-called financial assessment framework is used by the Dutch Central Bank to monitor and to control the financial position of pension funds. One of the underlying principles in this framework is that pension funds need to hold capital buffers in proportion to the risk they take: more risk implies higher required buffer. As such, this is a very sound principle. An important feature in this framework is that hedging interest rate risk always reduces the total portfolio risk. However, given the current low-interest-rate environment, reduction of the interest-rate hedge could be considered sound financial policy as well. The problem is that lowering the interest-rate hedge is not allowed, as the current financial position of Dutch pension funds is too low. These funds are therefore trapped in a position where they could suffer when the interest rate rises.

The current developments today in financial markets are in this respect quite interesting. Let me give you some idea of this. The Dutch pension fund industry has total assets under management of roughly €1,200 billion. Let us assume that their interest-rate hedge is somewhere around 50%, on average. Let us further assume that interest rates rise by 100BPS in a short period of time. The total amount of liquidity that has to be generated to satisfy the margin calls will be somewhere around €140 billion. This is quite an amount of money, even for the Dutch pension sector. That will surely cause some stress in the sector. If you think those interest rate increases are impossible, let me just mention that, from 20 April to 14 May this year, we have seen a spike in the 30-year swap rate of 17BPS. It is not that theoretical, ladies and gentlemen.

There is no easy solution to this problem of regulatory changes having unintended side effects. Any framework will have its advantages and its disadvantages. A possible improvement was recently put forward by my former colleagues, Professor Frijns and Professor Maatman, the latter also being a former Board member of the Dutch supervisory authority, AFM. In a Dutch newspaper article, they argued for more reliance on the open law of the prudent person principle. An open law would have the advantage that it gives pension funds more freedom of choice in designing their financial policies.

4. Replication of Behaviour

Remember what I said about the fact that the markets are becoming more and more intertwined. This effect is partly caused by the fact that strict regulations force large institutional investors to invest in a similar way, thereby promoting copy-and-paste behaviour. From a micro perspective, such an open law may be more difficult for a supervisor to monitor, but it might have a big advantage for a supervisor from a macro perspective, as countercyclical investment policies will strongly increase the financial stability of the system.

V. Concluding Remarks

Governments often see financial markets as a source of instability, and rightly so, as I have argued. However, from the examples I have given, we may conclude that governments themselves also can be a source of instability. Let me give you another example. Several institutional investors have invested large sums of money in French motorways. The yield on this investment was linked to inflation, which, as you know, is quite important for pension fund investors. The French Government, however, has jeopardised our investment strategy by imposing new restrictions on the fare that motorway companies may charge on motorists, a clear example of changing the rules after the game has already started. This type of government behaviour is highly detrimental to the long-term investment agenda of institutional investors.

If governments want to foster long-term investment, they also should also foster long-term agreements with investors. This holds true on a national level, and equally so on an international level, such as, for instance, the long-term investment plan that was recently put forward by Mr Juncker to push long-term investment in Europe. Investors much have assurance that the rules do not change during the game, so that we can rely on an adequate risk-return profile, something we simply owe to the participants for whom we invest. If these conditions are met, we may be able to explore possibilities for new investments in Europe, for example in the securitisation of SME loans, real estate and infrastructure. These investments could support the European economic system and could create some stability in the unstable world we live in today. Thank you very much.

Martin Schleck

Thank you very much indeed to Dick Sluimers for some very thought-provoking comments on the way that governments should behave in terms of promoting long-term investment. Our next panel is capital markets and growth, the buy-side perspective, and Bob Parker from Credit Suisse will chair this panel.

Panel: Capital Markets and Growth – the Buy-Side Perspective

Moderator:

Robert Parker, Chairman, ICMA Asset Management and Investors Council and Senior Advisor – Investment, Strategy and Research, Credit Suisse

Panellists:

Simona Paravani-Mellinghoff, Managing Director, Head of Client Solutions' Delegated CIO/Fiduciary, Blackrock

Hans Stoter, Chief Investment Officer, NN Investment Partners (formerly ING IM)

Andreas Utermann, Global Chief Investment Officer, Allianz Global Investors GmbH

Robert Parker

Thank you very much, Martin, and good afternoon everybody. We are going to talk about the asset management industry and its relevance to this topic. I have three very good colleagues with me on the panel, who are the leaders in the asset management industry, and I actually mean that; I am not just saying that to be nice to you. We have Simona Paravani-Mellinghoff from BlackRock. I met your boss recently in Singapore. Blackrock now has over $4 trillion under management, so it is an interesting question as to whether you are systemically important or unimportant but is another issue. We then have Andreas Utermann from Allianz Global Investors and Hans Stoter from NN Investment Partners, who have recently changed their name.

Hans Stoter

Exactly, we used to be ING Investment Management, but, other than the name, everything else stays the same.

Robert Parker

We are going to cover three topics. I start with a small apology, which is that Andreas and I both have to run off at 4.30 fast to go and catch an aeroplane. As a result, we are going to be very to-the-point in this section. Of the three topics we are going to cover, the first is: do we work currently in a very unusual financial environment, and to what extent is that changing investor behaviour? One key question there is: what is the role of quantitative easing in this unusual environment in which we are working?

