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LETTER FROM THE PRESIDENT

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EU Markets: An Expanding Regulatory Burden May be Easing
Observations from the ICMA AGM and Annual Conference
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HIGHLIGHTS:

The European banking system is under stress. The ratcheting up of capital and liquidity requirements has forced asset sales, restructuring of operations and retrenchment of traditional lending and trading businesses.

European regulators recognize the need to re-calibrate regulation to promote growth.

The EU Parliament and Commission have embarked on a formal "Call for Evidence" on how rules increase the regulatory burden, create inconsistencies and give rise to unintended consequences.

Canadian regulators have not followed the EU lead by undertaking a comprehensive review of the regulatory burden in domestic markets.

The International Capital Market Association (ICMA) AGM and Annual Conference is a long established and internationally respected event for global debt capital markets. Over 1,000 international delegates from the financial community, including senior representatives from both the sell-and buy-side of the market, as well as investors, asset managers, regulatory authorities, central banks and infrastructure providers, gathered in Dublin, Ireland in May to discuss market and regulatory developments. I attended the conference in my capacity as Chair of the International Council of Securities Associations (ICSA) and as President and CEO of the Investment Industry Association of Canada (IIAC).

The overarching themes across all presentations and panel sessions—and even informal discussions—was the ongoing structural transformation of credit markets in response to unprecedented disruption from financial-technology innovations, the consolidation of the buy-side institutions, the globalization of markets, and the compounding impact on primary and secondary markets of an expanding regulatory burden. The impact of structural adjustment from these factors has accelerated in an environment of weak global market conditions, and protracted low and negative interest rates.

Discussion also centred on the reduced secondary market liquidity, the European Commission's planned Capital Markets Union (CMU), and the development of Green Bond Principles.

Banks under pressure: Is the traditional broker-dealer model viable?

It is evident the European banking system is under stress. Banks have found profit margins squeezed, weighed down by rock-bottom interest rates, weak business conditions and even fewer funds available for lending. The IMF reported in April that a third of Eurozone banks face "significant challenges" to be sustainably profitable, compared to 15 per cent of banks in advanced economies.

The ratcheting up of capital and liquidity requirements at global banks to meet Basel III standards has forced asset sales, the restructuring of operations and retrenchment of traditional lending and trading businesses. We have seen the larger global investment banks streamline and sell-off businesses, and narrow their focus of business operations. Major banking institutions in Europe are also under pressure from shareholders to bring executive compensation in line with eroding performance.

The European Central Bank (ECB)'s accommodative monetary policy stance (including its quantitative easing operations) resulting in ultra-low interest rates and negative interest rates have complicated the adjustment process for the banks. The aggressive purchases of government bonds and even corporate bonds by the central bank and corresponding fall in yields has the intended consequence of pushing investors, including banks, into higher yielding riskier assets. This policy move has squeezed earnings at the banks, first by lowering interest rate spreads on balance sheet assets and liabilities, and second by forcing the banks to purchase riskier assets at much higher capital cost given new regulatory requirements.

These developments in the integrated banking system have put enormous pressure on the traditional broker-dealer model, as market maker and underwriter/distributor of new offerings of securities. Some participants questioned the long-term viability of the traditional business model, and anticipated intermediation to shift increasingly to the shadow banks, particularly the managed fund business and emerging fin-tech industry. While the shadow banks and fin-tech companies have taken on a greater share of financing and lending business, and increased trading through electronic platforms, the inroads into direct intermediation have been limited. Market participants, nonetheless, remain wary of sweeping change as technological innovation and its impact on markets moves exponentially, not linearly.

The regulatory burden: Some easing ahead?

There has been a sea change in thinking at the EU Parliament and Commission in the past year or so, as the impact of the regulatory burden on market retrenchment has become more evident, and as capital formation and the economy are mired in the doldrums. Increasingly, there is recognition that the regulatory pendulum has swung too far in the direction of financial stability at the expense of capital formation and economic growth. Regulators in Europe recognize the need to re-calibrate regulation to promote a positive growth agenda.

The EU Parliament and Commission have embarked on a formal "Call for Evidence" to identify the excessive regulatory burden caused by the EMIR (the European Market Infrastructure Regulation covering over-the-counter derivatives), MiFID (Markets in Financial Instruments Directive) and CRD (the Capital Requirements Directive) initiatives. The regulators intend to make suitable regulatory amendments if the evidence points to excessive regulation. The regulators have announced they will engage in a full monitoring of the "level 2" rules (beyond the broad general principles embedded in the legislation). Kay Swinburne, a European Member of Parliament involved in the regulatory agenda, admitted rule-making at the EU has moved quickly and been undertaken in silos, resulting in overlaps and inconsistencies in banking and securities capital rules.

