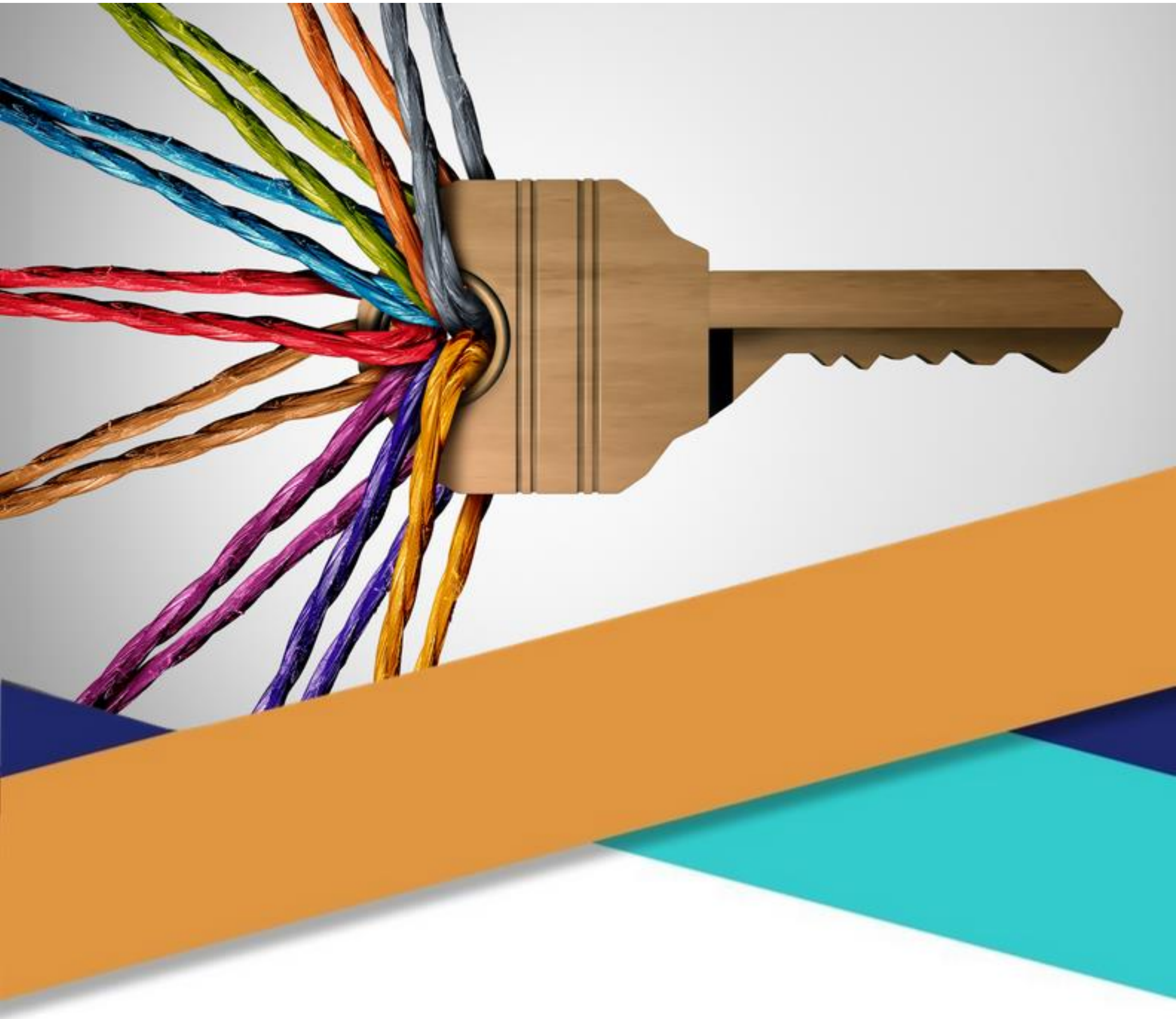

REPORT OF THE 2019 **ECMI** ANNUAL CONFERENCE

Unlocking Europe’s Hidden Capital Markets

Opening remarks

Fabrice Demarigny (Mazars and ECMI)

Ten years after the global financial crisis, the financial sector has not yet fully regained citizens trust. Impediments that rationalised the launch of the CMU project are still extremely valid (e.g. removal of cross-border barriers, diversification of funding sources, enhancement of private risk sharing). The geopolitical, social and economic environment has changed since the launch in 2015, international trade tensions are triggering a number of long-run stability uncertainties (both financial and economic), while Brexit will take away Europe's largest capital market.