The second question is: what role should the buy-side investors play in capital markets union? On the one hand – we have heard this from all our keynote speakers today – everybody wants the asset management industry to become more and more engaged in lending and replacing banks, and all of that is logical. On the other hand, I am called a shadow banker – I have banned that phrase, by the way – and people are worried about whether I am systemically important, so we need to get that balance right.

Thirdly, we are going to look at opportunities and threats to our industry, and where the growth drivers are. Let me just start with Simona. Do we live in unusual times and how is this changing our behaviour as investors?

Simona Paravani-Mellinghoff

It is interesting. To every generation, their time looks and feels unusual. The point is: is QE here to stay or not? Are we in an environment of low interest rates that is just a temporary blip, or is it something that we will have to face, potentially, for multiple years? I would say that the answer there – to rephrase the very famous sentence by Keynes, 'Markets can remain irrational for longer than most of us can remain solvent' – is that interest rates can remain fairly low for longer than most investors' patience and job security if they are betting against them.

Why is this the case? I would give two key considerations. The first is about economic growth. With almost no exception, if we look at the forecasts for growth over the next five years, they are definitely below all we experienced in terms of trend growth before the financial crisis. The second and very important point is about the deleveraging side. If we look at what has happened since the aftermath of the financial crisis, we have definitely seen a reduction in private debt, but that has been effectively offset by increasing market debt, so the debt issue is still pretty much there. Where does that leave us? It is potentially a low-interest-rate environment for multiple years, and that obviously raises the question of what we can do as investors and the implications for our performance.

Robert Parker

Andreas, does that mean – to put it in our jargon – that we are moving down the risk curve, into more illiquid assets? I call it down the risk curve; you call it up, but I mean taking more risk.

Andreas Utermann

That is true, but the question is: is it really more risk? I talked earlier to a colleague, and we were debating whether it would be riskier today to buy a 10-year bund now that it is back from 70BPS to about a percent or to buy an equity fund focused on dividend payments, an ETF or whatever. I agree that it is still riskier to own the one that will have lower interest rates for longer. However, if you are expecting probably a negative return after inflation, and certainly not a return of 1% per annum, it would need a very significant drawdown in the equity markets in 10 years' time to lose the advantage of a 3-4% dividend yield that might rise over the period. What may appear risky in terms of taking on liquidity, equity or spread risk may be in fact less risky than what used to be seen as risk-free.

This is the point. One of the things that is unusual about today's period, I would say, is that the risk-free rate over the past 30 or 40 years is being manipulated with intent. When you have a risk-free rate that is manipulated with intent, you cannot really benchmark your investment or your discounted cash flows, and that causes severe issues for the overall world economy.

Robert Parker

It raises a very key point. We have all been taught that the risk starts with very low-risk money market funds; then we move on to government bonds, with a little bit more risk; then, as we progress along the risk curve, we have equities; and then we have illiquid investments such as infrastructure and private equity. Our traditional thinking is that that risk curve implies that government bonds are very low risk. Hans, your background is fixed income. Are bonds now the lower end of the risk curve?

Hans Stoter

If you define risk as the chance of getting of getting your money back, I would say that most government markets are still low risk. If you look at it from a total return perspective, of course, it is a different story. What you do see is, for example, Solvency II still favours the traditional low-risk asset classes over the higher-risk asset classes, but I think that we need to start to take into account also the short-term volatility of the markets in the definition of risk and returns that we need on our investments. For example, if you take a traditionally more risky asset class like high yield, with a long-term return of 300BPS, over government bonds, now, in a much more illiquid market, maybe it should be 400BPS for bunds for the longer period of time, simply because there is an additional source of volatility that needs to be compensated for. I do not really see that back in markets yet. Of course, the same applies if you invest in Belgian OLOs, which are now quite illiquid.

Robert Parker

This discussion about volatility I think is very interesting. Do you think what happened, really from late April to now, is the start of an increased trend in income volatility, and therefore that will change investor perceptions that perhaps government bonds are not the lowest risk?

Hans Stoter

The big difference between fixed income and equites is, when you have a little bit of a selloff in equities, there is also very high turnover on stock exchanges. In fixed income, when you have a selloff, there is basically hardly any trading happening. In government bond markets, that never was a problem until recently, in the last half year. We have seen a couple of these shocks now, where very low trading volumes have caused significant shocks in prices of government bond markets. This is new. I think it is here to stay. However, I do not think this is the biggest source of worry, from a liquidity perspective, for the market. A bigger source of worry would be significant risk aversion.

