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All eyes on market liquidity

Editorial

Europe will finally have an answer to the Brexit issue on 23 June. If the "leave" vote prevails, our industry will face a major upheaval because the City is the world's leading financial centre.

In that event, the UK would officially have two years to negotiate its future relationship with the European Union. At one end of the spectrum lies a Norway-type situation. Here, in order to enjoy free trade in goods and services, the UK would adopt European regulations without helping to craft them. That would render Brexit largely meaningless. At the other end is an American-type situation in which the UK is outside the Union, enjoying greater autonomy, with free movement of goods and capital, but to be negotiated on a case-by-case basis. Anything in between these outcomes is possible, so the negotiations would be long and arduous.

During this interim period, which could easily exceed two years, it is unclear how London-based financial institutions would be treated. In theory, firms with a European passport would still be able to offer products and services in the EU. The risk is that their constraints would be loosened, even though they would still have the same status.

Thus the stakes are huge. Brexit is unwelcome, if only because continental financial markets do not stand to gain what London would lose. But one thing is sure: it is vital – and urgent – for Paris market participants to come together and discuss the implications for the French financial industry. But despite AMAFI's repeated calls, little progress has been made.

Brexit is not the only challenge that European markets currently face. With the planned merger of Deutsche Börse and the London Stock Exchange, stock market consolidation is on the move again, this time on a massive scale. The process may take a long time, and the Directorate General for Competition will play key role in it. The merger would raise numerous questions in addition to legal and trading aspects. In particular it would revive the debate about what model Europe wants for its market infrastructures. The risk is that in tomorrow's markets, SMEs and intermediate size companies, which are locally-based, will fall victim to this clash of the titans.

Pierre de Lauzun
AMAFI Chief Executive

Feature

Recent periods of turmoil have shown that market liquidity has weakened and that a serious crisis may be looming. Since liquidity is strategically vital to the economy, market participants are hunting for solutions to prevent it from drying up.

The issue troubling many financial institutions and asset managers at the moment is whether liquidity is about to dry up. The 2008 subprime crisis provided ample evidence of what can happen at the onset of a liquidity crisis as trust evaporates and the entire financial mechanism grinds to a halt. That crisis has since blown over, but market liquidity is currently showing worrying signs of shrinkage. Liquidity is an equivocal concept with varying definitions and different forms. Market liquidity is usually defined as the ability to buy or sell an asset in a reasonable timeframe without unduly affecting the price. It enables price formation and determines whether market participants are able to obtain funding or hedge their risk exposures cost-effectively.

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By that measure, the market liquidity situation has been a cause for concern since spring 2014 due to a spate of flash crashes – short periods during which liquidity shrinks or totally evaporates for no rational reason. On 15 October 2014, for example, the yield on the 10-year US Treasury dropped by 33 basis points in minutes. Three months later, on 15 January, when Switzerland announced it was scrapping the 1.20 franc floor on the euro exchange rate, the Swiss market suffered intraday losses of up to 12 per cent. And on 24 August 2015, better remembered as Black Monday, trading in more than 300 ETFs had to be suspended for 35 minutes as a result of a sell-off. The pattern of these events is borne out by statistical analysis. AMAFI reported in a paper *(see box page 3)* that the speed of asset rotation had fallen, along with average deal size, while at the same time investors were having to pay more for order handling. All in all, the evidence shows that market liquidity is in jeopardy. The reasons for the problem, and the possible solutions, are worth looking at.

