Date: 4 December 2012

ESMA/2012/803

Rebuilding investors trust in EU capital markets

DSW/EuroFinuse Conference

Wiesbaden

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Ladies and gentlemen,

Thank you for your invitation to speak here today in Wiesbaden about ESMA's work in supervising the EU's capital markets and how it impacts on investors in those markets.

As this is the first time I have had the opportunity to address this audience, I would like to give you a brief overview of ESMA, before moving on to address financial consumer protection topics, which I hope will be of interest to you before lunch today.

In June 2009, the Heads of EU Member States and governments called for a move towards more harmonised regulation and integrated European supervision to tackle the effects of the crisis and to ensure a true level playing field for all actors at the EU level. This reflected not only our attempt to tackle the fallout from the financial crisis, but it also responded to failings in the areas of cooperation, coordination, consistent application of Union law and a lack of trust between national supervisors.

This led to the establishment of the European System of Financial Supervision and the creation of the three new European Supervisory Authorities, or ESAs, for securities, banking and insurance in on 1 January 2011. The new system's objective is not only to secure a more robust legal framework for financial markets and all its players, but also to provide benefits to investors and the wider economy. Moreover, the benefits of a single financial market in the EU are even more obvious when looking at the alternative: 27 separated and isolated financial systems functioning with their own rules.

ESMA, as one of the three ESAs, was given the mission of improving the protection of investors and promoting stable and well-functioning financial markets in the EU. ESMA replaced an existing European advisory body - the Committee of European Securities Regulators – and while ESMA continues to provide technical advice to the European Commission it now has an expanded remit compared to its predecessor, including supervision of credit rating agencies, the power to write technical standards, ensuring the correct application of EU law by national competent authorities, delivering opinions on legislation, and coordinating responses in emergency situations.

Before I move on to talk about some of our specific work on financial consumer protection, I would beg your indulgence in allowing me to dwell on the concept of trust in financial markets. The trust that existed between market participants, which has been undermined over the last five years and which must now be slowly and painstakingly rebuilt.

Trust

Those of you who have an interest in the history of financial markets know very well that trust lies at the root of the development of our securities markets. Public companies and stock markets, which have been so important for the development of our economies and the generation of our wealth, cannot exist without trust. In essence, the level of trust needs to be at such a high level that savers are willing to transfer some of their carefully saved income to another person, who they do not know personally, and who will use it to undertake a productive activity. Considering the many potential risks involved, it is remarkable that we have been able to achieve the level of trust needed for the functioning of large and complex financial markets.

Applying the concept of trust to the world of securities markets of today, it is clear that investor trust has been severely undermined. It is also clear that to let our economies grow again and to move out of the current difficult economic phase, investor trust needs to be restored. However, while losing trust can happen quickly, restoring trust is difficult and takes time.

In my view, two main factors have been responsible for undermining investor trust, one related to the overall condition of our economies, and one related to the performance of the financial services sector.

On the first factor, a lot of investors' distrust and aversion to risk is related to the current fundamental problems in our economies. If I can only use a few words, the core of these fundamental problems consists of the high indebtedness of banks and sovereigns and the strong link between these two groups. In particular, the problems of indebtedness of Eurozone banks and sovereigns have resulted in high levels of risk aversion amongst investors.

I will refrain from adding to the impressive number of analyses and comments provided on these economic issues. However, as a securities markets regulator I would like to make just one remark. Growing our economies is one of the central themes in the current policy debates as it is obvious that without growth, solving the debt problems of the public and private sector will be extremely difficult. It is accepted that Europe's banking sector is very large both in relative and absolute terms and that compared with the US and emerging markets, EU companies rely more heavily on bank funding rather than funding based on securities markets. The current hope is that with a struggling banking sector, securities markets can to some extent take over the role of funding economic activity and growth. While I believe that it is important to think about policy measures which can help to improve securities markets as a source of funding, all these policy measures will not be effective without first solving the Eurozone's problems.

Let me now move to the second factor which has contributed to the undermining of investor trust. Investor trust is also low as a result of longer term problems in the financial services sector. Investors and financial consumers currently have very limited trust in the financial services sector. As always, this lack of trust is the result of various factors. First and foremost, investors and financial consumers have too many times experienced poor service performance resulting from a lack of transparency, promises of unrealistic expected returns, and unexpected hidden costs. In some cases, this has resulted in financial consumer scandals and the payment of compensation to investors. The reputation of the sector has also been harmed by the poor behaviour of some financial sector executives and traders.

