



EUROPEAN
PARLIAMENTARY
FINANCIAL
SERVICES

FORUM

FORUM

EPFSF AND FINANCIAL SERVICES

*Promoting Effective Dialogue
On Financial Services Issues*

2009

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*«PROMOTING EFFECTIVE DIALOGUE
ON FINANCIAL SERVICES ISSUES»*

2009

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Wolf Klinz MEP

Chair, Steering Committee (2009-)



«The recent financial crisis turned out to be of a truly global nature. If the Member States of the European Union want to participate actively in shaping the future architecture of the financial markets, they have to speak with one voice. The European Parliament will have to take additional legislative measures which should help to defend European interests and at the same time increase market stability and investor protection. To achieve this objective the Members of the European Parliament need a very close and constructive dialogue with members of the financial services industry. The EPFSF is the ideal forum for such a regular exchange of ideas, concepts and practical knowledge. I am delighted to be able to monitor this dialogue as the Chairman of the EPFSF».

Peter Skinner MEP

Vice-Chair, Steering Committee (2009-) and Former Chair (2007-2009)



"As only the third chair and a founding member of the steering committee, it is particularly pleasing to see the EPFSF continue to develop as a platform for a dialogue on financial issues. In an increasingly smaller financial world the impact of regulator's decisions in the EU, and elsewhere, have a direct bearing on the competitiveness of companies and safeguards for consumers. It is no small feat that this platform has successfully facilitated open and transparent discussions of these crucial issues in a timely manner. I look forward to working with my colleagues and the staff of the EPFSF as chair for the remainder of my mandate and for the positive good of the industry and consumers alike."

Guido Ravoet

Chair of the EPFSF Financial Industry Committee (2007-)
Secretary General, European Banking Federation



«As the Chairman of the EPFSF Industry Committee, I have been through a very interesting time with colleagues and Members of the European Parliament. I can only look forward to exchanging more ideas and knowledge on the shaping of the new landscape for financial services, as we are now facing what we hope to be a first economic rebound. Cooperation is crucial for us all, policy makers and industry representatives alike, and only a transparent exchange of views will help shape the best possible new structures, standards and practices to prevent future crises. The EPFSF is a very useful and efficient tool to ensure this transparent dialogue».

Promoting effective dialogue between the financial industry and MEPs and contributing to a greater understanding of financial services issues

The European Parliamentary Financial Services Forum (EPFSF) was founded in 2000 to **facilitate and strengthen the exchange of information** on financial services and Europe's financial markets, between the European Parliament and the financial services industry.

The Forum is a **not for profit organisation** under Belgian law (ASBL), which is supported by a wide range of MEPs from most political groups through a Steering Committee. Rather than a lobbying platform, it is an informative forum which contributes to the long-term effort to make financial services better understood by MEPs.

The principal purposes of the Forum are:

- to promote **integration of a single European market for financial services** across national borders, which is globally competitive and to the benefit of the European economy as well as suppliers and consumers of financial services;
- to provide a **focal point and resources for Members of the European Parliament** interested in financial services issues as well as a forum for industry-Parliamentary dialogue;
- to deploy the joint expertise of its financial industry Members in order to **spread factual information** about financial markets and services to the European Parliament via briefs, meetings, study visits and other regular activities as appropriate.

Relying on governance principles emphasizing transparency, inclusiveness, and neutrality

The value placed on the EPFSF lies in its position as an **acknowledged and reliable source of information**, allowing debate and the issuance of impartial commentaries on key issues.

Its briefing papers, available on the website, demonstrate the informative nature of the Forum's work. The Forum's website also contains extensive **public information about the activities of the Forum**, such as its Statutes and finances. As a result, the Forum has been classified as one of the highest ranking European organisations as far as transparency is concerned (2006 report by the Corporate European Observatory).

In order to guarantee its independent and open nature, the Forum has a **dedicated secretariat**, and its membership represents the **diversity of Europe's financial services industry**. It is open to any member which complies with objective membership criteria, i.e. providing financial services and supporting the integration of EU financial markets. At present, the EPFSF has approximately 50 financial industry members (see section «Financial Industry Members» on our website www.epfsf.org).



Organising events for an open and informal industry-Parliamentary discussion

The Forum organises events on a **monthly basis**. Attended by a large number of interested MEPs, these meetings focus on a variety of topics, with high-level, expert guest speakers from the financial industry, consumer groups, and relevant authorities, regulators and officials.

Topics are selected according to **MEP's interests and current priorities**. In 2008, the emphasis laid on the following issues:

- EU/US Financial Market Dialogue
- Financial Education and Financial Capability
- Electronic Payments: moving to a cashless society?
- Financial Turbulence: Lessons to be learned
- Supervisory Convergence
- MiFID Implementation
- What are the benefits of Solvency II?
- Capital Requirements Directive: Understanding the changes – and why?
- Will changes to the UCITS Directive open the market?
- Understanding current commodities markets

In advance of each event, the Forum prepares a **detailed briefing paper** on the issues to be discussed. In practice, high-level speakers briefly present the various approaches at stake in current issues, and MEPs subsequently ask questions and discuss the presentations, thus generating **lively debates**.

Favouring a transparent organisation providing a fair and equitable representation for all members

Interested Members of the European Parliament form a **Steering Committee**. Composed of MEPs from different political groups and nationalities, it gives impetus to the activities of the Forum: it reviews the Forum's role, the programme of activities and progress on agreed goals. Based on the input from Steering Committee Members, the Forum aims at developing more useful tools for MEPs, best meet their needs and ultimately increase its value to them.

Financial Industry Members, a wide range of leading players in the European financial industry, meet within a **Financial Industry Committee**. They undertake the task of providing speakers, drafting briefing papers, and making suggestions on the programme of events. They also decide the level of member contributions to finance the Forum, and they review the activities of the Administrative Committee elected each year at the Annual General Meeting.

The **Administrative Committee** has been given responsibility for regular liaison with the Steering Committee on the role of the Forum, the agenda and progress of meetings; for managing the business of the Forum; for deciding on applications for membership; and for convening meetings.

The work of these Committees is supported by a dedicated **Secretariat**. It is responsible for the practical organisation of the different events and the day-to-day management of the Forum and its committees.

Through this organisation, the Forum pays particular attention to the **fair and equitable representation** of all the different areas in the financial services industry, whether it be in the choice of topics and speakers, in the process of drafting briefings or in the participation in Administrative Committee meetings.

EPFSF Memo «The Banking Sector»

Banks and society

In any modern market society, banking is at the core of economic activity. Not only are banks economic actors of their own right, they also are key intermediaries between borrowers and savers, as well as facilitators of payments and transactions.

Because banking is based on money, which itself has no intrinsic value, exposure to changes in subjective valuations and in confidence is greater than for most other business activities. For this reason, confidence of consumers and other counterparties is paramount to the health of the financial industry. Furthermore, banks' success is also determined by the health of the economy, partly due to banks' role as creditors to economic actors and partly since the state of the economy determines the readiness of the population to conduct business and engage the banking sector's services.

The economic role of banking

Unlike other industry sectors, the main role of the banking sector is to facilitate economic activity and to ensure that liquidity circulates in the economy. In this traditional role, banks usually transform the maturity of funds to suit their creditors' as well as their depositors' needs.

Banks work with both public and private clients, whether corporate or individual. Their main activities can be roughly divided between retail banking, and wholesale and investment banking:

- *Retail banking* (sometimes called commercial banking) caters for individual consumers (important areas of business are payments services, savings deposits and instruments, consumer credit, mortgage credit, private banking), small and medium sized enterprises (important activities are payments services, credit and credit lines, facilitation of financing, business advice and cash management) and municipalities.
- *Wholesale and investment banking* includes activities in the inter-bank and wholesale financial market as well as lending to large enterprises (including the facilitation of bigger transactions, such as mergers, acquisitions, and the launch of new corporate programs), large scale fund-raising, corporate financial restructuring, investment advice and management.

While some banks are only active in one of these broad areas, others follow the *Universal Bank business model*, which means that they are active in the retail banking business as well as in wholesale and investment banking and on capital markets.

Because the business of banking is intertwined with international markets, banks are directly exposed to global developments and trends.

The banking sector in the EU

The European banking sector is generally estimated to contribute directly around 5% of Gross Domestic Product (GDP) of the EU-27. As regards the labour market, figures collected by EBF and ESBG show that the proportion of people employed in the banking sector is relatively stable, at around 1.5% of total employment. Such a profile would put it on a par with other economic sectors such as construction.



As regards the Euro area, ECB data on the Monetary Financial Institutions (MFI) sector in the euro area showed that by the end of 2007, the total volume of MFI loans to euro area residents was EUR 11.1 trillion, of which EUR 4.4 trillion to non-financial corporations and EUR 4.8 trillion to households (including EUR 616 billion as consumer credit and EUR 3.4 trillion as loans for house purchase). Deposits held by non-financial corporations were EUR 1.5 trillion and by households EUR 5 trillion. Summed up, the consolidated balance sheet of euro area MFIs was EUR 22.3 trillion.

Looking at the EU banking sector itself, at the end of 2007, there were close to 7,800 banking institutions in the EU-27. Although there are variations between Member States, on average this translates into one bank for every 68,000 people, or one bank branch for every 2,300 people. (For comparison: In USA, in mid-2007⁽¹⁾, there were 37,000 people per bank). During the last decade the number of banks has been gradually decreasing as a result of banking sector consolidation through mergers and acquisitions (more at national than at cross-border level).

Within the EU, there is by now a high level of cross-border financial activity. For instance, cross-border loans between Monetary Financial Institutions (MFIs) have reached around 25% of total loans for the euro area (as reported in the latest European Commission «European Financial Integration report»⁽²⁾). Many EU banks are now multinational, and have increased the share of their revenues derived from other European markets.

Within the EU, legislation lays down rules concerning the taking up and pursuit of the business of credit institutions, and their prudential supervision, where credit institutions are defined essentially as undertakings whose business is to receive deposits or other repayable funds from the public and to grant credits. The EU legislation allows banks to engage in other activities, among which, financial leasing, trading for own account or for account of customers, portfolio management and advice⁽³⁾. The industry itself is pluralistic and characterized by the coexistence of different bank types, of which the main categories are commercial banks, savings banks, cooperative banks, public banks and investment banks. The different market players compete on a level playing field and according to the principle «same business, same risk, same rules».

As regards the political agenda at EU level, the principal aim of EU policy makers is to achieve an integrated market for financial services, while ensuring that it is underpinned by appropriate rules and prudential regulation.

Current challenges and developments

The European banking sector is part of the global financial system, so that linkages are strong not only within Europe, but worldwide. In addition, the well-being of the banking sector is inextricably linked with economic growth and prosperity.

The banking sector is currently facing challenges not only as regards the worldwide confidence and funding crisis on wholesale markets and the deterioration in the value of securities held. It also will be increasingly confronted with the results of the ongoing global recession, since banks play a central role as lenders to the real economy. Furthermore, in Europe, the different national approaches to supporting the banking sector may reshape the competitive environment in the mid and long term.

A challenge which the financial services industry shares with policy makers is to identify and remedy the shortcomings which have led to the current financial and economic crisis. For banking sector and EU policy-makers alike, achieving effective and corrective financial sector regulation and supervision is of central importance.

(1) «Country Finance – United States of America», the Economist Intelligence Unit, November 2007

(2) European Financial Integration Report 2008, Brussels, 9.1.2009, SEC (2009) 19 final:

http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/efir_report_2008_en.pdf.

(3) For a complete list of activities subject to mutual recognition, please refer to Annex I of Directive 2006/48/EC.

EPFSF Memo «Credit Rating Agencies»

Summary

Credit Rating Agencies (CRAs) play a key role in European capital markets today, publishing opinions (“ratings”) for the use of investors and other market participants on the creditworthiness of issuers/issues of debt securities. Independent, objective and internationally consistent credit ratings raise the integrity, transparency and competitiveness of capital markets, lower the costs of capital for issuers and contribute to investor protection.

