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April 4, 2018

Member Call to Discuss European Commission Recommendations on Corporate Bond Markets in Europe

[31150]

April 4, 2018 TO: Equity Markets Advisory Committee
Fixed-Income Advisory Committee
ICI Global Regulated Funds Committee
ICI Global Trading & Markets Committee RE: Member Call to Discuss European Commission Recommendations on Corporate Bond Markets in Europe

As previously reported, the European Commission's Expert Group on Corporate Bonds has published 22 recommendations to improve European corporate bond markets.[1] The European Commission expects to issue a consultation in 2018 to gather views on whether and how to implement these recommendations.

We will hold a conference call on **Tuesday, April 17 at 10:00 a.m. (Eastern Time)/3:00 p.m. (London Time)** to discuss which of the Expert Group's recommendations are the highest priority for the mutual fund industry so that we can share these priorities with European Commission staff in advance of the consultation. If you would like to join the call, please contact Ashley Scarboro at ashley.scarboro@ici.org.

If you have questions or would like to share your views on the Expert Group's recommendations, please contact: (1) Patrice Bergé-Vincent at patrice@iciglobal.org; (2) Shelly Antoniewicz (primary author of the Analytical Report's Chapter 2 - Demand Side) at shelly@ici.org; or (3) George Gilbert at george.gilbert@ici.org.

Expert Group Recommendations

The Expert Group's recommendations are set out below. They are designed to pursue the following six objectives:

1. making issuance easier for companies;
2. increasing access and options for investors;
3. ensuring the efficiency of intermediation and trading activities;
4. fostering the development of new forms of trading and improving the post-trade environment;
5. ensuring an appropriate level of information and transparency; and
6. improving the supervisory and policy framework.

Making Issuance Easier for Companies (5 Recommendations)

Corporate bonds are a tried and tested source of finance for NFCs. However, their potential to finance the economy is not fully exploited in Europe. The Expert Group recommends six actions which will make it easier for issuers to access corporate bond markets.

1. When a company seeks to raise debt on capital markets it often conducts, through its bank, a market sounding, which aims at testing the appetite of investors for the new issuance and at determining the optimal price, terms and conditions. The Market Abuse Regulation has significantly increased the obligations regarding market soundings. The risks and uncertainties linked to the implementation of these new rules and their interpretation by National Competent Authorities can deter intermediaries from carrying out market soundings. Therefore, the Expert Group recommends that the Market Abuse Regulation be amended in order to alleviate the requirements regarding market soundings that could result in disproportionate burden for companies.
2. For high quality, investment grade corporate issuers, allocation of bonds to investors is carried out in accordance with clear and transparent rules, and records are kept of the allocation process. National regulators regularly check that the allocation process has been transparent, abiding by the rules and duly documented. These efficient, transparent and monitored processes are not implemented to the same extent in the high yield segment of the corporate bond market, where the allocation process is typically left to the discretion of one or more lead bank(s) and is thus more opaque. This means that, even though in principle issuers can influence the allocation process, the extent to which high yield issuers do so varies greatly – particularly in the case of smaller, less frequent issuers. Regulators should work with market professionals to support transparent and fair allocation methods in the high yield market.
3. National Promotional Banks should be given the necessary mandate to support SMEs to issue corporate bonds. In addition, authorities in these Member States where corporate bond markets are particularly under-developed are invited to make use of technical assistance from the Structural Reform Support Service.
4. In order to give information to investors, a company issuing bonds has to publish a prospectus. To make it cheaper and simpler for small businesses to access corporate bond markets, the Expert Group requests enhancing the alleviations of the Growth Prospectus foreseen by the recently agreed Prospectus Regulation.
5. Because they are an efficient gateway, private placements of corporate bonds should be further encouraged, in particular for SMEs. The Expert Group therefore calls on the Commission to expedite its long-promised Recommendation on private placements in order to extend good practices from lead Member States to other Member States.

Increasing Access and Options for Investors (6 Recommendations)

Efficient corporate bond markets are beneficial to investors, as corporate bonds represent a useful asset class in a diversified investment strategy.