Simona Paravani-Mellinghoff

Just to build on that point, I would say that the mix of short-term volatility in the fixed income being at a higher level than what might have been experienced historically and the search for yield is forcing a rethink of asset allocations by investors. Just to put in perspective the need for a search for yield, if we look at the history of the past 15 years and take a fairly representative portfolio of fixed income, for the first 10 years of that period, you would have had something in the region of 80% of the assets yielding more than 4%. In the last five years, that number has dropped to less than 20%. This gives an idea of the very significant shift we have experienced as investors. Therefore, we need to adjust our views of the future and portfolio allocation. That is obviously leading a number of investors to think out of the traditional toolbox into more so-called alternative asset allocations like infrastructure.

Robert Parker

You have raised a very good point. Do we need market liquidity when, if I am running a pension fund, I have 30-year liabilities and, if I am running a life insurance fund, I have 15 to 20-year liabilities? We are all complaining that liquidity is becoming and problem and volatility is increasing. Are we worrying too much? Andreas, what do you think?

Andreas Utermann

First, we need to be clear about the type of volatility we are talking about. Colleagues have stressed that short-term volatility has gone up in spurts, but regional long-term volatility, because of the quantitative easing policies, has been dampened quite substantially, and, over the period, we have had pretty stable markets. If you look at the second half of your question about the risks emanating from that, I would see it as an opportunity, to be honest. You need to just change your investment behaviour, as Simona was saying.

For example, in our case, it has led primarily, where we can, to redeem mutual funds, so, if investors want to sell, you will not be selling against yourself in the market, and also to own more liquidity for when gaps in valuation in markets occur. That is what is happening. If there is a three or four day move of the bund from 10BPS to 70BPS, and then from 70BPS to a percent, there is going to be a gap. If that happens, we want to be able to participate and not be selling against yourself. That shifts you more towards a total return or absolute return target mind-set. If you then buy into this analysis that interest rates are going to be lower for longer, and therefore long-term returns are going to be lower for longer, that also means that the return from the beta element for all the indices is going to be very low, and you need to completely change your investment behaviour away from index investing towards a different approach.

Hans Stoter

To answer your initial question about whether market liquidity is important for long-term investors, rather than being able to trade, a more important element is the mark-to-market risk. If the valuation of your positions goes down, then the coverage ratio of your pension fund goes down, which might force your regulator to tell you to start selling, at exactly the point you do not want to sell because you are a buy-and-hold investor. You are basically looking to bring yourself through the period of volatility, but the regulation tells you otherwise. That is one of the drivers behind the move towards more alternative debt structures, which are more stable and sticky in prices. Of course, you also get the benefit of an illiquidity premium, but the stable, sticky, uncorrelated prices are a benefit.

Robert Parker

One very quick solution is that regulators make appalling asset allocators, and I assume we all agree with that. One message I would give to regulators is: please do not interfere with asset allocation. It sounds like you are about to disagree.

Hans Stoter

I would say that many investors could also learn from regulators that stop-losses are sometimes also important.

Robert Parker

We talked about alternatives. First of all, let us define alternatives and talk a little bit about their role in global asset allocation.

Simona Paravani-Mellinghoff

It is interesting, precisely because we have created this term ‘alternatives’, but, in reality, it covers a number of very different types of assets. Just to draw a parallel here, given that, in the introductory speech, we heard about music and jazz, if you want to move from generating music just by using the piano and the violin, and you want to use the full orchestra, great idea, but one has to be very aware of what is in the orchestra. If we look at the alternatives landscape, what is in the alternative space that we need to be aware of? If we use a fairly simple categorisation based on the type of instrument, some are more like equity, where you have private equity, venture capital, infrastructure equity and real estate investment trusts, to name a few, and, on the other side, you have debt finance structures, direct lending as mentioned earlier, infrastructure debt and so forth.

What is interesting here is that, even within those fairly narrow sub-categorisations, we have different drivers of return. If we focus on infrastructure as one example, the sensitivity to the economic cycle of investment in hospitals or schools is minimal, but, if take airports or roads, it is a different story in terms of sensitivity to the economic cycle. Where does that leave us in terms of the implications for investors? Well, the complexity and variety of these instruments effectively means that it requires significantly more resources and potentially different skill sets to evaluate exposure to this particular space. It does require a level of governance that is significantly higher than what might have been in more traditional asset classes. Last, but by all means not least, there is an important consideration around diversification, precisely because you want to ensure that your exposures are well balanced.

To answer your question in short, I would say there is definitely a role for so-called alternative asset classes in global asset allocation, but it is precisely like making music. You have to make sure that you pick the right instruments and you know what they sound like, and that you have the skill to pluck them, because, otherwise, you end up with noise rather than music.

Robert Parker

Andreas, you and I had a conversation recently where we both voiced concerns that, in certain alternative assets – and our conversation was specifically on the infrastructure market – there is too much money chasing too few assets, and therefore valuations are now looking a little bit stretched. One thing we focus on an awful lot in our industry is to what extent we are working in market bubbles or whether there will be market bubbles down the road. I would just you to comment on the areas of stretched valuation that we need to be really careful about at the moment.

