# Peter Praet: Transition of the financial system in the wake of the financial crisis

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 8th Annual European Market Liquidity Conference of the Association of Financial Markets in Europe, London, 13 February 2013.

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## Introduction

It is a pleasure for me to give this keynote address on the occasion of AFME's 8th Annual European Market Liquidity Conference. The ECB has a vested interest in the efficient functioning of financial markets and, in particular, in their liquidity. In this context, I will also address the important topic of trade transparency, including AFME's work regarding the post-trade transparency calibration under the Markets in Financial Instruments Directive II (MiFID II).

## Restructuring funding and markets: central bank and market initiatives

The ongoing transition of the financial system in the wake of the financial crisis is driven by market initiatives, regulators and central banks. Before addressing financial regulation, let me start with some thoughts regarding the contributions of the central bank and respective market participants.

As we know, bank funding channels have changed significantly during the crisis. Several of the measures implemented by the ECB, notably the three-year longer-term refinancing operations (LTROs) and the adjustments in our collateral policy, have been effective in alleviating bank funding constraints and containing the risks of a disorderly bank deleveraging process. Further, non-standard measures – most recently, the Outright Monetary Transactions (OMTs) – have significantly contributed to an improved euro area financing environment, mainly stemming from an improvement in financial market sentiment and an alleviation of vulnerabilities affecting the supply of bank credit to firms and households. In addition, the OMTs announcement has helped to narrow sovereign spreads and to restore investor confidence.

However, the ECB's (non-standard) measures can only be temporary solutions. Most importantly, market participants have to continue their efforts to facilitate the transition to a less central-bank reliant, more market-based financial system, for which the ECB's measures, as well as the recent progress concerning the Single Supervisory Mechanism, have hopefully laid the foundations.

One market segment that suffered considerably during the financial crisis was the market for asset-backed securities (ABSs), the revival of which I consider essential for the provision of finance to the corporate sector. Given the restricted funding sources and elevated bank funding needs, a trend towards more disintermediation from larger corporate issuers has been observed in recent years, and this trend will most likely continue.

By contrast, small and medium-sized enterprises (SMEs) are more dependent on their respective domestic banking sectors and are subject to tighter credit conditions than larger firms that have greater access to global financial markets. The question arises as to how these restrictions could be overcome. A reopening of the ABS market may be one way of enhancing funding conditions for SMEs.

It will therefore be essential to better understand the factors that still constrain the recovery in this market and why investors are shying away, despite proven good performance and very few defaults on European ABSs. The regulatory treatment of ABSs, in particular the

proposed regulatory capital charges for banks and insurers, could be a factor, as could a lack of secondary market liquidity and the relative opacity of the loans packaged in an ABS.

In this respect, let me also mention the Eurosystem's ABS loan-level initiative. In November 2012 the ECB informed the public about the implementation of loan-level data reporting requirements for asset-backed securities as part of the Eurosystem's collateral framework.[1] The ABS loan-level initiative makes use of the European DataWarehouse, the single loan-level data repository for the handling of loan-level data reporting, which became operational on 3 January 2013. As a consequence, for residential mortgage-backed securities and for asset-backed securities whose cash-flow-generating assets comprise loans to SMEs, the reporting requirements became mandatory as of 3 January 2013. Commercial mortgage-backed securities must comply as of 1 March 2013, and other asset classes (auto loans, consumer finance loans, leasing receivables) as of 1 January 2014.

While the ECB launched this initiative in the context of its collateral framework, a positive externality is that the initiative should also support the revival of this market segment by increasing its transparency and therefore investor confidence.

The ECB also helps to accompany the fundamental change in the financial sector by changing the market structure and infrastructure, e.g. by actively supporting the Legal Entity Identifier (LEI) initiative as well as enforcing financial integration via the Eurosystem's TARGET2-Securities (T2S) project, which will make cross-border settlement identical to domestic settlement and hence the whole European securities market will become more attractive and cost effective.

### Financial regulation and transparency

I will now expand on this morning's discussion on "Making markets work: liquidity and regulation". Apart from central bank and market initiatives, a number of measures in the field of financial regulation, which are intended to prevent another crisis on the scale of the one we have just witnessed, have been decided upon or initiated by various authorities. Such measures contribute to structural changes in the institutional set-up of financial markets and are expected to restore market confidence and, ultimately, to support growth.

Yet the intended positive effects of regulatory measures have to be carefully weighed against their costs and unintended side effects. Market participants point out that the regulatory measures must be consistent with one another. The speed of regulatory innovation should not mean that too little consideration is given to the impact one measure will have when taken in conjunction with others. Also, consistency on the international level has to be ensured.

Very importantly, financial regulations should be designed and implemented carefully in order to avoid potentially adverse effects on market liquidity and price formation. For the ECB, efficient, resilient and liquid financial markets are a key prerequisite for the smooth implementation and transmission of monetary policy. The ECB therefore strives to ensure that regulatory reform initiatives do not impose restrictions which may hinder the efficient functioning of markets or impair their liquidity.

Formally, the Treaty on the Functioning of the European Union assigns to the ECB an advisory role as regards proposed EU acts[2,] i.e. the ECB is consulted on proposed EU directives (general framework legislation). Furthermore, delegated and implementing acts

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[1] Press release: ECB announces rescheduling of loan-level data reporting requirements for asset-backed securities, 27 November 2012.