1. An efficient and straightforward insolvency framework is an important pre-condition for sustained investor interest in corporate bonds. The Expert Group strongly supports the Commission's proposal on restructuring and second chance. In addition, it recommends (i) EU harmonisation of ranking of creditors and the definition of insolvency triggers, and (ii) national measures to increase transparency regarding the position of investors in creditors' rankings.
2. When a new corporate bond is issued, the demand for bonds often largely exceeds the amount of bonds offered. This leads some investors to inflate their orders. This

can be detrimental to other investors which, often constrained by strict internal rules, request only the amount which they ultimately seek to receive and end up being allocated a smaller portion of the issuance. Therefore, coordinated action between regulators and market professionals should discourage any artificial inflation of primary orders from all investors in a primary allocation process.
3. The Expert Group believes that the capital requirements associated with long term corporate bonds under Solvency II are excessively conservative. This deters investment by insurance companies in these assets. Therefore, it recommends a recalibration or alleviation of capital requirements for corporate bonds with a long tenor in the forthcoming Solvency II review (2020). It also recommends the review of eligibility criteria of Matching Adjustment to determine whether broadening their eligibility is appropriate.
4. Internal crossing of buy and sell orders in a fund can bring efficiency to fund managers and lower the cost for their investors. However, the interpretation of relevant UCITS and AIFMD provisions diverge across Member States. The rules are not applied in a clear and consistent manner to asset managers. Therefore, ESMA should conduct a mapping of existing practices in Member States with regard to internal crossing of orders. Building on this, it should promote convergence by setting out criteria with regard to how asset managers may internally cross buy and sell orders.
5. Retail investors' exposure to corporate bond markets could be facilitated through attracting investment solutions targeted at the retail market. This includes structures such as the recently proposed pan-European Personal Pension Product (PEPP). The PEPP should be swiftly adopted and implemented. Its take-up should be encouraged by national and EU authorities, including through eligibility for special tax treatments. National authorities should determine which tax breaks would be best suited to their national context. To support the cross-border distribution of funds, EU authorities should promote greater convergence in the interpretation by Member States of UCITS and AIFMD's marketing rules. It looks forward to advanced Commission work in this area.
6. Exchange Traded Funds (ETFs) can be an effective way for retail investors to achieve exposure to different asset classes, including corporate bonds. The Commission should review Member States' regulations and market practices to identify the obstacles that stand in the way of investors trading ETFs on exchange.

Ensuring the Efficiency of Intermediation and Trading Activities (4 Recommendations)

The Expert Group acknowledges the need to enhance the capacity of the financial system to withstand shocks after the financial crisis. However, the higher capital and liquidity requirements introduced since then have limited the capacity of market makers to hold inventories, reducing their intermediation capacity. The Expert Group supports the emphasis on safety and soundness of the financial system but also recognizes the need to ensure that market making is not dis-incentivised to the extent that the reduction in market liquidity raises the overall risk profile for the financial system and the economy as a whole. In particular, the treatment of corporate bonds in the calculation of some capital and liquidity requirements does not adequately reflect the true value of the bonds and their liquidity profile.

1. The Expert Group recommends that EU authorities review the capital and liquidity requirements, on the basis of a quantitative assessment of their impact on market-making and corporate bond liquidity. This review should notably:
    a. Adjust the haircuts and inclusion amounts applied to corporate bonds in the

Basel Liquidity Coverage Ratio (LCR), and distinguish between assets held on the trading book for market-making purposes from those held in the banking book;
   b. Adjust the factors applied in the Net Stable Funding Ratio (NSFR) to corporate bonds and to inter-bank financing activities in repos and securities lending;
   c. Amend the Leverage Ratio for the additional treatment of written credit derivatives to apply to contracts with a remaining term of less than one year.
2. Currently, the regulation on settlement and central securities depositories (CSDR) requires market participants having failed to deliver a security to initiate a buy-in process. This creates risks for liquidity providers, investors and securities lenders, and has a negative impact on market efficiency and stability. Therefore, the timing for the implementation of CSDR mandatory buy-ins should be carefully managed to cushion its impact and provide space to review the provisions before they have unintended and potentially irreversible consequences.

Moreover, the Fundamental Review of Trading Book (FRTB) rules, by increasing scrutiny on the delineation between banking book and trading book, will facilitate this approach. It will ensure that assets designated for the purposes of market-making are indeed held on the trading book.