Andreas Utermann

They are manifold, and there are different reasons for them. Property, broadly, has been stretched, which has been fuelled by low long-term interest rates. There have different dynamics in different markets, but that is broadly the case. We talked about the bond markets being in dangerous territory, which is why we see the short-term volatility increase, perhaps less so if you look at equities and the support that they get from dividends, but we still have to be cautious there as well. All of that is against the backdrop of an expectation that, at some point on the horizon, there will be a liberalisation of interest rates. If that is not the case and interest rates stay lower for longer, then this could go on for quite a period of time, so the valuation would not resolve itself very quickly.

The other point I would make, specifically about infrastructure – which is a whole topic, and other speakers have referenced it earlier – is that, while there is a lot of talk about supply of infrastructure products in the market and notwithstanding the regulatory uncertainty that sometimes comes with it, as we heard earlier, there just is not enough supply in the market. We have – and I suspect it is the same for you – much more money to deploy than we can usefully deploy. That is part of the reason why the spreads have come in a lot. If there was better supply available, then that would probably resolve itself.

Robert Parker

The next question ties up with this issue, which is the extent to which QE is having an impact on the buy side. Is it devastating, moderate or none?

Hans Stoter

I would say moderate. I would not choose devastating, because it also provides opportunity. If I had to choose one of those three, I would pick moderate.

Simona Paravani-Mellinghoff

I would definitely echo the same comment. Going back to my opening comment, at the end of the day, every period has its own challenges, and this is ours.

Andreas Utermann

I think it is moderately positive, and it is hastening the transformation away from this style of investing toward alternatives.

Robert Parker

I would actually say it is between moderate and none. The observation I would make is that there is this wonderful indicator produced by OECD called the OECD liquidity indicator. We all know which way that liquidity indicator has gone in recent years. The correlation between that and MSCI World is nearly 100%. Without QE, I think we all recognise we would not have these tight credit spreads and very good equity markets.

Let us move on to the role of investors in the buy side. We heard from our keynote speakers how they all want us to act almost as quasi banks, increasing lending, etc. Simona, how are we going to do it? Everybody is coming out with these grand statements, but there does not seem to be much detail on how it is going to be implemented.

Simona Paravani-Mellinghoff

There are a number of opportunities for improvement, to help investors play a bigger role in providing funding to the real economy. I will split them into three areas. The first is perhaps to take more of a private investor’s perspective than has been prevalent in some of these discussions. Any framework that will enable private investors to save in a more effectively is definitely to be welcomed. The evidence is quite strong in this sense that, the more investors have access to advice and general guidance, the more likely they are to put their cash to use. Any measure that would make advice more accessible and robust should definitely be seen as a welcome development.

Technology will play quite a key role in this space. Digital Passport is just one example of practical technological innovation that can help save time for clients and advisors and make the whole process much faster and more seamless. Moving to a slightly different area, we continue to see the public markets as critical to providing funding and their big role in terms of standardisation. I think many of you are familiar with our proposals for standardisation in the corporate bond market. Last, but by all means not least, in terms of the private markets, anything that can be done to help the harmonisation and putting everything on a comparable level playing field would definitely be welcome in terms of making the life of investors easier.

Robert Parker

What would you add to that in terms of implementing all these very strong objectives from the European Union and Commission?

Hans Stoter

It almost sounds like they want asset managers to replace the role of banks, given that the transition mechanism is currently not working via backs, as banks are being held back by the micro regulation. Somebody else has to carry that torch, but I do not think that asset managers can do that. In this world, asset managers and banks have to operate as partners, because asset managers do not have the deep origination and servicing network capability that the banks have. What we need to work towards is a model where the origination and servicing of SME loans happens in the banking world, where half or two thirds of those loans are being passed on via a vehicle to institutional investors, so that we create alignment of interest and a full transition mechanism, without burdening the balance sheet of the bank too much.

Robert Parker

Do you have a model whereby the banks finds SMEs who want to borrow and they are the source of the loans; the asset managers are the managers of the loans – i.e. it is not on bank balance sheets, but it is basically in an asset management world; and then the banks have the distribution, so the banks become the creators and the distributors, and the managers are us?

Hans Stoter

For SME, I think that is an intelligent way to go forward, as loan platforms start to emerge. Of course, for larger corporates, the direct lending takes place, or otherwise it is private placement for corporates, infrastructure, export credit or real estate financing. For smaller tickets, where the monetary policy is aiming at, banks play a crucial role.

Robert Parker

Where you are trying to access smaller borrowers use the banks as creators and platforms. For larger, you can go from asset management straight to the borrowers.

Andreas Utermann

I agree with Hans that there is a very significant gap that exists between what we are expected to be doing and what we can actually do. Five years ago, asset managers typically could not invest in infrastructure debt or equity, and certainly were not able to source significant private loans in the market, so that is something that needs to happen. There is a deficit in terms of infrastructure. The banking infrastructure around that has built up over decades. The asset management infrastructure in terms of the legal controls and frameworks in which we can offer certain deals to certain clients in certain markets, with all these new EU laws, is a significant challenge.

