SESSION SUMMARY - BUCHAREST APRIL 2019

Is the EU securities market structure adequate?

1. The evolution of the EU trading/post-trading market structure

1.1. Progress made in the post-trading area

An official explained that much progress has been made over the last few years in the eurozone in the integration of securities markets with the building of the necessary infrastructure. TARGET2 allows the exchange of large value payments in central bank money in real time in the euro area. TARGET2-Securities (T2S) provides in addition the capacity for the securities market of the whole eurozone to settle transactions in central bank money. T2S was conceived as a single market initiative providing a unique multi-currency central bank money settlement platform. It settles euro and Danish Krone transactions at present, but can be extended to other currencies, showing that integration in the securities market can go beyond the euro area to deliver a single market for the EU.

Further infrastructure projects are being developed in the eurozone. The new generation of RTGS [1] (Real Time Gross Settlement System) supported by enhanced technology such as ISO 20022 type messages, is being built to harmonise the different types of exchanges that exist for central bank money and liquidity. This will allow all central bank money liquidity to be managed centrally and will ensure that banks get access to sufficient liquidity to be able to handle large value payments in TARGET2 for securities, money market and repo transactions, as well as retail payments. TIPS (TARGET Instant Payment Settlement) is another new service that allows instant payment in the euro area and will be eventually extended to the EU.

A policy-maker stated that much progress has been made in the harmonisation and efficiency of post-trading in the EU, which is relevant for the capital markets union (CMU). Each country had its own procedures and requirements until recently, which hindered the cross-border settlement of securities transactions. The Central Securities Depository regulation (CSDR) and T2S have brought significant improvements. Investors can now more easily buy securities in other member states. CSDR allows the establishment of regulated links between CSDs in order to facilitate cross-border transactions. Harmonised rules and the removal of national barriers make settlement processes more efficient. That has created cost cutting opportunities and helped reduce settlement failures.

Competition among service providers has also increased in the trading and post-trading spaces, extending choice for securities issuers, market participants and investors. At the operational level, T2S provides market participants with opportunities to pool liquidity and collateral at EU level and contributes to financial stability by allowing settlement in central bank money. EMIR increases derivative market resilience and improves transparency thanks to transaction reporting requirements. In addition, the Securities Financing Transactions Regulation (SFTR) will bring more transparency to securities financing markets.

Further improvements were proposed in the European Post Trade Forum's (EPTF) report published a year ago, which was followed by a public consultation. The main output of this consultation was a request to focus first on the implementation of ongoing initiatives before starting new ones and to carefully consider any further adaptation of the EU post trade legislation before initiating it, which is the way forward adopted by the Commission.

The co-legislators have also recently agreed to some simplifications of the EMIR requirements (EMIR Refit) making them more proportionate, while maintaining a careful balance with financial stability requirements. EMIR 2.2, which will strengthen the supervision of non-EU CCPs has also been adopted and some more limited measures have been voted regarding the supervision of EU CCPs. The implementation of new rules is underway in other areas. The CSDR settlement discipline regime will apply from 2020, with new reporting requirements and SFTR will be implemented in April 2020. The evaluation with the industry of the changes these different initiatives will bring in the market and the identification of possible additional needs are critical to ensure further innovation and competition in the post-trade market, the policy-maker emphasized.

An industry representative welcomed the progress made in the wholesale market particularly in developing a liquid and harmonized collateral market, as collateral is strategic. The ECB initiative to harmonise and create a CSD in this area is positive. A Central Bank official agreed that collateral management is an area for action at the wholesale level but is not so pressing as CMU.

1.2. Progress made in the trading area

An industry representative noted that the implementation of MiFID II has significantly decreased unregulated trading in securities markets. That increases transparency for investors and also improves the access that supervisors have to the data needed to evaluate whether objectives have been achieved. Competition has also significantly expanded in the trading area with a reduction of barriers to entry. There are now 500-plus execution venues in equity and non-equity instruments in Europe under the new MiFID II regime.