Incumbent market makers are jumping ship

The most common explanation for markets' recent vulnerability to liquidity shocks is that regulation has been tightened since the 2008-09 financial crisis. Participants blame these regulatory constraints for a scissor effect whereby incumbent market makers are deterred from carrying out their role, even though liquidity demand is on the rise. This situation is due to the tougher capital requirements imposed on banks in the aftermath of the subprime crisis to make the industry more resilient. As the cost of doing business rose, banks reined in their horns and, in some cases, actually discarded businesses such as proprietary trading, which had come under closer regulatory scrutiny. AMAFI noted in its study that the number of market makers per instrument in the corporate bond market fell from nine to four between 2009 and 2013. Meanwhile, demand for these assets has been growing steadily. Central banks have pumped monetary liquidity into their economies, thus maintaining the illusion of market liquidity while lowering interest rates to an unprecedented degree in terms of both scale and duration. For collateral, the banks have launched asset purchase programmes – the European Central Bank is buying as much as 60 billion euros-worth every month – that have crimped the supply of prime assets. In consequence, other market participants have turned to lesser-quality assets, a shift that has been intensified by a search for yield and could contribute to the formation of speculative bubbles. In parallel, the growing appeal of asset management has pointed up the immediate nature of investors' expectations, since the industry could experience a demand for liquidity at any time. Another contributory factor is the development of index investing, which is cheaper than active investing but also less diversified.

Loosening the regulatory straitjacket

Specialists are now warning that a routine crisis which once would have played itself out could now mutate into a major upheaval with systemic repercussions, since private firms are no longer able to provide liquidity when the market is in freefall. Some analysts believe that a process of Schumpeterian creative destruction is underway. In other words, the market is changing radically and new market participants are bound to emerge. That view does not sit easily with everyone. According to Vincent Remay, advisor to the CEO of Viel & Cie and vice-chairman of AMAFI, "We're told that if banks stop making markets, other players will step up to take their place. I don't believe it. BlackRock floated that idea some time ago but no longer talks about it. By and large, asset managers are unwilling to get involved. As for hedge funds, it would go against the grain to entrust such a sensitive function to non-regulated market participants". As for new entrants, the dilemma is simple: "Either they are well-capitalised and will run into the same problems as banks in terms of regulatory capital costs," says Nathalie Gay-Guggenheim, Head of Regulatory Transformation Global GBM Europe, at HSBC Global Banking, "or they aren't, in which case the liquidity they bring to the market is unlikely to hold up if they are unable to retain risk or inventory at the close of trading". It is widely accepted that the trend towards stricter regulation has played an important role in squeezing liquidity at times. Loosening the regulatory straitjacket is vital, in the opinion of Vincent Remay. But there lies the problem because banking resilience is the Holy Grail for prudential regulators. Their stock response to a crisis is that banks should shore up their balance sheets in order to endure if liquidity problems arise. The aim is not to unravel regulations. In Nathalie Gay-Guggenheim's view, "We want banks to be more robust, but we haven't asked ourselves whether that would affect the functioning of capital markets, and if so, how. This is vitally important because these markets are a crucial source of financing for our economies in a post-Basel 3 world. Central banks and market participants seem to agree that we are in the midst of a transition period. Without undermining the foundations of prudential regulation, we need to swiftly make technical adjustments that will give markets some room to breathe, while pondering the optimal market structure for funding the European economy and establishing an appropriate framework for that purpose".

Feature

What solutions?

In the view of AMAFI, the excessive and unwanted effects of regulation should be identified and the prudential standards currently being drafted should be recalibrated to protect market making activities that are still viable. Another proposal is to revise the prudential regulatory treatment of securities issued by small, midsized and intermediate enterprises provided these assets pose no systemic risk to the financial system. Accounting standards are also in the crosshairs. Fair value measurement on the balance sheets of financial institution was introduced by IFRS applicable in Europe in 2005. But the 2008 crisis showed the procyclical effects of this requirement: if a portion of an institution's assets is marked to market and if the market is volatile, then that volatility filters through to the balance sheet, replicates the negative effects observed in the market, and makes them worse through contamination. "If market making remains under the regulatory cosh in Europe, only US firms will be left to do the job. But it would be unreasonable to count solely on the Americans, particularly since they are likely to head back across the pond if the slightest problem occurs," says Vincent Remay.

The onus is now on Europe to address this issue as part of the Capital Markets Union project. But, with the threat of Brexit looming, the willingness to do so is in doubt.