I do think the model you describe is the one we are moving towards. Ultimately, it does make sense, because where are the long-term liabilities? They are in the pension funds. Where can you match the long-term projects better? It is in fund management, as opposed to on bank balance sheets. How do you make the banking sector more resilient? It is by having less of this type of illiquid security on their balance sheet, so I think that makes a lot of sense.

Robert Parker

Do you think the asset management industry has become much more sophisticated? I am very biased on this subject. If you talked to asset management firms 20 or 30 years ago, they had fixed income departments, equity departments and there might have been a bit of real estate. Frankly, they did not really know how to manage private equity, infrastructure or other alternatives, or sophisticated asset allocation models. Do you think we are better at it now? I am biased.

Simona Paravani-Mellinghoff

I cannot comment on how the industry was 30 years ago from personal experience, but, in terms of where we are going, for sure, there is now a need for a skill set that will, to my point, enable us to assist a client across their needs, which increasingly requires us to use the full orchestra. If we want to be a true fiduciary to our client, we need to develop expertise in all of the instruments that will be available to address their problems.

Robert Parker

Let us talk a little bit about threats. There has been a lot of discussion about poor bond market liquidity, particularly in the corporate bond world, and we have talked about volatility in government bonds. To what extent should we worry about how that might impact on our mutual funds and exchange traded funds? Do we think there is a potential systemic problem there?

Hans Stoter

In the end, especially in credit markets, we are all playing what we call the ‘close to the door’ game: ‘I am smarter than everybody else. I can get out of the room before anybody else, before the world collapses.’

Robert Parker

Is this called ‘the first lemming over the cliff’?

Hans Stoter

Exactly, and the door that we all want to go through all of a sudden has turned out to be a small window. The solution can only come from lengthening of investment horizons, maybe different structures around mutual funds, so more gating-type structures. Why do we not fit illiquid fixed income into the daily liquidity fund? Well, not all industries are organised like that. It could also be, as was remarked earlier, on the supply side. Standardisation might be a difficult topic, but, for example, the use of fungible bond issues to create larger size rather than to create a whole bunch of small issues, yes, might reduce the flexibility for the issuer, but it might also come at a better price for the issuer if they want to go for a more standardised solution. There will be a greater price for illiquidity for a specific bond issue, rather than just a generic spread based on rating and sector. I think that is just an evolution in the market that will happen.

Robert Parker

Do you think, Simona, that is making us as investors more cautious? How is it changing our behaviour, if we are worried about a liquidity shock in the market?

Simona Paravani-Mellinghoff

It is certainly making us more aware. I go back to the point that I made when I discussed the alternatives. It is very important for investors to know what they are buying into. In the alternative space, it is even more important, because of the novelty and complexity, but even in terms of the asset classes that are already in their toolkit, there is a need to be aware of what it means to be operating in the environment they are operating in in terms of the liquidity that they have at their disposal.

Hans Stoter

The buyer of last resort is gone. The buyer of last resort used to be leveraged money, so you borrow money in order to buy those assets and try to make some money out of that. That leverage proposition is going, which basically means that real money is the only one that can pick you up from the street. If I, as an asset portfolio manager, believe that an asset is super cheap, but the clients in a mutual fund want to redeem, I basically am selling in this super cheap market anyway because I have to. That is a situation where I still do not see a lot of room for improvement. Who is going to be the buyer of last resort? Sovereign wealth funds might have an interesting role to play, but, when I speak to them, I do not really see a lot of appetite yet for them to set up, for example, a distressed opportunities fund. It is not there. They are still in traditional asset allocation models.

Robert Parker

Do you think there is a case for developing new products where we are saying to investors and client that we are giving them liquidity? I always think it is a mistake that, when I buy, personally, an exchange traded fund, I am led to believe that I can basically buy and sell it every second of the day. Likewise, if I buy and sell a mutual fund, I am led to believe that I can sell it very easily. I think there is a case for developing products where there are very clear lock-up periods. Some work needs to be done there.

Andreas Utermann

If your fund is more liquid than the underlying assets, there is always room for this liquidity to come into play.

Robert Parker

One key message from today is that we need to be very careful about these liquidity gaps – and this, I think, is where we do have some systemic risks – where we think we are offering liquidity to investors but we are investing in less liquid underlying assets.

Andreas Utermann

To reiterate a point I made earlier, that has led us to hold more liquidity in these funds. That is one of the answers, because, clearly, as Hans said, you do not want to be selling against yourself. Ideally, if there is a gap in valuation, you want to be seizing the opportunity. That is the issue. I think you can afford to hold more liquidity today, because, if you believe in this ‘lower for longer’ type environment, then the beta returns on your market will be lower, and, therefore, liquidity comes at a lower opportunity cost.

Robert Parker

I am going to wrap up by asking each of you the following question. For a balanced portfolio, for Dick’s long-term pension fund, how much are we going to make him per year over the next 10 years? Simona, you are first.

Simona Paravani-Mellinghoff

This is one of those occasions where lady first is not a good thing, but I will take the challenge. Obviously, to some extent, it is looking into the crystal ball. However, the reality is, if we are in a low-interest-rate environment, it would be difficult, keeping risk within moderate boundaries, to make more than, if I have to quote an absolute number, 5-6%.

