International
Capital
Market
Association

30 April 2015

ICMA RESPONSE TO EUROPEAN COMMISSION GREEN PAPER ON *BUILDING A CAPITAL MARKETS UNION*

Introduction

The International Capital Market Association (ICMA) is a unique organisation which represents issuers, lead managers, dealers, investors and market infrastructure providers in the international capital markets. ICMA has around 470 members. They are based across Europe and globally. ICMA has set standards of good market practice in the international fixed income market for almost 50 years. (ICMA's identification number in the EU Transparency Register is: 0223480577-59.)

ICMA welcomes the European Commission's Green Paper on *Building a Capital Markets Union.* ICMA's response to the Green Paper focuses on specific questions relating to fixed income. In preparing its response, ICMA has consulted the ICMA Board and the following committees of member experts: the ICMA Regulatory Policy Committee; the ICMA Primary Market Practices Committee; the ICMA Legal & Documentation Committee; the ICMA Corporate Issuer Forum; the ICMA Financial Institutions Issuer Forum; the ICMA European Repo Committee; the ICMA Secondary Market Practices Committee; and the ICMA Asset Management and Investor Council (AMIC) Executive Committee. ICMA has also consulted two industry-wide product committees: the Pan-European Private Placement Joint Committee; and the Green Bond Principles Executive Committee. Collectively, these groups of experts cover the full span of the debt capital markets, from issuers, through intermediaries, to investors.

ICMA's response to the European Commission's Green Paper develops in more detail the broad themes set out by ICMA in Issue 36 of the ICMA Quarterly Report (pages 6-12) on *Capital Markets Union: a Discussion Paper*, published in January.

Section 3: Priorities for early action

Q1: Beyond the five priority areas identified for short-term action, what other areas should be prioritised?

Q1: International Capital Market Association (ICMA) response

ICMA agrees with the five priorities for early action identified in the Green Paper. In our response to Q1, we recommend short-term action required and we also identify other priorities:

ELTIFs

1 The European Commission should examine the obstacles to loan funds to determine whether they can best be addressed at national level by Member States, or whether the Commission needs to introduce a 29th regime. In addition to ELTIFs, this recommendation also applies to private placements and investment in longer-term projects.

Private placements

2 The Commission should consider revising the final calibrations for insurers of the spread risk capital weightings in the Solvency II Delegated Act to contribute to a level playing field for investment in European private placements by institutional investors.

3 The Commission should promote the availability of credit and scoring information, not only for SMEs, but also for suitably defined and identified medium-sized companies.

4 In order to avoid disincentives for institutional investors to invest in the pan-European private placement market, the European Commission should not exclude the use of suitable existing European guarantee or risk-sharing mechanisms (such as the EIB Group - EC SME initiative, and the European Commission/EIB European Fund for Strategic Investment).

Standardisation in corporate bond markets

5 Some investors support standardisation in the belief that it can help secondary bond market liquidity. However, for corporate borrowers in the bond markets, standardisation is not desirable for a number of reasons. Borrowers need to be able to choose maturities and coupon structures to match their cash-flows. While very frequent large borrowers may in principle be qualified to issue on a standard schedule, applying a broad-brush approach to all borrowers would disadvantage smaller borrowers with their own particular funding habits. Borrowers would seek compensation for any loss of flexibility.

Green bonds

6 The self-regulatory approach represented by the Green Bond Principles is preferable to any regulatory norm or label.

Diversifying the supply of funding

7 In addition to revising the final calibrations for insurers of the spread risk capital weightings in the Solvency II Delegated Act, the Commission should examine and encourage the removal of national barriers which discriminate against capital market investors, such as withholding tax on loans or private placements.

Infrastructure investment

8 There is a strong case for the creation of a sub-asset class for infrastructure investments which should benefit from recalibrated capital requirements to reflect that these assets are held to maturity and their low loss-given default.