Olivia Dufour, Anthony Bulger

AMAFI Comments Paper

AMAFI published a comments paper on 26 October 2015 (*15-48-EN)* to take the measure of current developments in market liquidity and to examine appropriate responses. Part of the analysis focused on the possible ways forward.

Move from recognising the situation to looking for solutions. While there is broad consensus about the factors underlying the current situation, the solutions are less clear-cut, while the stakes are high.

AMAFI's approach seeks to reflect the complexity of the issue and, more importantly, the effects of overlapping regulatory initiatives. Interactions between the objectives assigned to these initiatives, on the one hand, and market liquidity, on the other hand, call for very careful weighting. This should be done within a broad framework involving the many affected stakeholders, and financial regulators first and foremost.

Address "routine" rather than major crises. The current liquidity situation is worrying because it looks capable of mutating into a major crisis with virtually systemic effects *(see main article).* This is a key point: too often this discussion has been dismissed based on the argument that liquidity providers do not play a role in a systemic crisis, as shown by what happened in 2008.

It is certainly true that during a major crisis, no private firm can proactively provide liquidity if the market is in free-fall, so central banks have to handle crisis management by injecting cash into the system. Yet we cannot deny that market makers play a role during "routine" periods of stress. Risk may be greater than it is during periods of low volatility, but it can be managed by participants equipped to analyse and manage it, particularly through hedging instruments.

Two avenues of discussion. With this in mind, the discussion should follow two avenues. First examine the potential ability of new players to act as liquidity providers in the future to replace those that are withdrawing. Second, based on the findings of this analysis, identify the steps to take more generally to foster a new and stable balance between liquidity supply and demand, using a range of measures involving different market participants.

News

Europe

MiFID 2

A delay to implementation

On 10 February the European Commission proposed amendments to the MiFID 2 package and suggested a delay in its entry into force, initially intended for 3 January 2017. The delay has yet to be approved by the European Council and Parliament, which could also introduce amendments of their own to the Level 1 measures. The move largely reflected ESMA's difficulties in establishing the data collection and processing systems required by the legislation. AMAFI had raised these concerns with the authorities as early as September 2015.
With the timetable for Level 2 measures already running several months late, it is now public knowledge that the European Commission had asked ESMA to review its proposed standards on secondary trading and position limits on commodity derivatives markets and on the transparency of non-equity instruments.

Transaction reporting

AMAFI replied to the ESMA consultation launched on 23 December relating to draft guidelines on transaction reporting, record-keeping and clock synchronisation *(AMAFI / 16-15)*.
Work on the reporting issue was carried out together with AFTI (Association française des professionnels des titres). It prompted a request for details on certain transactions exempted from reporting (SFTs, corporate actions), on the information to be provided under different trading scenarios, on the trading capacity parameters and on certain difficulties relating to the reporting of derivatives.

The MiFID 2 Implementation Managers Group

The MiFID 2 Implementation Managers Group set up at the end of 2015 focuses on operational issues arising from the directive. Its aim is to formulate solutions to the main difficulties encountered by financial institutions in their efforts to implement the package; they will then be submitted to the regulators (AMF and ESMA) with a view to the drafting of Level 3 measures (guidelines or Q&A documents). The Group is currently working on systematic internalisers, market transparency, high-frequency trading and clock synchronisation. In the coming weeks it will also examine best execution and investor protection issues. The consultancy firm Equinox-Cognizant is assisting in this work.

Investor protection

AMAFI continues to work on investor protection issues. It is taking part in a series of meetings with the AMF to discuss ESMA's efforts on drafting Level 3 measures and to enable the AMF to take account of identified difficulties in its own deliberations.
The themes given priority in this process are the definition of the target market referred to in provisions on product governance, recording of telephone conversations and electronic communications, best execution, investment advice, underwriting and placing.

Véronique Donnadieu, Perla Elbaz-Dray, Emmanuel de Fournoux, Victor Maurin

News

Europe

Market abuse

Agenda

Although the new Market Abuse regulation enters into force on 3 July, the Level 2 provisions indispensable to its implementation have yet to be published. That is unlikely to happen anytime soon, as the draft adopted by the European Commission on the basis of ESMA proposals is still subject to the European Council and Parliament objections procedure. This will make it impossible for financial institutions to adapt in time to the requirements of this far more onerous regulation. A meeting with the AMF will have to be arranged soon to highlight the matter.

