INVESTMENT INDUSTRY ASSOCIATION OF CANADA

The Challenge for European Market Participants: Navigating Between Difficult Market Conditions and New Regulatory Standards

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The euro crisis has become a lot like a Hollywood thriller movie. Every time you think the problem is solved, it takes on new life. The 2008 global financial crisis marked just the beginning, as diminished confidence and adjustments to fiscal constraint followed a year later and led to the great recession of 2008-09. That crisis was followed in turn by the sovereign debt crisis in 2009, with a run-up to debt from already high levels in Greece, and the other "PIGS" countries – Portugal, Ireland and Spain. In effect, Europe made a transition from highly leveraged financial institutions to highly leveraged national governments.

Is the crisis finally over – or does another version lurk around the corner?

I got the chance to hear a number of informed views on this question as a special delegate to the annual meeting and conference of the International Capital Markets Association (ICMA), formerly the Association of International Bond Dealers, on 23-24 May 2013. The ICMA operates as a self-regulatory organization in the European debt markets, setting best practices and industry standards for bond dealing in the European markets. The ICMA membership includes the global investment banks, national banks and securities dealers operating in European primary and secondary bond markets. The Association and its member firms are at the heart of the debt markets – in the eye of the regulatory storm cascading through financial institutions and market infrastructure.

Conference Consensus: Europe's Sovereign Debt Crisis is Behind Them

The European markets have been through a succession of crises since the initial global financial crisis in 2008, and are now facing a barrage of regulation from Basel III, the EMID (European Market Infrastructure Directive) and MIFID 2 (Market in Financial Instruments Directive). The conference offered an opportunity to hear first-hand from market participants about the outlook for Europe, the conditions in European debt markets, and the market and regulatory challenges faced by participants in the marketplace.

The consensus at this conference, and probably in the general market, is that over the last six years Europe has experienced a "wheel of crisis" – turning from one crisis to the next. But the market has concluded the sovereign debt crisis has been put to rest. This is not to say that problems will not reappear, rattling investors and markets. However, European Central Bank President Mario Draghi's comment in 2010 that "the ECB will do whatever it takes to preserve the Euro" has convinced the markets that the EU will provide sufficient financial support through the Emergency Financial Stability Fund (EFSF) and European Stability Mechanism (ESM) to prevent a sovereign debt default, and catastrophic consequences for financial markets. Europe has in effect been put on monetary policy respirator.

The prospect of another euro crisis fades as market participants conclude the ECB will succeed in its stated objective. Fears of another crisis, however, are displaced by fears of an emerging asset bubble, particularly in property markets and financial assets. But that outcome is in the future, and for the time being at least the spectre of inflationary bubbles lies dormant, despite a massive injection of reserves into the banking system through quantitative easing programs.

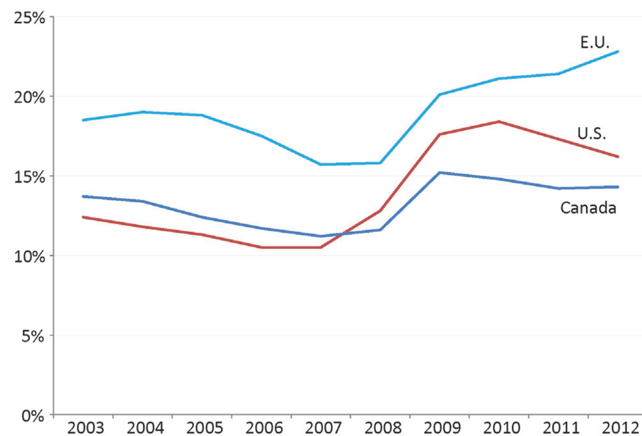
Slow Growth in Both the Short and Long Term

While a crisis is unlikely anytime soon, Helge Pederson, Chief Economist at Nordea Bank, concludes that Europe is condemned to slow growth for at least the next 3-5 years. The key factors contributing to continued economic malaise include: i) an ongoing crisis of confidence among consumers, businesses and investors; ii) restrictive fiscal policy, with increasing realization (notably on the part of the IMF) that the fiscal multipliers have been underestimated, resulting in much more retrenchment in economic activity than anticipated; iii) high prevailing oil prices; iv) the ongoing deleveraging of the private and public sectors; and v) new financial regulation exerting a strong pro-cyclical effect – through higher capital and liquidity requirements, clearinghouse rules for OTC derivatives, tax reporting requirements (FATCA), etc. The Danish Bankers Association estimates the higher capital and

liquidity requirements, taxes and reporting rules have taken nearly two percentage points out of the Danish GDP.