Regaining the trust of investors and financial consumers is primarily a task for the financial services sector. As I am convinced that a sector can only be viable in the long term when it is trusted by its consumers, therefore it is also in the self-interest of the financial services sector to restore this trust. Regulation and supervision can support the industry in its moves towards regaining users trust and confidence.

Rebuilding Investor Trust

I would now like to turn to how ESMA has contributed to rebuilding investor trust through a series of concrete initiatives aimed at strengthening the European framework for investor protection. In July 2012, for example, we published two sets of guidelines aimed at enhancing investor protection. One set concerns the suitability of advice under MiFID and the other deals with investment firms' requirements regarding their compliance function. As you are aware, before recommending a specific product, an advisor needs to take client information into account like the investment objective, his or her financial state of affairs, and the client's expertise and knowledge.

While we are on the subject of suitability of advice under MiFID, I would like to mention that inducements provided to advisers are an important factor leading to unsuitable products being recommended to clients. I firmly believe that the problem cannot be solved by yet more transparency alone. I fully support the ban on inducements in certain situations as included in the proposal by the Commission for MiFID. At a minimum we need to ban inducements in the case of discretionary portfolio management and when an advisor wants to use the *independent* label.

Getting the incentives right for providing good advice to clients is in all of our interests. Tackling poor incentives only via corrective measures like internal controls and external supervision can add costs and will too often fail to achieve the desired outcome. I therefore hope that the European Union will follow the example of some member states and move to ban inducements.

I am convinced that banning inducements will contribute to the development of a viable business model with a high level of investor trust – although this will also require efforts to improve financial awareness among investors. I do understand that it will take some adjustments, both on the industry side and the investor side, to move to a new business model without inducements. Therefore, allowing sufficient time to all stakeholders to adjust before a ban is introduced would be reasonable.

I know that concerns have been raised that banning inducements might affect the competitive positions between banks and advisors or intermediaries. These competition concerns vary to some extent with the predominant distribution model. In some EU Member States banks are the main distributers of financial products, while in other Member States intermediaries and independent advisors are an important distribution channel of financial products. Whatever the distribution model, we should ensure there exists a level playing field between the various distributors.

Advisors and intermediaries, especially, have raised concerns about how a ban on inducements may negatively affect their competitive position. Banks can recommend products that they have originated and therefore there are no explicit inducements involved. However, there still can be conflicts of interest in this situation. When offering a range of products, advisors within a bank might be tempted to be biased towards their in-house products or to those in-house products with a higher benefit to the bank. To address this risk we should not only look at inducements, but also look at the remuneration of advisors and sales staff in financial institutions as I see inducements and remuneration as different sides of the same coin.

Consistent with that line of thinking ESMA published a consultation paper in the autumn on proposed guidelines on remuneration policies and practices under MiFID. The guidelines aim to strengthen investor protection by seeking to improve the implementation of the MiFID rules on conflicts of interest, thereby preventing mis-selling of products.

The guidelines will apply to investment firms, fund management companies when providing investment services, and to credit institutions. Firms must ensure that they have appropriate remuneration policies and practices in place, bearing in mind the obligation on firms to act honestly, fairly and professionally in the best interests of their clients.

As stated earlier, during the last few decades we have seen a number of mis-selling scandals affect the retail investor across Europe. A key factor identified as a driver for the promotion, recommendation and selling of unsuitable products is the presence of financial incentive schemes for sales staff that do not take account of the clients' best interests.

The proposed remuneration guidelines for MiFID investment firms are key to ensuring that the pay and incentive structures for sales staff and their superiors do not create false incentives when selling financial products to retail investors. The consistent application of ESMA's remuneration guidelines will help strengthen investor protection and achieve the same level of protection for Europe's retail investors no matter where they invest.

Before I conclude on this element of investor protection let me mention that ESMA has also exercised its power to issue warnings to investors. In December 2011, ESMA issued a warning on the main risks involved in forex trading, and this September we issued a warning on using the internet for investment purposes, following an observed rise in complaints reported by national authorities.

As you might have noticed, in my speech so far I have not been very precise in the use of the terms 'financial consumers' and 'investors', and have discussed issues relevant to both groups. While the terms somewhat overlap, 'investors' typically refers to those directly investing in securities, 'financial consumers' refers to a broader group, including those consumers buying a wide scope of financial products like structured products, securities products with an insurance element, and plain vanilla investment funds.

