Editorial

Rethinking Regulatory Structure – What Do Our Financial Markets Need?

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After decades of de-regulation in the global financial sector, 2010 will probably mark the beginning of a new era of re-regulation – though hopefully not of over-regulation. So far, the term "paradigm shift" used by some EU Commission officials to denote the new regime envisaged for EU financial markets under Internal Market Commissioner Michel Barnier allows a wide range of interpretations. At the very least, however, it means a move away from the previous emphasis on self-regulation.

Without doubt, the recent crisis has exposed various deficiencies in financial regulation in the EU: OTC trading in derivatives, especially in complex instruments such as credit default swaps, is still characterised by excessive bilateral exposures and too little collateralization. Risk valuation and risk management capabilities of both market participants and regulators have turned out to be insufficient. This is worsened by the fact that trading does not take place in a transparent environment. Finally, the OTC market for these instruments has operational inefficiencies and offers only limited legal certainty.

In order to overcome such deficiencies, the new regulatory regime should be structured according to the following guiding principles: First of all, individual responsibility for risk taking should be increased, and excessive risk exposures should be avoided. In order to achieve this, risk taking and risk management need to be strictly separated. Furthermore, market transparency needs to be optimized, and market complexity should be kept at a manageable level.

The overall objectives of reforms along these principles must be twofold: firstly, a reduction of systemic risk, and secondly, an increase in financial market stability. Two major projects to implement such reforms are already emerging:

(1) European Market Infrastructures Legislation, in short: "EMIL", announced in November 2009:

Sweet and curiously Germanic as this acronym may sound, it might have far-reaching consequences for financial infrastructure providers such as Deutsche Börse. The outlines of this legal project are still too vague to allow comments. Therefore, all I can say for the time being is that Europe's financial infrastructure is a major factor in strengthening the international competitiveness of the EU economy. All in all, it is technologically far more advanced and better integrated than its US counterpart. I find it surprising that, in the wake of the worst financial crisis since the late 1920s, some still claim that the US financial market should serve as the role model for the world to follow. If the financial crisis has shown one thing then it is the vital importance of being able to supervise and control decisions with major repercussions on the stability, and indeed the survival of systemically important financial institutions. Therefore, it might be wise to have key institutions for the stability of EU financial markets within one's own legislative reach – be it in London, in Frankfurt or in Paris. This would especially be true for central counterparties entrusted with the new and necessary task of playing a larger role in the OTC derivatives markets.

(2) Review of the Markets in Financial Instruments Directive (MiFID):

MiFID is about to undergo a review, especially regarding transparency requirements – for stocks, but possibly also for bonds and derivatives. At Deutsche Börse, we generally welcome any effort to increase the transparency of markets. However, apart from some exemptions such as for very large orders, transparency levels should be equal across all types of trading platforms. This is especially true for pre-trade transparency, because knowledge of the availability, price, and size of quotes still awaiting execution in the order book is essential for recreating a substitute for the central order matching venues that have been deliberately fragmented by MiFID in order to make room for more competition.

While many issues in this broad field of establishing a new regulatory structure may still be open, one thing is certain: Politics on a national, European and global level will play an essential role in the financial sector in 2010 and quite a number of years to come.