Speech by Martin Wheatley at FRC Conference:

Capital Markets Union and Corporate Governance: How can investor stewardship be enhanced in Europe?

Thank you – it's a pleasure to join everyone this morning and my thanks to the FRC for the invitation to speak today.

Given that the CMU green paper consultation period is behind us, I want to focus today on the next stage of the policy making process. The translation of political aspirations for capital markets union into worked-up policy.

Now, this phase may lack some of the 'pizzazz', if you like, of the former. Everyone likes a 'grand design' – a bold, compelling vision – and CMU is, at one level, exactly that: a grand design.

But its successful implementation now lies in its detail. Not first stage arguments over the broad sweep of its direction.

Indeed, we are in a position today where no-one is seriously debating the aspirations of CMU. Nor of course the economic imperative behind them.

Since 2008 we have seen gross new lending in the Eurozone drop by some 40pc – peak to trough.

While in terms of scale and level of activity, we know European markets are, on aggregate, only 53% as deep as they are in the US[1]. Falling to 34% in the corporate bond market. To 29% in hedge funds. And to less than 20% in core areas like venture capital, securitisation and leveraged loans.

Now, you can torture the numbers here, as the saying goes, to make them 'confess to anything'. But in this case, those figures really do speak for themselves.

I don't intend therefore to linger too long this morning on the FCA's support for CMU. Other than to repeat our backing for its broad aspirations.

I do, however, want to reinforce the importance and complexity of the stage we're

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[1] New Financial figures, taken across 26 different measures - http://newfinancial.eu/wp-content/uploads/2014/10/Driving- growth-New-Financial-report-on-better-capital-markets-high-res-v2.pdf

now in.

MANAGING EXPECTATIONS

And I would certainly caution against assuming that agreement over destination, equates to easy agreement over the route you take to achieve it. Free movement of capital is not, as European experience suggests, a policy goal that bends easily to expectations.

Indeed, I doubt few, if any, at the signing of the Treaty of Rome, would have predicted that man would walk on the moon before the continent would abolish exchange controls.

Nonetheless, we have seen important steps forward over the years, including delivery of the single market, the Maastricht Treaty and so on. So both pessimists and optimists can select evidence here to fit their respective world views.

I want to argue, however, that the success, or otherwise, of Capital Markets Union is neither a matter of pessimism, nor optimism. But ‘unflashy’ pragmatism. A focus on ‘practical goals’, as Thatcher described it in the build-up to the single market programme.[2]

And if that sounds an uninspiring goal, it certainly shouldn’t. Because it underpins a serious opportunity for regulators to contribute to the European growth agenda.

So, this morning I want to outline a few sensible – rather than sensational steps – that should be priorities for policy makers on CMU over the next four years.

The **first** is the importance of promoting a regime that’s underpinned by investor protection principles.

The **second** is the importance of implementing current legislation – so not reinventing wheels already in motion.

The **third** is ensuring that the Better Regulation agenda is taken forward.

And the **fourth** is around innovation.

INVESTOR PROTECTION

[2] Speech to European Parliament, 1986: http://www.margaretthatcher.org/document/106534

So, let me start with the first – investor protection – because it's effectively the hinge mechanism on which the other three turn and pivot.

Moreover, and more importantly, it's also at the centre of Europe's ambitions to scale up its capital markets. And to encourage a greater share of retail savings to find their way to SMEs.

So, what we have in mainland Europe at the moment, as we know, is persistent small 'c' conservatism in terms of private household investment. Capital markets are effectively viewed with real suspicion.

Now, on the one hand of course, that does nothing to help savers in a low return environment.

Nor to help policy makers deal with a barrage of wider societal issues. Not least the challenge of adequate retirement incomes in an ageing population – or as one actuary put it to me: 'people not dying early enough...

But, on the other, it also does little to carry the EU's wider economic ambitions of supporting future employers to access capital markets and grow. An estimated $1tn a year shortfall in capacity here, is a lot of potential Google's, Amazons and Apple's[3].

The first conundrum for regulators then, is to break through this natural investor caution in Europe. Supporting savers on the one hand. Borrowers on the other.

And to accomplish this, we know a cocktail of factors are required.

