Speech at the Thirteenth Financial Conference Expansión – KMPG

RODRIGO BUENAVENTURA, CNMV'S CHAIRMAN
29 November 2022

Thank you, Ana and Juanjo for your introduction and for inviting me to participate in this event again. I'm glad to see how this year, compared to last year's event, you have highlighted asset management and non-bank capital markets.

This is important because collective investment and the non-banking financial system must have an essential and key role in Spain's economic transformation in the coming years. More specifically, I am referring to the role that stock markets, fixed income markets and venture capital itself should play, complementary to the banking system, as a source of financing of the extraordinary investment that our companies will need for digitalisation and decarbonisation processes.

Such extraordinary investment cannot be fully leveraged. Therefore, we will need new equity contributions to complement external financing. The equity market offers viable alternatives to provide not only the necessary proportion of equity in new investments, but also a diversification of funding sources to provide a more balanced liability structure.

To be clear, the Spanish and European economy needs, in percentage terms, less bank financing and more non-banking financing. Much more. Almost double the historical average if we are to resemble the most resilient corporate capital structure economy, as in the case of the US. I think we can all agree on that, including the European Union, the Spanish government, the CNMV, Spanish companies and, of course, banks. Financial markets must be promoted and strengthened because Spanish economy's ability to catch up to the digital and sustainable transformation depends on it. If we can't make Spanish companies recapitalise in the market, they won't be bankable.

That is why we are compelled to have more, much more, non-banking financial intermediation. Is that a bad thing? I don't believe it is, but rather a blessing for the Spanish economy. But, in the last two years we have heard different statements with different origins, exposing the alleged high systemic risk associated to non-banking

financial intermediation and, specifically, to collective investment, or part of it. As a result of the situation of the money market funds suffered in March 2020, and more recently with pension funds in the UK, some point to non-banking financial intermediation as an alleged source of systemic risk. I believe such type of statements in such generic terms do a disservice to having a serious debate.

International collective investment is generally sound, safe, and stable. Certainly no less than the banking sector. It has no intrinsic or inherent feature that is a permanent source of systemic risk. What is true, nonetheless, is that there are, depending on market conditions, specific focal points, and very specific in some countries, of significant risk that can be systemic. As I will display further on, there are no relevant cases in Spain to date. In my opinion, there currently are three such focal points:

1. Constant value monetary funds. Such vehicles, relatively common in other jurisdictions, were launched with an impossible goal: for a share in a short-term securities portfolio to always be worth one euro (or one dollar), come what may. This, in times of extreme volatility, cannot be enforced (because treasury bills and promissory notes have a set value, not whatever we want it to be) and can create incentives for investors to leave the fund when they believe the going gets tough, creating a potentially dangerous comeback.
2. Extra-leveraged vehicles. This cannot come as a surprise to anyone. Over-leveraging is dangerous if prices suffer a sudden drop, while additional margins are needed to secure transactions that exceed the cash available or the accessible financing. We have known this for years, since the 1998 LTCM crisis (leveraged 25 times despite having two Nobel prize holders among its board) highlighted such a risk. Any over-leveraged vehicle, whether of collective or individual investment, generates such risks. A subset of this category is pension funds that must cover benefits defined in the future, which must be leveraged to be able to cover these commitments. The latter led to the latest example in Britain, which was linked to the turbulence generated by the Liz Truss government's mini-budget.

3. Illiquid vehicles that nevertheless offer daily liquidity or generally offer a frequency of liquidity that does not match the liquidity of their investments. When a fund investing in fundamentally illiquid securities is sold as an immediate liquidity, it is making a promise that it will not be able to keep in difficult times when market liquidity weakens and prices drop. Repayment deadlines should be adjusted to the liquidity of the portfolio to avoid conflicts of interest among investors. And, if the supervisor does not control or monitor this aspect, this risk may go unnoticed.

These are the concrete elements that we should be discussing and analysing internationally rather than discussing the risks of "non-banking financial intermediation" or "shadow banking" in general terms, as if we were facing a monster

or the Bogeyman. If we want to have a mature discussion, we must pay attention to details and debate on the measures that these three issues require.

In such a case, two questions must be answered:

1. What is the case in Spain regarding said risks?
2. What legislative measures are being implemented?

Spain's situation is very different from other jurisdictions:

- There hardly are any money market funds and certainly none of constant value.
- There hardly are any defined benefit funds.
- Our funds have very low leverage (close to 40% gross and 27% net, which represents only 0.4% leverage).
- Our alternative funds adopt strict liquidity management frameworks, at the core of CNMV's Technical Guide.
- Since 1991, the CNMV receives monthly information on the portfolios of every Spanish fund and has been conducting regular liquidity stress tests for years, from macro and a micro perspective (at IF and SGIIC level).

On the topic of the so-called limited sense of non-banking financial intermediation, it should be noted that this accounts for a scarce 6% of the size of the financial system in Spain.

If we widen the focal point and consider collective investment as a whole, including equity portfolios, we can find that, in March 2020, Spanish funds were able to face the visible increase in reimbursements without any relevant incidents. No Spanish fund had to apply any extraordinary liquidity measures, such as suspensions of redemption or side pockets, and the CNMV reinforced its liquidity coordination and surveillance mechanisms with fund managers. They were also encouraged to use, where necessary, available liquidity management tools and, in particular, asset valuation based on bid prices and swing pricing schemes. This is and has been the situation in Spain.