The financial market turbulence which started in summer of 2007 has raised questions regarding the methods and models CRAs used to evaluate financial instruments, and in particular certain complex structured finance instruments⁽¹⁾. Consequently, some commentators consider that CRAs have contributed to the current financial market turmoil. Market participants’ confidence in the performance of CRAs and in the robustness of ratings has suffered, prompting policymakers to review the role of CRAs.

Given the global nature of credit ratings, such work has in part been coordinated internationally – initially through the Financial Stability Forum (FSF) and an IOSCO Code of Conduct and subsequently at the level of the G20 Leaders at the November Washington D.C. Summit as well as at the April London Summit. In the EU a Regulation on CRAs was agreed in April 2009 and is due to be formally adopted in the autumn and to come into force in mid 2010.

Background

CRAs provide opinions on the creditworthiness of issuers accessing public (and to a lesser extent) private debt markets. A credit rating is an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system (AAA etc). Credit ratings are not recommendations to hold, purchase or sell any security, nor do they provide information about other features of a security, such as its liquidity.

Credit ratings can be traced to the 19th century in the US, but they have gained global acceptance and recognition, especially in Europe since the early 1990’s, through the expanded role of capital markets in global financing, and globalisation and disintermediation of the markets. While a relatively small number of CRAs are global players, in 2009, CESR identified 22 CRAs with presence in nine Member States while IOSCO identified a further 11 CRAs from five countries outside the EU.

Credit ratings are an internationally recognised indicator of credit risk, and allow cross-border investors to easily compare the presumed credit risk in investing between different jurisdictions and market segments. For example, an “A” rating on a Japanese industrial firm carries, in a CRA’s opinion, broadly the same credit risk as an “A” rated European bank. CRAs generally demonstrate the ratings performance over time through default and transition studies⁽²⁾. Public disclosure of rating performance studies allows users of ratings to review the coherence and robustness of ratings performance over time.

(1) Such complex instruments include specific types of Collateralised Debt Obligations (CDOs) – that is, complex derivative instruments the underlying of which does not consist of other financial instruments or commodities but instead of other structured finance instruments such as Credit Default Swaps (CDS) or Asset Backed Securities (ABS).

(2) Default studies demonstrate observed defaults per initial rating category and may be presented by segment, asset class, geography and for selected time periods. Default studies have repeatedly shown that there is a clear correlation between initial ratings assigned and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa. Transition studies demonstrate the migration of rating categories over time and may be presented by segment, asset class or geography.



CRAs and the recent market turmoil

Given that credit ratings are generally forward-looking «through the cycle», CRAs need to make certain assumptions about future economic performance. With the benefit of hindsight, it has now become apparent that certain assumptions that CRAs made on the behaviour of the US housing market have not held up – and this has caused the performance of structured finance instruments with exposure to housing related assets to be out of line with historical performance trends of ratings, as well as with rating performance in other sectors. Consequently, some commentators considered that CRAs have contributed to the current financial market turmoil by failing to predict the impact on creditworthiness of a loss of confidence in this market, although it is important to note that that catalyst of the market downturn was a failure of liquidity, which credit ratings are not designed to predict. As a result of the fact that credit ratings do not make predictions about liquidity, market participants' confidence in the performance of CRAs and in the robustness of ratings has suffered, prompting policymakers to review the role of CRAs in the market as well as regulation of CRAs.

Regulation of CRAs and their use by market participants

CRAs, and the use of their ratings by market participants, are already subject to different forms of oversight. The International Organisation of Securities Commissions (IOSCO) drew up a Code of Conduct for CRAs in December 2004. In the US there has been formal oversight of CRAs by the Securities and Exchange Commission since September 2007, and there was a system of formal recognition by the SEC before then.

In the EU the Capital Requirements Directive, implementing the Basel II Accord allows institutions to use external credit assessments to determine the risk weight of their exposures (and thereby determine their regulatory capital) provided that the External Credit Assessment Institution (ECAI – the Basel term for CRAs) that produces the assessment has been recognised as eligible for that purpose by the competent supervisory authority, according to criteria of objectivity, independence, transparency and disclosure, and credibility and market acceptance. To ensure consistent application of the recognition criteria the Committee of Banking Supervisors (CEBS) has produced Guidelines on the recognition process, implementation of the CRD recognition criteria, and the criteria for mapping external credit assessments to the CRD risk weights. Although the responsibility for recognition and mapping lies with competent authorities, in practice supervisors have co-ordinated their assessment of international rating agencies.

While policy review of CRAs – given the global nature of credit ratings largely addressed at the international level through the Financial Stability Forum as well as the ECOFIN Roadmap within the EU – was initiated from autumn 2007, CRAs, either individually or jointly, also took initiatives to address perceived shortcomings. The FSF in April 2008 presented a report to the G7 on “Enhancing Market and Institutional Resilience”, which included specific recommendations on CRAs, to be addressed largely in a revision of the IOSCO Code (eventually published in May 2008).

At the international level, CRAs featured on the agenda of the G20 Leaders' Summit, which in November 2008 in Washington D.C. and in April 2009 at the London Summit adopted conclusions that «all CRAs whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration by end 2009. This will be monitored by IOSCO to ensure full compliance with the substance of the IOSCO Code of Conduct Fundamentals».

The new EU Regulation on CRAs needs to be considered in the context of existing regulation, both within the EU and globally.

EU Regulation on CRAs – key points

The proposed Regulation is partially inspired by the IOSCO code, but also includes additional requirements. It includes the following features:

- CRAs may not provide advisory services;
- CRAs will not be allowed to rate financial instruments if they do not have sufficient quality information to base their ratings on;
- CRAs must disclose the models, methodologies and key assumptions on which they base their ratings;
- CRAs will be obliged to publish an annual transparency report;
- CRAs will have to create an internal function to review the quality of their ratings;
- Requirements for independent board directors;
- A rotation mechanism for analysts restricting the duration of the relationship with an issuer;
- In order for a CRA to operate within the EU, it must act through an EU incorporated legal entity which has to be registered in the EU;
- EU-regulated financial institutions may only use for regulatory purposes credit ratings issued by CRAs established and registered in the EU, or third-country ratings “endorsed” by the EU based CRA. Ratings from third country CRAs without EU presence may be certified if their home jurisdiction is deemed «*equivalent*»;
- CRAs must publish a description of how rating methodologies differ for structured finance instruments and differentiate the ratings of more complex products;
- The independence of the analytical content and methodology of ratings is explicitly protected.

EU Regulation on CRAs – Implementation and review

Within the Regulation, CESR has been tasked to provide guidance on various topics including: the registration process; the functioning of the college; the application of the endorsement regime; standards on the presentation on information for a credit rating repository; enforcement practices; common standards for compliance of ratings methodologies with certain requirements; measures to ensure compliance; and certification. CESR would cooperate with CEBS and CEIOPS. There are also provisions on cooperation with third countries. Such cooperation and coordination between regulators in different sectors and different countries is important, given the range of regulation affected, the fact that many CRAs’ activities are not focused in any particular country, and the importance of global consistency. The provisions in the Regulation on reviewing the impact of its implementation will be an important tool to gauge its effectiveness and allow for better integration of the regulation of CRAs globally.



EPFSF Memo «Derivatives markets»

Introduction

«Derivatives» is a term used to describe a range of financial instruments whose primary role is to provide commercial users and institutional investors with a means of “hedging” or protecting themselves from future negative price movements across a range of exposures, including particularly in equities, bonds, credit, commodities, currencies and interest rates and indices. Their value is generally based on, or derived from, the price of one or more underlying assets, rates or indices and, unlike the case with physical dealings which result in the physical delivery of the underlying product, the vast majority of derivatives are cash settled.

Using derivatives to control price risk has been an integral part of trade in commodities worldwide for centuries. Their emergence was generated by the need to develop some form of price certainty in the face of sudden fluctuations in commodity prices caused by, for example, irregular or cyclical production, changing weather patterns or political instability. Growth in their popularity led to the establishment, for certain products, of centrally regulated markets or exchanges for the trading of standardised derivatives to better access prices, information and counterparties. The dismantling of Bretton Woods, which led to the privatisation of the process of stabilising money rates, resulted in derivatives being extended to cover the raw material of the financial world, namely, money and financial instruments.

Uses

- *Hedging*: The proliferation of derivatives worldwide has meant that organisations are now able to hedge their positions in most of the world’s capital and money markets in the world’s most traded commodities. Financiers and borrowers can fix the cost of lending/borrowing money; importers and exporters can protect themselves from adverse movements in exchange rates; producers can lock in their profits; factories can hedge against sudden rises in the cost of manufacture; lenders can hedge concentrations of credit risk; and farmers and growers are able to protect their budgeted farm profits. At the same time, managers of equity funds or individual portfolios can hedge against sudden fluctuations in the value of securities by taking positions in individual stock options or derivatives based on stock indices and/or undertake a whole range of investment strategies in diversified markets not otherwise available to them.

At its simplest, a hedge is put on by taking a position in a derivative instrument that is equal and opposite in price sensitivity to an underlying cash or physical position or money rate, such that losses in the underlying position will be offset by a commensurate gain in the derivatives position. The process may involve «going short» the price of the underlying (where the object is to protect an existing physical position) or «going long» (where the object is to protect an anticipated physical position). By taking such a derivative position, the hedger gives up the opportunity of benefiting from any additional unforeseen profits in the underlying position, but the primary concern of the hedger is to protect budgeted profit margins by using derivatives to become secure as to price and profit if the market moves against the underlying position.

Today, derivatives markets are used by a wide variety of businesses around the world ⁽¹⁾ to predict prices and to deliver price assurance and business stability. In the retail sector, their use has facilitated the development of fixed rate mortgages for homeowners, more stable retail prices for foodstuffs and, for the consuming public, interest-free credit.

(1) 94% of top companies, according to a recent ISDA survey

- **Trading and Investment:** While the vast majority of market participants use derivatives as risk management/transfer instruments, some financial institutions and traders also use them for trading on price and, while this has sometimes come under criticism, particularly in commodity markets, these non-commercial traders play a fundamentally important role in sustaining high levels of market liquidity and taking the other side of the hedging positions of commercial market participants. This is because the trading motivation of a physical market participant is simply to protect trade profits, whereas the financial market participant is looking to secure a profit on anticipated price movements or to diversify portfolios.

Characteristics

Whether derivatives are traded OTC or on a central regulated exchange or some other execution platform, they all have a number of unique and shared characteristics:

- The ability to hedge/profit in falling as well as rising markets;
- The existence of a wide product range;
- Deep, liquid markets in the benchmark contracts;
- The ability to create immediate exposure quickly and often at low cost;
- Contracts can be traded on payment of a small proportion only of the total price exposure afforded by the contract (i.e. leverage or gearing);
- Provision of a mechanism for formulating a view on forward prices over a chosen timeline.
- Targeted risk transfer through the blending of different derivative products covering different underlyings (e.g. bonds risk, credit risk, currency risk, etc.)

Types of Instruments

Derivatives cover a very broad range of contracts and generally fall into three principal categories, each of which may at the agreement of the parties be cash-settled (sometimes referred to as settled 'for differences') or physically settled:

- **Futures** (often called in the OTC markets "forwards"): Agreements to buy or sell a commodity, financial instrument or other underlying property for an agreed price, but with delivery taking place on a specified date or range of dates in the future.
- **Options:** Agreements under which one party (i.e. the purchaser) acquires the right (but not the obligation) to buy (in the case of a "call option") or sell (a "put option") a commodity, financial instrument or other underlying property (including other derivatives) at a price (the "strike price") agreed at the time of the agreement (including an additional payment or "premium" for that right). The seller (or "writer") of an option is under a contractual obligation to effect (or take) delivery at the strike price, but only at the election of the buyer who may decide either to "exercise" the option or to "abandon" it in the event it has no intrinsic value.
- **Swaps:** Agreements to exchange a series of cash-flows determined by reference to an underlying instrument, product, index or notional amount (e.g. a fixed rate of interest versus a floating rate). These are part of a category of derivative product called "contracts for differences" because the underlying product (whether exchange traded or OTC) is not capable for delivery other than by way of a cash settlement. Swaps are sufficiently distinctive and their use sufficiently wide to merit being categorised separately.