9 An up-to-date transparent pipeline of information on infrastructure projects on a national basis would highlight investment potential. Efforts to create an up-to-date credible and transparent pipeline in the form of a European Investment Project Portal, and the potential creation of a comprehensive technical assistance programme to channel investments where they are most needed under the coordination of a European Investment Advisory Hub, are both welcome.

10 Investors' concerns over the regulatory risk associated with project revenues need to be addressed by a transparent and consistent approach by the authorities.

11 A review of national procurement practices – in particular, with respect to value for money and deliverability of funding – could help to establish a level playing field between bank financing and bond financing options. In furtherance of this goal, AFME/ICMA have produced a *Guide to Infrastructure Financing – through Bank Loans, Debt Private Placements and Public Bonds*.

12 An expansion of the EIB Project Bond Credit Enhancement Programme would act as a catalyst for investors, mindful of the balance to be struck between encouraging demand and "crowding out" potential investors who want the additional yield on an un-enhanced product.

13 Public sector usage and demand guarantees would help to ensure fair risk-sharing for investors.

Boosting retail investment

14 The Commission should minimise unnecessary regulatory disincentives to retail investment by focusing on pan-EU securities regulation (eg MiFID, MAD, TD, PD, UCITs and PRIIPs) as a whole, and without disrupting wholesale markets for borrowers and institutional investors. ICMA's response to the Prospectus Directive Consultation Paper addresses this issue in more detail.

Attracting international investment

15 Consistent with the Commission's "better regulation" agenda, the Commission should review existing EU legislation affecting capital markets to ensure that capital market participants are not prevented by inconsistencies in EU legislation, or its unintended consequences, from doing so.

Powers of the ESAs

16 The Commission should ensure consistent supervision within the existing framework. A resolution is needed to the debate about how the ESAs are funded. It makes sense for the ESAs to be able to play a fuller role in the formulation of new Level 1 EU legislation. This would help ensure that the requirements for Level 2 work are fully understood and that there is an adequate amount of time for their orderly adoption; and more can be done to help improve the consistency of supervision.

Improving the cross-border flow of collateral

17 ICMA's reports on the cross-border flow of collateral have demonstrated the importance of collateral fluidity. If collateral fluidity is inhibited, this poses a risk to the overall functioning of capital markets, with serious repercussions throughout the whole economy. As an important building block on which to base Capital Markets Union, some work is needed to identify and address problems, taking particular account of the cumulative effect of EU regulations.

18 The Triparty Settlement Interoperability (TSI) project remains important and needs to be driven to conclusion, along with essential inter-related work necessary to upgrade the settlement bridge between Clearstream S.A. and Euroclear Bank; and other COGESI-led work is also important to the improvement of the euro-area collateral market.

19 The tracking of collateral in securities financing transactions is not feasible. It is unclear why attempting to track re-use is really necessary and what benefits this would bring.

20 Mandatory buy-ins, as required by CSDR, are a particular concern, as they will have the effect of significantly reducing liquidity across secondary European bond and securities financing markets,

while bid-offer spreads will widen dramatically. They should be deferred at least until after T2S is fully implemented, and their application should be recalibrated.

Taxation barriers

21 The two taxation barriers identified by the Giovannini Group – barrier 11 relating to domestic withholding tax regulations and barrier 12 relating to the collection of transaction taxes through a functionality integrated into a local settlement system – still need to be addressed fully.

22 The effect of implementing a Financial Transaction Tax would clearly run directly counter to the objectives of Capital Markets Union.

23 A different tax matter flagged by the Commission is the "tax bias in favour of debt in corporate taxation". This is not a European phenomenon. The IMF has considered the question of what can be done to mitigate any debt bias in the tax code.

24 The authorities should continue to progress the OECD's Base Erosion and Profit Shifting initiative in close coordination with industry to avoid unnecessary adverse consequences, counter to the objectives of Capital Markets Union.

