financial market briefing

darien analytics
FINANCIAL MARKET ANALYSIS

JANUARY 2012 ISSUE 3

The Future of Financial Market Infrastructure In Europe

The structure of European financial markets is being transformed

As European leaders scramble to prevent further deterioration in European credit markets and address the immediate threat of a Greek default, European officials and parliamentarians are engaged a fundamental and long-term restructuring of the way financial activity is conducted in the European Union's 27 member states.

The result will be the most fundamental redesign of European financial markets in a generation. When complete, it will determine how financial transactions will be conducted in Europe for decades to come; where they will be conducted; and which banks and financial institutions will be able to take part.

The proposed changes to European financial markets began in response to the global financial crisis of 2007 – 2009 and are part of an international effort to strengthen financial institutions and market infrastructure worldwide.

But in Europe, there is an extra dimension to financial market restructuring. Not only is the content of financial market regulation being revised – how much capital should banks hold, which financial instruments should be traded on exchanges rather than over-the-counter? – but, more significantly, the process by which such decisions are made is undergoing dramatic changes as regional regulators and European-wide bodies gain precedence over national regulators.

Following the global financial crisis, three new financial regulators were created to oversee European financial markets – The European Banking Authority, based in London, the European Securities and Markets Authority, in Paris and the European Insurance and Occupational Pensions Authority, in Frankfurt. These three new bodies work with a fourth, the European Systemic Risk Board, also based in Frankfurt, which is responsible for overseeing macro-prudential oversight of European financial markets.

But the policy agenda is being driven by the European Commission and in particular by its Internal Market and Services Directorate, headed by Commissioner Michel Barnier, a former French foreign minister.

The result is a steady shift of power and initiative from individual member states to Pan-European bodies. Many believe that this will lead to stronger financial systems with fewer loopholes and reduced opportunity for regulatory arbitrage. Others resent the loss of national sovereignty and implied reduction of regulatory sensitivity.

New Initiatives Following the Global Financial Crisis

It was the global financial crisis of 2007-2009 which established the need to re-regulate global financial markets, including those in Europe. The Basel Committee on Banking Supervision produced new guidelines on bank capital, liquidity and leverage, and redefined the boundary between micro-prudential and macro-prudential supervision. The Financial Stability Board led efforts to reduce the risks to the financial system posed by Global Systemically Important Financial Institutions (G-SIFIs) and to address skewed incentives in bankers' pay and bonus structure.

- **CRD IV** is the fourth version of Europe's Capital Market Directive, which incorporates the Basel committee's recommendations into the European banking system. Pillar 1 provisions will be introduced as a Regulation, giving member states no leeway to adapt them to national circumstances. Pillars 2 and 3 will be introduced as a Directive, offering a modicum of room for adaptation.
- **EMIR** the European Market Infrastructure Directive – aims to increase transparency and reduce the potential for instability in derivatives markets. It implements the Pittsburgh recommendations that standard OTC derivatives should be traded on exchanges, cleared through central counterparties and registered on trade depositories
- **Mifid II** the updated Market in Financial Instruments Directive and an accompanying Regulation, Mifir[1], aim to ensure that significant market activity cannot take place outside a regulated environment: for example, Mifid takes aim at "dark pools" of equity trading, and "high frequency" trading, while Mifir will require those derivative transactions which remain OTC to be traded on organized trading facilities.

A fourth important initiative entails updating the Market Abuse Directive (MAD) and extending its provisions to cover new forms of market activity that are captured in the Mifid regulations, such as "high frequency" trading.

1 Member states of the European Union are required to incorporate Directives into national regulation/ legislation and have some ability to adapt the directive to national circumstances. In contrast, the provisions of Regulations apply automatically to all member states without incorporation into national regulation/ legislation.

Equally important have been the efforts to improve transparency in the trading of financial instruments. In 2009, the G20 meeting in Pittsburgh recommended that nearly all derivatives currently traded over-the-counter (OTC) should be moved onto exchanges and cleared through central counterparties (CCPs). Since 90% of all derivatives are currently traded OTC, this represents a huge change to the market in financial instruments, and in Europe it is expected to lead to profound changes in where instruments are traded and who is able to clear them.