Types of Markets

The derivatives market is a global market where competition takes place across multiple geographical regions, execution venues and methodologies and products. They may be traded "on-exchange", i.e. on a "regulated market" (or some other regulated multi-lateral trading facility) or off-exchange (otherwise known as over-the-counter (OTC)). The choice of market will depend upon the underlying needs of the counterparties and the prevailing liquidity of the market in question.



It is difficult to evaluate relative size of on-exchange and OTC derivatives markets due to a lack of common statistical indicators, but the December 2008 figures of the Bank for International Settlements show a notional amount for financial instruments traded on organised exchanges of around USD 60 trillion. In addition, 1,684 million commodity contracts were traded on-exchange in 2007⁽²⁾. While the notional amount outstanding in OTC derivatives totals around USD 591 trillion, the real risk is considerably less. Before a) netting and b) collateralisation of the net exposures, the market value of these contracts is USD 34 trillion.

The OTC markets are essentially wholesale professional markets (e.g. the precious metals, or bullion, market, the foreign exchange market, the oil market, the interest rate and currency swaps market, the equity and credit markets), in which derivative contracts are traded bilaterally between banks, other financial institutions and large corporate organisations, often in large size. Most OTC contracts are comparatively straightforward and resemble exchange-traded contracts, but there is no requirement that they be fungible (i.e. interchangeable), meaning that others can be very specifically tailored. Because of their tailored nature, some OTC contracts are difficult to value. They offer certain additional advantages:

- they can be tailored to meet the individual needs of the parties (thereby reducing “basis risk” or the risk that the hedging instrument is not precisely matched to the underlying asset or exposure);
- they enable organisations to access commodities, instruments and/or maturities/delivery dates that are not available on an exchange;
- they enable organisations to choose their own counterparties and their own methodology for managing credit risk (including close-out netting and collateralisation or margin arrangements);
- while the market place is not itself directly regulated, dealings are executed with regulated firms;
- some OTC contracts are significantly more liquid than their exchange-traded counterparts (and, in some cases, the entire liquidity in a particular instrument can only be found off-exchange, such as the foreign exchange market).

Exchange-traded contracts are fully standardised contracts executed in regulated wholesale professional markets and cleared by regulated clearing houses. As such, they offer other additional advantages:

- Exchanges are centrally-regulated markets which are supervised by the relevant national authority; and regulators have a complete view of market players and risk taken.
- Dealings are in standardised products which enable buyers and sellers to trade multi-laterally and to open and close positions easily in a liquid market.
- Dealings are supported by a clearing house guarantee, which assumes and reduces therefore the counterparty risk of each buyer and seller. A direct market participant therefore no longer needs to look at the risk from different other market participants but is only exposed to the CCP itself and its risk management processes.
- Contracts are recorded and published in real time and supported by a transparent price formation and price discovery mechanism, automated risk-reducing trade processing, and transparent post-trade processing offered by the clearing house.
- The risk of loss is covered by daily «margin» payments set by the clearing house (i.e. a deposit based on a percentage of the full contract value and calculated daily according to historic/possible market movement).

Growing convergence across products, increasing standardisation and the complementary nature of the different markets has resulted in some exchanges looking to offer non-standardised instruments. Others are providing a wide range of «back office» and clearing services to OTC dealers, such as valuation and management services in relation to collateral. At the same time, OTC derivatives are traded using standardised documentation (and this is being extended rapidly to new products) and, in some cases, trade on margin; and will, where possible, be centrally cleared by a clearing house. It has been possible to clear the more standardised interest-rate swaps since 1999, and now over half of all inter-dealer swaps are processed by a CCP⁽³⁾.

(2) IFSL Research: Commodities Trading 2008, June 2008: http://www.ifsl.org.uk/upload/CBS_Commodities_2008.pdf

(3) See http://ec.europa.eu/internal_market/financial-markets/docs/cesame2/presentations/20081020-lch-clearnet_swapclear_en.pdf

EPFSF Memo «Equity Markets»

What are equity markets?

Main characteristics of the EU equity markets

Equity markets trade shares in companies. Broadly speaking, EU companies can be divided into private companies and public companies; only public companies can offer their shares to the public (typically via a combination of IPO and admission to trading on an exchange: also called a “Regulated Market” (RM). Public companies are owned by professional investors, including banks, insurance companies and pension funds, as well as retail investors. Private companies are typically owned by qualified investors (same as above, plus certain qualified individuals).

The following table compares market capitalisation, number of companies listed and equity turnover between Europe and the US.

	Year 2008	
	EU	US
Market capitalisation (EUR billions) ⁽¹⁾	6,180	8,339
Number of companies listed	12,352	5,963
Equity turnover (EUR billions) ⁽²⁾	23,308	50,360

Equity markets matter to the whole economy because they meet the needs of companies of all sizes for long-term capital finance. At the same time they allow investors to participate in the economic growth generated by these companies either directly or indirectly through collective investment vehicles. The function of these markets is to allocate capital efficiently to its best uses in the economy, give equity shareholders control over the companies, and contribute to a democratisation of capital.

As well as facilitating the buying and selling of securities, public markets act as a price discovery mechanism: they are a sophisticated way of ascertaining the buying and selling prices for a particular quantity of shares at a particular moment.

The EU Financial Services Action Plan (FSAP) modifies a number of provisions based on whether an equity product (as indeed for all other financial instruments) is admitted to trading on a RM or in other cases whether it is offered to the public. Admission to trading on a RM triggers a set of rules such as initial and ongoing disclosure obligations for the issuer (under the Transparency Obligations Directive -TD), certain market abuse rule (under the Market Abuse Directive - MAD) and transaction reporting to regulators (under the Markets in Financial Instruments Directive - MiFID). Public offering rules (under the Prospectus Directive - PD) are triggered by admission of financial products to Regulated Markets or by their public offering. Other rules (e.g. customer protection rules on suitability and appropriateness of financial instruments) apply regardless of whether or not an instrument is admitted to trading on a Regulated Market or publicly owned.

The FSAP – particularly the Markets in Financial Instruments Directive (MiFID) – has facilitated significant changes in this market, including greater competition among and between intermediaries and market operators, and the acceleration of integration and of technological improvements in trading.

(1) A company's market capitalisation is the total number of issued shares of the company multiplied by the respective share price at a given time. Sources: Federation of European Securities Exchanges (FESE) and World Federation of Exchanges (WFE).

(2) Sources: EU: FESE, BATS Europe, Chi-x, NASDAQ OMX Europe, Turquoise and BOAT; US: WFE.



EU equity markets have developed significantly in recent years: they have become bigger, deeper, more integrated and in certain ways more efficient. Some market participants see cause for concern in some of the trends – that is, the possible negative consequences of the fragmentation of trading for those securities where competition now exists, for the price formation process and the supervision of markets or the conflicts of interest caused by the bundling of trading and investment services or indeed by the integration of trading platforms with clearing and settlement activities, although this is being tackled by the unbundling and accounting separation part of the Code of Conduct. While equities were previously often traded on exchanges across national lines, there is a tendency for the same securities to be traded across several pan-European venues as modern technology allows today's financial service providers and supervisors to monitor prices on a range of such venues. Other market participants are concerned about the market positions which some trading and clearing venues still enjoy in their respective national markets or point to the reduction in frictional costs to European investors where MiFID has introduced competition.

In the new legislative cycle, certain aspects of the FSAP will be under review, including parts of MiFID, PD, and MAD. The European Commission also intends to adopt legislation on post-trading, in particular in relation to Harmonisation of Securities Law, which should come to the European Parliament in 2010.

How is the process of equity trading and post-trading structured?

- Issuance: public equity markets, private placement market

The issuance of shares in the primary markets is the means by which new capital is fed into the market. During the month of May 2009, 12,321⁽³⁾ companies are listed on European Regulated Markets, 11% of these companies are foreign⁽⁴⁾ companies. Publicly issued capital is increasingly accessed by a pan-European and international investor base and contributes to the European integration process. The increasing integration helps lower the costs of capital for European companies and increases the range of choice for the European investors.

Some specialised markets allow small and medium sized companies across Europe to access the capital markets. In May 2009, 2,289 companies are listed on these specialised markets/segments increasing choice for investors and allowing growth companies to access capital.

- Trading: Competitive Environment with Different Venues

Secondary trading is the process by which already issued shares are exchanged for cash. It can take several forms: multilateral or bilateral, auctions or continuous trading, dark (no pre-trade transparency to the public) or lit (pre-trade transparency). Markets and market participants make sophisticated use of advanced technology; telephone trading is now in the minority and face-to face trading on an exchange floor is in increasingly insignificant. One of the major indicators of a secondary market is its liquidity, which is a measure of the quantity of shares that can be traded without moving the price. Competition among trading venues has existed in most EU jurisdictions in one form or another for decades, but received a boost with MiFID, which introduced a common framework to allow competition among trading venues with a coherent set of transparency rules. Specifically, RMs and «Multilateral Trading Facilities» (MTFs) are subject to the same rules determining when an order can be kept «dark» (i.e. not made public until after execution) when it is deemed not to damage price formation (in particular large orders and specific cases of prices taken from another market).

(3) Data source: FESE Statistics, May 2009

(4) According to the FESE statistics methodology used herewith 'foreign company' means that the company is incorporated in a country other than that the Exchange is located.

- Regulated Markets (RMs)

In the EU, equity trading on the exchanges has been electronic since the early 1990s (unlike the US, where electronic trading has only slowly replaced floor trading). There are 23 market operators operating a total of 41 exchanges/market segments. More than 57 million electronic order book (EOB) equity trades were carried out on RMs with a value of EUR 582 billion during May 2009. Based on the common industry methodology underpinning the European Equity Market Report⁽⁵⁾ published by FESE, trading on RMs accounts for 86% of the total trading by RMs and MTFs.

- Multilateral Trading Facilities (MTFs)

There are two types of MTFs: pan-European equity MTFs and Specialised Markets. Pan-European equities MTFs, operated by Investment Firms or Market Operators, generally trade shares admitted to trading on a RM (generally blue-chips) on a pan-European basis. Junior/Specialised markets, operated by Market Operators, list and trade financial instruments issued by small and medium-sized firms.

There are currently 13 pan-European equity MTFs in the secondary markets, of which nine are operated by investment firms, the rest by market operators. As of April 2009, MTFs' EOB equity volumes were 16 million with a value of EUR 91 billion. MTFs' equity turnover accounted for 14% of the total trading by RMs and MTFs.

- Systematic Internaliser

Intermediaries executing away from a RM or MTF and dealing on own account are required to register as «systematic internalisers» when their activity fulfils a number of conditions under MIFID, and to provide public price quotations for the relevant liquid shares. The requirements seek to ensure that investors – particularly retail investors – dealing in this way are not disadvantaged and that the price formation process for the whole market is not undermined.

- Broker-dealer platforms and other OTC

In the wholesale markets, where the size of business to be transacted may be large in relation to the market in which the business is to be done, it has long been accepted practice to trade «over-the counter» – bilaterally, between broker and broker or broker and client. New, automated ways of doing this business have led to the introduction of systems which match quantities rather than prices and execute at prices taken from the best bid and offer in the primary markets (generally RMs). While some tend to consider this kind of venue as a natural extension of the traditional OTC, others believe that it has the same functionality as an MTF and should be classified as such. A number of detailed technical questions arise about how this trading should be organised and whether and if so how it should be supervised; it is likely that these will arise in the MIFID review process.

Post-trading⁽⁶⁾:

The trading of securities leads to the subsequent transfer of ownership of the relevant securities from the seller to the buyer as well as (in most circumstances) a reciprocal transfer of funds in payment.

Post-trading services (often referred to as Clearing and Settlement) are the services that allow these transfers to be made efficiently and safely. Clearing and settlement can be achieved in different ways and can involve a number of intermediaries in addition to the buyer and the seller; this is particularly true for a cross border securities transaction.

(5) <http://www.fese.be/en/?inc=art&id=81>

(6) The post-trade processes and infrastructures for fixed income trades are similar as those of equity trades.