Robert Parker

Andreas, are we going to struggle to make money?

Andreas Utermann

4% over Libor.

Robert Parker

Where Libor is zero. By the way, I agree with you. Are we all in the right ballpark here?

Hans Stoter

The issue is that it would be great if Dick could convince the regulator, saying, 'My fund has never been richer than it is today. Maybe I should monetise some of that and loosen my interest-rate-risk hedge somewhat.' If he was allowed to do that and put it in a more total return product, then inflation plus 2-3% would be a very interesting return for his pensioners.

Robert Parker

You have raised a very good point, which is, if we assume inflation over the next 10 years averages 1%, then your 4% return is pretty good. I just want to wrap up. Thank you for listening to us. I hope we have given you some stimulating ideas. I would just comment on two things. First of all, I think the growth prospects for the asset management industry are very good indeed. Having said that, we have a big challenge in generating investment performance for our clients, the underlying investors. There are some very obvious traps, particularly the liquidity trap. I think we, as investors, have to be very careful indeed. Linking in to how we help everybody develop capital markets union, I think there are some very interesting opportunities for investors to work with distributors and banks collectively to address this key issue of SME provision of finance.

Please join me in saying thank you very much indeed to my fellow panel-istas. I enjoyed this and I hope you did.

Martin Schleck

Thank you very much to Bob, Hans, Simona and Andreas for a very stimulating panel. That brings us to the last segment of the day. We have one more keynote speaker before we break. I am delighted to introduction Duncan Wales. Duncan is the Group General Counsel from ICAP and, whilst being responsible for legal affairs at ICAP, he is also responsible for the government affairs function and a member of the Group Executive Committee. Thank you very much for being with us, Duncan. I am looking forward to hearing your comments.

Back to the Future

Duncan Wales

Group General Counsel, ICAP plc

I. Preamble

Some of you might be slightly disappointed that I am not Michael Spencer. Occasionally, I too am slightly disappointed that I am not Michael Spencer, but he sends his sincere apologies that he is not with us today. As I thought about what I was going to say to such an august senior group of industry professionals, regulators and policymakers, I pondered on the fact that ICMA had its origins and was created in 1969, so it grew up and developed in an era that saw the US coming out of a long, embroiled overseas war; a standoff between the west and the Kremlin; proxy conflicts being waged throughout the Middle East; huge volatility in energy and oil prices; ballooning public debt; huge changes in financial services regulation and in financial markets. There was a Democratic President in the White House with very little ability to do anything, and the UK was facing a looming referendum of its membership of what, at the time, was called the EEC. Does any of that sound familiar?

Certainly, the post-crisis world is less certain; as we have heard, it is more fragmented; capital is more constrained. It is a pretty sobering thought that the share price of a lot of the world's largest banks is now at the same level as it was in the 1990s. The question I have to ask myself is: are we going back to a world without universal banks; a world where there are more fragmented specialisms in the financial services sector; a world where there is a centre of gravity in dollars on one side of the Atlantic and euro, sterling and other currencies on the other side of the Atlantic? Is there generally going to be less liquidity? Are we going to see new forms of securitisation and the rebirth of something like the first version of the euro-bond market? Are we going back to the future?

II. Characteristics of the Current Market

1. Interest Rates

Again, this has been touched on by several of the other speakers. The big difference between now and the 1970s, despite the similarities, is that rates are persistently and adamantly low. If you look at the entire history of interest rates since the Second World War, they have never been lower, and certainly it shows as a very odd pattern over time. Euro yields are still negative. Money has become somewhat like an entirely un-conflicted FIFA official: surprisingly difficult to get hold of and not intrinsically worth very much. I am sure I am being unfair, for anybody who is recording this.

2. Global Pressure

The pressure on capital is certainly being felt by both buy and sell side, and that is after a period when individuals and central governments borrowed more than ever before. The financial crisis was obviously global. Its origins may have been in US domestic housing, but they managed to contaminate the value of all other assets and undermine credit in the wider sense. The crisis saw riots and demonstrations in the streets of the world's great cities and it led to the cynicism about the perceived industrial-political government complex that inspired the intelligence leaks that so contributed to the collapse of the corrupt Arab states. In many respects, I believe that the Arab spring was a by-product, as much as anything, of those changes, which clearly has led to the sad chaos that we see going on now.

3. Fragmentation

We saw unelected EU officials walk into the halls of elected governments and tell them what to do, notable the Republic of Ireland. The Irish, as they often do, behaved magnificently and have salvaged their economy as a result. The experience between the EU and Greece is a little bit more complex and final endgame of that set of circumstances is less clear. All the same, we see some really strange forces of separation and fragmentation. Even in the EU, we see signs of resurgent separatism in countries like Spain, which has just had elections, and also, rather distressingly for me as an Anglo-Scot, in the UK. I was not quite sure if it was a high or a low point in democracy to see members of the Scottish National Party take their seats at Westminster and take selfies of themselves. The British still allow their MPs to carry a sword, but they have banned selfie sticks.

