Letter from the President

INVESTMENT INDUSTRY
ASSOCIATION OF CANADA

Building Bond Market Liquidity in Europe: A Key Step to Stimulating Growth and Reversing Disinflation

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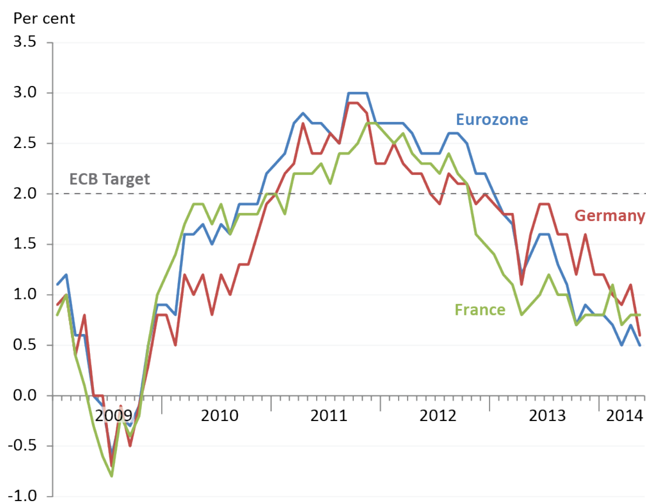
What impact are recent reform measures in Europe, such as steps taken by the European Central Bank (ECB), having on capital markets and trends among European investors and global markets? The annual conference of the International Capital Markets Association (ICMA), representing the large universal banks and smaller capital market intermediaries in Europe, provided important insights. This year's conference focused on the impact of recent reforms, notably the ECB measures, on capital markets and market structure. There was general recognition the reform process going forward must be managed carefully, not just to avoid damaging market liquidity, but also to enhance efficiency and breadth of market. In coming years capital markets will become more important than ever to complement the banking system as a mechanism to channel savings to business investment and stimulate economic growth. Renewed growth is the key to job creation, and crucially important to reverse the serious threat of "lowflation" in Europe.

"Lowflation"
Consistently low inflation in the Eurozone



Source: Eurostat

Revitalized capital markets will turn on the effectiveness of reforms in dealing with debt market transparency, and the regulatory framework for repo and ABS markets, and for shadow banking. The industry has a role to play, consulting closely with the regulators and complementing reforms with efforts to improve the integration of trading and clearing systems to strengthen transactional efficiency and lower transaction costs.

Paul Achleiter, Chair of the Deutsche Bank Board of Directors and former Goldman Sachs partner, described three areas of risk in European and global markets:

- i) poor liquidity in debt markets,
- ii) a shift in risk assessment to the back office, and
- iii) regulatory nationalism.

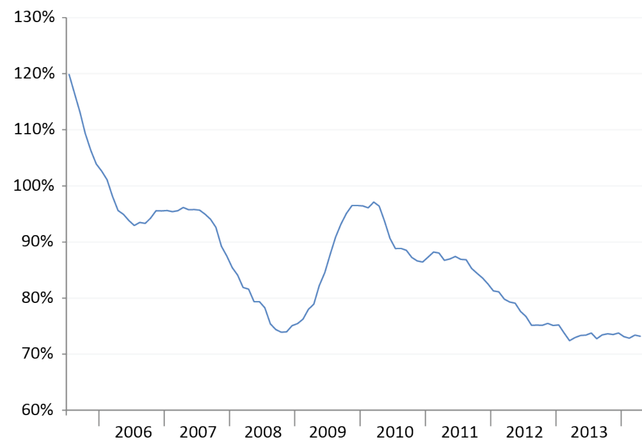
i) Poor Liquidity Poses a Challenge

He emphasized the distinction between capital and liquidity, noting that, despite $7 trillion injected into the banking system, bond markets are characterized by a thin veneer of liquidity, reflected in reduced securities turnover, lower bond inventories and greater reliance on agency trading. The steady downward move in interest rates and yield spreads across the Eurozone, together with the extended period of market stability, has surprised investors and issuers. While bond issuance has accelerated in the past several years in response to these conditions, there is a concern about the lack of accompanying support from the secondary markets. The large companies, however, have dominated bond offerings in European markets. The fear is that this thin liquidity relative to growing primary markets will interfere with the capital-raising process and leave bond markets susceptible to economic and market shocks. The overriding questions at the conference were a) will the reform process aggravate this imbalance in bond markets, and b) what can be done to improve bond market liquidity?

Ralf Thomas, CFO at Seimens, gave the large corporate perspective. Successful companies like Seimens have sufficient

access to capital, benefitting from strong ratings, and financing flexibility with the ability to diversify among products and across marketplaces, and take advantage of good timing. On the other hand, small business continues to struggle to find capital in debt markets. The problem is serious in Europe, particularly in the peripheral countries, as regional banks have been reluctant to extend high-risk loans to small companies, preferring the safety of sovereign bonds.