Clearing is the process of establishing settlement positions, including the calculation of net positions. It is now a term that is most commonly used to refer to central counterparty clearing where an entity (called a central counterparty or CCP) interposes itself legally between the buyers and sellers of securities, enabling full anonymity, multilateral netting and improved counterparty credit risk management.

Settlement involves the transfer of securities and related payment of funds between the buyer and the seller. Settlement is closely linked to the provision of custody services.

Securities in most European markets are either immobilised or dematerialised and are held through a central securities depository (CSD) into which companies and borrowers issue their equity and debt instruments. The owners of a security will generally not be a member of a CSD and may interact with the CSD through an intermediary (e.g., a bank, broker) that is a member. Most EU countries have at least one national CSD. In addition there are two international CSDs (ICSDs) that were originally set up to settle transactions in international debt instruments and which now are also active in the settlement of internationally traded securities from numerous domestic markets and typically across currency areas.

The distinctive feature of a cross border settlement relative to a domestic settlement is that it involves gaining access to a settlement system in another country and/or the interaction of different settlement systems. There are a variety of ways in which cross border settlement can be achieved, but all of them involve chains of intermediaries which tend to increase the cost of a cross-border transaction when compared to a domestic transaction.

In 2004, the European Commission issued a Communication setting out its strategy and priorities for clearing and settlement, which included an action plan outlining the various initiatives necessary to achieve an integrated, safe and efficient clearing and settlement environment for securities trading in the EU, based on a level playing field for the different providers of services.

Within the Communication, the Commission recommended that an expert group be set up to advise on, promote and monitor the progress of in removing the barriers to efficient and low cost cross border settlement. The barriers are commonly referred to as «the Giovannini Barriers». Two of them have already been dismantled and the other thirteen are making progressing towards dismantling, either through EU policy actions or through industry initiatives⁽⁷⁾. Whilst the post trade landscape in Europe remains fragmented and barriers remain, the cost of cross-border clearing and settlement in Europe is significantly higher than in the US⁽⁸⁾.

Code of Conduct on Clearing and Settlement for cash equities

The Commission's Communication in 2004 reflected on the need for a framework Directive on Clearing and Settlement. After numerous consultations, the Commission decided to ask the industry to come up with a Code of Conduct on clearing and settlement for cash equities. The Code was agreed upon in 2006 with the aim of offering market participants the freedom to choose their preferred provider of services at each layer of the transaction chain (trading, clearing and settlement). The Code aimed to deliver price transparency; a framework for access to, and interoperability between, trading, clearing and settlement providers; and service unbundling and accounting segregation. A monitoring group (MoG) was established by the European Commission to overview the Code's implementation. There are already examples of competitive clearing that are live and according to the central counterparties' published plans, it appears that this 'user choice' model is likely to become the rule rather than the exception over the next few months.

(7) See http://ec.europa.eu/internal_market/financial-markets/docs/cesame/cesame_report_en.pdf for EU Commission CESAME report.

(8) "A CEPS study in 2001 found that intra-EU international transactions were eight times more expensive than US ones". Commissioner McCreevy said in April 2008: "Clearing and Settlement in the EU is as much as 10 times more expensive than in the US, according to some estimates."

EPFSF Memo «The European Fixed Income Markets»

What are fixed income securities?

In its simplest form, a fixed income security (also known as a debt security or bond) is evidence of a loan. The issuer (or borrower) agrees to repay a specified sum of money together with interest at a specified future date/s to the holder (also known as the investor or lender) of the security. But unlike an ordinary loan it is readily capable of being transferred from one lender to another by delivery or endorsement. The price fluctuates depending on changes in interest rates and the creditworthiness of the issuer. The word “fixed” term “fixed income security” can be misleading because, while most bonds carry an obligation to pay a fixed sum of maturity, the income, i.e. the interest paid, can take a variety of forms. As with borrowing money from a bank, the interest paid may be fixed (e.g. 5% a year) or variable (e.g. a % over the current rate at which banks lend to each other). There are also a variety of hybrid instruments which have characteristics of both equity and debt securities, such as preference shares that are considered to be fixed income securities. Some have derivatives embedded in them.

Who issues bonds and who invests in them?

Bonds are one way public and private institutions can borrow significant sums in various currencies for all kinds of general and specific funding purposes. At the same time, bonds are a core savings product for investors as they offer investors a (usually) higher return than a cash deposit at a bank but with lower risk than an investment in equities. The biggest investors in bonds are investment firms and pension funds as well as insurance companies and banks. Insurance companies and pension funds buy bonds to have stable sources of cash flow to pay the obligations arising from the policies and annuities they sell, while at the same time preserving their initial capital.

Issuers must also manage their cash flows which means that they may have to issue a wide range of bonds with different maturities, currencies and structures to ensure that they match their income flows, diversify their investor-base and avoid paying all their obligations at once. This largely accounts for the much greater number of bonds issued compared to the number of equities.

Individuals also purchase bonds, generally as an alternative to a savings account at a bank. Wealth invested in bonds varies widely, from ca. 2% in the UK to 30% in Italy (2004). However, investing in bonds is not risk free: even the highest rated bonds carry a risk of default (with no compensation scheme unlike bank deposits). Capital gains are generally more limited than is the case with equities. It is also more difficult for most retail investors to minimise their risk by diversifying their portfolio because of high minimum denominations of bonds (e.g. EUR 1000) compared to equities. Indeed, most debt security markets in Europe are predominantly wholesale with retail investors accessing them mainly through specialised UCITS. Some classes of debt securities such as commercial paper and securitised products are targeted purely at wholesale investors and the denominations in which the securities are issued effectively bar even wealthy retail investors. This also impacts on the functioning of market: the average size of a bond trade tends to be much greater than for an equity. Trade sizes between EUR 1m and EUR 2m are normal and trades in excess of EUR 50m are common. Prior to the crisis, trades in excess of EUR 100m were not infrequent. By contrast, European legislation defines the typical retail trade in equities as EUR 7500.



The introduction of the Euro has led to a massive growth and integration of the EU debt markets. They continue to be dominated by government debt. However, the driving force behind the recent growth of EU bond markets is the corporate bond market, which is very integrated and had been growing steadily until the crisis. In the first half of 2009, the primary market has recovered dramatically, with record levels of issuance by financial institutions and corporations. Secondary market trading remains at low levels however compared to the decade up to 2007.

How and where are bonds issued?

Bonds are issued through private placement (sales limited to wholesale investors) and public issuance accompanied by a prospectus and often by admission to trading on a Regulated Market (RM). This is partly because institutional investors in some jurisdictions are only permitted to invest in bonds admitted to trading on a RM. In 2008, 120,229 bonds were admitted to trading. The two largest exchanges in the EU for bond issuance are Luxembourg and London. London is also accounts for the largest underwriting business for bonds. The issuance of government bonds in some jurisdictions has become fully automated (through electronic auction systems that may lower the costs of borrowing for governments). In others, syndicates of dealers bid for the bonds in traditional fashion.

How and where are bonds traded?

While many bonds are admitted to trading on RMs, the vast majority of trading takes place over-the counter (OTC) or via Multilateral Trading Facilities (MTF). Only a very small amount of trading occurs via the electronic order books of RMs, in contrast to equity trading. Aggregate statistics comparing OTC and on-exchange trading for all bond market sectors in Europe are not available but in 2005, according to one estimate, the daily turnover of the secondary fixed income market in Euro-zone government debt was approximately EUR 65 billion, of which EUR 28 billion was traded electronically. In 2005 the German, French and Italian markets accounted for about 75% of the total Eurozone government bond market volume with about EUR 50 billion daily turnover. Only EUR 2 billion was traded via electronic order book on exchange.

How does the OTC market function?

In the OTC market buyers and sellers negotiate directly with one another, rather than submitting anonymous orders to the order book of a RM. Dealers act as market makers by quoting prices at which they will sell (ask) or buy (bid) to other dealers and to their clients. This can be done via the telephone (either directly between the counterparties or with the intermediation of a specialised inter-dealer broker) or via electronic trading platforms operated by individual dealers. An important trend is that of automation in the trading of bonds. Two models currently predominate. In one, clients can request that a dealer (or several dealers in the case of an MTF) bid or offer competitively for a particular bond in a particular amount. In the second, dealers display to their clients the bonds they own and the prices at which they are prepared to sell. Here too some MTFs have consolidated the individual dealer platforms into one system thereby reducing search costs for investors. With electronic systems gaining ground, operated by a variety of organisations, the clear division between on-exchange and OTC trading has become somewhat blurred, creating instead a hybrid market, where although the vast majority of bond trading in Europe is still conducted off-exchange, bond trading has become more centralised with the introduction of electronic trading and the capacity of these platforms to allow for multipleparties to post offers and request firm dealing prices.

Several features of bonds in contrast to equities explain the different trading structures, such as differences in investor behaviour (many bond holders buy and hold to maturity – pension funds etc. do this to match long term liabilities and individuals do this as bonds are an alternative to bank savings accounts) and differences in market structure (there are far more bonds in issue than shares. Furthermore, almost all bonds trade very infrequently, with liquidity being provided by dealers who either put their own capital at risk or take an order e.g. from a client who wants to buy a quantity of a particular bond and then search the market for an investor who is prepared to sell those bonds). RMs' order books provide neither service, but merely display the trading intentions of dealers and investors. This may partly explain why RMs have, to date, largely been unsuccessful in attracting order flow except for some retail sized orders.

There are various links between the bond markets and the rest of the financial sector which appear to be most efficiently maintained via the OTC market model. Where dealers put their capital at risk, they need to hedge their positions until they are able to find buyers or sellers on the other side. Typically, for each bond they will need to hedge the credit risk (the risk of the issuer defaulting) and the interest rate risk (the risk that the general level of interest rates will change) and to do this they will use OTC and exchange traded derivatives such as interest rate swaps, credit default swaps and futures and options. They will also need to finance their long positions or to borrow securities where they have sold securities that they do not own. To do this, they use the repo market and reverse repo market. "Repo" is short for «sale and repurchase» whereby a dealer simultaneously sells the security today and buys it back at a future date. Reverse repo is the opposite, used by dealers to cover short positions. Very large trades or trades in particularly illiquid bonds may take weeks to cover making hedging and financing particularly critical. This is also the market used by central banks to control the degree of liquidity in the financial markets.

The post-trade arrangements for the European fixed income securities are broadly similar to those of equity securities, particularly for the settlement layer (for more information, please refer to the briefing sheet prepared for Equities). The clearing and settlement arrangements for bonds, particularly in Europe's largest securities market – the international debt securities market – are generally recognised as being very efficient. Many European CCPs provide clearing services for fixed income transactions and in particular for the government bond repo markets; CCP clearing is less common for transactions in government and corporate bonds. Settlement takes place in central securities depositories (CSDs) and international securities depositories (ICSDs).

What regulations apply to bond markets?

Non-governmental issuers of bonds that are admitted to trading on a RM or making a public offer must comply with the Prospectus Directive PD. Issuers on RMs must also comply with the Transparency Obligations Directive and the Market Abuse Directive. The PD includes separate disclosure regimes for all bonds by type, and also allows a more flexible regime of issuance and disclosure for all bonds denominated over EUR 1000 (with regulatory competition allowed) and separately for wholesale bonds over EUR 50,000 (with less disclosure and more flexible format and language regime).

Financial institutions and others engaged in bond trading are subject to the Markets in Financial Instruments Directive (MiFID). Particularly relevant are the suitability/appropriateness requirements as well as the best execution rules. MiFID's pre- and post-trade transparency rules do not apply to bond markets. This is because the bond markets rely on dealers maintaining an inventory of bonds which would make them vulnerable to post-trade disclosure particularly in less liquid issues. Finally, the Market Abuse Directive as well as the transaction reporting requirements of MiFID (linked to MAD enforcement) apply to all bonds admitted to trading on a RM regardless of whether the trade takes place on an RM, MTF or OTC.



What regulatory and self-regulatory initiatives are under way which may affect bond markets?