First, consumers must have products and services that are appropriate for their needs and appetite for risk.

Second, they must have trustworthy suppliers, who deliver a) what they promise and b) products with the safeguards consumers expect.

And third, investors must have products and services that are adequately explained to them. In other words, disclosure is an imperative. But it must be enriched.

So, the reality here is that consumers – even so-called 'sophisticated' consumers – struggle to make economically rational decisions when faced with the black-box of finance.

People do not read terms and conditions. Nor do the majority of us have the time

[3] New Financial figures – report on Driving Growth: making the case fo bigger and better capital markets in Europe (Oct 2014). Figure based on difference between what EU companies currently raise in capital markets, and what they would raise if they were as developed as the US.

to work through calculations of compound interest and the like. So information asymmetries become particularly acute in financial services.

Now, you can argue here – as others have done[4] – that you don't need to know the inner workings of a financial product any more than you do an airplane engine.

But the problem here, is that complex financial products are far more prone to catastrophic failure than aeronautical engineering.

It is therefore makes sense that information asymmetries matter more to consumers in finance than they do to passengers in airplanes.

Indeed, when things do go wrong, the first investor question inevitably is: ok, so why didn't you tell me about the dangers here, or at least explain them to me better?

And it is this question that is at the centre of a long list of difficult lessons from recent history around Europe. Including interest rate hedging products and PPI in the UK, as well as high interest preference shares in Spain[5].

So, for CMU to achieve its ambitions to support growth and depth in capital markets, it has to consider carefully how it handles core issues of disclosure, product safety, risk appetites and so on.

And in keeping with my theme for this morning, there are a few quick, practical policy wins here for European legislators.

The first, is to potentially extend MiFID 2 product governance requirements to a wider range of products, including insurance and lending, as well as credit.

The second, is for the Commission to look into the possibility of resurrecting plans for a EU Insurance Guarantee Scheme framework. And also to consider reintroducing an updated Investor Compensation Scheme Directive.

So, you would effectively create a level of protection here for deposits akin to the UK's Financial Services Compensation Scheme. Providing additional incentive for savers to invest and therefore deepen capital markets.

IMPLEMENTING CURRENT POLICY

But of course, you can fulfill this same objective through my second priority: the

[4] Jamie Dimon – at WEF in panel in Davos 2013: http://www.cnbc.com/id/100397316#.
[5] Flared up in 2012 – Spanish government in talks with Brussels to allow tens of thousands of retail clients to avoid losing their investments in risky savings products after lenders were nationalised. Many marched on streets of Madrid in protest http://www.ft.com/cms/s/0/4dcab54c-e626-11e1-ac5f-00144feab49a.html

sensible, if less ‘glamorous’ step of completing current legislative programmes before embarking on new ones.

Indeed, finish the work of the last ten years, and you’re effectively half-way to capital markets union.

MiFID 2; IMD2; the UCITS Directive; MCD; PRIIPs and so on and so forth - all are live.

And all feed into the core debate in CMU around creating faith in the transmission mechanism between savers and borrowers.

In fact, all those directives, as we know, put obligations on firms to describe products in clear ways, including:

- to manage conflicts of interest;
- to achieve ‘best execution’ for clients;
- and to have strong governance arrangements around creating and developing financial products.

On top of which, you have MiFID 2, EMIR and CSDR, all already promoting and developing elements of a single market in capital, by harmonising trading and post- trading rules, and strengthening transparency.

So, dry and technical as this might all seem, it’s important to complete those projects before thinking about where the gaps need to be plugged.

And it is certainly important – while we’re on this theme of pragmatism – for those rules to then be applied consistently. Partly, of course, to avoid obvious issues related to arbitrage.

But also because the legal and compliance cost of taking advice and doing due diligence can be prohibitive for intermediaries. Particularly if they have a thicket of rules to manage across different borders, and all are applied differently in each jurisdiction.

There’s a clear advantage therefore to supervisors having largely equivalent powers in supervision, investigation and enforcement.

And certainly an advantage in using those powers to promote consistent standards and outcomes for customers.

So, the European Supervisory Authorities, the ESAs, have a profoundly important balancing role to play here.