Fostering the Development of New Forms of Trading and Improve the Post-Trade Environment (2 Recommendations)

1. Electronic platforms offer new solutions to bring together buyers and sellers in timely and efficient manners. They also have the potential to attract more participants to bond markets and reduce transaction costs. To support the development of a strong e-trading system, industry groups representing the buy side, the sell side and all trading venues, including Fintech firms, should issue guidance papers on good practices for electronic trading. In addition, stakeholders should benefit from some regulatory leniency when testing new models (regulatory sand boxes).
2. No capital market is efficient without efficient post trade processes. This applies as much if not more to corporate bonds. However, the fixed income post-trade environment in Europe remains highly fragmented. In the area of settlement, most Central Securities Depositories (CSDs) and International Central Securities Depositories (ICSDs) lack interoperability. They should accelerate investment in inter-operability and provide an update on Target2-Securities (T2S) and CSDR implementation. As regards clearing, all Central Counterparty Clearing Houses (CCPs) should accelerate and provide an update on their compliance with MiFIR provisions on open access. Lastly, CCP services designed to simplify trade processing and settlement could be extended to more non-cleared fixed income trades. To encourage progress in this area, building on the European Post Trade Forum, the European Commission should (i) report in 2018 on how barriers to greater fixed income clearing are being addressed, and (ii) identify best practices.

Ensuring an Appropriate Level of Information and Transparency (4 Recommendations)

At EU level, pre and post-trade transparency requirements are incorporated in MiFID II.

1. The lack of comparable data on European corporate bonds constrains participation and activities in corporate bond markets, and makes it more difficult for national and European authorities to effectively supervise and legislate. This significantly undermines the development and functioning of European corporate bond markets. The Expert Group supports the proposal by the Commission to centralise data

collection at ESMA level. A consolidated tape owned by ESMA should be created expeditiously to collect data on all eligible public and private corporate bonds. This should be accompanied by an "easy to use" interface accessible to all EU bond markets stakeholders at reasonable cost.
2. To avoid fragmented liquidity across jurisdictions and limit regulatory arbitrage, ESMA should actively encourage NCAs to adopt similar deferral regimes across European jurisdictions in regard to post trade transparency requirements. In addition, to reduce the risk that post trade transparency requirements dis-incentivises the provision of liquidity (by potentially putting at risk market makers executing trades), the obligation for execution venues to publish details of trades of all sizes should be either narrowed in scope and in depth of details provided, or replaced by an obligation to report aggregated information.
3. Ratings can help investors to assess the credit risk and therefore the price of an issuance. However, they are very expensive for small issuers. Therefore, the Commission needs to explore different mechanisms that would enable smaller issuers to obtain reliable credit worthiness assessments. This would greatly enhance small issuers' ability to reach a critical investor base and make bond issuance meaningful.
4. Research is another valuable source of information for market participants in European corporate bond markets. However, requiring the cost of research to be unbundled from the cost of execution may result in a reduction of the number of issuers covered by research, and/or the quality of this research, as well as the diversity of views from different research analysts. The European Commission should monitor the impact of MiFID II rules on the availability of research in the corporate bond market. It should devote particular attention to small issuers, and take appropriate action swiftly should this impact be found to be negative.

Improving the Supervisory and Policy Framework (1 recommendation)

1. Overlaps and inconsistencies between different EU capital market laws also hold back the development of European corporate bond markets. Therefore, the Expert Group recommends that the European Commission and ESMA: (i) assess the differences between EU legislations having an impact on corporate bond markets; (ii) streamline and consolidate overlapping and inconsistent rules and reporting requirements affecting corporate bond markets; (iii) set up a specialist industry group which would advise regulators on how to adapt the framework for corporate bonds, notably on a suitable methodology for ESMA's yearly assessment of corporate bond liquidity thresholds, and to support policymakers negotiating international standards at Basel; and (iv) upgrade capacity and knowledge of all competent authorities and ensure

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endnotes

[1] *See* ICI Memorandum No. 30956 (November 21, 2017), *available at* https://www.iciglobal.org/iciglobal/pubs/memos/memo30956. The recommendations are provided in two reports, a “Headline Report” that provides 22 recommendations to improve

the European corporate bond markets and an "Analytical Report" that provides more detailed background and in-depth discussion about those recommendations.