With Europe at an important crossroads, a new growth agenda needs to be set out, focusing on long-term sustainable investments and innovation in an ever-accelerating digital economy. CMU needs to be transformed into an ambitious EU-wide project that responds to citizens' needs, provides means for innovative and sustainable economic growth and creates a well-integrated, competitive, deep and liquid CMU. To achieve these objectives, four components are necessary: i) generate significant long-term savings and investments, ii) develop dynamic and sophisticated equity markets, iii) create a deep pool of liquidity, and iv) increase the international funding role of the euro.

The recommendations that will deliver these components and were put forward by the Next CMU High-Level Group[1] do not necessarily require further EU legislation. They do nevertheless require establishing a number of KPIs (key performance indicators), expected outcomes and objectives, that can be monitored regularly and make sure Europe is on track to deliver a Capital Markets Union, or to put it better, a "Savings and Sustainable Investment Union"

[1] The Next CMU High-Level Group was tasked by the ministers of finance of DE, FR, NL to deliver recommendations for deepening the CMU. It also included high-level experts appointed by the ministries of finance of ES, SE, PL. IT.

In conversation with: How to make CMU a reality?

The opening panel with three MEPs demonstrated how diverse the views are on the future of CMU, and how much remains to be done during the ninth parliamentary term (2019-24).

Paul Tang called for a sense of ownership by member states and the financial sector at large. The launch of the CMU project created great expectations, that have not materialised. The future should therefore focus on a pragmatic agenda, not on the harmonisation of insolvency law, which is almost impossible, but on actions that can facilitate risk sharing, not only private but also public. Two areas in which the EU can set the standard for the rest of the world are digital and sustainable assets.

Danuta Hübner focused on supervisory convergence and the competitiveness of EU capital markets. Much has been achieved, she argued, but a lot remains to be done. This concerns EU-wide supervision and strengthening the international role of the euro through a safe asset. Brexit should be seen as an opportunity for EU financial centres to specialise, but with a global mindset.

For Markus Ferber, the priority is the MiFID2 review, with the reduction of dark pools of liquidity, the improvement of post-trade transparency, with possibly a consolidated tape, and amelioration of investor protection on a cross-border basis. The PRIIPS review requires a horizontal approach, in particular for the Key Information Documents (KIDs). To make the European pension product work (PEPP), a tax initiative is needed.

Panel debate: Delivering integration through a European safe asset

The CMU initiative is essential for growth and stability in the EU as a whole. However, progress on the agenda has proven difficult and slow. Many argue for the creation of a European safe asset that will contribute to private sector risk-sharing, a deeper and more liquid bond market, enhance the international role of the euro and lower the risks on banks' balance sheets. Others warn against the dangers of an 'artificial' safe asset and advocate for more portfolio diversification. Structural dispersions across EU member states and the lack of political consensus also stand in the way. How can these differences be overcome?

While the debate around the creation of a European safe asset is much driven by the US experience, one should not forget the unique situation that exists in the euro area: a single currency for a group of countries that have different fiscal policies. As Natacha Valla (ECB) explained, the ECB's interest in a safe asset is not only from a financial stability or a European integration perspective, but rather from a monetary policy perspective. The last is the least known, but the most relevant in terms of the imminent challenges that the euro area is facing. There is a shortage of safe assets as indicated by the fact that the share of government debt instruments with AAA rating as a share of GDP is less than 10% in the euro area, while in the US it is more than 30%. This shortage is why the ECB implements monetary policy beyond very short-term money market instruments, and focuses on the whole spectrum of the yield curve and its composition at the end of the horizon (e.g. term premium, credit spreads).

Eva Wimmer (German Federal Ministry of Finance) stressed the fact that there is lack of appetite among member states for any kind of joint liability (explicit or implicit debt mutualisation) with regard to a safe asset. Based on that, there are two popular concepts for a synthetic safe asset[2]: i) sovereign bond-backed securities (SBBS), and ii) E-bonds. However, three key problems with these popular concepts should be considered. First, even though in normal times such a safe asset can contribute to higher financial stability and offer a secured alternative investment, its complexity might lead to a high information demand by market participants about potential risk in times of crisis. Second, a safe asset could negatively

[2] In the case of SBBS, the intermediary (whether private or public) will pool member states government bonds into a senior 'safe' and a junior 'risky' tranche. In the case of E-bonds, a senior euro area public financial intermediary (e.g. ESM) will absorb and pool sovereign issuance (in other words lend fixed amounts to each euro area member state as a proportion of its GDP) but without any tranching of the underlying debt.

impact the national sovereign bond markets by draining liquidity and increasing financing costs for some sovereigns. Third, if such an asset is not accepted as a real safe asset by market participants, it could harm the euro's international role and, potentially, be counterproductive for the CMU project.