In the remainder of my contribution I will focus on the protection of the traditional investor. This is the type of investor that might actively search and analyse information from issuers, and transparency and high quality financial information are essential for him or her. Supervisory initiatives addressed at improving the information provided by issuers are an important tool to rebuild trust of this group in Europe's capital markets.

Firstly, ESMA is heavily involved in the completion of the revision of the Prospectus Directive, one of whose objectives is to facilitate access by issuers to capital markets. As requested by the European Commission, ESMA has provided technical advice on proportionate disclosure to make access by SMEs to capital markets easier and less costly.

Secondly, in order for investors to regain confidence in financial markets, we consider that they need access to appropriate and reliable financial information. To ensure that the information they receive is clear, understandable and useful in their decision-making, the proper enforcement of IFRS is crucial and ESMA has started to play a very active role in ensuring the consistency of the enforcement of these rules by the various competent authorities in the EU.

ESMA strongly believes that financial reporting with strong measurement principles along with entity-specific and relevant disclosures reflecting economic substance are important in underpinning market discipline. This contributes to investor protection and stability. Market discipline can only be achieved through the development and application of high quality accounting standards, which is where the International Accounting Standards Board (IASB) has an important role to play, by developing clear, auditable, enforceable and globally accepted standards

In the EU, the supervision of financial statements and their subsequent enforcement falls within the competence of national supervisory authorities. However, the benefits of strong enforcement could disappear within the EU if we do not aim to improve on the consistent application at the Union level, and enhance comparability within the single market and at the global level. Therefore, consistent application of IFRS needs pan-EU coordination, which is one of ESMA's primary objectives. I have spoken about how ESMA does this in practice during past speeches and will not repeat myself here.

In support of this pan-EU coordination, ESMA recently published a set of common enforcement priorities in the EU. This is the first time EU enforcers have agreed on common enforcement priorities highlighting the areas on which all EU enforcers will focus when reviewing 2012's financial statements. These common areas are:

a) financial instruments;
b) impairment of non-financial assets;
c) defined benefit obligations; and
d) provisions that fall within the scope of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.

I would like to briefly comment on two of these areas:

- *Financial instruments*: since the beginning of the financial crisis, transparency related to financial instruments is a top priority. Issuers should provide disaggregated and expanded disclosures on material exposures to all financial instruments – not only sovereign debt exposures – that are exposed to risk. We would expect relevant quantitative and qualitative disclosures reflecting the nature of the risk exposure, elements related to the valuation of the instruments as well as an analysis of the concentration of exposure to relevant risks.

- *Impairment of non-financial assets*: the current economic situation increases the likelihood that the carrying amounts of assets might be higher than their recoverable amounts. The market value of many listed companies has fallen below their book value, a situation potentially indicating impairment and thus the need for an impairment test. ESMA considers that particular attention has to be paid to the valuation of goodwill and intangible assets with indefinite life spans, whenever significant amounts are recognised in the financial statements. ESMA emphasises the need to use assumptions that represent realistic future expectations and would expect issuers to provide entity specific information related to assumptions used, when preparing discounting cash flows (such as growth rates, discount rate and consistency of such rates with past experience) and sensitivity analyses.

For further information on our four enforcement priorities I suggest that you consult our website. However, let me make one general concluding remark on this topic: for all four priorities we highlight the need for improved disclosures. That is not because ESMA believes that disclosures could replace the recognition or measurement principles, but rather that it allows issuers to provide investors with high-quality information within a principles-based environment. We think that the IASB should set objective-based IFRSs (such as is currently the case with IFRS 7 – *Financial Instruments)* allowing a company's management to align it as best as possible to its own situation. However, a principles-based environment can only survive if clear and entity-specific disclosures, re-assessed at the end of each reporting period, bring useful decision-making information to investors. If not, detailed prescriptive requirements would need to be developed and we all know that what is important today will not necessarily be so in the next financial year. The only way to avoid this is to stop providing boilerplate information directly mimicking the standards.

Forbearance

Following on from our enforcement priorities, I would like to highlight two developments which affects investors indirectly through the banking sector. Firstly, while there have been substantial improvements in recent years, bank leverage is still high and a very important issue of concern. Secondly, many holders of bank loans are impacted by the difficult economic situation in the EU and are struggling to meet their obligations.