As part of the MiFID review due in 2010, the European Commission will prepare a report on whether MiFID's pre- and post-trade transparency requirements should be extended to debt markets, and if so in what form. In the light of the financial crisis and recommendations from the Financial Stability Board and G20, CESR recently decided to re-evaluate its earlier conclusions from August 2007 on bond market transparency (provided to the EU Commission as part of its Article 65 MiFID review published in 2008). Also in 2008, the International Capital Market Association (ICMA), which has provided a self-regulatory regime for the issuance and trading of international debt securities for 40 years, and the Securities Industry and Financial Markets Association (SIFMA) launched free services targeted at retail investors (though also accessible by professional investors).

www.bondmarketprices.com publishes actual trade prices for retail sized trades in a wide range of domestic and international bonds executed by many of the major dealers in Europe. www.investinginbondseurope.org is primarily an educational site with a large amount of price data provided by the largest consolidator of quote and price data in Europe. Professional investors have a wider range of pre- and post-trade data available for a fee, although at the current time, when dealers are reluctant to commit capital to facilitate client orders, the quality of such information is significantly less than pre-crisis.

Finally, one form of transparency is that of aggregate positions held. Following the onset of the crisis regulators and central bankers were frustrated in not knowing who held, or indeed the aggregate positions within the market. Moves to bring these within regulator reporting regimes should help to ensure that information is available to regulators in the future⁽¹⁾.

(1) Regulation of CRAs may have an impact on European bond markets as well. For more information please refer to the EPFSF Memo on Credit Rating Agencies

EPFSF Memo «The European Insurance Industry»

Introduction

The insurance sector plays a fundamental role in the economy and society of Europe. The insurance industry acts as a catalyst for economic growth while providing essential services to protect citizens against all kind of adverse events. The European insurance industry contributes to economic growth by:

- promoting sensible risk management by firms and households, contributing to sustainable and responsible development and increasing consumption;
- offering supplementary social protection alongside the state, releasing pressure on public sector finance;
- enhancing financial intermediation, creating liquidity and mobilising savings;
- fostering entrepreneurial attitudes, encouraging investment, innovation, market dynamism and competition;
- providing broad insurance coverage directly to firms, improving their financial soundness.

It is important to acknowledge that insurance is not banking. The specific characteristics of the insurance business model deserve different and differentiated regulation and supervision. Justified regulatory reaction to the crisis must not be translated into a “one size fits all” approach.

Providing protection for European consumers

The insurance industry provides people with the means to live and work in a stable environment. By offering guarantees to consumers, as for instance lifelong financial protection. Insurance acts as a security net, allowing stable consumption throughout an individual’s life. Guaranteeing a stable lifestyle to consumers increases their confidence in the future and enhances consumption.

In a world characterised by social changes, an ageing population and the increasing difficulties of the public sector to provide adequate pensions, healthcare and social security, private insurance offers an efficient way to support and substitute the state in these areas crucial to citizens. Through products designed to complement state provision, the insurance sector contributes significantly to guaranteeing a stable and lifelong level of revenue (pension, education leave, maternity leave) and to limiting the impact of demographic change on states’ budgets.

Insurers have also demonstrated their ability to manage other fields of social security such as compensation and rehabilitation following accidents at work, for which insurers of several countries provide high-quality social protection. These products have a double economic impact, protecting workers from the economic consequences of accidents and encouraging a healthy working population.

Fostering economic growth

Insurance promotes growth in a variety of ways: it provides stability; it promotes sustainable use of resources; and it reduces the strain on public sector budgets by providing complementary services.



- Insurance reduces the capital firms need to operate. The risk-transfer function of the insurance sector contributes, on the one hand, to the creation of a more stable operating environment for companies and, on the other hand, to a reduction in the level of capital required by undertakings to protect themselves against risk. This allows companies to concentrate their attention and resources on their core business. By creating an environment of greater certainty, insurance also fosters investment and innovation. Through mitigating and pooling procedures, insurance decreases the risks supported by entrepreneurs and allows them to take additional risks. This impact is particularly significant for small and medium-sized enterprises (SMEs) that do not have easy access to capital markets and that are a main source of innovation.
- As institutional investors, insurers contribute to the liquidity of financial markets and facilitate firms' access to capital. Through investment in shares and bonds, insurance contributes directly to the financing of the economy and to the good functioning of the financial markets, in particular of their long term needs.
- Insurers are sound partners for the development of a supplementary system of social protection and provide an efficient way to support the State in the provision of pensions, healthcare and social security. Insurers offer for instance individual and occupational pensions, as well as private healthcare solutions.
- Insurance promotes continuous improvements in risk management systems and contributes to responsible and sustainable economic development. Insurance not only provides a stable operating environment, but it also improves companies' awareness of risk management, and influences their investment decisions. As institutional investors, insurers have also a significant responsibility in ensuring good corporate governance in the wider financial sector and the real economy.
- Insurance contributes to sustainable growth and the reduction of risks linked to climate change by supporting government policies designed to limit climate change and to reduce its impact.

European insurance in figure

More than 5 200 insurance companies operate in Europe, representing all types of insurance and reinsurance undertakings. Their size ranges from truly global players through nationally or regionally active companies, to small niche players, often highly specialised. They may offer a broad range of insurance services or specialise in a given product as so-called "monoliners". In many European countries, insurers in different legal forms operate alongside each other, such as limited companies, cooperative and/or mutual insurers.

The European insurance market, as represented by the CEA and AMICE, is the largest in the world, with a market share of over 40%, followed by the US with 30%.

The European insurance industry employs over one million people directly. In addition to their own staff, insurers also employ indirectly numerous professionals: approximately one million agents, brokers and financial intermediaries.

Impact of the economic crisis

The European insurance industry entered the crisis in a strong position and has generally been stable in the countries of the EU, with a few exceptions. It has shown resilience to the continuing shocks to the financial system. European insurers have been improving their internal risk management over recent years and this has smoothed the impact of the crisis on the EU insurance sector. Both the crisis that the insurance industry went through in 2000-2001 and taking part in the Solvency II project have enhanced insurers' focus on risk management.

The unique characteristics of the business model of the insurance industry have protected it from a more severe impact. The principal aim of insurers when investing in assets is to match their commitments to policyholders. Insurers therefore generally invest in products with well-defined cash flows and risk profiles and largely limit the risk profile of their investments so that it is in line with their commitments.

In contrast to other financial services providers, insurers are also characterised by the inversion of their cost/revenue cycles. This means that insurers are primarily funded by policyholders' premiums, making them less exposed to liquidity risk and to any problems accessing credit markets. Indeed, the insurance industry could be said to have had a stabilising effect on the financial markets as a result of its anti-cyclical investment behaviour.

Overall, European insurers had not taken significant exposure to credit risks and as a consequence have not been directly affected by the credit crunch that was at the root of the crisis. There have been a few notable failures but these have been mainly caused by non-insurance business. In terms of premiums, barring a small number of lines of business, such as credit insurance, that have strong links to economic activity, non-life business has generally been little affected by the economic downturn. In the life market, however, the impact has been quite significant, with term-life and unit-linked products hardest hit.

One of the dominant developments of the past 18 months was the finalisation and adoption of the Solvency II Framework Directive, the prudential regulatory framework for the insurance and reinsurance sector. The industry regards Solvency II as a timely response to the crisis and is delighted that the key economic risk-based approach of the Solvency II Framework Directive has been preserved, despite the difficult political negotiations. The Solvency II regime, although drafted before the onset of the crisis, addresses in large part the regulatory and supervisory issues raised by the financial crisis, and it is a vital element in supervisory reform at European level. This new solvency regime will create an advanced risk-based supervisory structure for (re)insurers in the European Union; the principles of which we hope will serve as a benchmark for supervisory reform efforts around the globe.

Conclusion

Efforts are underway globally to address the economic crisis and to push the world economy out of recession. The insurance industry has generally shown resilience to the shocks of the global financial system, reflecting the strength of the insurance business model. By investing more than EUR 6800 bn in the economy, providing supplementary layers of social protection, fostering stable consumption and protecting millions of citizens and firms against adverse events, the European insurance industry has and will continue to have a positive impact on economic recovery and growth.



EPFSF Memo «Investment Services in the EU»

Introduction

The investment services sector of the EU's financial services industry is large and highly differentiated. The wholesale component entails financial business conducted between financial services companies and institutions such as banks, insurers, fund managers, institutional funds and stockbrokers, while the client base at the retail end, which comprises hundreds of millions of individuals and non-commercial organisations, is serviced by a variety of firms including banks, private client investment managers, stockbrokers, and financial advisors.

The range of securities or financial products in which investments are made includes equities, bonds, derivatives, securitised and structured products, and complex financial instruments of all kinds, many of which are for use only in the wholesale markets. There is also a myriad of products based on underlying equities and bonds specifically designed for retail investors, including thousands of different pooled vehicles or funds, of which UCITS is the key category (see below).

EU investment services firms, as well as exchanges, must be authorised and regulated by their home state competent authority. The number of regulated businesses in the EU runs into the hundreds of thousands while in size they range from global multi-service financial institutions down to tiny one-person retail operations. Between them they offer a full range of services to investors at both wholesale and retail level, including for example listing, dealing on and off exchange, trade execution, product distribution, marketing, buying and selling, intermediation, arranging, advising, managing, establishing collective investment schemes, custodianship, and clearing and settlement. Small-scale investment products are marketed to individuals and families by smaller retail firms on the basis of commission from the product provider while at an intermediate level firms offer bespoke, fee-based private wealth management, discretionary and non-discretionary advice, and execution only brokerage to wealthier retail investors.

Regulation and Investor Protection

Appropriate, proportionate, effective, and well-targeted regulation across the EU is important to ensure both high standards of consumer protection and a level playing field across countries and sectors. Wholesale market regulation in the EU has a stronger prudential content while regulation in the retail sector focuses more on the conduct of business.

Ideally, market regulation should foster efficient capital markets and the efficient transformation of savings into investments by permitting both professional and private investors to make well-informed decisions and providing issuers with lower capital costs. Information is paramount to efficient, effective and fair capital markets. Investors need transparent information that is fairly and consistently disclosed in order to make informed investment decisions. This includes making sure that information is readable, in plain language, accessible, and meaningful to the average investor. Transparency is therefore of the greatest importance in any regulation governing the investment sector if the overall goal of investor protection is to be achieved. Regulation should also ensure confidence in using the financial markets by maintaining and enhancing market integrity, credibility and openness, enforcement against breaches, and a level playing field in trade execution for all market participants which encourages healthy competition.

A degree of cross-border harmonisation is required to achieve a regulatory level playing field in the EU. While this has been achieved to an extent in the investment services sector, especially with MiFID, UCITS, and the Capital Requirements Directive (CRD), there remains some work to do particularly with regard to differences between member states in retail investor protection and product regulation. Variations may be due to different causes, including discrepancies in the national implementation of directives, divergences in the practical application of harmonised rules, different taxes and incentives between member states, and distinct cultural preferences for different products.

Directives

The investment services sector is affected by many Directives which form the market framework. The key among these are described below.

MiFID

The MiFID, meaning Markets in Financial Instruments Directive, takes a horizontal approach and regulates distribution, conduct of business, and trade execution policies relating to most wholesale and retail financial services in the EU, including investment services. Its provisions apply to banking, funds and fund managers, and investment services firms and products, but not to insurance undertakings. Its aim is to protect investors and safeguard market integrity by establishing harmonised requirements governing the activities of authorised intermediaries and regulating for fair, transparent and integrated financial markets. Key provisions relate to the best execution of clients' orders, mandatory suitability and appropriateness tests when advising and selling product to investors, governance of conflicts of interest, the authorisation to do business cross-border through the passport system, and cross-border supervisory arrangements to oversee authorised activities.

UCITS

The UCITS-Directive (Undertakings for Collective Investment in Transferable Securities), introduced in 1985, is a product-specific Directive and the cornerstone of Europe's investment fund legislation, including for cross-border purposes. It defines the rules and procedures for setting up and managing a fund that will be marketed to retail investors in the same or another member state, including stringent rules with respect to assets eligible for investment. It also includes provisions on investor information, on cross-border marketing and managing of funds and on supervisory cooperation. The UCITS Directives have greatly promoted the integration of a European market for investment funds, and today more than 2/3 of all European investment funds are UCITS.