Having said that, Boudewijn Dierick (BNP Paribas) argued that if there is a need for a safe, liquid and fully EU member state-supported product, there are other options to consider. For example, covered bonds or mortgage loans. In the US, as opposed to Europe, there is a market for good quality mortgage loans. The risk of most mortgages in Europe is very low, perhaps even lower than in the US. Thus, to face the major future challenges (e.g. sustainability and digital revolution), banks should be able to sell their mortgages to the market and free their balance sheet. By doing so, they would be able to invest more towards the financing needs of Europe. Importantly, such a proposal does not require mutualisation.

In summing up, Cinzia Alcidi (CEPS) emphasised that the safe asset debate has been unfairly driven by very specific proposals covering a wide spectrum: from very deep financial engineering to purely fiscal proposals. However, a safe asset is a much richer concept that should go beyond the political debate. She concluded that it is indeed very difficult to come up with a proposal that could really have a similar size, impact, and way of functioning as exists in the US, and above all contribute to integration and financial stability.

Panel debate: Re-shaping corporate debt markets in Europe

Corporate bond markets are providing a valuable asset class in a diversified investment strategy. The segment has grown strongly since 2007, and is not bound by localisation requirements for issuance. However, regulatory overlaps and inconsistencies, may hold back this development. New prospectus rules should ease access for SMEs, also on the equity side, while the reliability and comparability of market data should be improved. In the CMU context, financial market infrastructures have a key role to play. What opportunities lie ahead for issuers, investors and market intermediaries?

Since the global financial crisis, both the issuance of corporate bonds by non-financial companies and the number of issuers have increased significantly, as Mats Isaksson (OECD) presented. The increased use of corporate bonds has been supported by many actions, such as banks' efforts to clean their balance sheet, expansionary monetary policy and quantitative easing, and legislative actions undertaken. However, certain risks and vulnerabilities still exist. Concerns have been expressed regarding the large amount of outstanding corporate bonds, as well as the decline in the quality of bond issuers and covenants. A potential future slowdown, similar to that in 2008-09, could result in an increase in 'fallen angels' (i.e. bonds downgraded from investment to non-investment grade) and spark fire sales by investors.

In preparation for Brexit, corporate issuers have moved their headquarters to the continent, as Luca Bagato (LSEG) highlighted. While such moves are not expected to impact the sell-side (i.e. liquidity providers), they might have consequences for the buy-side (pension funds, insurance companies, mutual funds). To minimise that impact, it is in the best interest of both the EU-27 and the UK to work together and find a solution that would avoid potential market disruptions (e.g. equivalence).

MiFID2 has also impacted the European corporate bond market. Despite the fact that it has introduced 'best execution' and supported the evolution of stock exchanges from regulated markets to multilateral trading facilities, the investor protection rules (alongside PRIIPS) have added extra layers of complexity for both retail investors and issuers, while the unbundling of brokerage fees and sell-side research fees have generated a threat to the coverage of smaller companies.

For a 20-year-old market, the European corporate bond market has a lot of potential according to Jean-Marc Mercier (HSBC). But it needs time to close the gap between the 15% bond financing of EU non-financial companies (NFCs) and 70% of US companies. Moreover, 40% of EU households' savings go into bank deposits, while only 10% in the US. In order for the EU to, directly or indirectly, channel savings into the bond market, issuing procedures should be simplified and banks' participation in the secondary market eased (capital treatment, leverage ratio, etc.).

In conclusion, Martina Tambucci (Consob) stressed the importance for a closer connection between the financial sector and the real economy. This is evident from the Commission's agenda, not only in the legislation passed (e.g. ELTIF, EuVECA, EuSEF) but also in the measures announced. One of them, the sustainable finance package, offers a unique opportunity to channel funds towards those activities that might prove to be sustainable in the medium to long term from an ESG perspective. Europe, as a leader in green financing, should harness the momentum. If indeed this is the goal, then it might be more easily achieved by gentle nudges to professional investors than by trying to influence the choices of retail investors.

Keynote speech

Mario Nava (European Commission)

Banking union has been a relatively undisputed success, and the centralisation of supervision has brought very good results. The remaining elements, risk reduction and risk sharing, are still on the table. On the contrary, CMU is a bottom-up project, where the impact of member states on policymaking remains quite significant.