Market soundings

ESMA has launched a public consultation on draft guidelines for the Market Abuse regulation aimed particularly at recipients of market soundings, who are mainly fund managers.

AMAFI is especially concerned that unwarranted administrative constraints could be imposed on entities receiving the market sounding *(AMAFI / 16-17)*. That could dissuade them from participating in such soundings, with the result that the disclosing market participant would be unable to assess the features of an upcoming transaction as well as before. Given that the markets have become very volatile, this could increase the chances of issuers having to accept a significant increase in their costs in order to avoid risks of a failed transaction and the damage that can cause. Such an outcome would be paradoxical, as the whole point of the drive to integrate EU capital markets is to strengthen their capacity to finance the European economy.

Perla Elbaz-Dray

France

'Sapin 2' Law

The French government recently approved a draft legislative package ('Sapin 2') on transparency, the fight against corruption and economic modernisation. It incorporates numerous provisions relevant to financial market participants on which AMAFI was consulted at the start of the year *(AMAFI / 16-09)*. They include measures related to whistleblowing, a change to the market abuse sanctions system following last year's Constitutional Court decision, adaptation of the market abuse regime to take account of the impending European regulation, an extension of the AMF's competence in administrative penalties, the transparency and security of derivatives transactions, powers to order measures to ease corporate debt financing and a prohibition on advertising certain financial products.

AMAFI is particularly concerned by this last measure. It believes that this power – to be integrated into the AMF General Regulation – has to be used in a precise and targeted manner and solely for remedial purposes in clear instances of fraud whose number and extent warrant a reaction.

Sylvie Dariosecq,
Perla Elbaz-Dray,
Bertrand de Saint Mars

Prudential standards for investment firms

Following the publication on 14 December of a European Banking Authority report recommending a revision of the implementation procedure for the CRD IV / CRR prudential rules applicable to investment firms, AMAFI has started discussions with ACPR teams around this theme in an attempt to determine how it could make a useful contribution. The report's conclusions bear a close similarity to long-held AMAFI positions, notably the need for a new classification of investment firms that takes better account of what they do.

AMAFI is carrying out this work with the help of the consultants One Point and has initiated discussions on the subject at the European Forum of Securities Associations (EFSA).

Emmanuel de Fournoux,
Victor Maurin

Amafi Highlights

Taxation

Tax evasion
Deducting interest

In the international arena, the OECD's 'base erosion and profit shifting' (BEPS) initiative includes a recommendation to limit companies' ability to deduct interest charges from their tax liabilities. The OECD suggests limiting the amount of deductible interest to a certain percentage of gross operating profits (EBITDA). At European level, the European Commission echoed this idea in its Anti-Tax Avoidance directive unveiled on 28 January. The notion does not yet exist as such in French law but several overlapping measures effectively limit the deduction of interest charges already.

Against this backdrop, France will soon have to comment on the mechanism envisaged by the OECD and European Union and how it fits in with existing domestic law. AMAFI has voiced the position of market professionals in terms of three major recommendations *(AMAFI / 16-13)*:

- As envisaged (quite rightly) by the OECD and EU, the financial sector should be exempted from the new rules because its activities and funding are already strictly regulated.
- The financial sector to be excluded from the scope of the new rules necessarily comprises investment firms.
- France should ensure that its own rules are competitive relative to those in other member states.

Eric Vacher

New Members

CMC Markets UK PLC, the French branch of the UK company of the same name, whose main business is order receipt, transmission and execution and own-account trading. It is headed up by Guilhem Tranchant (Managing Director France).

LCL - Le Crédit Lyonnais, credit institution, which offers a range of services from order receipt, transmission and execution, investment advice, underwriting and guaranteed placement. Yves Nanquette is its Managing Director.

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at
www.amafi.fr
Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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