In order further to improve the UCITS framework, to increase the efficiency of the single market for investment funds, and to enhance the European fund industry's competitiveness, the UCITS Directive has just been revised in a number of important areas. Member States must transpose these changes into national law by July 2011. In parallel, implementing measures must be adopted, most of which will be subject to scrutiny by MEPs.

Prospectus Directive

The single passport for issuers harmonises the requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading. It aims to ensure that adequate and equivalent disclosure standards are in place in all Member States, so as to afford investors throughout the European Union a uniform degree of protection. Related directives include that on the admission of securities to official listing on stock exchanges in EU member states which aims to provide uniform guarantees to investors and to facilitate the pan-EU listing of securities. Together with common EU disclosure rules for traded securities and other measures these directives provide the basis for the EU-wide capital market.



Shareholder Rights

The Shareholder Rights Directive facilitates the exercise of voting rights by shareholders of listed companies cross-border in the EU by providing a legislative framework and addressing issues including the abolition of obstacles to electronic participation in General Meetings, the right for shareholders to question and be answered by company management, and the abolition of constraints impeding the easy appointment of a proxy holder. Other areas of importance include the application and enforcement of consistent and universal corporate governance principles and rules for use by listed companies. In addition, shareholders require a full range of information to exercise their rights and responsibilities.

Capital Requirements (CRD) and other Directives

The equity capital of investment firms and credit institutions in the EU must be adequate to safeguard market stability, guarantee an identical level of protection against bankruptcy to investors, and ensure fair competition. The Capital Requirements Directive seeks to fulfil these objectives by laying down minimum initial capital requirements and setting the equity capital level, which must permanently be held in order to cover position, settlement, exchange and interest rate risks. All member states must provide for minimum compensation for investors in the event of the failure of an investment firm authorised to provide cross-border services. The directive setting up common rules for collateral pledged to payment and securities settlement systems aims to limit credit risk and improve the functioning and stability of the European financial markets.

Alternative Investment Fund Managers Directive

At the end of April 2009 the European Commission published a proposal for a directive on alternative investment fund managers. The idea is to regulate and supervise managers of all non-UCITS funds (i.e. hedge funds, real estate funds, private equity funds etc.) to enable the competent authorities to identify systemic risks. At the same time, once authorised, managers would be allowed to manage and market their funds to professional investors throughout Europe. The proposal is highly controversial and will be subject to the scrutiny of the new Parliament.

Packaged Retail Investment Products (PRIPs)

The European Commission also published in April 2009 a Communication on PRIPs in the EU. This deals with investment funds, investments packaged as life insurance policies, retail structured securities, and structured term deposits and describes a way of creating a robust and coherent framework for consistent and effective standards of investor protection together with a level-playing field for PRIPs' originators and distributors. The Commission intends to publish specific proposals for consultation before the end of 2009.

The Financial Crisis and Consumer Confidence

Confidence in the EU's financial markets has been damaged by the financial crisis. Citizens and businesses have suffered losses and governments have had to step in to help. As markets recover and confidence is restored it will be important to reassure investors that their investments are secure and subject to responsible risk taking. The EC's future regulatory plans for investment services, some of which are outlined above, will be important in this process. New MEPs will play a significant role in ensuring that their constituents know that their interests are being taken into account.

EPFSF Memo «The Mortgage Industry»

Introduction

The importance of the mortgage industry in the European Union is multi-level depending on the perspective adopted, but from whichever perspective taken, mortgage credit has always been and remains a major driver of European development.

Mortgage lending is a core retail banking activity; retail banks, be they commercial, savings or cooperative banks, are the major providers of mortgage loans.

EU Citizens and the Mortgage Industry

Starting with the EU's primary stakeholders, its citizens, the mortgage industry offers over 70% of them access to housing. Providing stability, security and shelter to a significant part of the EU's population, mortgage credit has an important societal role to fulfil in laying the foundations for social and economic development across the EU. Equally importantly, mortgage credit establishes an equity cushion that is likely to prove helpful at one or another moment in a citizen's life, as regular payments of mortgage credit instalments amount to a form of "compulsory" saving, with the specific advantage that the amounts "saved" are blocked for a period of time, i.e. not readily available for impulsive consumption expenses. More than simply granting citizens access to credit, mortgage loans also offer citizens affordable credit thanks to their long maturity and low interest rates, which are rendered possible by the existence of a surety that mitigates lenders' risks.

In terms of national figures, levels of homeownership tend to be higher in southern European countries, largely due to tradition (reaching 86.3% in Spain in 2007), and in Central and Eastern European (CEE) countries, due to the widespread privatisation of former state-owned dwellings (97.2% in Romania in 2007). Levels of homeownership in northern European countries tend to be significantly lower, with the region's rental markets traditionally being more developed.

EU Economy and the Mortgage Industry

Turning to the EU's wider economy and the importance of the mortgage industry in this respect, the role of mortgage credit can again be witnessed at various levels.

Beginning with a few headline figures, the European mortgage industry was in boom from around the mid-1990's until 2005/2006 (depending on national markets) with, in the majority of cases, a two-digit annual rate of growth that resulted in the doubling of the European mortgage market's size every 10 years. This growth in absolute values was reflected in the EU total outstanding residential mortgage debt to GDP ratio, which was 31.9% in 1997 and had reached 50.1% by 2007. Incidentally, in Europe, it was this explosion in growth that led mortgage lenders to seek out alternative sources of funding as funding through savings deposits became insufficient. In turn, this led to the highly successful development of covered bond markets in Europe.

Clearly, this landscape has changed lately with the emergence of the current credit crisis being a turning point in this evolution. However, despite the crisis' onset in late 2006/early 2007, 2007 still witnessed a significant increase in the aggregate EU27 total outstanding residential lending market of 7.4%, increasing to EUR 6.1 trillion from the 11.2% and EUR 5.7 trillion it had stood at in 2006.



On a general basis, in 2007, growth rates in outstanding residential lending slowed in comparison with the previous years. This was especially the case in the more mature markets of the EU15, while some CEE countries recorded higher increases than the previous year. Clearly, the size of national markets varies significantly across the EU, ranging from EUR 2,021 million in Malta to EUR 1.7 trillion in the UK, which is by far the largest EU mortgage market and represents over 28% of total outstanding EU residential mortgage lending. Other major markets in absolute values are Germany with EUR 1.1 trillion, France with EUR 651,100 million, Spain with EUR 646,676 million and the Netherlands with EUR 558,982 million. Emerging markets in the CEE countries are still quite small in absolute terms but they have experienced rapid growth. In 2007, the growth rate in outstanding residential mortgage loans varied from 55% in Slovakia to 86.9% in Romania when compared to 2006. In the same period, the fastest growing markets in the EU15 were Luxembourg (22.1%), Greece (21.4%), Ireland (13.4%) and Spain (13.1%).

Today, 2007 remains the most recent year for which final, full-year figures are available; however, based on provisional figures for 2008 (where available), the European Mortgage Federation estimates that 2008 will show either stagnation or slight decreases depending on the different national markets. In this respect, there are a number of other interesting indicators of the importance of the European mortgage industry to the EU's wider economy, such as:

- *The outstanding mortgage debt per capita ratio*: in 2007, annual data here ranged from EUR 38,700 in Denmark, which had the highest level of per capita mortgage debt in the EU, to EUR 372.5 per capita in Bulgaria, the lowest. Luxembourg, Ireland and the Netherlands also recorded very high levels here. In general, per capita mortgage debt ratios continued to rise across the EU during 2007 in comparison to 2006.
- *The residential debt to GDP ratio*: in 2007, this indicator reached 100.0% in the Netherlands and 92.8% in Denmark, while the lowest ratio was recorded in Romania with 3.5%. The average residential debt to GDP ratio across the EU27 was 38.7% in 2007 (36.1% in 2006).

Another aspect worthy of note is the strong link that exists between the mortgage industry and the housing market. Indeed, the mortgage industry is instrumental in the development of the housing market insofar as access to credit is a condition for such development. Furthermore, it can also influence the prices available on housing markets with affordable and accessible credit helping prices upwards, while more expensive and less-accessible credit pulls prices downwards. Incidentally, the pace of growth in house prices also slowed in 2007, despite remaining positive in all Member States except Ireland.

Impact of the Current Crisis

The current and ongoing crisis has hit the European mortgage industry in a way that was largely unforeseen with respect to its origin and the strength and amplitude of its consequences, its initial catalyst to be found in the USA's sub-prime mortgage market.

Against this background, parts of the Industry faced a severe drying-up of liquidity, reflecting a general shortage of funding as well as an increasingly more difficult economic environment, which is now characterised by a general decrease in economic growth and, in some countries, by recession and falling house prices. The covered bond market has proved the more resilient of the asset classes and shows encouraging signs of improvement, whilst official and industry efforts continue to achieve a restart of the public securitisation markets.

The central role played by covered bonds in the current challenging market conditions has further emphasised that they remain one of the cheapest wholesale funding instruments available to banks, with most issuers viewing them as a vital element in ensuring optimal asset-liability-management. In the current credit and liquidity crisis, the covered bond world has been characterised by spread differentiation between market segments, issuers and collateral types. Naturally, with the increased level of differentiation, the focus upon differences between covered bond laws and covered bond structures across jurisdictions has also increased.

At the same time, the expansion of covered bond markets has not come to an end with a still rising number of first time issuers entering the market as other alternatives either become more expensive (unsecured bank debt) or, since the crisis, non-existent (Mortgage Backed Securities). On the latter specifically, the market for securitisation has been inactive for most of the crisis, and all securitisation across Europe is now for the purpose of accessing ECB/NCB liquidity. By comparing covered bonds with other market sectors, the news for the latter has been bleak, whereas covered bonds, although affected by the crisis, have nevertheless performed significantly better than most other asset classes.

The crisis has resulted in consumers changing their attitudes and adopting a more cautious approach to spending and taking out loans, whilst lenders are re-assessing their underwriting conditions and the prices of their highest risk loans/products.

Furthermore, it is important to note that given that national mortgage markets across Europe functioned differently before the crisis, they now face different challenges because of the crisis depending upon factors such as their primary choice of funding tool, the range of products offered, the characteristics proper to their national housing market and other national specificities. This diversity of national circumstances implies that only a limited number of targeted actions/proposals can be applied equally to all EU mortgage markets, with a number of specific responses developed and implemented on a national level being required to address the more individual needs of those differing markets.

Current Mortgage Specific Initiatives at EU Level

Since 2003, DG Internal Market and Services have been examining the margin for further integration of Europe's Mortgage Markets, a decision prompted by the publication of a number of studies prior to 2003, which concluded that the integration of retail financial markets continues to be insufficient. This assessment, which has involved a series of expert groups, reports and stakeholder consultations, culminated in the publication of a White Paper on Mortgage Credit in December 2007, which in turn launched a series of currently ongoing studies and additional consultation of stakeholders.

Unfortunately, the White Paper was prepared and published at a time which did not allow for the credit crisis to be taken into account. The events of recent months have subsequently led to a re-evaluation of direction by the Commission, and in its March 2009 Communication on Driving European Recovery, the Commission announced that it would be considering a package of measures on responsible lending and borrowing.

The components of the planned responsible lending and borrowing initiative will remain largely the same as envisaged in the current White Paper follow-up (e.g. information requirements, advice, creditworthiness, non banks etc.), although this is not to be the case for the issue of early repayment, which is not a fundamental element in the elaboration of responsible lending and borrowing policy.



In parallel to this policy reorientation, the Recommendation on Foreclosure, Land Registration and Property Valuation, announced in the White Paper and originally planned for earlier this year, has been indefinitely postponed, reflecting the current especially difficult climate, both in economic and political terms, in which policy measures touching on foreclosure issues need to be carefully targeted. Against this background and in recognition of the need to deliver a balanced package to both the industry and consumers, the Commission has also announced plans to investigate, for the first time, possible measures on foreclosure prevention, as a counterpart to preparing measures focussing on the length of enforcement procedures. To this end, the Commission will prepare a report setting out existing national practices designed to help consumers experiencing financial difficulties.

