Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

T +353 1 224 6000 F +353 1 671 6561

Cúirt Uíbh Eachach, Bloc D, Bóthar Fhearchair,
Baile Átha Cliath 2, Éire.
Iveagh Court, Block D, Harcourt Road, Dublin 2, Ireland.

www.centralbank.ie

Response to the EU Commission Green Paper on Capital Markets Union ("CMU")

Dear Sir/Madam,

The Central Bank of Ireland ("Central Bank") welcomes the opportunity to respond to the European Commission Green Paper on Capital Markets Union (the "Green Paper"). The Central Bank supports measures which will increase the safety and efficiency of Europe's capital markets. The Central Bank believes that these dual aims, which resonate strongly in different parts of the Green Paper, must be pursued in equal measure in order that a true Capital Markets Union (CMU) is created. This has the potential to provide sustainable and meaningful channels of finance to the European economy.

Benefits of CMU

CMU has the potential to deliver significant benefits to the European economy. It is well documented that the supply of finance to the European economy is fragmented and overly-reliant on bank credit.[1] As much of this fragmentation is along national lines, many non-bank channels of funding to European corporates and SMEs lack depth.

In a functioning and mature capital markets union, one would expect deeper channels of intermediation matching more savers with borrowers as (heretofore) national markets are pooled at a European level. For corporates and SMEs, this should mean improved access to a more varied range of funding options that are efficiently priced. For savers and lenders, this should mean that funds are channeled through reliable products that match the desired risk-reward-liquidity characteristics.

Implementation challenges

The realisation of the full potential of a CMU will take significant effort and commitment on the part of all stakeholders in the EU.[2] Previous attempts to tackle some of the fundamental fault-lines which give rise to fragmentation in European capital markets have foundered due to significant sectoral and national interests. In light of the various initiatives to complete the Single Market and to further

[1] European Commission Green Paper on Capital Market Union.
[2] See Veron and Wolff (2015), "Capital Markets Union: A Vision for the Long-Term".

European integration, the CMU project is the natural next step and it provides a valuable focus to tackle these fundamental issues which have been highlighted on a number of occasions in previous reports.[3]

Phasing and prioritisation

Given the range of issues that are identified in the Green Paper, the Central Bank believes that a realistic timeframe for implementing priority areas on a phased basis will need to be set down. To assist with this prioritisation, the Central Bank has highlighted some key areas where policy initiatives would materially improve the functioning of Europe's capital markets and has therefore confined its remarks to a short list of questions raised in the Green Paper.

What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market? (Q29)

Recovering client assets from failed financial services firms

A harmonised framework for predictable and expeditious recovery of client assets (and investor monies) from a failed regulated financial services firm (RFSF) domiciled in any one of EU jurisdictions should be a feature of CMU. A key pillar of CMU is investor confidence and trust. Investors expect that the assets which underlie their investment claims are protected against the failure of those firms servicing those assets.[4] The Central Bank has identified that there is significant legal uncertainty, in many European Member States, concerning the treatment of client assets and investor monies held by regulated financial services firms not covered by the Bank Resolution and Recovery Directive[5] (BRRD) in the event of a failure of such a firm. Often, additional and costly levels of asset segregation are required to improve (but not guarantee) the chances of asset recovery in the event of the failure of the firm holding the assets. In such circumstances, the failure of a RFSF can have extremely damaging consequences for investors, local industry and, indeed, financial stability.[6]

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[3] Reports of Giovannini Group, November 2000, November 2001, April 2003.
"Finance for Growth", report of Giovannini-Moran High-Level Expert Group, December 2013.
"Long-Term Financing of the European Economy", report of European Commission, March 2014.

[4] For example, custodians, administrators and fund managers.

[5] Directive 2014/59/EU.

[6] For example, in the UK, the failure of the investment firm Lehman Brothers International Europe on 15 September 2008 highlighted the absence of a bespoke insolvency regime which has amongst its objectives the prioritized and expeditious return of client assets and investor monies over the liquidation of the creditor estate of the failed RFSF.

With this in mind, the Central Bank believes that a range of options should be considered to eliminate this legal uncertainty through targeted legislative change that would have the effect of providing a consistent and predictable legal framework across the EU for the treatment of client assets and investor monies in the event of the insolvency of a RFSF.

