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COMMENTS ON THE IMPLICATIONS OF THE CURRENT CRISIS FOR EU FINANCIAL SECTOR POLICY

I. Introduction

This Note sets out preliminary observations on the ongoing financial crisis from the perspective of Europe's Market Operators. The Note does not purport to analyse the various factors behind the crisis. This is not least because the full extent of the crisis is not yet known and its causes are not yet fully understood. However, FESE Members believe that the perspective of Europe's Regulated Markets (RMs) should be considered and the interests of the Market Operators recognised in the framing of possible policy responses. In particular, **FESE believes that its Members' market model has not only shielded their products from the crisis but has helped the investors and industry participants to alleviate some of the consequences by providing an efficient mechanism for asset pricing.** The FESE Members' concern going forward is that the strengths of this market model are safeguarded by the future policy framework and taken into account in any lessons drawn after the 'dust has settled' and the analysis of the crisis is complete.

II. Preliminary Observations on the Crisis

How Were European Regulated Markets Affected by the Crisis?

The perspective of the RMs in Europe is unique in that RMs have been by and large outside the origin of the crisis and in many cases they have mitigated the crisis by providing opportunities to generate liquidity. However, this does not mean that the RMs have been immune to the crisis. Financial markets are increasingly inter-linked and the trading of instruments bilaterally off-exchange has had a direct impact on instruments traded on RMs. **During the crisis, Europe's exchanges provided much needed liquidity and helped the economy by providing a reliable channel for trades.** The crisis increased trading activity in terms of numbers, while the exchange-listed companies - many of them investment firms (including credit institutions) - lost market capitalisation as the crisis spread from its origins to wider sectors. From August 2007 to February 2008, the *number* of trades executed through the electronic order book of FESE Members has increased by 2 percent (on an annualised basis). During the same period, the *volume* of trading decreased by 2 percent (annualised) while the market capitalisation of companies listed on European exchanges decreased by 14 percent.

During a period of high volatility and market rumours, RMs have performed extremely well in trying circumstances, with investors able to trade high volumes and with prices readily available at all times. Furthermore, **the lack of liquidity in the inter-bank market has been mitigated by the flow of off-exchange deals to RMs as a means of generating liquidity.**

Members of FESE are confident that their RM model with high levels of pre- and post-trade transparency in standardised instruments - be these equities, bonds, or financial or commodity derivatives - inspires the **confidence** of investors in securities markets. Detailed and continuing disclosure obligations reduce the risk of sudden shocks. There are a number of other factors, described further below, which contribute to the robustness of these markets.

Preliminary Responses by Regulators

FESE welcomes the attempt by European and global policymakers to assess the causes of the financial crisis and its implications for the functioning of European and global banking systems and securities markets. In this context, FESE welcomes the recently published Report of the Financial Stability Forum, which calls for authorities to encourage market participants to ensure that the operational infrastructure for OTC derivatives is sound and reliable. Equally, we welcome the International Monetary Fund's recent Global Financial Stability Report, which calls for strengthening liquidity in OTC derivative markets. FESE Members are also aware of the work assigned to a group of banking sector associations in Europe to propose solutions to address the need for comprehensive data on alternative credit markets. We support

ECOFIN's call for a thorough examination of the treatment of so-called 'non-organised debt markets' and acknowledge the work that has been carried out since October 2007 by CESR, which recently announced its work plan aimed at strengthening market confidence; the European Commission; and the Financial Services Committee. We particularly welcome ECOFIN's call for standardisation of instruments, better management systems for counterparty risk, and improved transparency. We consider it of utmost importance for the EU institutions **to continue the analysis of the risks arising from such products/markets for investor protection and systemic stability.**

While we see great merit in each of these separate and important initiatives, which one can describe as **micro** level, we believe that the crisis has called into question some of the **fundamental implicit assumptions** on which our current legislation is based, necessitating a **macro** level discussion. In particular, the crisis has challenged the basic assumption that all **market structures** are equally valid and pose the same **level of risks** for the system. On the contrary, during the crisis, **certain products** (due to their nature and non-standardisation) **traded on certain market structures** were revealed to be riskier, to be more difficult to assess, to have inherently greater conflicts of interest, and to be more prone to illiquidity. The valuation of such essentially complex instruments appears to have been particularly difficult under the circumstances of a crisis and may thus have augmented the risks.

The crisis has also shown that the quality of such products - in which substantive investments are made - is difficult to assess even for professional investors. This in turn calls into question the tacit assumption that it is acceptable that professional investors need limited or no advice and information before investing. Rather, **due diligence by intermediaries and professional investors** is always appropriate before they issue, buy, sell or invest in financial instruments, particularly where there is no, or strictly limited, multilateral, transparent trading of the instruments.

In the next section, we will focus on the lessons surrounding **market structure and products**, which is directly related to our area of expertise and reflects the knowledge we can offer in drawing lessons from the crisis.

The Resilience of the Public Market Model

While markets primarily affected by the crisis were unable to determine prices to allow for a proper valuation of assets, RMs have offered a flawless provision of liquidity to end-investors at all times, despite the high volatility of prices, softening the negative impact of the crisis for the financial system as a whole.