Market development of new technologies and business models

25 New technologies and business models will continue to develop and evolve in the European fixed income space. Some will survive, while others will fall by the wayside. Those that do succeed will be the ones with superior execution and that provide solutions to support connectivity, promoting the sourcing of liquidity between buyers and sellers or enhanced intermediation. However, given the structure of corporate bond markets, this will never be enough to provide true liquidity in the sense of an executable price at any time. If this is the goal of Capital Markets Union, then regulation to support market-making will need to be a key consideration. This will include closer attention to pre- and post-trade transparency requirements, a review of mandatory buy-in regulation, and possibly the provision of capital relief for market-makers.

Q3: What support can be given to ELTIFs to encourage their take up?

Q3: International Capital Market Association (ICMA) response

26 European Long-Term Investment Funds (ELTIFs) are still in an early phase, with the final legislative text of the agreement yet to be published in the *Official Journal* and Level 2 implementing measures still outstanding. There are still some technical hurdles to overcome, primarily the need for certainty around the technical standards to be published by ESMA that will complement the Level 1 text. Managers will also need to wait to find out what kind of tax treatment ELTIFs will be given at national level before they can be set up. The European Commission should encourage Member States not to introduce unfavourable tax treatment for investments in ELTIFs.

27 Once the legislation is formally in place, ELTIFs can play an important role in capital market funding in the EU, but they need more official support. One of the major barriers ELTIFs will face in trying to develop into a genuine cross-border fund structure, with a UCITS-like passport, is the lack of a level playing field for non-bank providers of credit when compared to bank lenders. Because ELTIFs are intended to invest in illiquid, often private (as opposed to public) assets, ELTIFs may need to operate only nationally if at all, given the various national restrictions on banking law, insolvency law and tax regimes.

28 Some of the existing obstacles to cross-border operation of ELTIFs are:

- the inability of funds to originate loans;
- the need for a banking licence to originate loans;
- the fact that bank liabilities are preferred in bankruptcy;
- the lack of standardised procedures for taking security, enforcement and for creating loans/bonds, like EU company registers for registering and enforcing pledges and similar charges;
- the restrictions on the availability of credit data, which can be restricted to only actors with banking licences; and
- the different tax treatments of funds: for example, withholding tax on interest.

29 ICMA recommends that the European Commission should examine these obstacles to loan funds to determine whether they can best be addressed at national level by Member States, or whether the Commission needs to play a coordinating role by introducing a "29th regime" for loan types of asset to allow cross-border funds like ELTIFs easier access to such assets.

Q4: Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?

Q4: International Capital Market Association (ICMA) response

30 The Pan-European Private Placement Joint Committee[1] (PEPP Joint Committee), coordinated by the International Capital Market Association (ICMA), published on 11 February 2015 *the Pan-European Corporate Private Placement Market Guide* (the Guide). The Guide sets out a voluntary framework for common market standards and best practices for the development of a Pan-European Private Placement market aimed at providing medium to long-term finance to European medium-sized companies, in close alignment with the EU's goal of bringing about a Capital Markets Union. The PEPP Joint Committee would welcome the support of the European Commission and EU Member States in promoting the standards that have now been agreed by the PEPP Joint Committee and set out in the Guide.

31 In addition to supporting market-led standards, ICMA considers that there are four other actions by the EU needed to support the development of private placement markets.

---

[1] The PEPP Joint Committee is an umbrella European initiative coordinated by ICMA that also currently includes the Association for Financial Markets in Europe (AFME), the European Private Placement Association (EU PPA), the French Euro Private Placement (Euro PP) Working Group, the Loan Market Association (LMA), TheCityUK and The Investment Association. It also brings together representatives from major institutional investors (including Delta Lloyd, Fédéris Gestion d'Actifs, KBC Group, LGIM, M&G Investments, Muzinich, Natixis Asset Management), and benefits from the participation of major law firms, including Allen & Overy LLP, Ashurst, Bonelli Erede Pappalardo LLP, CMS Bureau Francis Lefebvre, DLA Piper, Gide Loyrette Nouel AARPI, Herbert Smith Freehills, King & Wood Mallesons, Kramer Levin Naftalis & Frankel, Linklaters, Loyens & Loeff, Simmons & Simmons, Slaughter and May and White & Case. This initiative benefits from the support of the official sector participating in an observer capacity (including the Banque de France, the Bank of Italy, the French Trésor and HM Treasury).