A consultation document on responsible lending and borrowing was published on 15 June 2009 with a deadline for comments by 31 August 2009. This will be followed by a Commission Hearing on 3 September 2009. Key policy decisions will likely not be taken before next year when the new Commission and EP are installed.

Conclusion

The European mortgage sector will remain a key driver of the EU economy in the future just as it has been in the past. Each Member State's mortgage market will slowly recover its vitality, at its own pace, as soon as the necessary market corrections have taken place and as both consumers and lenders slowly recover the necessary confidence in each other and in the wider economy in general. The European mortgage industry remains ready and willing to play its part in this recovery and to take action where necessary, including to discuss possible improvements to supervision at the EU level and communication between supervisors at national level.

On the ground, perspectives for the remainder of 2009 and 2010 are marked by the awareness that the consequences of the current financial crisis for mortgage lending and consumer demand for housing loans in the EU have not been as dramatic as is the case in the USA. Moreover, EU governments' various capital injections and guarantee schemes, as well as repeated cuts in central bank interest rates between the 4th quarter of 2008 and the 1st quarter of 2009, are likely to result in significant decreases in mortgage rates for consumers. Such decreases, in turn, would help to sustain demand for mortgage credit whilst at the same time assisting with the restoration of confidence in all market stakeholders across the EU.

2010 will also see the follow-up to the Commission's plans for measures on responsible lending and borrowing, which will undoubtedly have an impact on the EU mortgage landscape. The extent of this impact will remain to be seen but the Industry has warned and will continue to warn against a knee-jerk regulatory over-reaction to the current crisis, which could stifle markets and their recovery. A clear distinction should be made between the US, where a common disregard for responsible lending and borrowing practices in an environment of inadequate supervision and regulation fuelled a crisis triggered by subprime lending, and the EU, where existing incentive structures in the EU regime (e.g. covered bond regulation, principle of first loss remaining with the lender, losses appearing on the balance sheet) coupled with comprehensive supervision result in a cautious and most importantly responsible approach to lending.

EPFSF Memo «Electronic and other Retail Payment Services»

Introduction

Retail payment services, in particular electronic payment services, are increasingly important in the European Union (EU). Banks have been the main service providers offering retail payments but increasingly a number of non-bank payment service providers have been entering the market, such as e-money institutions or, as of November 2009, payment institutions. These service providers offer a broad array of retail payment services ranging from traditional card-based payment methods through to modern electronic or mobile solutions.

The benefits and cost effectiveness of electronic payments is nothing new to regulators and policy makers in Europe. In fact, the policy objective to increase the total share of electronic payments is virtually unanimously accepted. Replacing divergent national rules and technical standards with harmonised European ones – which is the objective of the Single Euro Payments Area (SEPA) and the internal Market for Payments – is a step closer to this objective as well as a step closer to making the European economy the most competitive in the world.

The SEPA process and the concept of the Internal Market for Payments is wholeheartedly supported by the payments industry. However, in order to provide SEPA compliant products and services, industry in general is required to make considerable investments to upgrade and change infrastructure, systems and processes. The costs for these investments are borne primarily by financial industry – and though they are considerable – pose no major concerns provided that the financial industry is allowed by regulators to use business models that are sustainable in the long run.

Little recognition of the tremendous value

Electronic payments are often not given a second thought though they are an essential part of our everyday lives and a pillar of the European economy. We therefore easily underrate the benefits that they bring to us as consumers, as business, as government or even to society as a whole consequently creating a discrepancy between their perceived value and the cost of producing and supplying them.

Perhaps the easiest way to grasp the true value of electronic payments is to envision a world without them. Many facets of commerce - travel, trade and the internet, just to name a few - would face dire consequences. While cash still has a place, it lacks the speed, convenience and security that customers, businesses and governments demand in today's fast-paced, interconnected economy.

Though cheaper than cash – electronic payment services cost money

Like any valuable service, electronic payments have costs associated with their production and supply: continuous upgrading with respect to new norms and rules is one we have already addressed, innovation and development of new products and increased safety features are another, and, last but not least - there are the operational costs linked to the provision of the payment service. Competing payment methods such as cash is no exception as it too has costs attached to it: printing and minting, security and transfer of cash, inventory holdings, storage facilities and overheads associated with the handling, dispensing, loss and theft of cash – though it is perceived "free to use" – a fact that is not sufficiently acknowledged or taken into account.



Actually the social cost of electronic payments compares favourably to that of cash - a fact vindicated over and over again by a number of studies carried out by Central Banks. Regarding cards the ECB e.g. has stated: «*The potential benefit of cards replacing cash as a means of payment is considerable. For consumers, using cards instead of cash will considerably reduce transaction costs*», the Swedish Central Bank stated that «*debit and credit cards are socially less costly than cash for payments above EUR 8 and EUR 18 respectively*» and the Finnish Central Bank stated that «*the unit (social) cost of cash transactions is EUR 0.30 and the unit (social) cost of card payments is EUR 0.26*»

Electronic payments – transparent cost

A person making or receiving a payment by cash derives immediate value without having to pay - or even be aware of - the full cost linked to cash payments. This discrepancy between the value and the perceived cost derives from the fact that cash is legal tender and that the full cost of cash is borne by society with no obvious link to the actual transactions. This is neither efficient, transparent, nor desirable.

The value of electronic payments is also very clear and is illustrated by the considerable increase in the number and volume of electronic payment services over time. Contrary to cash, the cost of the electronic payment service is borne by those users benefiting from it – as is the case for any commercial service.

Unlike the case for cash, the cost for electronic payments is set taking into account the actual «production cost» (externalities and network effects) of the service and the value to the persons making and receiving the payment service. Those using electronic payments therefore get a clearer and transparent appreciation of the cost linked to the provision of the payment service which can be broken down and quantified more easily.

This is the most transparent, fair and efficient way of operating payment services. Because the cost of electronic payments is more transparent and quantifiable it unfortunately has come under increased scrutiny and calls for regulation.

EU and the electronic payments industry

Industry, government and society more widely have a shared responsibility in reducing cash's share of payments in Europe. Industry, on the one hand, is making the necessary investments in order to provide SEPA compliant products and innovative solutions as one step in this direction. Governments, on the other hand, need to lead the way by being 'first movers' in the migration towards the SEPA compliant instruments as well as, together with the financial industry, building more awareness of the benefits of SEPA to consumers, merchants, business and society as a whole, as awareness is critical for its ultimate success. However, above all, what is needed is recognition from regulators and policy-makers of the importance of sustainable business models for the payment service providers. In other words recognition - that all those benefiting from the payment services need to pay their fair share of the cost - is required, just as is the case for any commercial service.

Remittance services

Not all retail payments are made electronically yet. Remittances include consumer-to-consumer cash transfers, both domestic and cross-border. The best-known example for this type of retail payment is workers' remittances, where one family member supports his family living abroad with frequent, small-sized payment transfers back to home. According to the World Bank, global remittance flows have risen strongly and reached almost US\$400 billion in 2008, thereby dwarfing official development aid. Both the European Commission and the ECB have started to show great interest in the subject of remittances from both a development policy as well as from a regulatory point of view, in particular since the Payment Services Directive (PSD) will harmonise and streamline the licensing regime for all non-bank payment providers, including remittance service providers, as of November 2009.

Conclusion

The SEPA project remains a key priority for the retail payments sector. The European Payments Council (EPC) has delivered the basic milestones for the SEPA process. Banks and other payment service providers are investing considerable sums to provide SEPA compliant products. Regulators and policy-makers on their end need to recognise the importance of sustainable business models and provide support to the SEPA process by being early movers towards SEPA compliant products - while actively raising awareness of the benefits of SEPA to consumers, merchants and society as a whole. Policy-makers also have a key role to play in the speedy and proper transposition as well as implementation of the Payment Service Directive.



EPFSF Memo «Pension Funds»

Introduction

Pension funds play an important role in Europe by contributing to the delivery of adequate and sustainable retirement income to future generations. In addition, pension funds stimulate economic growth by supplying the European economy with a steady flow of long-term capital.

Overview of European pension funds

European pension funds annually collect 150 billion euro in contributions and pay out 125 billion euro in retirement benefits. European citizens have accumulated over 3000 billion euro (2007) in retirement savings in pension funds, which amounts to about 25 percent of GDP. The latter figure conceals though huge differences between individual countries. Traditionally, occupational pension funds have – as a percentage of GDP and based on pre-2008 data – a large presence in the Netherlands (138%), Iceland (134%), Switzerland (119%), the UK (79%), Finland (71%), Ireland (47%) and Denmark (32%). In all other Member States pension fund assets are below 15 percent of GDP.

Occupational pension funds administer retirement plans that are part of employee compensation packages or collective labour agreements negotiated by the social partners. Those plans are very diverse with respect to targeted benefits, indexation of accrued rights and pensions and the distribution of risks. This is largely attributable to a wide variety in state pension provision as well as social and labour law requirements in each member state. In the past decades, we have witnessed a trend from defined benefit plans (DB) – in which risks are shared between employers and/or employees – towards defined contribution schemes (DC) that shifts investment risk to individual plan members. Furthermore, the shift towards DC tends to be accompanied by an overall reduction in contribution levels, resulting in lower levels of retirement wealth.

The economic literature shows that people for retirement do not save enough by themselves and make poor investment decisions. This issue can be addressed by organizing collective pension schemes for which pension funds are efficient vehicles. They are well-equipped to develop an independent investment policy that caters to the best interest of plan members and is implemented by financial professionals. Despite their collective character, pension funds can be structured to offer pension solutions that are to a significant degree individualised. In DC schemes, they can also mitigate investment risk by providing minimum guarantee and developing a life-cycle approach towards investments. An additional strength of pension funds is their ability to provide life long retirement income at very low costs. This can be explained by their size: they can exploit economies of scale in investments and pension administration and obtain wholesale prices for external asset management and other financial services.

Ensuring adequate and sustainable pensions

Europe faces the major challenge of providing adequate and sustainable retirement income to its citizens. At the moment, there are four persons of working age for every retiree, but due to the population ageing this will decrease to only two people of working age in 2050. As a consequence, public pay-as-you-go schemes will become increasingly hard to afford in the coming decades. Pension expenditure will rise, while the number of people to support this expenditure will decline.

Many governments have responded to this demographic trend by reforming public pension provision. The European Commission projects that public pension replacement rates are to fall by on average 25 percent in EU member states by 2050. The economic and financial crisis will exert additional pressure on state retirement provision. The recent turmoil has already resulted in upward revisions of government budget deficits and public debt.

Hence, there is the need for retirement income diversification to prevent or minimise the risk of old-age poverty. Capital funded private and occupational pensions need to be further developed to increase their coverage ratios and include the population at large. Pension funds are particularly well-suited to cater pension contracts to companies and industry sectors.

In a number of countries pension funds already play an important role in supplementing first pillar pensions. In other Member States pension funds are assuming growing relevance as governments are encouraging workplace pension provision.

Enhancing EU competitiveness

European pension funds are sizable investors in international capital markets. Their assets represent 10 percent of the capitalization of EU bond and equity markets. Pension funds allocate about 40 percent of assets to equities.

These figures illustrate that pension funds are an important source of long-term capital. European industry can rely on a steady supply of capital reducing the cost of capital for companies. This stimulates investments and, hence, increases economic growth and employment creation. In addition, capital deepening will improve long run productivity growth. As such, pension funds significantly contribute to enhancing competitiveness of the European economy.

As very long-term investors, they also contribute to the stability of financial markets. Pension funds can sit out short-term volatility on financial markets and face low liquidity risk as most pension liabilities do not fall due for decades to come. Moreover, they only invest their own money and do not engage in financial leverage. As a consequence, pension funds do not have to act as forced sellers during bear markets.

Pension funds tend also to be insulated from short-termism since they often have long-term shareholder relationships with companies. Pension funds may wish to have an interest in companies being managed in a responsible and sustainable manner. Therefore, many pension funds have active shareholder policies in place and include – as part of broader responsible investing initiatives – corporate governance criteria into the investment decision-making process.