4. Uncertain Rates Outlook

In the downturns that we have seen in previous decades pre-crisis, there was always something to record to, and that was nearly always a positive interest rate. In fact, it was only really around the oil crisis of 1972 that there was a negative yield, so yields were positive for the majority of the period of time, certainly in the major currencies. Those economic blips felt a bit like turbulence. We were still in the air, being bounced up and down. The situation we now face is one where we are trying to take off – real development, real economic growth, real invest-ability – from the rough, unpredictable airfield of this near zero-rate environment. In fact, as we know about flying, the dangerous bit is take-off and landing. We have just had a fairly heavy landing. We are going to have to figure out what the take-off will mean, because we have plenty of opportunities for crashing in the process.

While we all anticipate that Yellen and the Fed will eventually raise dollar rates, the timing and the pace of subsequent rises and even that first rise are not entirely clear. The Fed has departed from the polite thing for central banks to do, which is to be very predictable, and make their decision-making data dependent. They have taken something that should not really be a surprise and made it something that could actually cause a bit of a surprise. Then, despite the fact that QE is now over in the US, the Fed still has something in the region of $4 trillion worth of public debt, US Treasury securities, on its balance sheet. The ECB, as we know, is going through a similar, much more fragmented process, with national banks buying euro-denominated debt only of their own countries, which is a bit of a complex issue in itself. The Bank of Japan has ended up becoming the investor of first resort.

5. New Asymmetries

Even a powerful, huge, vast economy like China protected itself from this American crisis by increasing domestic debt very substantially, particularly since 2010. It also massively increased its corporate debt. There is a talk tomorrow, which should be very interesting, on that very subject. These are rather American-style solutions, so I sincerely hope they are not vulnerable to American-style asset bubbles. While the crisis was the product of globalisation, dramatic increases in private and, indeed, public debt, borrowing, consumerism, the aftermath is showing up in fractures: asymmetries caused by the prospect of a US interest-rate hike; genuine US long-term energy independence; a potential housing bubble in China; a much more assertive Russia; and a future for the eurozone economy that potentially feels a little bit more like the recent decades for Japan.

6. Regulatory Reform

In the western world, regulation has had a really strong hand in all of this. If we look at the last letter that Mark Carney, in his role as Chairman of the FSB, wrote to the G20 in November, following up on progress made from the original G20 Pittsburgh 2009 regulatory reform agenda, in an annexe, he notes that the only areas in which new rules have universally been adopted are two: one is in transaction reporting, so regulators get told what is going on through transaction reports; and the other one is in capital constraints. This is all entirely logical, considering the over-exuberance that led to the crisis in the first place. However, even in the depressed rates environment, the reduction of capital, which was the first thing that regulators did, has led to less depth and less consistency, even in markets that one would expect and hope were extremely liquid by nature.

7. Volatility

We saw, on 15 October in US Treasuries, the world’s most liquid government bond market, a mini flash crash. We have spent the last several weeks – in fact, this week in particular – seeing an enormous gap and volatility in the bund. These experiences are likely to become more frequent, which is slightly alarming if you think public debt should be the first benchmark measure for the cost of borrowing and all the rest of it. Further rollouts of further capital rules, all of which are coming, certainly onto the bank side of things, will directly target a market-maker’s ability to exploit and commit its balance sheet. It seems that these risks of volatility and gapping will continue and potentially amplify.

8. Circulation of Capital

The other thing I want to make you dwell upon for a moment is that, even though we may be faced with low rates for a long period of time, we will not feel the full impact of that level of capital constraint until rates do start to rise in some of the major currencies. The other obvious factor is that central banks became both the lender and investor, not of last resort but of first resort. Somebody described it to me as the western world having turned into a self-licking lollipop, where governments issue debt on the full expectation that central banks will buy it from them. If we think about the scale of how much public debt is in the hands of the central banks, there is the problem of how to filter it back into the financial system safely and meaningfully. This is all at the same time – and I am sure this audience is pretty sensitive to this – that regulators are incredibly sceptical about repo as a technique.

We are in a world where lending unsecured is not viable and lending secured is going to become prohibitively expensive, and we may artificially create further boundaries to the circulation of cash by putting constraints on the circulation of collateral. That is something, indeed, that Lord Hill alluded to briefly earlier.

9. Transparency

Other initiatives like MiFID 2, with its heavy emphasis on pre-trade transparency, may also, in these strange circumstances, have implications well beyond what their authors originally envisaged. It is, of course, essential, for all investors and market participants to have fair, timely valuation bases. Valuation is, at the end of the day, a hugely under-focused on area for regulators. However, it is entirely counterproductive to expose capital, when it is so constrained, to live market risk without having any diversity in that market culture. There is a rather old-fashioned concept that used to accompany best execution in the old days, mainly in an equities context, which was chances of trading success. Actually being able to get in or out of a position is hugely important, and we should not lose sight of that. Transparency is important and it is useful, but only to the extent that it does not destroy liquidity. If capital remains too constrained, if commitment becomes too fragile and inconsistent, and the chances of trading success keep going down, it really will be extremely problematic for everyone involved, and we will see much more gapping and uncertainty as a result.

