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Wrap-up on CMU challenges and next steps

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DAVID WRIGHT:

I have the pleasure to have Jeff Tessler next to me here. We are going to discuss the Capital Markets Union, particularly from the infrastructure side. Maybe, just to start Jeff, how do you see the Capital Markets Union from your perspective, do you see a big opportunity and what do you think the priorities are?

JEFFREY TESSLER:

In a way, this is a little bit déjà vu for me. When I first moved to continental Europe in 2004 to join Deutsche Börse, the Commission was shifting from the Lisbon Agenda and at that time, there was a lot of focus on the capital markets and the question was: how can we explain that the capital markets of Europe cannot compete with the United States, and if we were going to fulfil the intent of the Lisbon Agenda, what would the impacts on the financial market be?

When I think about where we were and where we are today, I think we have made progress.

Let me just explain, from the private sector standpoint. We had issues with trading, clearing and settlement and there were fingers being pointed back and forth on that side of the equation. Why were the costs ten times more expensive than the US? Was it on the trading level? Was it on the clearing level? Was it on the depository level? The industry tried to come up with the answers. We had the Code of Conduct which did not have the impact which was originally expected. Then, we began the legislative process, and when you look at the trading layer today, a lot has happened. MiFID has been very successful, competition has been brought into the trading layers, and most of the major exchanges throughout Europe have lost significant amounts of market share to the MTFs.

When you look at the clearing layer, there is a lot of work that was in the process of being

addressed, but since the time of the Lisbon Agenda and today, something else happened and that was the financial crisis in 2008. So, the focus of the CCPs has really been around resiliency, robustness, allowing them to take on all of this new activity from the OTC market. When you think about the progress that has been made on the CCP level, with the advent of EMIR, and the requirement for the CCP which is to have more skin in the game, the work that IOSCO and others are doing in terms of risk and resiliency, you can say things are not yet finished, but they are in a much better state than they were.

When you look at the depository level, which is probably the least well-known level of the chain, there you can say a lot has been done. Some of it is still work-in-progress, as a result of CSDR, although I honestly don't think the need from the depository level was as big as on the CCP level. Nevertheless, CSDR has addressed the issues of settlement discipline and coming to a consistent T+2 as well as some governance-related topics. On the depository level, we've had in the meantime TARGET2-Securities and that is the first true cross-border initiative which has fostered, or is in the process of fostering, harmonisation. So, when I look at the private sector side, the job's not yet done, but a lot has been done over the past ten years.

Looking at the public sector side, and I am sure this has been mentioned 20 times today, most of the issues such as insolvency regimes, companies law, securities law and tax issues are still with us. For the Capital Markets Union (CMU) to be a success, we really have to finish what we started on the private side and address some of the issues on the public side.

I just have two things that I want to also highlight. It is easy to say, we have these public issues, let's just deal with them. We know that if they were easy to deal with, they would have been dealt with already. But there are things that can be done through the work that we're about to embark on, maybe not by changing the existing laws but by coming up with one law. I know there's some work that has now been started on the insolvency regime but the processes in Europe also needs to be refined.

Clearstream recently sponsored a session on Capital Markets Union in London and one of the participants in that session said, when processing a tax reclaim in Europe, why do we have to have so many different forms? Why can't there just be one? There are other aspects of the process that we can look at and try to change and harmonise without tackling the ones that are going to be very, very difficult to tackle for a whole range of reasons, but I think, if we're serious about CMU, and we're serious about seeing the true development of the capital markets into a vehicle for growth creation, then we have to also take some additional steps around these public policy issues to move us forward.

DAVID WRIGHT:

As you know, one of the big four issues that the Chairman of the FSB, Governor Carney, has identified, is making progress on CCP safety. Do you agree with that or would you argue that current techniques, current processes inside your organisations, clearing and settlement organisations are sufficient?

JEFFREY TESSLER:

I have watched this development from a front row seat, as we have gone through the various implications of preparing for this new environment that sets out in EMIR, I think from the CCP standpoint, the issues of risk and resiliency, the robustness of the CCPs - are they fit for purpose? Basically, to take on the OTC market - and I think it is going to be an evolving approach - that was significant and by the way the biggest action that was taken. There is skin in the game, right? So that was a problem in the past, the CCPs actually do have significant skin in the game and now the risk management techniques used - I can only speak for the CCP I am affiliated with - are first class and that did not exist in the past. Some of the CCPs are banks, so the issue of recovery and resolution are issues that are actually being dealt with at two levels. Firstly, because it is a bank, the local or national regulator addresses the issues from a banking perspective and secondly, IOSCO ensures that it is also complying with the principles. So, is the job done? No. Are we fit for purpose? I think so, but it will be a constant evolution of this new world into which we are about to embark.

DAVID WRIGHT:

So we need to do the stress testing and all of that...

JEFFREY TESSLER:

Yes. From a governance standpoint of a market infrastructure, the amount of time we now spend on risk management issues and the sophistication of our approach to risk management is so far almost a complete turnaround from where we were a decade ago.