Advancing capital market integration

In 1999 the European Commission introduced the Financial Services Action Plan 1999-2005 (FSAP) to advance European financial market integration. A key priority in the FSAP was the introduction of an EU-wide regulatory regime for pension funds as the development of occupational pension provision acts like a two-edged sword. It will contribute to providing European households with adequate retirement income and European industry with a steady flow of long-term capital.



The prudential framework for institutions for occupational pension provision (IORP) was adopted in 2003 and implemented by all Member States in 2007. The IORP Directive is a first step towards the creation of an internal market for occupational retirement provision. The Directive lays down minimum standards for the operation of IORPs. The prudential regime is based on minimum harmonisation with mutual recognition and home country control. Pension funds should have sufficient assets to cover future pension expenditures, dispose of qualified governing bodies, practice sound administrative procedures and adequate internal control mechanisms and be transparent about the target level of benefits, risk exposure and investment management fees. Currently the European Commission is investigating whether any further harmonisation of solvency rules is necessary for those IORPs that engage themselves into a specific liability – without any other backup mechanism, such as an employer’s covenant – as well as for cross-border IORPs.

In the IORP Directive investment regulation is based on the prudent person principle. This opened up the European capital market as it is no longer appropriate for Member States to impose quantitative restrictions on foreign investments by pension funds.

Pan-European pension funds

The IORP Directive contains another innovative feature in that it enables the establishment of pan-European pension funds that manage the pension schemes of employees in different Member States. Cross-border pension funds continue to be subject to the supervision of the home Member State, but have to apply the social and labour law of the host Member States. However, when engaging in cross-border activity pension funds have to be fully funded ‘at all times’, a requirement that is an exception to the mutual recognition principle.

A pan-European pension fund offers multinational companies with an in-house solution to optimize the management of their various retirement schemes. It will lower costs by exploiting economies of scale in pension administration and investment management, but it will also simplify governance as the company’s management no longer has to oversee multiple pension funds. Higher efficiency will benefit employers as well as plan members in terms of lower contributions and higher retirement benefits.

Especially, non-EU headquartered corporations are keen to set up a ‘European’ pension fund that can manage the occupational schemes across the EU. Viewed from this angle, the possibility to establish a pan-European pension fund helps attracting foreign direct investment into the EU.

Conclusion

Pension funds weathered the storms on financial markets rather well. They have suffered decline in funding levels due to the asset decline on the stock markets while at the same time bringing stability to turbulent markets by pursuing an anti-cyclical investment policy. The financial crisis has also highlighted the importance of pension fund governance and risk-management systems to control investment and other risks.

In the next decades, pension funds – like other financial institutions that provide funded pensions – will gain more relevance in overall retirement provision to EU citizens. The diversification of retirement income is key to ensure adequate and sustainable pension provision in Europe.

EPFSF Memo «Securitisation»

Summary

Securitisation is the process of pooling cash-flow-producing financial assets into securities which are then sold to investors. Securitisation provides a significant source of funding for the owners of the cash-producing assets, it broadens the availability and lowers the cost of credit to consumers, companies and governments, and it allows investors to diversify their risk exposure. However, the financial crisis has revealed weaknesses in specific areas of this market that both the industry and public sector are taking steps to address. This paper outlines the key components of and parties to the securitisation process, the importance of securitisation to the provision of credit, and the securitisation related issues raised by the crisis and initiatives taken to address these. The paper concludes with high-level remarks on the future of securitisation.

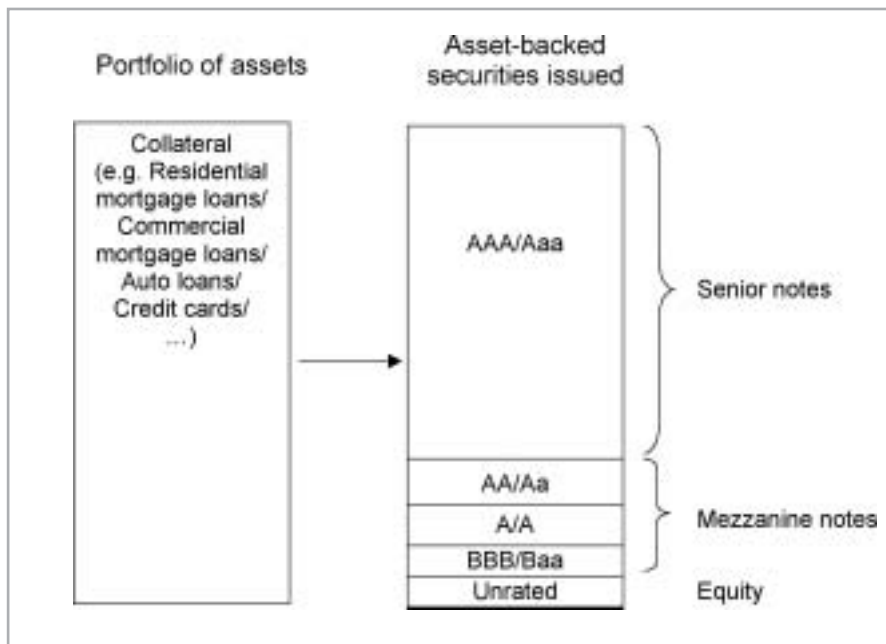
What is Securitisation?

The Securitisation process is started by an 'Originator' (typically a company looking to raise funding, or manage its risk) who owns the cash-flow-producing assets (e.g. mortgages, credit card balances, car-loans and securitised assets) or an equivalent synthetic position in credit derivative form, although the discussion below focuses purely on cash securitisations. The Originator pools the assets into a suitably large portfolio which is then sold to an 'Issuer' (typically a 'bankruptcy remote' (i.e. not affected by the bankruptcy of the Originator) 'Special Purpose Vehicle' created specifically to fund the purchase of the assets).

To be able to buy the assets, the Issuer issues tradable securities. Depending on the asset used as collateral, these can be categorised as Residential Mortgage Backed Securities (RMBS); Commercial Mortgage Backed Securities (CMBS) and Asset-Backed Securities (ABS) – the latter comprising securities backed by financial assets other than residential or commercial mortgages, such as credit card receivables, auto loans, commercial loans, and already securitised assets.

Investors purchase the securities, either through a private offering (targeting institutional investors) or on the open market. The cash flows to pay interest and principal on the securities are directly derived from the cash flows on the underlying assets. Payments are collected and assets monitored by a 'Servicer' (who is often but not always the Originator). Investor expectations as to the performance of the securities are informed by their credit-risk profile and repayment structure.

Securitisation bonds are (unlike corporate bonds) tranching (see diagram below); meaning that a number of bonds will be issued with different credit qualities, backed by a single pool of assets. A variety of internal and external credit supports are typically used to increase the likelihood that investors in the senior or mezzanine tranches will receive the cash flows to which they are entitled. A popular type of internal credit support is the senior/subordinated structure characterised by a senior class of securities and one or more subordinated classes. If an underlying asset or assets (e.g. a loan) in the pool defaults, any loss incurred is absorbed first by the subordinated securities while the senior tranche if the losses exceed the entire amount of the subordinated tranches. The senior portion of a securitisation is typically rated AAA while the lower-quality (but higher-yielding) subordinated classes receive a lower rating or are unrated. In addition to internal credit supports, some securitisations use external credit enhancement from third parties such as an insurance company or a bank who undertakes to reimburse the securitisation (or typically the more senior tranches) for losses incurred. Credit rating agencies publish ratings of asset-backed securities based on the performance of the collateral pool, the credit enhancements and the probability of default



Unlike corporate bonds, most securitisations (typically those other than credit card or RMBS master trust structures) amortise, meaning the bond principal is repaid gradually over the specified term of the bond rather than in one lump sum at the maturity of the loan. The possible rate of repayment varies widely with the type of underlying asset pool so a variety of controlled amortisation structures have evolved to provide investors with a more predictable repayment schedule. Securitisations are often paid off in a sequential manner based on maturity. This means that the first tranche (which e.g. has a one-year average life) will receive all principal payments until it is retired; then the second tranche begins to receive principal, and so forth. Pro rata bond structures pay each tranche a proportionate share of principal throughout the life of the security. With respect to interest payments, mortgage or asset backed bonds can be issued with a fixed or floating interest rate. Fixed rate securities set the 'coupon' (rate) at the time of issuance, in a manner similar to corporate bonds, while 'floaters' will periodically adjust up or down according to a designated index or reference rate such as LIBOR. Foreign exchange and/or interest rate swaps are used to manage the differences between the required payment profile and the flows on the assets.

Role of Securitisation

For companies that have assets with contractual or predictable cash flows, securitisation provides an important source of funding. Securitisation can also reduce the cost of that funding (a company rated BB but with AAA worthy counterparties may be able to borrow at much more favourable rates by selling on their cash flows). It also reduces the asset-liability mismatch by allowing credit institutions to create a self-funded asset book and lowers their capital requirements in so far as securitised assets are removed from their regulatory balance sheets. In addition, securitisation allows originators to lock-in the profits for a given block of business and therefore lower earnings volatility. It also makes it possible to transfer risks from an entity that does not want to retain all of the risk to an entity that wants to purchase that risk, thereby providing a means to manage risk concentrations. On this basis, originators that are credit institutions are able to increase the availability and diversity of credit products and reduce the cost of credit for consumers, companies and governments.

For investors, securitisation offers: attractive yields (e.g. among AAA rated assets, ABS offer higher yields than comparable-maturity government securities); high credit quality (secured by collateral and credit enhanced by internal features and external protections); investment diversification (the diversity of the ABS sector in terms of structures, yields, maturity and collateral allows investors to diversify their fixed income portfolios); predictable cash flows, and reduced exposure to disruptive events affecting the Originator (because of the bankruptcy remote structure).

Over 2006 and 2007, more than 90% of European securitisations (over EUR 800 billion) were issued and helped finance European companies' and citizens' needs. They were backed by a variety of different assets, including residential and commercial mortgages, SME and other corporate loans, infrastructure receivables, trade receivables from companies, lease receivables on autos, equipment and aircraft, consumer and credit card debt, and government receivables (i.e. tax and social housing receivables).

Impact of Crisis and Initiatives to Restore Securitisation

The bursting of the US property bubble in the summer of 2007 caused a sharp downgrade of the small percentage of securitisation and re-securitisation transactions that had US subprime mortgages as underlying collateral, thus causing a loss of confidence in the broader securitisation market resulting in reduced market and funding liquidity as well as valuation losses. The crisis also highlighted that a number of highly complex and leveraged transactions (e.g. Collateralised Debt Obligation (CDO) of ABS, or "CDO squared") had evolved out of the basic securitisation model in response to the investors' search for yield. The securitisation market has remained largely shut since that time.

However, in recognition of the importance of securitisation, both public bodies and market participants have conducted analysis to identify weaknesses in securitisation and launched initiatives to address these.

A number of initiatives from the public sector are in progress in Europe, the US and from the international standard setters to address the following main issues: misalignment of incentives between participants in the securitisation chain; poor underwriting standards in certain markets; risk management shortcomings; incentive distortions in the regulatory framework; poor investor due diligence (including over reliance on ratings); lack of information to enable good due diligence and weaknesses in disclosure.

The capital markets industry has acknowledged that certain business practices and controls should have been different and must be improved. The industry has therefore developed and delivered initiatives to align incentives, improve due diligence disclosure standards and enhance transparency in the securitisation market.

Conclusion

Securitisation is widely recognised as a significant mechanism for providing the financial system with the capital needed to finance demand for consumer and business credit and thus the stability and growth of the European economy. The remedial steps that have so far been taken will need time to take effect, but it seems clear that when securitisation does return, it will likely have a different profile to that existing prior to the financial crisis and it is unlikely that the more complex and problematic structures will return at all. In the meantime, certain governments in Europe and the US are proposing government supported schemes that aim to facilitate the return of securitisation, sending a strong signal that securitisation has a role to play as part of the exit strategy to the current crisis.







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