For CMU 2.0, there are three areas that deserve significant attention, namely i) retail investors' participation, ii) the funding ecosystem for SMEs, and iii) an integrated market architecture. More harmonisation of consumer protection rules could be part of a solution to enhance the participation of retail investors. Accessible and comparable company data is essential for closing the funding gap. Efficient withholding-tax procedures would enhance cross-border investments.

Digitalisation and sustainable finance remain cross-cutting themes. A technology-neutral regulatory environment as well as legal certainty for the distributors, product manufacturers and users of financial services is needed. The ultimate objective of the sustainable finance initiative is to mobilise vast amounts of private capital in addition to public money to meet climate and energy targets. The International Platform for Sustainable Finance also offers a tremendous opportunity for the EU to play a global leadership role (the members that signed up so far account for 44% of world emissions, with the EU accounting only for 9%).

In conversation with: Where next for sustainable insurance?

For **Gabriel Bernardino (EIOPA),** Solvency II remains a risk-based regime. Insurers can already move forward with the explicit ESG consideration in risk management, underwriting practices and investment decisions and be transparent about it. They are encouraged to fulfil their stewardship role. There is no evidence yet that justifies any tweaking of prudential requirements. Standardisation of data and methodologies on ESG will bring about more market efficiency. 'Green washing' needs to be avoided at all costs, as ensuring public trust is crucial. Also, transformations in the real economy can lead to more investable assets/projects. Insurers should also aim at improving the resilience of our societies, in particular addressing protection gaps in the areas of natural catastrophes, healthcare and pension provision.

Swenja Surminski (LSE) warned against diluting the term ‘sustainability’ and the danger of complacency. Climate dashboards showcase the urgent need for action. The current analytical framework looks at physical, transition and liability risks and their material implications. However, identifying, understanding and taking action is not always that straightforward for insurers, i.e. product lines and asset allocation. The industry needs to build trust, capacity and long-term solutions and make resilience an investable proposition. Insurers should be engaging more with their customers through better ESG-risk signalling as well as informing other sectors and governments about how to transition to more sustainable practices.

Pascal Christory (AXA Group) outlined the objective of mainstreaming the ESG analysis within the overall risk-return assessments. While there are investment targets in green assets, the group is also strongly favouring transition bonds, especially for those companies with a clear path towards sustainable business models. In general, it is much easier to divest than to restrict the insurance business. Making data disclosure mandatory for corporates and governments will allow insurers to set decent KPIs for the investment portfolio and illustrate more clearly to clients whether their expectations are met or not.

Josina Kamerling (CFA Institute) highlighted the strong demand for sustainable solutions and that the financial industry has an opportunity to rethink engagement with their customers, in particular aiming for a more holistic, transparent way that accounts for different circumstances and preferences across their lifetime. With respect to inclusiveness, she called for the creation of a Young Consumer Group by the ESAs in order to give a real voice at the table to younger generations.

2019 ECMI Best Paper: Presentation & Award Ceremony

What is the link between liquidity and tail risk in the euro area sovereign bond market? Are there feedback loops between those two?

To answer these questions, Daragh Clancy (ESM) and his co-authors Peter Dunne and Pasquale Filiani (Central Bank of Ireland) used high frequency (i.e. intra-day) data of German, Italian and Spanish sovereign bonds over two periods of time characterised by aggregate (or systemic) risk and idiosyncratic (or country-specific) risk.

The results demonstrate substantial own- and cross-market linkages between liquidity provision and tail risks in all three selected sovereign bond markets. Particularly, in terms of own-market effects, the 2019 ECMI Best Paper find that contractions of Italian and Spanish liquidity are associated with subsequent falls in their own market's 1% VaR (meaning higher exposure to extreme tail risks). In terms of cross-market effects, reductions in the Italian and Spanish VaR (i.e. greater potential losses) are related to contemporaneous increases in the German 99% VaR (i.e. lower potential losses) and a positive expected return of German Bund.

The findings have an important policy relevance. On the one hand, they show the role that the German Bund – as the benchmark asset for the euro area – can have in amplifying the interdependency between tail risks and liquidity in national sovereign bond markets. On the other, they highlight the fact that national sovereign bond markets remain highly vulnerable to non-fundamental shocks (these are shocks related to sentiments, consumers of investors, and their effect is only transitory and not permanent), and thus further integration of the institutional architecture is required in order to improve the resilience of euro area sovereign bond markets.

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