A policy-maker considered it too soon to determine whether all MiFID II objectives have been achieved, although the first stages of implementation have been satisfactory. Liquidity did not dry up in the first months, contrary to predictions, and market structure has strengthened. Many loopholes have been closed and this will continue, as with systematic internalisers in the investment firm regime. Closing all possible loopholes and keeping track of new ones is challenging however, because the market takes advantage of any opportunity to make a profit. That

1 The Real-Time Gross Settlement (RTGS) service is the infrastructure that holds accounts for banks, financial market infrastructures and other institutions. The balances in these accounts can be used to move money in real time between these account holders, this delivers final and risk-free settlement.

is not a reason for not pursuing the development of competition, which is essential for increasing market competitiveness. MiFID I already helped to increase competition in the market and MiFID II continues this objective, but in a more sustainable way.

1.3. Brexit implications

A policy-maker stressed that Brexit also has implications for the EU securities market structure. The two conditional equivalence provisions that the Commission has decided to grant to the UK are in this area. One is for CSDs in order to address the specific situation of the Irish CSD. The other is for EMIR to address the challenge posed by the concentration of centrally cleared derivative markets in the City.

Answering a question from the audience about the absence of a temporary recognition of equivalence for UK-based trading venues, related to the shared trading obligation, the speaker explained that the priority in the EU had been given to mitigating the systemic implications of Brexit and not to eliminate all costs related to Brexit and the fragmentation it will lead to. Brexit will have many undesirable consequences and increase costs and frictions for private operators, although the consequences in the financial sector are much lower than in many other industries such as car manufacturing. Benefits from the Union cannot be retained when leaving the EU. For the time being, the Commission does not intend to provide any equivalence regarding shared trading obligations or derivative trading obligations, but going forward this might be addressed in the future framework to be possibly negotiated with the UK.

2. Issues still in need of addressing

2.1. Remaining fragmentation and high cross-border costs in the post-trading area

An industry representative suggested that the adequacy of the EU's market structure should be measured against its capacity to support the CMU and make Europe an appealing venue for investing. The persistent complexity of European capital markets clearly shows that more work is needed to make them fit for purpose in order to achieve these objectives going forward. Reviewing the achievements of T2S, for example, shows that a layer of harmonisation was added to a layer of unharmonized settlement, with multiple CSDs still operating in the market. Adding this layer of infrastructure with T2S has not led to significant cost reduction.

Comparing European and US markets is useful in this perspective. The US solution does not provide a model to follow for the EU, as it is not necessarily the most appropriate, but it is an interesting point of comparison. US and European markets have similar transaction volumes, with about 350 million transactions in the US and 450 million in Europe in 2016. Whilst the volume in Europe is higher, the US has a greater level of netting. There is a difference in orders of magnitude in terms of value. In 2016, the latest year for which information is public, the value of US transactions was $111 trillion compared to €1.1 trillion in Europe. Calculations also show that assets held by US CSDs amount to $48 trillion, whereas in Europe, it is only €1 trillion of assets.

Looking at the different components of market structure, the US has one legal system, Europe, 27. Utility structures support post-trade activity in the US, whereas Europe has a mixture of utility and commercial entities. Securities infrastructures are predominantly horizontal in the US, but Europe has a mixture of horizontal and vertical ones. The US has two regulators, the EU more than 40. All this illustrates the complexity in the European market that must be dealt with, creating costs. The extra-costs are difficult to calculate due to the intricacies of the various fee schedules, but transaction post trading costs in Europe are still higher than in the US. When T2S started, settling a trade in the US cost 18 euro cents whereas European CSDs would typically charge between 40 and 50 euro cents for domestic DvP settlements (and higher fees for cross-border settlements within the EU). T2S and the implementation of harmonized rules are helping to reduce costs, although not to US levels yet.

Another industry representative considered that post trade efficiency and resilience has generally improved but agreed that further progress is still needed. After a couple of years, the weakness of cross-CSD settlements in T2S demonstrates that T2S alone will not deliver the single market for securities Europe needs. In addition there are difficulties to passport CSD services and to overcome national licensing.

Inefficiencies in European retail post trading processes are also apparent for investors and mean that European securities markets remain domestic. Clients prefer purchasing US stocks rather than those of another EU country. Part of the explanation is that it is easier and less costly to purchase stocks on Nasdaq and NYSE than on another European exchange. This is an issue for SMEs, because they need retail investors. The EU market is fragmented particularly on fiscal and legal rules, indicating a possible political preference for retail investors who are also voters to purchase local stocks. Although a push has been called for with the CMU to further integrate EU capital markets in order to improve the financing the economy, it is likely that the retail market in particular will remain fragmented if no more is done.