It is difficult to get overly optimistic about broadly-based efforts in the EU to ease the regulatory burden.

- First, the sluggish growth conditions have had more to do with the debt overhang at sovereign governments and in the banking system and the lack of business confidence, than the regulatory burden.

- Second, the EU is not prepared to pare back the Basel rules and undermine hard-won financial stability in the banking system.

- Third, the EU regulators are not convinced the quantitative evidence demonstrates an unambiguous weakening in corporate bond liquidity, despite anecdotal evidence. The industry will have to redouble efforts to make a persuasive case, through stronger quantitative evidence that supports its position and solid anecdotal evidence that indicates the damaging impact of eroding corporate debt market liquidity on the real economy.

Perhaps the best the industry can hope for are specific changes to certain technical rules, such as the bond buy-in rule, possible delay in rule implementation dates and possible respite from further adjustments in capital, liquidity and leverage rules beyond the Basel III standards. It is important to note the EU Parliament has mandated modifications to the liquidity standards for bond transparency, and delayed the implementation of MiFID II given the unreasonable timetable for implementation.

It is notable that the Canadian regulators have not followed the EU lead by undertaking a comprehensive review of the regulatory burden in domestic markets. After all, the regulatory burden on large and small dealers has escalated significantly in the post-financial crisis period in the wake of aggressive and extensive rule-making. Additionally, capital market financing and trading activity, particularly for small and mid-sized businesses, has fallen precipitously in the post-crisis period. There are numerous factors responsible for this collapse in financing and trading, to be sure, but the regulatory burden is clearly an important one. The impact of the regulatory burden on markets is particularly relevant given that the layering of rules and regulations in retail and institutional markets has taken place without detailed a priori cost-benefit analysis or periodic review of the impact of new rules on the marketplace.

The need to promote capital formation and growth

The review and assessment of the existing regulatory burden through the "Call for Evidence" at Brussels is one approach to reinvigorate capital markets activity. The regulators also recognize the need to build out and diversify the European capital markets, as the financial sector in Europe is too dependent on bank financing and trading.

The Capital Markets Union (CMU) is designed to achieve more dynamic capital markets, particularly to finance new and emerging small and mid-sized businesses and infrastructure projects in Europe. Deeper and more integrated capital markets will lower the cost of funding and make the financial system more resilient. The measures in the CMU focus on areas such as greater harmonization in securities regulation across the European national markets. The single rulebook for capital rules and for trading and transparency in markets is a positive step. The CMU moves beyond these rules to introduce such measures as the standardisation in asset-backed securities to facilitate a more liquid market in securitized bonds, boosting SME financing by enabling banks to package SME loans for resale to investors in the marketplace. Further, greater commonality in bankruptcy laws could achieve more efficient and deep markets for private and public equity financing.

Finally, the EU Commission will embark on public consultations to identify barriers to investment funds operating across borders, reflecting standards set by national supervisors.

The EU continues to examine the SME financing problem through the prism of traditional bank lending. This explains the focus on improving securitization standards to free up bank balance sheets to promote more lending. However, the real need for small business start-ups and expansion is access to private equity capital through angel networks, venture capital funds and individual purchases of listed equities of small business. The UK has demonstrated the most dramatic expansion of small business within Europe, relying on tax-assisted financing programs, like the Enterprise Investment Scheme (EIS), to draw equity capital to new and emerging businesses. While tax policy falls outside the ambit of the EU Commission and is the responsibility of national governments, the EU could play a constructive role scoping out optimal tax incentives and market structure to promote the flow of equity capital to small business across European jurisdictions.

Conclusion: Facing the challenges

Structural adjustment to technological innovation, consolidation of buy-side institutions, globalizing markets and an expanding regulatory burden have presented an even greater challenge in light of weak global market conditions and protracted low and negative interest rates. These challenges are foremost in the minds of European investment banks and buy-side institutions. The ICMA Conference made that clear.

The good news is that the European Commission is serious about "better regulation". It realizes the regulatory program following the crisis was rolled out in haste, and inevitably in silos. The probability that they got everything right is zero. The regulators intend to make suitable regulatory amendments, if the evidence points to excessive regulation.

This highlights the importance of Canadian regulators undertaking a rigorous cost-benefit analysis of all proposed new regulatory initiatives to confirm that the benefits of these reforms justify the additional costs imposed on registered firms and advisors, and on clients. The efficiency and competitiveness of Canada's capital markets are at stake.

Yours sincerely,

Ian C. W. Russell, FCSI
President & CEO, IIAC
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