Additional desirable elements of this regime, would also include (a) pre-determined payout rules which would obviate the need of an administrator (or liquidator) to receive court consent to distribute assets, (b) a source of funding for the costs of administration or liquidation of a failed RFSF for the distribution of assets and (c) harmonised compensation rules and a compensation fund in the event that assets are not recoverable in full and recourse to the net positive assets of the RFSF's balance sheet is not possible.

Are there other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take? (Q32)

Under this broad question, the Central Bank would like to remark on: (i) the data infrastructure that is likely to be required to measure the achievement of CMU and to monitor financial stability, (ii) the potential for investment funds to originate loans and (iii) the current fault-lines in Europe's capital markets.

<u>Measuring success and monitoring financial stability</u>

To track the safety and success of CMU, a coherent data strategy is needed for the collection, validation, storage and analysis of data on all relevant capital markets in Europe. Regulators and supervisors are hindered by substantial data gaps in parts of Europe's non-bank financial sectors and also by a lack of data infrastructure for managing the data once the gaps have been identified. Various sectoral regulations have sought to close these gaps.[7] With the creation of the European Supervisory Authorities and the European Systemic Risk Board, it is more likely that risks will be identified at a European level. However, there are four important limitations to these significant developments:

1) In many cases, the collection of regulatory reports is mandated at a national level and this leads to the possibility that data infrastructure is created at least 28 times[8] – this is costly (at

[7] CRD IV, MiFID II, EMIR, AIFMD, Solvency II and (forthcoming) SFTR.

[8] In fact, some parts of the infrastructure are created 32 times: 28 EU NCAs, 3 EEA NCAs and 1 ESA.

a national level and when aggregated across the EU) and it is likely to lead to issues of data quality and data harmonization;[9]

2) Taking a horizontal view across various pieces of sectoral legislative, there are substantial inconsistencies between definitions of key concepts. A coherent data strategy which aims to ensure that financial services activity can be comprehensively measured and monitored must be based on consistent and robust data definitions.
3) In addition, there are differences in technical standards for the submission of data with some data being required in an *xml* format and other data required in *xbrl*. As a result different data architectures must be created by both regulators and firms.
4) Even at a European level, there is fragmentation in the aggregation of financial sector data which the ECB, ESAs and ESRB all playing different and sometimes overlapping roles. Moreover, some of the EU institutions are quite constrained in their capacity to adequately resource this area. It is noteworthy that following the financial crisis, the Office of Financial Reporting was created in the US with sufficient resources and capability to have oversight over all financial sectors in the US.[10]

The aim of CMU is to increase and diversify funding channels with a view to maximising the benefits of capital markets and non-bank financial institutions for the real economy. As noted by Veron (2014)[11], capital markets can be seen as a catch-all term for a host of market segments and activities whose common theme is non-bank intermediation. These market segments include venture capital, private equity investment, public equity issuance and initial public offerings, corporate bond issuance, corporate debt securitisation, and capture activities such as loan origination by investment funds and other non-bank financial institutions, such as leasing companies, non-securitisation SPVs and consumer finance companies. In many cases, there is limited data on the activity in these sectors and there is limited regular reporting on a mandatory basis.[12] Looking ahead, a full assessment of the success of CMU and the financial stability impact will require a data strategy for collection, validation, storage and analysis of all relevant capital markets data across Europe.

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[9] Recently, various national competent authorities took the initiative to mandate certain data collection projects to ESMA to economise of aggregate development costs and to improve data quality. However, not all NCAs are participating in this initiative. A specific empowerment to ESMA in this area, which acknowledges the need to adequate human and financial resources, would have been beneficial. http://www.esma.europa.eu/system/files/20150326_2015-674_esma_launches_centralised_data_projects_for_mifid_and_emir.pdf

[10] See http://financialresearch.gov/

[11] Veron (2014), "Defining Europe's Capital Markets Union", Bruegel Policy Paper 2014/12, November 2014.

[12] As highlighted for example in the European Commission Green Paper on Shadow Banking, March 2012.

The Green Paper states that CMU should "be built on firm foundations of financial stability." However the very success of the CMU project raises public policy issues. The greater the dependence of the European economy on these non-bank channels of finance, the greater the damage to the European economy if (some of) these channels fail.[13] Therefore, increased credit intermediation through non-bank channels will require oversight and monitoring in order (i) to fully assess the successful evolution of these channels, (ii) to monitor their potential vulnerabilities and (iii) to assess the level of interconnectedness with the traditional banking system.