[2] See Articles 127(4) and 282(5) of the Treaty.

qualify as proposed EU acts, and therefore the scope of the ECB's consultation also extends to such acts as well as to draft technical standards.[3]

In addition, we continually exchange views with market participants, for example via our ECB market contact groups.[4] The regulatory debate has become a standard agenda item in those meetings.

A number of regulatory measures target financial markets. Let me focus in the rest of my speech on a very important regulatory initiative and on a concrete example: the review of the MiFID II and, specifically, the proposed price transparency requirements. The ECB also provided an opinion on the MiFID II proposal.[5]

As you know, the MiFID II proposal extends pre- and post-trade transparency requirements from equity instruments (MiFID I) to additional asset classes such as bonds, structured finance products, derivatives admitted to trading or traded on a regulated market, a multilateral trading facility or an organised trading facility and derivatives considered eligible for central clearing. The aim is to enhance price formation and to support the evaluation process of such instruments.

The requirements cover pre-trade transparency – i.e. the provision of quotes and market depth to market participants ahead of a trade – and post-trade transparency – i.e. the timely publication of the prices and volumes upon trade execution. These mandatory transparency requirements represent a major change, especially for the fixed income market. For brevity, I will only address the issue of post-trade transparency.

As we have known since the publication of the seminal work of the Austrian economist and philosopher Friedrich Hayek, prices reveal information that is dispersed among the numerous individual members of an economy. As a consequence, market outcomes are directly influenced by the time and degree to which prices and volumes are disclosed to the public.

In reality, different markets are subject to different transparency regimes and disclosure requirements, which are a consequence of the existing heterogeneity among both financial assets and market participants. While this implies that a one-size-fits-all level of transparency is unlikely to exist, a number of economic forces are omnipresent and therefore allow us to draw some conclusions from the academic literature on post-trade transparency.

In those market segments that the MiFID II review aims to address, liquidity providers play a central role as they intermediate between end investors and thereby help to secure a well-functioning marketplace. Yet an efficient and resilient market requires a sufficient level of competition. Several studies[6] show that a lack of transparency can be a serious threat to a level playing field because intermediaries may use their private knowledge of customer order flow as an informational advantage that allows them to exert market power. Therefore,

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[3] See opinion of the ECB of 25 January 2012 on a proposal for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and a proposal for a Regulation on prudential requirements for credit institutions and investment firms (CON/2012/5).

[4] In particular the Money Market Contact Group, the newly established Bond Market Contact Group, the Foreign Exchange Contact Group and the Operations Managers Contact Group (see the ECB website for more information on these groups).

[5] See ECB Opinion of 22 March 2012 on (i) a proposal for a directive on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council, (ii) a proposal for a regulation on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories, (iii) a proposal for a directive on criminal sanctions for insider dealing and market manipulation and (iv) a proposal for a regulation on insider dealing and market manipulation (market abuse) (CON/2012/21).

[6] See e.g. Madhavan, A., "Consolidation, fragmentation, and the disclosure of trading information", *The Review of Financial Studies*, Vol. 8, No 3, pp. 579-603 and Bloomfield, R. and O'Hara, M., "Can transparent markets survive?", *Journal of Financial Economics*, Vol. 55, No 3, pp. 425–459.

opacity enables the extraction of rents and can lead to increased price dispersion[7,] with negative consequences for market integrity and fairness. Furthermore, a low level of post-trade transparency can significantly distort the informational role of prices by preventing the diffusion of value-relevant information, which may hamper market liquidity because of adverse selection.

In line with this rather positive view of post-trade transparency, a number of empirical studies[8] have found that the introduction of mandatory trade reporting has significantly improved formerly opaque market segments, such as the market for US corporate bonds.

At the same time, one must be aware of potentially negative side effects. For example, liquidity providers may be reluctant to take on a large inventory position because they will find themselves in an unfavourable bargaining position if this information is known to others. They may ask for an additional premium in order to take on such a risk, which can raise transaction costs for investors.[9] Similarly, very large market participants, such as pension funds, may find it more difficult to execute large transactions without being front-run by predatory traders. In very transparent markets such as those for equities, this has become a substantial concern.

With these issues in mind, it is imperative that the new regulatory environment carefully considers all possible implications of increased market transparency. In particular, it is important that the new set of rules is calibrated in a way that avoids excessive market liquidity distortions, in particular in those market segments whose functionality is still partially impaired as a consequence of the market disruptions that we have witnessed over recent years.

With this in mind, the ECB explicitly welcomes private sector initiatives such as the AFME framework for post trade transparency, which I believe is a constructive proposal because it aims to fine-tune the reporting requirements across different liquidity categories, something that is certainly a sensible approach given the economic trade-off I have just outlined.

## Concluding remarks

So, I will now conclude my keynote address, and I look forward to participating in what I am sure will be an interesting panel discussion.

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[7] De Frutos, M-A. and Manzano, C., “Trade disclosure and price dispersion”, *Journal of Financial Markets*, Vol. 8, No 2. pp. 183–216.

[8] See Goldstein, M., Hotchkiss, E. and Sirri, E., “Transparency and Liquidity: A Controlled Experiment on Corporate Bonds”, *The Review of Financial Studies*, Vol. 20, No 2, pp. 235-273, and Edwards A., Harris, L. and Piwowar, M., “Corporate Bond Market Transaction Costs and Transparency”, *The Journal of Finance*, Vol. 62, No 3, pp. 1421–1451.

[9] See Naik, N., Neuberger, A. and Viswanathan, S., “Trade Disclosure Regulation in Markets with Negotiated Trades”, *The Review of Financial Studies*, Vol. 12, No 4, pp. 873–900.