An official stated that the EU securities market is adequate in many respects and improving significantly, but not fully. The cross-border dimension is key to the development of national capital markets in the context of the CMU. However there are still major differences between the rules applying to different domestic securities markets, such as bankruptcy procedures and business registries, creating fragmentation. These are some relatively "hidden" issues that still need addressing in the CMU.

2.2. Price formation issues and the complexity of MiFID II requirements

An industry representative stated that the efforts made to increase the choice of execution venues and to increase competition in the trading area have been successful, but further work is needed to ensure the quality of markets, which is equally important. The speaker raised the issue of reference prices that are used by most of the execution venues that have developed with MiFID. This evolution is problematic because these venues do not take part in the price discovery process, which might affect price quality in the longer term and reduce transparency for investors. Everyone is in favour of transparency and price discovery, but not all players are ready to contribute to them. Price quality must be ensured as prices are important benchmarks, as well as vital indications for securities traders and investors. Access to price information is also important for investors.

Improving the price discovery process involves tackling two main components. The first is ensuring that the flow of transactions is not disincentivised to take part in the discovery process. Issues regarding the tick size regime for example were tackled via the investment firm review but this needs to be monitored over time. The second one is ensuring sufficient liquidity provision. That issue was tackled in the context of discussions about the capital requirements of liquidity providers in particular.

A policy-maker added that the provision of fair price discovery information is only possible with an effective transparency regime. The present transparency regime in MiFID II is however too complicated and requires more proportionality and simplicity, which is not easily achieved in the EU where compromises between different stakeholders tend to increase complexity. The policy-maker also felt that MiFID II investor protection requirements are overly complex, involving a great deal of paperwork. Created with the best intentions these rules have significant unintended consequences and have become an obstacle to more retail investment in the capital markets.

In addition requirements still differ across investment product categories creating regulatory arbitrage issues. This complexity ultimately undermines effective investment protection and means that the framework is not sufficiently conducive to developing investment in capital markets.

2.3. Barriers to the development of SME markets

An industry representative emphasized that the SME listing market has mostly disappeared in the EU. There are practically no more IPOs, especially for SMEs and private equity has taken over as the main source of funding for these companies. SMEs prefer private equity funding because there are less constraints in terms of transparency and governance and private equity funds, which are highly leveraged, benefit from the current low interest rate environment and the liquidity coming from central banks. The result is a reduction of investment supply for retail investors, because they cannot access the private equity market. Although there are economic explanations for these difficult market conditions, the time has come to find appropriate solutions.

An official also noted that requirements related to financial stability are costly for smaller transactions that do not require that level of reporting. The threshold is maybe too high. A Central Bank official mentioned that prospectus requirements have been refined and a new securitisation framework adopted to support SME financing in particular, but agreed that more needs to be done to facilitate the issuance of securities by smaller issuers.

3. Priorities going forward

3.1. Defining a future vision for EU capital markets

An industry representative considered that there needs to be a discussion about the future evolution of EU capital markets and how to find the right balance between openness to global flows and financial stability. This topic tends to be overshadowed by Brexit discussions but is very relevant for the EU. The initiative about the international role of the euro launched by the Commission at the end of 2018 is important in this regard since one of the aspects is to define how the development of European capital markets can contribute to reinforcing the role of the euro. These two elements are mutually reinforcing. This requires defining a future vision for European capital markets, which the speaker thought should be less about developing competition in Europe and more about improving the competitiveness of European markets on the global scene.

A policy-maker saw no opposition between competition and competitiveness. There might be some short-term benefits in reducing competition but this is not true in the longer term. Markets benefit from more competition, which must continue to be fostered by EU frameworks. There is however a balancing act with financial stability and stability will always be given priority. There are calls e.g. to develop open access for derivatives, but this must be assessed carefully, as too much open access may connect players in a way that threatens financial stability.

An official suggested that the euro area capital market should be developed as a domestic market, together with the community of market infrastructure service providers operating in the area. There should be a public consultation of the ECB in the coming weeks to evaluate if it is possible to capitalise on T2S and the CSDs present in the euro area to develop a domestic euro-denominated debt instrument that could help address some of the questions raised by the CMU in terms of access to capital markets.