DAVID WRIGHT:

When I look at the infrastructure of Europe, correct me if I'm wrong, we have moved towards vertical models, but if you are really building a European wide capital market, those vertical models have got to link up, haven't they? As I understood, certainly from the industry point of view, that is where huge economies were potentially available. Has that happened? I mean, do we have connectivity between clearing houses today, or is it a dream?

JEFFREY TESSLER:

I think we should not just limit the discussion to clearing houses; you should have the discussion around market infrastructures. And when you look at it from a market infrastructure standpoint, the best example of a horizontal approach has been TARGET2-Securities.

TARGET2-Securities was an idea that was put forward in 2006 to lower the cost of cross-border trading in Europe by a single platform run by the ECB. Europe is Europe and it didn't exactly pan out the way it was expected because the UK stayed out and most of Scandinavia stayed out. So the platform was denied volume to reach its ultimate goal of being cross-border. At that point in time, the market could have said, it doesn't make any sense, the business case doesn't support it, let's kill it, right? But the market did not; the market went forward with the gentle guidance of the ECB because this was the first step towards true harmonisation.

In the meantime, with the financial crisis - and this relates to the CCPs - the most important benefit of TARGET2-Securities is that, instead of having multiple pools of cash and collateral throughout the Eurozone, you can now have one pool of cash and one pool of collateral which is significant, and from a user standpoint, that is the real benefit. It is not, according to me, just lowering the cost of cross-border trading so much, but the fact that I can now have one pool of collateral.

Why is that important? Everything that we have built within the CCPs requires the easy flotation of collateral from where it is held to where it is going to be used. So, TARGET2-Securities in itself is in the process of revolutionising how a CCP operates. When considering CCP interoperability, you really have to make the distinction between equity CCPs and derivative CCPs because the big difference is when it comes to derivative CCPs, the product is designed by the exchange. For equity CCPs, it is an issuer who issues the security. In a derivative CCP, they are providing risk-mitigating functionality for a proprietary product that has come out of the exchange. And then to say, well we will just interlink everything and have interoperability, to me, doesn't make sense.

DAVID WRIGHT:

Let us stay on the stability agenda just for a second. So we have this policy of driving as much OTC derivative trading through on to trading exchanges and through clearing system and through trade repositories (TR). For the time being, the trade repositories don't work, something like 60/70% of interest rates swaps are now being traded and cleared but an awful lot is not. Can we expect all the stuff that's not being – or how much of the stuff that is not being currently cleared could be cleared? In other words, how far has that agenda progressed?

JEFFREY TESSLER:

Well, I think the agenda has progressed according to regulation. EMIR outlines what needs to be cleared in a clearing house and reported to a TR. There are reporting requirements under MIFid, a TR or actually even a TR in another reporting mechanism can undertake the responsibility to do that, but there are a whole host of market transactions. So the next contracts to come into the trade repositories are energy contracts, and then we have the Securities Financing Directive and then you are going to have collateral, you are going to have repo, you have securities...

DAVID WRIGHT:

It's a progressive...

JEFFREY TESSLER:

Yes, obviously we have a trade repository. We had a Board meeting today and we looked at over the next five years, what additional functionality we have to provide for. Admittedly, in the beginning it was a mess, but it is going much better now. Actually, I even had a conversation today with our friends from DTCC about how we need to work more closely together amongst the trade repositories, so we don't wind up with a system where we're very good at just giving information to those who ask for it, but they can't do anything with it.

DAVID WRIGHT:

Well, I mean, we have got 29 of them, we heard earlier today. Perhaps a final thought from you Jeff. Commissioner Lord Hill and Kara Stein, a Commissioner from the SEC, will speak to us very shortly: what are the two messages, or three messages that you would like to give to Lord Hill? What are the priorities from your perspective, to make Capital Markets Union work?

JEFFREY TESSLER:

The absolute top priority is to think if the Capital Markets Union can work with a financial transaction tax of significance on top of it. It is just incongruous to think that we would be the only major market in the world to have a financial transaction tax and think that we were going to develop the capital markets with that type of cloud over us.

DAVID WRIGHT:

So you have two other shots.

JEFFREY TESSLER:

In the short term, we need to be seen to take actions that are identifiable and the public sector should address the issues that we outlined before. Even if they are not directly dealing with the harmonisation of a law, they should at least try to improve the process under which we have to operate.

Lastly, we would like to think of one single capital market. There are a lot of issues that cause home market bias that we have to address, and some of those could be pretty easy. There are connectivity issues, there are reference data issues; but right now, it is still very difficult for a German investor to buy a security in Italy and vice versa and we have to deal with issues – part of them is education, part is culture, part is the systems, but I think those things need to be addressed.

DAVID WRIGHT:

Well thank you very much for being with us, Jeff, and hopefully you'll be coming back to us very shortly in outlining the enormous progress under way. Thank you very much.