Since the financial crisis a large number of European markets and securities regulations have been introduced which aim to increase oversight and transparency of activities in the non-bank financial sector and can form part of a financial stability analysis of CMU.[14] These regulations have brought more entities within the regulatory perimeter. However, while some entities are within scope or are due to fall within scope of financial services regulations, other non-bank financing entities and activities remain outside of the regulatory perimeter.

As part of the CMU project, the Central Bank recommends that European policy-makers give serious consideration to the development of a coherent data strategy for the monitoring of non-bank finance. In its own right, this is a significant piece of the regulatory infrastructure for monitoring the success of CMU. But it is also necessary for tracking the financial stability implications of greater non-bank finance of the EU economy. Such a strategy would embrace the following elements:

- a coherent set of data definitions and a single data dictionary;
- a consistent standard for data submission and validation;
- a single collection point for all relevant data;
- a secure and efficient storage architecture;
- appropriate gateways for the transmission of the data to financial authorities;
- analytical capability to evaluate the data;
- resources to fund all of the above.

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[13] Independence and diversity across the channels of finance will mitigate the risk of over-reliance on any one of those particular channels.

[14] For example, the European Market Infrastructures Regulation (EMIR) provides for the collection of information on derivative trades. In addition, the proposed Securities Financing Transactions Regulation (SFTR) will create reporting requirements aimed at improving the oversight of the securities financing transactions market in Europe. AIFMD requires alternative investment fund managers to report extensive data on their investment activities.

Ideally, the technical requirements for the implementation of such a strategy would be mandated to a suitably empowered European body which has expert resources and technical infrastructure funded on the basis of a separate European budget line.

Loan origination by investment funds

A harmonised European regime (with a passport) for alternative investment funds which originate loans will contribute to the aims of CMU. At present in Europe, investment funds can gain exposure to loans either (i) through participations in loans which have been acquired in the secondary market (ii) through the origination of loans directly to borrowers (depending on the jurisdiction) or (iii) more recently under the ELTIF regime which is due to come into force shortly.[15]

Banks are typically the main source of loans for the secondary market in which investment funds can acquire participations in loans. As such, much of the supply of credit related to this channels is driven by bank origination and credit approval platforms. However, the Central Bank is aware of specialist investment managers, typically with a banking background, who have identified segments of the corporate borrowing market which are underserved by the banking sector which present promising investment opportunities to institutional and sophisticated investors when loan portfolios are packaged in alternative investment funds.[16]

There are a variety of national approaches to loan origination by alternative investment funds. Various countries have developed bespoke regulatory regimes for alternative investment funds to originate loans.[17] In quite a few EU jurisdictions there are outright bans on loan origination by investment funds. Lastly, there are jurisdictions where there is no express regulatory framework to deal with investor protection and financial stability risks but funds or fund-like vehicles may originate loans.

After extensive consultation with European peers, such as the ESRB and the European Securities and Markets Authority (ESMA)[18], the Central Bank introduced a regime (last October 2014) that permits Qualifying Investor Alternative Investment Funds (QIAIFs) to originate loans. This carefully calibrated

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[15] Whilst ELTIFs are allowed to originate loans, the regime was not designed for the express purpose of facilitating loan origination by alternative investment funds. It is likely to be too restrictive for investment managers that wish to originate loans owing to the lack of leverage. Also, in the absence of a specific 'loan originating capability/substance' requirement, there are insufficient mitigants to prevent large-scale inappropriate lending at the top of the credit cycle should ELTIF become a very significant funding channel in the EU.

[16] See chapter 2 of Central Bank Discussion Paper "Loan Origination by Investment Funds"

[17] Germany (recently), Ireland, Italy, Malta and Spain

[18] Press Release: ESRB General Board meeting held on 20 March 2014

regulatory framework introduced necessary elements to ensure prudent lending can take place and provides institutional investors with another channel to finance the European real economy.[19] This initiative by the Central Bank was focused in equal measure on the three objectives of (i) providing funding to the real economy, (ii) while ensuring financial stability and (iii) safeguarding investor protection.