Today, there is a practice resulting from these two developments, on which I would like to go into more detail: the practice of forbearance. This concerns the situation where a borrower is in financial difficulties and does not pay on time, and the lender decides to wait and see, perhaps he even renegotiates the arrangement on more favourable terms. If a number of borrowers and banks have problems at the same time, the issue has not only micro but also an important macro-prudential dimension. We are thus working, even more closely than usual, with the European Banking Authority and the European Systemic Risk Board in this area. The latter's Advisory Scientific Committee issued an interesting report on forbearance and bank resolution in July 2012.

Under the practice of forbearance, the lender hopes to get his money back, waiting to see whether the borrower will eventually pay up which means taking a risk regarding the borrower's ability or willingness to pay. If the risk turns out badly and the bank's solvency is affected, some of the costs are borne by its creditors and, possibly, the other financial institutions and general taxpayers contributing to the funding of the resolution of the bank. While forbearance can in some cases be justified and economically rational, it can also become a waste of additional resources if the banks continue to lend to their old debtors rather than to new clients. Continuing to lend to old debtors may be a way of "kicking the can down the road", so to speak, avoiding a credit event that would have to be entered into the books, but continuing to lend to old debtors may also be a case of throwing good money after bad. From the perspective of the overall economy, such a use, or misuse, of funds is an impediment to economic growth. Even if the old borrowers do not receive any new funds, banks with weak balance sheets may reduce new lending in order to make their balance sheets appear stronger, rather than by writing off old loans and recapitalising.

Personally, I think that Europe can learn a lot from the Japanese experience of the 1990s, which demonstrates some of the perils of forbearance. When the Japanese banking crisis began in 1992, it was known, or it should have been known, that many loans in the bank's books were worthless. However, fears of write-offs inducing open insolvencies motivated forbearance by banks towards borrowers and of supervisors towards banks. The avoidance of write-offs and the failure to acknowledge insolvencies had large economic and social costs. As banks continued to lend to problem borrowers, lending to new firms fell and growth slowed or stopped completely. Today there seems to be a consensus in the academic community that the strategy of "denial, deferral and opaqueness" was one of the main reasons why the Japanese crisis lasted for more than a decade, during which it stifled economic and social development.

For this reason, I believe that it is important for lenders to clearly reflect in their financial statements the credit risk they are exposed to in relation to forbearance. They should do this by providing clear disclosures (including both qualitative and quantitative information) that help investors to understand the extent of the forbearance practices when the exposure is material and to evaluate the need for potential impairments.

Empty Voting and Proxies

In drawing to a close on issuers, and moving beyond the topic of transparency, ESMA has become more active on topics directly related to corporate governance. Last year, we examined empty voting and considered that the issue, at least for the time being, was not justifying regulatory intervention.

Another corporate governance issue we are currently looking at is proxy advisors and we have recently closed a consultation on this topic. We have studied in detail the key role that these entities are playing in the involvement of shareholders in the general matters of corporations. Though we have identified a few issues such as potential conflicts of interest, it is likely that ESMA will not suggest regulating this part of the financial industry but rather push proxy advisors to come up with a code of conduct built around key principles. Lastly, ESMA is likely to do some work around the Takeover Bid Directive and more precisely on the notion of "acting in concert".

One final area of ESMA's activities I would like to refer to is that of financial stability. Traditionally, securities market regulators have had a stronger focus on investor protection, transparency and conduct of business, while treating stability as the poor relation. One of the lessons of the financial crisis is that stability issues should receive much more attention from regulators. While we still have a major focus on investor protection, transparency and conduct of business, we now also fully take into account in our work possible stability issues in securities markets. This additional perspective is badly needed with, for example, investment funds being heavily involved in securities lending and repo transactions, and market infrastructure such as CCPs being under the remit of securities regulators. Of course, the stability perspective is also important to protect investors: in the past years, many investors have paid a very high price for instable financial markets.

Conclusion

Let me once again thank DSW for affording me the opportunity to speak about ESMA and how we are, through our work on the single rulebook, convergence, supervision and financial stability, working to support and promote stable and well-functioning financial markets and to enhance investor protection in the EU. It is my earnest desire that this will go some way also towards restoring investors' trust in our financial markets.

I would like to leave you with a final thought today. Many parties are involved in rebuilding our financial markets. And as you are aware, the decisions that we take today, will determine the shape of financial markets for many years to come. To do its work, ESMA needs the input not only from national regulatory authorities, market participants, and European institutions, but also from you, the investors and shareholders of Europe. Hence, it is extremely important that you also actively participate in rebuilding our financial markets and ensure that your voices are heard.

Thank you for your attention.