CAPITAL MARKETS UNION:

The systemic issues buried deep in the markets infrastructure plans

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Among its various objectives, the CMU Green Paper aims to improve market effectiveness by upgrading the 'plumbing' of financial markets. This brief identifies five main challenges of the Commission's market infrastructure plans.

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Among its various objectives, the CMU Green Paper aims to improve market effectiveness by upgrading the 'plumbing' of financial markets. This brief identifies five main challenges of the Commission's market infrastructure plans:

1. Regulation of Securities Financing Transactions (SFTs) receives minimal attention, especially compared to high-quality securitisation. Yet SFT markets larger in volume than, and closely connected to, securitization markets.

2. The CMU plans are inconsistent with the Commission's work on shadow banking. Whereas the latter work stream stresses the urgency of regulating SFTs due to their crucial role in leverage, procyclicality and interconnectedness, the CMU Green Paper downplays the systemic issues related to SFT markets.

3. In the CMU, the Commission's thinking about SFTs seems reduced to a notion of promoting the "free flow of collateral" - intimately related with the concept of "collateral fluidity" - a position that is indistinguishable from that of the main industry organization in the area. With this, there is considerable risk that CMU plans repeat mistakes of the pre-crisis period, when Member States and European institutions delegated regulatory responsibility to SFT market participants.

4. The CMU proposal similarly suggests a simple trade-off between regulation and market liquidity, in direct contradiction to the widely acknowledged complexity of this relationship (including amongst market participants).

5. These weaknesses of the CMU plans may be seen as part of a larger regulatory trend, by which proposals to regulate SFT markets have been watered down recently (evident also in the gradual erosion of the FSB's plan to introduce universal mandatory haircuts).

CMU approach to SFT markets is at odds with Commission's work on shadow banking

The CMU Green Paper notes that 'the fluidity of collateral throughout the EU is currently restricted, preventing markets from operating efficiently'. The concept of 'collateral fluidity' was introduced and is (still) exclusively used by ICMA's European Repo Council (ERC)[1], the association that represents repo market participants in Europe. It refers to the absence of barriers to the free flow of collateral via SFT markets (repo and securities lending markets). The Commission's view that markets operate less efficiently where collateral is not 'fluid' echoes the ERC position that regulation 'inhibiting collateral fluidity' poses systemic risks.

Conceptually, 'collateral fluidity' is inconsistent with the Commission's work on SFT markets. Since the 2012 Green Paper on Shadow Banking, the Commission adopted the Financial Stability Board's

[1] Hill, A. (2014). Collateral is the new cash. The systemic risks of inhibiting collateral fluidity. ICMA European Repo Council paper.

view that SFT markets are systemic to shadow banking, alongside securitisation markets. In the Green Paper, and the 2014 proposals on Reporting and Transparency of SFTs, the Commission stresses the urgency of regulating SFTs due to their crucial role in systemic leverage, pro-cyclicality and interconnectedness. Whereas the CMU plans dedicate substantial analytical effort to define high-quality securitisation – seeking to bring this market out of the shadows – SFT markets receive limited attention. This is unfortunate since European repo markets are roughly three times larger than securitisation markets, and are used to finance securitisation products[2]. Despite mentioning (in passing) the risks of collateral reuse and despite committing to seek views on 'an appropriately regulated flow of collateral', the Commission itself makes no attempt to suggest what 'appropriate regulation' might be. In contrast, the CMU consultation questions focus on improving collateral 'fluidity'.

The CMU risks repeating mistakes of the pre-crisis period that held SFT markets work best where regulatory responsibility is delegated to market participants. Indeed, the vision of freely flowing collateral is not new. As early as 1999, financial market participants (the Giovannini Group) persuaded European authorities to introduce policies that would create a European repo market. The 2002 Financial Collateral Directive enshrined the Giovannini recommendations, allowing banks to move liquidity and collateral across borders unhampered by regulation. European authorities encouraged and enabled repo markets to become systemic without putting appropriate regulatory structures in place, seduced by promises of market liquidity and financial integration[3].

This laid the foundations for a symbiotic relationship between SFT markets and large European banks. European banks collectively migrated to interconnected, leveraged, trading-based business models, funded in SFT markets with Euroarea government collateral[4]. The financial stability implications of the SFT-based bank/sovereign nexus came to fore during the crisis, when SFT market disruptions affected both banks and government bond markets in Europe[5]. Yet CMU plans are silent on (the integration of) government bond markets, although these are the backbone of most fixed-income securities markets that CMU seeks to promote and of SFT markets.

Progress on regulating SFTs is slow and may be permanently derailed by CMU

Since 2008, regulators have asked critical questions about the regulation of market-based financial systems. Since institution-based regulation can be easily avoided by moving in the shadows, it was agreed that markets need direct regulation. Yet direct regulation of SFT markets is proceeding at a slower pace than new rules that affect SFT markets indirectly (EMIR, CRR, Basel III liquidity/leverage rules) and, according to US regulators, marginally at best [6].

At international level, the FSB has watered down its plans for universal mandatory haircuts considerably. Moreover, given the specific nature of European SFT markets - dominated by banks and

2 See ECB (2012). Shadow banking in the Euroarea. An overview. Available at https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf

3 See Gabor, D. and C. Ban (2015) Banking on the state: the European repo market. Mimeo.

4 Haldane, A. (2009) 'Rethinking the financial network', also Liikanen Report (2012).

5 Bank of England (2011) 'Financial Stability Report'. December 2011. Issue 30. See also Courre, B. (2013) 'Ensuring the smooth functioning of money markets', Luxembourg, 16 January 2013

6 Jeremy Stein on 'Fire Sales in SFT markets' http://www.federalreserve.gov/newsevents/speech/stein20131107a.htm

intensive in government collateral – the FSB rules would only apply to less than 20% of SFT transactions, failing to restructure the complex collateral chains between regulated banks that pose financial stability risks.

European regulators have so far prioritized reporting and transparency of SFTs. While SFT transparency may shed much-needed light on systemic markets, the structural impact is limited. Excessive leverage occurs via SFT markets not (solely) because these are opaque, but because leverage is cheapest in SFTs with government bond collateral. The amendments introduced by the European Parliament[7] – that proposes to introduce the FSB mandatory haircut framework in EU law – may not gain traction in policy circles if the CMU prioritizes the free flow of collateral in SFT markets, at the expense of their effective regulation.

Promises to improve market liquidity downplay its cyclical nature

On market infrastructure the CMU plans signal a readiness to introduce measures that would improve market liquidity. Here, the Commission is treading on rocky conceptual terrain. With the global financial crisis, regulators recognize the 'complex, contingent and volatile' nature of market liquidity, its pro-cyclical, leverage-driven aspects and so far have failed to resolve the conceptual dilemmas this poses. Yet the CMU Green Paper alludes to a trade-off between regulation and market liquidity, as did the 2013 Green Paper on Long-term Growth in Europe. This trade-off presumes a conceptual clarity that is difficult to find even among market participants[8], and raises the question whether the Commission will eventually resort to scaling back regulation, particularly when affecting market-makers that are also large, systemically interconnected banks. Basing policies on ill-defined concepts may create new sources of systemic risk as well as revive pre-crisis ones. The Commission would be well-advised to consider the desirability of less liquid markets that would create incentives for buy-to-hold investors and reduce the scope for impatient trading.

[7]http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARL&reference=PE-544.170&format=PDF&language=EN&secondRef=01
[8] http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/survey-report-liquidity-in-the-european-secondary-bond-market-perspectives-from-the-market/