Based on discussions with European regulatory peers, there is significant appetite, in some quarters, for regulatory convergence in this area. It would appear that European legislators, in consultation with relevant stakeholders, may be best placed to further this important work. A harmonised approach in this area should aim (i) to assist non-bank lending to the real economy, especially to small and medium-sized enterprises, (ii) to ensure financial stability and (iii) to safeguard investor protection across the EU. In addition, allowing the managers to market these funds on a cross-border basis will increase investor choice and widen the channels of funding to European corporates.[20] Such a regime should require:

i. that funds should only be available to qualified investors as distinct from retail investors (for investor protection reasons);
ii. that the fund manager are required to have certain operational capabilities related to the business of originating loans, similar to those at a bank (to ensure appropriate lending standards and the proper management of the borrower-lender relationship throughout the entire life-cycle of the loan).;
iii. a specific leverage limit (to control aggregate leverage); and
iv. a closed-ended fund structure (to avoid maturity mismatches).

Fault-lines in Europe's capital markets

Significant differences remain hardwired in national company law making the domiciliation of a company an overarching determinant of the quantum and cost of finance. If well-designed, CMU has the potential to contribute to the stability of the financial system and to enhance risk-sharing.[21] One test of a well-designed CMU is the extent to which the domicile of (i) the investor providing finance or (ii) the domicile of the firm seeking finance is a determinant of their respective investment and funding outcomes. However, domicile is likely to be a relevant factor whilst there

[19] AIF Rulebook, Chapter 2, Part II, Section 4
[20] See "Finance for Growth", report of Giovannini-Moran High-Level Expert Group, December 2013.
[21] If CMU is successful, it is likely that there will be reduced dependence on the banking system and greater reliance on non-bank channels of finance. For example, many non-bank channels of finance are less likely to directly impact sovereign finances as they tend not to benefit from explicit or implicit government guarantees.

are significant technical, fiscal and legal impediments at a national level. Many of the securities settlement issues - known as the so-called 'Giovannini barriers' - identified over a decade ago[22] remain. This highlights the significant challenges which the CMU project presents.[23] It is clear that location of European corporates can have a significant impact on their cost of finance owing to idiosyncrasies in company law.[24] Many of these issues are rooted in national restrictions and an inevitable 'home bias'.[25] As a consequence, there is excessive reliance on bank-funding and elevated costs of non-bank finance, where available, due to a lack of depth in local capital markets. In addition, the structure of European capital markets is also impacted by the fragmentation of market infrastructures.[26]

These are the significant fault-lines which lie at the heart of Europe's capital markets. While many of the short-term objectives of the CMU agenda[27] may create greater capital markets activity, the long-term ambitions of the CMU project - which include safer and more efficient capital markets - will not be realised without the tackling of these fault-lines.

Conclusion

The Central Bank fully appreciates the challenges which policymakers and industry face in delivering a true capital markets union. Many of the fault-lines which lead to fragmented European capital markets run deep and will require significant commitment by all stakeholders to ensure that they are overcome. The Central Bank is committed to working constructively to achieve the core aims of

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[22] See report of Giovannini group (April 2003).

[23] Of the 15 'Giovannini barriers', seven have been fully addressed via the Target2Securities project and the Central Securities Depositories Regulation and two have been partially addressed. The remain six which have not been addressed concern: (i) National restrictions on the activity of primary dealers and market makers; (ii) Domestic withholding tax regulations serving to disadvantage foreign intermediaries; (iii) Transaction taxes collected through a functionality integrated into a local settlement system; (iv) The absence of an EU-wide framework for the treatment of interests in securities; (v) National differences in the legal treatment of bilateral netting for financial transactions; and (vi) Uneven application of national conflict of law rules. See https://www.ecb.europa.eu/paym/t2s/about/html/giovannini.en.html

[24] See European Commission Staff Document "Initial reflections on the obstacles to the development of deep and integrated EU capital markets" accompanying the Green Paper, February 2015.

[25] 'Home bias', the tendency of European investors to overweight domestic assets in their investment portfolios and underweight foreign assets is substantial. According to Veron and Wolff (2015), 64 per cent of European equity holdings are of domestic origin. Furthermore, differences in languages across Europe can stifle cross-border investment, particularly for retail products. These cultural factors can lead to information asymmetries thereby reducing the allocative efficiency of European capital markets.

[26] Almost every European country has at least one CSD, mostly serving the local market. In contrast, there are only two CSDs servicing US securities markets.

[27] Such as the revision of the Prospectus Directive and the Simple, Transparent and Standardised Securitisation initiative.

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safe and efficient capital markets in Europe which will better serve the European economy and its citizens.

Yours sincerely

Gareth Murphy
Director of Markets Supervision
Central Bank of Ireland