Longer-term growth prospects are further impaired by the structural imbalances in financial balance sheets, reflecting the holdings of legacy illiquid assets and insufficient capital. These imbalances constrain bank lending. As well, most European countries, particularly in the south, have done little to address the structural rigidities in their labor and goods markets, limiting needed adjustments to weaker conditions. Perhaps the most serious concern is the staggeringly high levels of unemployment, particularly among young people, creating the prospect of a "lost generation" and social unrest. These concerns, reinforced by the unanticipated impact of austerity policies, are prompting a call for short-term stimulus.

Lost Generation
Youth Unemployment Rate (aged 15-24)



Source: Eurostat, Stats Canada

Banking Reforms: Attempting to Prevent Future Shocks

The policy-makers in Europe are focused on structural reform to the European banking system, and harmonized regulatory oversight, to strengthen the banking system from future shocks, promote more bank lending, and bolster confidence. Erikki Liikanen, Governor of the Bank of Finland and Chairman of the EU "High Level Expert Group", explained the Group's recent recommendations. The Group concluded that structural reforms were needed, beyond the new capital requirements, to ensure the safety and resilience of the European banks.

The Group has brought forward recommendations for: i) the mandatory separation of deposit banking from securities trading, including proprietary trading and market-making operations; ii) "bail-in" provisions for unsecured depositors that will result in the write-down in claims or the conversion of claims to equity in a bank resolution process; and iii) strengthened corporate governance rules. The "bail-in" provisions will reduce the implicit government guarantee on unsecured funding in the event of bankruptcy, as a result raising funding costs for the banks.

Not all deposit categories will be subject to "bail-in" provisions, making transparency important in order to clarify the treatment of respective deposit instruments in the case of resolution. These developments should make covered bond financing, already an active market, even more popular. The recommendations of the High Level Expert Group are still at an early stage, with further consultation and review before legislation is forthcoming.

The EU has also focused on bank supervision and resolution mechanisms. Bernard Coeure, member of the Executive Board of the ECB, described the steps to achieve a single supervisory scheme and resolution framework for the banks to strengthen Europe's banking system, bolster confidence and obtain a level playing field in regulation. The Single Supervision Mechanism (SSM) would define a single and independent regulatory scheme. The ECB proposes to regulate about 100-200 institutions in Europe out of the estimated 6,000, but would have the discretion for oversight of any other institution in the markets, if circumstances warrant.

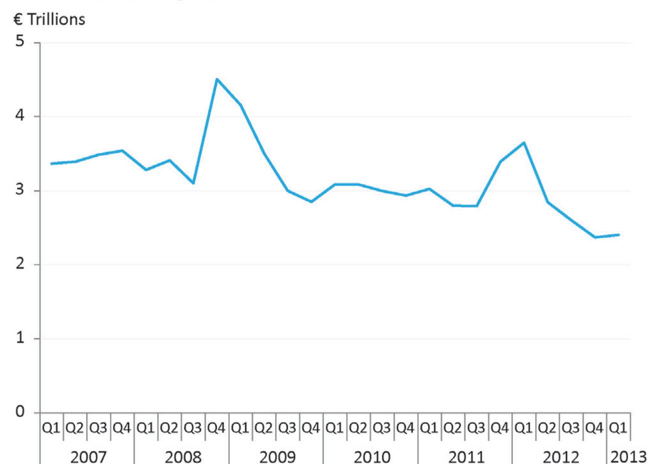
The second component of these proposals is the Single Resolution Mechanism (SRM), which would provide a framework to deal with failing banks, such as the treatment of deposits in the event of bank failure. The deposit preference rules would determine those deposits subject to a "bail-in" or haircut in bankruptcy, and those deposits fully protected by the public sector. The EU still has much to do to define these rules.