Bond Turnover
Amount traded as a percentage of bonds outstanding



Source: MarketAxess

ABS markets were talked about as an effective vehicle to stimulate bank lending by enabling the banks to package loans and re-sell off their balance sheets. Mario Draghi, governor of the ECB, recently stated the Bank may agree to buy ABS backed by corporate loans to simulate lending. It is unlikely that without this support recovering ABS markets will improve conditions for small business lending. This malaise in funding small business, both with debt and equity, is a top concern for EU authorities and individual countries, with reform efforts giving increasing profile to market efficiency considerations.

ii) Shifting Risk Assessment to the Back Office

Achleiter made one of the most insightful observations about risk that has escaped the notice of market commentators, the media and perhaps even the regulators. In the years leading up to the financial crisis, there was a trend to consolidate institutional risk oversight and risk control within distinct risk management operations, drawing the risk function from the front office to separate back-office risk management operations. While trading operations would still be subject to intense scrutiny, risk control tied to securities trading was no longer integrated with transactional decision-making. As a result, traders focused exclusively on revenue generation. This reconfiguration may have pushed credit and liquidity risks higher than otherwise. Perhaps more interestingly, disregard for reputational risk on trading desks may have contributed to some of the scandals endemic across the global banking system.

iii) Regulatory Nationalism

Achleiter spoke of insufficient coordination among regulators that has led to inefficiencies in the regulatory process, rule duplication and higher compliance costs, and the fragmentation of markets. This has been particularly evident in OTC derivative markets. He argued that regulators need to develop a more coordinated approach to rule-making, reach a common understanding of what rule equivalence means, and find ways to achieve formal recognition of rules and regulations across jurisdictions. IOSCO has begun an exercise to tackle this agenda to enable more efficient and integrated global capital markets.

The Regulatory Landscape in Europe

Steven Maijoor, Chairman of the European Securities Markets Authority (ESMA), the new pan-European markets regulator, gave an overview of the reform initiative. One of the key accomplishments of ESMA over the past few years has been the development of a single rulebook for European securities markets. This progress in developing harmonized regulations stands in contrast to the global rule-making effort. Maijoor referred to the important task ahead of ensuring consistency in the application of the new regulatory framework.

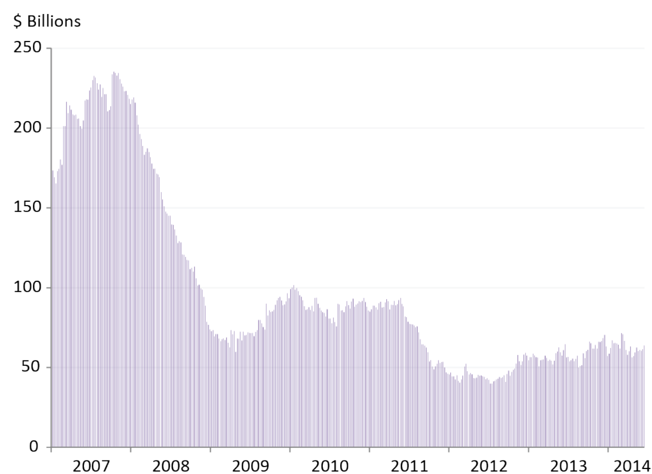
ESMA seeks vigorous industry input to find the right regulatory mix to balance full disclosure of information in bond markets, against exemptions from transparency and time delays to preserve market liquidity in less liquid over-the-counter markets.

ESMA has concluded that, at this time, it has insufficient information to determine whether to regulate the repo markets. ESMA has, however, reached the interim view through its research that that there is no collateral shortage in terms of overall demand and supply. Maijoor noted the real issue of collateral adequacy is the ability to access collateral on a timely basis when needed. This outcome turns on the fluidity of collateral through the trading and clearing systems. Substantial progress has been made in improving inter-operability across the various clearing systems. While there were differing views on the extent of reform needed for the repo markets, a key point that emerged was the need to examine the marketplace, and reforms, from the perspective of its efficiency as a financing vehicle, and as a mechanism to transfer collateral efficiently across clearing systems to back OTC derivative transactions.

Maijoor's recognition of the need for industry consultation highlights a regulatory concern to proceed carefully and limit unintended consequences in the capital markets, achieving the right balance between stability and investor protection, and market efficiency. But what sometimes goes missing in this thinking is recognition that rules are not the full panacea. Regulators must make an effort to encourage change in the cultural ethos of market participants, a point made in a recent speech by Mark Carney. Market practitioners and institutions need to instill a culture that recognizes their actions are not just about personal and shareholder remuneration but, as stakeholders in the financial markets, they have a responsibility

to recognize these actions can affect the legitimacy of the system in which they operate.