III. Solutions

1. Capital Deployment

What are the solutions? How can ICMA and its members, with their perspectives and industry expertise from buy side, sell side and policymakers, contribute? Capital has to be centralised. It has to be deployed more efficiently. All the big banks have been going through and continue to go through that process. Future efficiencies, accuracy and clarity over all this will be increasingly technology-enabled, all of which is positive. I fully expect a Noble Prize for Economics to go to person who can genuinely design the three-dimensional risk surface, where you can move around any one point and see the waves moving right in front of you.

2. New Providers

In the interim, finance seems destined to be more fragmented, which may not be a bad thing, with more fragmented specialist finance providers and small regional banks taking up the space of the large internationals. Central banks need to be able to release investible bonds back into the system and allow the system to have cash circulating within it, and banks need to fulfil their social functions, being able to get their clients into transactions and investments, and provide liquidity and oxygen to that system.

3. Reducing Burdens

Perhaps that means reducing the capital burdens for cash and repo public debt. If we expect public debt to be high-value collateral and we expect collateral to work, we need to make it a cheaper, easier thing for those intermediaries to be able to provide. Investors who have inventory, particularly in corporate bonds, in the comparatively less liquid parts of the spectrum, need to have the ability to access liquidity. That may not be centralised; it might be a smart order routing and identification system. I think we have to be open to the idea that wall-to-wall exchange-like transparency is not the right answer for all asset classes at all times. We should accept that economic and asset class reality means that investors need to have access to everything from a wall-to-wall, very transparent market type-platform to price screening, RFQ, RFS, crossing network, intelligent search engines. There is a lot of technology in there that can facilitate that liquidity.

4. Looking Forward

Policymakers and regulators have achieved a lot since the crisis, but we must not be static. We must not be backward-looking; we have to be forward-looking. The FICC markets, and the macro products within that spectrum in particular, are obviously driven by real economy, real politics, real demographics. It is about the cost of money. It is about investing in things. It is about companies and SMEs, real people doing real things. We have to dwell on the fact that, if and as, rates, certainly in dollars and maybe in other currencies in due course, do come up, the risks we have all programmed ourselves to get used to at 0.5% is not going to be the same at 2-3%. We are going to have huge magnifications as we go.

It is quite easy for us to forget a pretty obvious point, which is that it will be the real economy that creates the next crisis: real people doing real things. It will be to do with the over-extension of credit, incorrect risk assumptions and unnoticed concentrations and correlations. It always is. We have to, as we collectively think about how we deal with these issues, set our minds to those priorities. We must put our minds to real risk; the healthy circulation of capital – not the unconstrained, unregulated circulation, but certainly the healthy circulation of capital; appropriate and constructive levels of transparency and verification; market, trading and investing opportunity; and a well-developed sense of danger. No one element of the financial system can make this happen. We will have to involve governments, central banks, the sell side and the buy side. The debate must be constructive, evidence-led – we have more and better data, and better ability to process it, than ever before – and collaborative.

5. Data

We have the ability to collectivise a lot of data and other things that we really did not have the ability to do seven or eight years ago. We should be creating warning indicators, thinking about correlations and about the warning signs we are currently seeing in public debt markets, with gapping and liquidity problems. We should be thinking about novel technology, distributed ledger-style logs, with log chains, which I am sure you have come across at one time or another, where you have not bilateral reconciliation but multilateral, real-time reconciliations. That is the sort of thing I can imagine helping us at the industrial level.

6. International Collaboration

In an ideal world, we would also be searching for international solutions. I know there are one or two things out there. I know the UK is trying to engender some sort of international cooperation off the back of its Fair and Effective Markets Review. We will see how that works. The capital markets union, I think, is the only positive regulatory wealth-creation idea we have seen in the last eight years, but it will take a lot of effort for us to have any genuine international cooperation.

IV. Concluding Remarks

The challenges are significant; the tools are increasingly there; and we have to be clear as to our priorities. ICMA, with its membership and broad mandate, can absolutely be a part of that. Thank you.

Closing Remarks

Martin Scheck

Chief Executive, ICMA

Thank you very much, Duncan. That is a very realistic way to end the day, with a very thought-provoking and wide-ranging speech. Thank you particularly for stepping in, rather at the last minute, with such a fine keynote speech to end the day with. Thanks to all of our panellists and speakers today. It has been a very varied and stimulating conference opening day. I hope you have all enjoyed it, found it worthwhile and stimulating, and I am looking forward to more of this tomorrow. Of course, before then, we have the gala reception to look forward to tonight. That is being sponsored by our two other gold sponsors, ABN AMRO and Rabobank, and is aboard the ship in the harbour called the Ocean Diva.

That concludes today's conference. I am very much looking forward to seeing you all tonight. Thank you all.

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