These harmonized rules to strengthen the banking system are important for renewed lending, given that businesses in Europe rely heavily on the banks for term lending and equity financing. Bond markets are still important for larger businesses, and for government financing. The covered bond market is a key source of funding for the banks. The tone of the bond markets has improved in Europe recently, despite the problems in Cyprus. Government bond markets are obviously more resilient for the northern European countries than the south. Aside from improved confidence, massive liquidity searching for yield and currency diversification have helped firm up government bond markets.

Despite recent rejuvenation in market conditions, liquidity has failed to respond as expected, and still remains below pre-crisis levels. There are a series of factors to explain the incipient recovery in secondary markets. Overall investor confidence remains weak, although conditions have improved. Second, allocations of capital to fixed-income businesses have been cut back reflecting higher capital and liquidity requirements under Basel III. For the same reasons bank financing has become more expensive. Third, the "risk on-risk off" pattern of trading in recent years has increased the risks to market makers, contributing to lower inventory holdings. Finally, repo financing has become more expensive, reflecting tighter access to collateral, discouraging short positions for hedging purposes. All these factors have conspired to shift bond trading to smaller size transactions, agency trading and to new

electronic platforms, fragmenting the marketplace. The dealer community is also worried about the impact of enhanced bond market transparency called for under MIFID 2.

Issuance of Debt Securities in Europe
Bonds and Money Market Instruments



Source: Eurostat

Managing Collateral

The growing shortage and need for effective management of collateral have been a common theme in debt and OTC derivatives markets, in response to increasing demand for collateral for covered bond transactions and repo trading, reluctance to lend securities because of legal uncertainties about ownership, and newly mandated clearinghouse requirements for OTC derivative transactions. The ECB has played an important offsetting role through its QE operations, exchanging low quality collateral for high quality collateral.

The market consensus, however, is that there is sufficient collateral to meet the needs of the market. The real issue is to obtain collateral quickly when it is needed. Transparency needs to improve as well as inter-linkages between clearinghouses. Much progress has been made by Euroclear and Clearstream to improve the linkages and inter-operability between their operations. The general view is that increased demand for collateral will improve the price of collateral, encouraging more participants to bring collateral to the markets. The technological linkages between trading and clearing venues will be important for the markets to work efficiently.

Asset Managers' Challenge: Meeting Liquidity Demands

Asset managers have been adversely impacted by recent conditions in the government and corporate bond markets. Low bond yields have presented a challenge to managed funds to earn a competitive return for their clients and for pension funds to meet actuarial commitments. These pressures have led to an increased investment focus on emerging market investments, private equity and real estate. Poor liquidity conditions in secondary bond markets and increased holdings of illiquid assets have left asset managers with the difficulty of meeting the liquidity demands of their clients. Hedge funds have imposed redemption gates to mitigate the downward impact on returns from a sudden call for redemptions. These investments in illiquid infrastructure assets, private equity and real estate also provide challenges in valuing portfolio assets. The barrage of new regulations for the investment funds industry, focused on transparency, stewardship and client fairness, exacerbates the difficulty in reacting to these market-related developments. Moreover, some are of the view that asset managers are effectively part of the shadow banking system and therefore should be subject to regulations governing banks. However, while a review of the rules is appropriate, it is important to bear in mind asset managers are not of sufficient scale to have systemic implications in the marketplace, as demonstrated in the last crisis by the hedge funds, and are not leveraged to the extent of the banks.

Conclusion: Stuck Between a Rock and a Hard Place

While the growing confidence that the sovereign debt crisis has been put to rest is welcome, in many areas Europe seems stuck between the rock of difficult market conditions and the hard place of new regulatory standards. The challenge is to address the former without making the kind of adjustments in regulatory standards that will create more problems than they solve.

Yours sincerely,

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