In regards to ongoing legislative measures, the European Union is currently discussing a change to the AIF and UCITS Directives which includes supervisory reporting of portfolios and liquidity management requirements, extending the Spanish system to all EU countries. This will undoubtedly lead to greater soundness and stability of European collective investments and allow for better supervision.

Now, on to another popular subject: investor protection and cryptocurrencies. Before we get into the topic, I would like to take this opportunity to remind you that yesterday, the CNMV launched a public consultation on a measure to limit the marketing of contracts for difference (CFDs) to retailers through the use of advertising. The reason is the high level of risk that such products entail, the fact that the vast majority of clients end up losing money, and the aggressive sales techniques that we are

witnessing, especially from foreign firms. Comments and suggestions are welcome until 31 January.

Going back to cryptocurrencies, in the last four years we have seen a rapid but uneven development of cryptocurrencies as an investment element. After last year's "crypto winter", and even more so with the collapse of FTX, there are a few surviving investors of these types of products who have experienced valuable losses.

Since 2018, as financial supervisors, we have been warning every year about the risks involved in investing in cryptocurrencies, the likelihood of losing an entire investment and the lack of intrinsic value in such products. We pointed out that they are unregulated and unsupervised, with no safety net or minimum investor protection, that they are not suitable for retailers and that, overnight, cryptocurrencies, its custodians, passwords, and the entity itself could disappear.

In Spain, advertising of crypto-assets as an investment is regulated since February 2022. We force advertisers to warn that investing in such products is not regulated and that the money invested may be lost.

Unfortunately, this is exactly what has happened in the recent default of FTX.

We are still to learn of the details of FTX collapse, but the information available suggests that it does not appear to be associated with the complex technicalities of cryptocurrencies, but rather with a series of mundane, more traditional elements seen in other events throughout financial history. Total absence of controls, non-existent governance, allegedly fraudulent or at least irregular use of client assets, imaginative accounting and a complex and opaque corporate structure, which conceals obvious conflicts of interest.

In short, classic elements of the long history of financial crises. It has also highlighted the danger of the "aura effect" that sometimes surrounds apparent entrepreneurial geniuses that, in the long run, are not always examples of success. To invest, even if it sounds boring, it is better to rely on regulated, solid, prudent and professionalised companies, such as the vast majority of firms licensed to operate in Spain related to investment services.

In any case, if the weaknesses that FTX seems to have had are reproduced in one of the top five largest crypto firms in the world, it is not hard to imagine what smaller firms in a market with more than 10,000 cryptocurrencies are going through. We must assume that irregularities and business weaknesses, inadequate controls, are not merely an exception, which must make us, in the medium term, once again be extremely cautious and to regulate this sector.

This is precisely what the European Union has done ahead of the other economic zones: the European MiCA regulation provides the first regulatory framework

(complemented by the Pilot DLT regulation). It is important to anticipate that it is not a complete, perfect or as secure a framework as for financial instruments. But it is a first layer of regulation and investor protection, which will take time to develop the regulatory standard and start its implementation. The aim is to prevent cryptocurrency providers from following the path taken by FTX, Celsius, Terra/Moon or, just yesterday, Blockfi.

Until MiCA arrives, the only solution is to continue warning every one of the risks associated to investing in cryptocurrencies, especially if we take into account that cryptos (when they were on the rise, which is not the case today, of course) were used as a lure in several scam cases that fooled thousands, thinking that they could achieve a very high return with this type of investment.

In this dark time, there is, in my view, a piece of good news that should be highlighted. It relates to the fact that Spanish regulated entities, mainly ESIS and banks, have not significantly adopted cryptocurrencies in their product offerings to clients. Some called us conservative when we warned of the risks for regulated entities. Considering the current situation, I am glad that I have been conservative in this aspect and I am glad that regulated entities have emerged unharmed from this crypto winter or “crypto glaciation”. I stand firmly with the view that the CNMV, as well as other international supervisors, have been communicating for some time now to the investment community and society as a whole regarding the crypto world: DLT technology applied to finance is undoubtedly promising in many aspects and potentially generates great efficiencies in the markets, but digital currencies are lack content and are useless as investment assets. In this sense, as I usually say, we need crypto financing more than cryptocurrencies.

Ironically, the continued loss of value of cryptocurrencies, the collapse of some of its entities and the whirlpool of speculation to which it has been subjected may lead to a decline in the reputation, reliability and confidence in DLT technology itself. In a way, even to its own discredit.

The more we associate the future of crypto-finance with the limited usefulness of cryptocurrencies, the more we are likely to damage and discredit the possible transformations that our financial system requires and from which it could benefit through DLT technology.

Let me end with a hopeful message for regulated entities. I encourage them to focus their efforts on transformative projects such as those we are seeing in the sandbox, which, through the use of technology, improve the financial system, customer services and business finance, rather than worrying about offering a trading opportunity to their clients in worthless currencies with a high risk of loss of investment. I ask that the precautions taken, to date, to protect clients' interests be sustained in the future. While the regulations and mechanisms discussed are refined for their implementation,

investor asset management must continue to be governed by the transparency, control and professionalism that the industry has proved so far.

I trust and hope that you will enjoy the rest of the conference.
Thank you for your attention.