On the one hand, you want them to provide that mechanism to promote both effective supervisory standards and outcomes across the EU.

On the other, you want them to recognise and accommodate differences. Whether that's differences in local markets, in products, consumer behaviour or preferences. Such flexibility is essential to effective regulation and policy making.

BETTER REGULATION

And this brings on to my third core priority: the EU's Better Regulation agenda, which was last month launched to minimal fanfare. But with ambitions that may yet affect the regulatory centre of gravity in Europe.

So, not only does it set out ambitions to make the policy making process both more transparent and rigorous. It also directly links them to wider political priorities, including growth priorities.

What we are effectively seeing then, is a potential shift here in context and debate - where the first question becomes whether regulation is the right mechanism by which to achieve a social goal.

And the second question, if policy makers do intend to step in, is how to ensure you usefully support wider societal or economic ambitions.

Now, fairly or otherwise, these are both challenges that regulators have been accused of getting wrong in the past.

Either by failing to ask the question in the first place. Or by trying, but then struggling with the complexity involved: particularly in areas such as unintended consequences, and difficulties in calculating economic elasticities.

So, in addressing these concerns, if not definitively solving them, the Better Regulation Agenda is a potentially significant step.

And it certainly moves the debate forward in a few core areas:

- First, by recognising the importance to policy making of extensive analysis.
- Second, by its focus on the potential value of options, beyond the dirigiste, that could effectively target a problem. For example, market-led solutions.
- And third, by highlighting the imperative of undertaking effective studies of the costs and benefits of possible solutions.

But on this final point, one word of caution.

It's worth reflecting that you can't resolve every regulatory policy issue, such as the treatment of vulnerable consumers, by cost benefit analysis alone. Precisely because those arguments can't be boiled down to Dollars or Euros.

For a majority of interventions though, effective CBA is now a vital means of stress testing policy. And it's also one that's increasingly reliable thanks to giant steps in technology and data.

Indeed, if you look at areas like setting the price cap in UK pay-day lending, the FCA was able to model cost, revenue and repayment information for some 2.3m anonymised borrowers, on 16m transactions.

At the same time, we were able to assess the market impact of the price cap at different levels. All using processing power that was unimaginable ten years ago.

For regulators then, the analytical opportunities here are frankly enormous. And nowhere more so than in making sure regulatory intervention is socially useful. Not just mere 'activity'.

INNOVATION

And this newfound processing power and flexibility links to my final practical priority this morning. The importance to the European growth agenda of promoting innovation and competition.

Technology, in particular, is an irrepressible force here. Particularly in terms of diversification and the emergence of areas like crowd-funding and other types of non-bank lending.

For some, of course, this is the great prospect for improving capital allocation to the real economy.

For others, there is more caution, and there's an argument here that banks are actually in a better position than financial markets to manage the investment relationship required with SMEs and to make intelligent credit decisions.

Either way however, there is no argument that this is a fast expanding area. The European alternative finance market as a whole grew by 144% last year – albeit from a relatively low base. So, from €1,2bn in 2013 to €2,9bn in 2014.

Now, the UK, with a €2.3bn chunk of that market represents the large bulk of this. But for European leaders, this is clearly a significant trend that may yet become truly transformative.

So in a very immediate sense, this is a significant test of regulators' ability to manage the growth equation.

And a key area here the FCA, which is in our response to the CMU green paper, is in bringing practical efficiency to the way investors and borrowers find each other, as well as to how services are provided.

In other words, there is a challenge here for policy makers to make sure the current legislative framework properly accommodates digital channels.

And there certainly seems to be a quick win here in encouraging a movement away from current paper-based disclosure regimes. Most of which have now underpinned the development of European disclosure requirements for decades.

CONCLUSION

So, some food for thought there in terms of how we might best move things forward.

A lot of this work does, as I say, lack some of the pizzazz of genuinely disruptive, headline grabbing policy. The grand designs that policy makers have been absorbed in in the past.

But it would be a grave mistake to underestimate the importance of the detail in capital markets union.

If we want Europe to be a centre for innovation, for business, for growth – for the new generation of start ups and businesses that will challenge the twin mights of the US and China – it is an imperative, frankly, to get this right.