Will Debt Markets Overcome Regulatory Obstacles?
One of the key panel sessions, led by Haken Wohlin, Managing Director, Global Head of Debt Origination, Deutsche Bank, was a deep dive into the functioning of the European debt markets. The panelists explored the scope of markets to the regulatory obstacles of expected ring-fencing of retail banking operations, and the new capital, liquidity and leverage restrictions on banks, and the capacity to provide sufficient capital for enterprise. Panelists commented on the positive factors in the marketplace: increased issuance activity, broadening spectrum of debt securities and securitized products, and stepped-up investor participation, with an intense focus on the search for higher yield. The panelists were surprised at the modest issuance of infrastructure bonds given pent-up institutional demand for these high yielding securities and attractive benefits of economic spin-offs from expanded infrastructure spending.



There was a consensus that debt markets were functioning well, but it was tempered with limited confidence in the longevity of these conditions. It is evident that the growth in primary markets in the last few years has outstripped the size of secondary markets, in terms of liquidity support. This has caused investors and issuers to adopt a cautionary approach, recognizing that the thin layer of liquidity leaves market stability vulnerable to sudden changes in market conditions. The ECB announcement on June 5, in the midst of the conference, was hailed as a positive initial step but not sufficient to address the weak economic conditions and disinflation in Europe. Market participants expect follow-on action in terms of quantitative easing to achieve the right stimulus.

The recent ECB announcement will have a profound impact on European capital markets, signaling low interest rates for a long time and a flattening in the yield curve. This liquidity will encourage increased bank lending, particularly in the core countries. Many believe the ECB move needs to be accompanied by other measures, such as effective derivative reforms to rekindle the ABS markets, enabling banks to move assets cost-efficiently from the balance sheet to encourage lending. Another focus of reform is to encourage SME financing through the capital markets as an alternative to bank financing. Banks now account for about 70% of available credit to SMEs.

Surprisingly the private placement markets in Germany have done a good job in complementing bank finance. One of the interesting features of the market has been the rapid expansion of the "Schuldschein" private placement market for debt securities. Smaller issuers have tapped into this market, attracted by funding rates below bank credit rates. Institutional investors have been drawn to these offerings by the yield pick-up. It was noted that even the small institutional firms in Germany have built up expertise to assess credit risks of smaller issuers. The success of this market may hold interesting insights for Canadian dealers and SMEs searching for attractive sources of capital.

Structural Change in Investment Banking
It was clear from the conference presentations by the German investment banks and general discussion with conference participants that the universal banks are pulling back from global markets and streamlining their trading and underwriting operations, shuttering or selling off business units to reduce costs and boost earnings and shareholder returns. Business conditions and regulatory restrictions on capital, liquidity and leverage have driven retrenchment. European universal banks are following the Barclays lead, withdrawing from offering certain investment banking services and trading on a global scale and specializing operations.

The observation was made that this retrenchment was pushing more risk to the non-banks, notably the private equity and hedge funds that are buying financial assets and operations, and broadening their business models in different directions. The corollary was a need to understand the market implications of this institutional restructuring to ensure systemic stability and a level playing field across the market, without jeopardizing market efficiency.

Banking Union Translates to Cross-Europe Banking Intermediation
Michael Meister, Parliamentary State Secretary, German Ministry of Finance, outlined the progress on the European banking union. The EU has made considerable progress on the broadly-based rules on banking oversight and resolution that will go a long way to dealing with future banking crises. The EU has implemented a model of banking supervision, with the ECB taking on direct supervision of the systemically important banks (24 in Germany out of 2,000 banks), and relying on national banking supervisors for the smaller institutions. The EU has also put in place a single resolution mechanism that

shifts responsibility for bailing out bankrupt institutions from the state to debt-holders and shareholders, and establishing rules for member countries to back-stop depositors.

The media has criticized the resolution mechanism not going far enough by not implementing an EU-funded default fund, instead relying on national governments to provide the funding. The media, however, has generally ignored the key benefit of the banking union, namely enabling banks to expand intermediation right across Europe providing a stimulus to bank lending in the peripheral countries as banks in the core countries expand their business south.

Conclusion: The Need to Strike the Right Balance

Recent reforms, especially ECB decisions, will have significant impact, both on European and global capital markets. There is consensus on the goal: Enhanced economic growth and private-sector job creation. But it must be achieved while preserving and enhancing the liquidity, breadth and efficiency of capital markets. This is the challenge that the ECB and other policy makers face; the conference illustrated the potential pitfalls and opportunities on the way to meeting it.

Yours sincerely,

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