3.2. Implementing the measures already agreed

Several speakers concurred that delivering the measures already agreed and assessing their impact is crucial before launching any further initiatives.

An industry speaker explained that market participants need time to adapt to such a significant revamp of the regulatory framework and noted that transparency has already increased in the securities transaction value chain and that markets are more stable than in the past. Another industry representative observed that the barriers listed by the EPTF group are one example of work that needs to be finished as quickly as possible, What should be fixed in the post-trading marketplace and the order of priority has repeatedly been considered by market participants and the work of the EPTF group is the latest iteration of this. Some of the issues it identified were already included in the 2001 Giovannini Report and have still not been addressed.

A Central Bank official agreed that reforms and initiatives require time to "sink in". Many business models have not yet adapted to MiFID, EMIR, CSDR and T2S. More harmonisation is expected. The settlement discipline regime may lead to some improvements, such as the fees paid for not adhering to it fostering harmonisation.

An official considered that further rationalisation of the EU market infrastructure is necessary to tackle the cross-border cost issues identified in the EU. The problem is that there is not yet a real single market in the EU. The ECB is contributing to this rationalisation with the development of some platforms such as T2S. A question is whether further consolidation of EU market infrastructure is to be encouraged and if the ECB could play a greater role in some areas notably in settlement and collateral.

Another official emphasized the importance of continuing the supervisory integration process. The process launched with the ESAs review did not achieve all expected outcomes in the end and should be pursued, notably regarding certain issues such as AML that constrain cross-border activities.

3.3. Further developing and integrating retail capital markets in the EU

An industry representative considered that a political push on the CMU particularly in the retail area and for harmonising the remaining fiscal and legal issues across member states is needed because otherwise fragmentation will persist and many on-going CMU initiatives will not be effective. Improving MiFID II rules on research is also necessary. Without these improvements there will be no development of retail cross-border capital markets.

An official agreed that a political push is relevant, particularly in the retail area, but this requires tackling difficult harmonisation topics. Some of these are best approached in a depoliticised way, such as business registry issues for example. Addressing these questions in a proportional and simple way is also essential.

The official also noted that maybe too much attention has been paid to the wholesale part of the market so far. This has enabled cross-border wholesale markets to develop in the EU and the functioning of these markets has improved. Further integration has also been achieved in the core infrastructure of the market with T2S in particular. But the development of capital markets in Europe also depends "on the last mile" and the development and further harmonisation of local infrastructures. Without these, there will be no development of local markets or no cross border markets. It is crucial to continue to work with different small markets across the EU and their different components and identify the improvements that might be needed in the legislation impacting retail investors in particular in order to improve pricing and proportionality.

The retail payment market is also relevant to the securities market, the official believed, as it supports small cross-border transactions and trading and can also help to educate customers in cross border dealing. If cross border payments for goods develop, then it will seem more natural to buy shares cross-border.

A Central Bank official agreed with the importance of local markets and the "last mile". The CMU is about bringing issuers to the market and making it simpler for SMEs to access funding and for investors to purchase securities. This means reviewing prospectus law, crowdfunding and other things. This is the next frontier to be tackled in the CMU.

Another official agreed that the development of local and retail markets is important but these need to be connected to the broader European market and economy as well, which is why the development of capital markets at the eurozone and EU levels is necessary. Much progress has been made in this respect, but there is still some way to go. Platforms developed by the ECB are playing a role in terms of harmonisation. When T2S was developed for example, work was done on the harmonisation of certain legal and fiscal rules (e.g. tax withholding mechanisms) in order to support the implementation of the platform and ensure that it could play a sufficient role in further integrating securities markets in Europe.

3.4. Leveraging new technologies

An official suggested that further thought should be given to how new technologies such as fintech or DLT can contribute to solving some integration issues in the EU market e.g. some fiscal issues. A taskforce is looking at that in the market and has delivered a report also on two other aspects: corporate events and shareholder transparency.

A Central Bank official agreed that it is crucial not to forget tokenization, DLT and the platforms based on these new technologies in this debate. Payments were the first area of application of these technologies, but they will extend further in the future, and notably into securities trading, clearing and settlement. At present regulatory oversight is not ready to handle situations where securities are directly issued on a blockchain or a platform that does not need to be licensed under MiFID. An official suggested that technology neutrality should be respected in that perspective. ■