There are three wide-ranging regulatory initiatives which together cover most of the issues arising from the financial crisis: updating the Capital Requirements Directive (CRD), the new European Market Infrastructure Directive (EMIR) and the revised Market in Financial Instruments Directive (MiFiD II). Other initiatives include proposals for a tax on financial transactions and rules to restrict short selling. One recent study listed 34 separate new regulations passed through the European legislative process, and another 15 which were in the pipeline.

Are Financial Markets a Problem or a Solution?

Many of the provisions of these initiatives are uncontroversial, but some are highly contentious. In general, the European Commission wants to centralize regulation within European bodies and diminish the authority of national regulators. The Commission also takes what some believe is an overly "interventionist" line to financial market regulation, for example by setting maximum capital ratios for banks in Europe and forbidding national regulators to require higher ratios for their own banks, and by giving ESMA powers to ban certain types of trading which, the Commission believes, have contributed to market volatility in recent months. Furthermore, the Commission takes a strong line on the regulation of non-European firms wishing to operate within Europe – it requires such firms to demonstrate exhaustively that their home regulator adheres to regulatory standards that are at least as stringent as those in Europe.

In contrast to the Commission, some member states, and in particular the United Kingdom (U.K.), prefer a more market-friendly approach based on maximizing competition, minimizing government interference in market activities, and eschewing new taxes.This approach is rejected by the Commission and by some member states, notably France, that believe that light regulation and over-emphasis on competition was a root cause of the global financial crisis.

Changing Regulations Will Lead to Changing Geographies

Such ideological differences have very real implications for where and how financial activity will be conducted in Europe in the years ahead.

In the U.K., the Government is committed to implementing the recommendations of the "Vickers Report," which called for some banks to show capital ratios substantially higher than those recommended by the Basel Committee. But CRD IV would prevent member states requiring ratios higher than Basel's. The European Commission is concerned about regulatory arbitrage and the danger that riskier banks, or banking activities, could become concentrated in a small number of member states. Specifically, the Commission is willing to cede discretion to national regulators under Pillar 2 – allowing them to require higher ratios in order to preserve financial stability; in response to national circumstances, such as a real estate bubble; and in response to the risk profile of individual banks – but it is not willing to allow national regulators to specify higher ratios ex ante, under Pillar 1.

More far reaching are the implications for trading in financial instruments. London is currently the center for trading in OTC derivatives, while Frankfurt dominates in exchange traded derivatives. Mifir will push much OTC trading onto organized trading facilities and may curtail certain forms of activity, in particular "high frequency" (or "algorithmic") trading. The U.K. fears that this will lead to a migration of activity from London to Frankfurt.

Emir will require standardized derivative contracts to be cleared through Central Counterparties (CCPs), but the Commission is arguing that any CCP clearing Euro-denominated trade would have to be domiciled in the Eurozone, so as to benefit from European Central Bank liquidity facilities: again, the result would be a shift of financial activity out of London. On the same theme, the U.K. has also been pressing hard for "open access" to CCPs, to enable them to clear trading conducted on any trading venue (a so-called "horizontal" structure), so diluting the market power of trading venues that control their own CCP (a so-called "vertical" structure).

The Commission also takes a firmer line on the authorization of CCPs from non-EU countries, requiring evidence both of equivalent regulatory stringency on the part of the home regulator, and reciprocal access for EU-based CCPs. ■

Four Policy Themes Are Driving the Agenda for Change

The shape market infrastructure in Europe is being driven by four policy themes: a desire to strengthen regulation of financial markets to prevent a re-occurrence of the global financial crisis of 2007-2009; a belief among some, but not all, European member states that European-wide, rather than national, regulation is the most effective way to fulfill that objective; a desire among some, but not all, member states to include centralization of financial market activity within the broader centralization of European fiscal activity occasioned by the current budgetary crises in the Eurozone; and the interplay of British, French and German rivalries in respect of their own financial sectors.

The result is a complex interplay of technical rule making and political brinkmanship on issues of fundamental long-term importance for European financial markets – all happening against the backdrop of deepening fiscal crisis in the Eurozone, currency instability and a Greek sovereign default.

Andrew Cunningham has spent more than 25 years writing, training and consulting on banking and finance, both in the Middle East and in Europe and the U.S.

Darien Consulting advises clients on international financial regulation and best practices in risk management and corporate governance. The firm was founded in 2010 by Andrew Cunningham and is based in London.

darien analytics
FINANCIAL MARKET ANALYSIS

Phone +44 (0)755 75 27 243
Email andrew@darienmiddleeast.com
Website www.darienmiddleeast.com