Although the credit crisis is not over yet, analysts, commentators and supervisors concur that the crisis has demonstrated not only the systemic importance of liquidity, but also the value of **transparent and reliable price-formation mechanisms.**

Markets disrupted during the crisis, which we can call generically '**non-public markets**', display certain common features:

- They operate under significantly **lower transparency** standards. Information is fragmented and only available to certain investors.
- The exotic instruments that they trade may be difficult to value. **Valuations of exotic instruments**, for example structured products, may be readily available but the crisis has demonstrated that the ability to trade, if at all, at or near those prices is far from certain.
- They operate on a **bilateral basis**. Trading, as well as a substantial share of clearing and settlement, is agreed mostly through bilateral agreements.
- They are organised by investment firms that are at the same time market participants, creating **substantial conflicts of interest**. In many occasions, the provision of liquidity is at the discretion of the investment firms that organise the market or issue the instruments or both.
- There are no obligations on participants to **provide liquidity**.
- The trading **technology** used by these platforms and systems, if any, may be but is not necessarily advanced.

By contrast, RMs, which we will call ‘**public markets**’, display a very different market structure with the aim of offering transparent price discovery, the ability to trade at or near to those prices, and liquidity for assets admitted to trading on their markets. These attributes result from a number of important principles that exchanges worldwide put into practice:

- Public markets are **transparent**. Prices are set with all the possible information available through real-time dissemination tools.
- Public markets are **multilateral**. Prices are discovered through the aggregation of the expectations of many investors through their bids and offers (as well as price formation by market makers or liquidity providers) which ensures reliability, a high degree of information as well as liquidity under the most demanding market conditions.
- Public markets are **neutral and independent**. They endeavour to ensure an equal treatment for all participants as well as to provide the set of rules and the IT infrastructure that best serve the interest of all investors.
- Public markets use robust and appropriate **technology**. Public market operators invest significantly in technology to ensure that it is reliable and that it continually advances in anticipation of customer needs, e.g. regarding speed and volume.
- Operators of public markets have regulatory functions that include **monitoring and surveillance of trading**, with RMs having more stringent obligations in this area than operators of MTFs.
- RMs only admit to trading securities issuers that comply with **stringent initial and ongoing disclosure requirements and accounting and auditing standards** imposed by EU laws. When operating MTFs, Market Operators have chosen to impose similarly stringent requirements to ensure the highest level of company disclosure possible for the issuers on these markets.

While one or more of these characteristics might on occasion reside in other types of markets (such as investment firm-operated trading venues), it is only public markets that bring together this unique set of characteristics.

Risks for the Public Interest

It is important to stress that the public market model and the non-public market model described above are not mutually exclusive and that each serves a different function in the economy. In a well-functioning financial system, there is a need for both types of markets and there are benefits unique to each. However, this does not mean that the **public interest** is equally served by the financial sector business (capital raising, investing, trading) that occurs in one versus the other. During the previous months, it has become clear that the drying up of liquidity does not remain confined and that risk becomes contagious due to the inter-linkages between the two models. Disclosures of the origins of the crisis to date appear to indicate that opaque and illiquid non-public market models may be more prone to increase the threat of systemic risk developing as market participants and investors lose confidence in their ability to deal in instruments offered in those markets and the solvency of those issuing or holding the instruments.

In a well-regulated and well-supervised market environment, investors should be fully aware of the consequences of having recourse to private markets as opposed to public markets. Therefore, it is important to assess whether our current legislation treats both models adequately and whether it creates a **sufficient level playing field between them that allows the market to choose between the two models optimally.**

The fact is that the regulatory framework implemented over the last few years may have created too big a gap between the regulated, public market space and the unregulated, private market space, generating distorted incentives for issuers to prefer private markets over public ones.

III. Conclusion

The policy reforms of the last few years have rightly opened up competition by facilitating alternative market models in capital issuance and trading. The growth of alternative markets during the bull market of the last ten or so years has even led some commentators to question the value of highly regulated RMs when other practices such as internalisation, private equity, OTC trading or dark pools of liquidity have been successful in attracting investors. Other commentators have been looking at the link between **economic growth** and **public markets**, questioning whether **sufficient safeguards** have been built into the de-regulatory approach against the potential **drawbacks** of alternative markets for the investors and issuers more broadly, such as the increasing **non-standardisation and opacity of instruments**, **fragmentation of volumes and data**, **inadequate transparency for investors**, **unresolved conflicts of interests** and more **expensive** or **limited access to capital for smaller companies**.

The crisis perhaps poses an additional question, which is ‘**Can alternative, private markets cope as well in bear markets as regulated, public markets?**’

FESE considers that recent events indicate that there is now a need for a re-adjustment of focus in the public policy discussion on the question of public versus non-public market models, the treatment of different asset classes and their role in the capital-formation process. The **challenge for policymakers** is to assess whether the legislative framework creates a sufficiently **level playing field** between **market models** and the **attractiveness of the asset classes** that they trade. It is important to examine whether existing legislation treats the two models adequately and whether a fair level playing field exists for the operators as well as the users/investors of the two models.

FESE Members are confident that they will be able to make a positive contribution to this debate, particularly in the light of the recent reports of the ECOFIN, the FSF and the IMF. We believe that **non-organised, private markets** should be a central part of any follow-up to these reports and that further work should be carried out on this subject to identify the needed **improvements** towards the orderly functioning of these markets. In the meantime, FESE offers itself and its Members as a source of expertise in considering the case for, and the shape of, policy responses to the current financial crisis.