Solvency II calibrations

32 First, ICMA believes that the most significant policy measure that the European Commission can undertake is to create a level playing field for investment in Pan-European Private Placements[2] (PEPPs) by institutional investors. We estimate that European institutional investors may face higher capital charges investing in PEPPs under Solvency II than banks under Basel III rules. This discrepancy exists also to a higher degree with respect to US insurance companies investing in the US Private Placement market under the rules of the National Association of Insurance Commissioners (NAIC). European institutional investors face capital charges under Solvency II that can represent multiples of those weighing on US insurance companies under NAIC rules for private placements that have otherwise comparable maturity and risk profiles. This situation can be addressed by the European Commission through a revision of the final calibrations for insurers of the spread risk capital weightings in the Solvency II Delegated Act (Commission Delegated Regulation (EU) 2015/35).

33 Although the final calibrations in the Delegated Act (the "long term guarantees package") has helped remove obstacles to investing in certain long-term assets (infrastructure projects, SME loans or start-ups), the final calibrations are still problematic due to the focus on volatility risk as opposed to default risk, and also they do not sufficiently address PEPPs. For buy-to-hold investors – such as insurers acquiring PEPPs – the impact of market volatility on spread risk is indeed immaterial as the assets are held to maturity.

34 The matching adjustment in Article 77b-77d of Solvency II (2009/138/EC) recognises this fundamental concern but does not go far enough.

35 ICMA believes that the European Commission should lead a thorough consultation process to determine whether the current long term guarantees package calibrations are appropriate, or whether it needs adjusting, in order to avoid disincentives for investment in PEPPs, as well as more generally in long-term assets. ICMA welcomes the recent request to EIOPA for technical advice on the identification and calibration of infrastructure investment risk in Solvency II, but urges the Commission to go further and widen the recalibration to other asset classes like PEPPs. ICMA recognises that this may be difficult to achieve in the short term, but considers that the original review date of 2018 for Solvency II is too late.

Credit and scoring information

36 Second, PEPPs are designed especially to raise medium to long-term finance for medium-sized European companies, as well as larger companies seeking to diversify their funding sources. Efforts to improve the availability of credit and scoring information would support the development of the market by facilitating the evaluation of these companies by potential investors. Successful national examples and models for such a system are the FIBEN company scoring produced by the Banque de France and credit information resources provided by the Centrale dei rischi of the Bank of Italy. This is also consistent with the statement in the Green Paper that a "common minimum set of comparable information for credit reporting and assessment could help to attract funding to SMEs". It is important here, however, to point out that medium-sized issuers in the PEPP market would be companies that are typically not captured by the EU's definition of SMEs. More suitable definitions of such companies are for example intermediate size enterprises (ISEs) as construed by the French

[2] A PEPP is a medium or long-term, primarily unlisted, private debt financing transaction between a listed or unlisted company and a small number of institutional investors, based on deal-specific documentation negotiated between a borrower and investor(s), generally but not necessarily with the participation of one or more bank intermediaries as arranger(s) usually acting in an agency capacity.

National Statistical Office (INSEE) or mid-sized businesses as defined by the UK's Department for Business, Innovation & Skills. We would recommend that the Commission promote the availability of credit and scoring information, not only for SMEs, but also for suitably defined and identified medium-sized companies.

Guarantees or risk-sharing mechanisms

37 The credit profile of companies issuing in the PEPP market extends from implied or explicit investment grade to cross-over risk. This is different from the practice of private placement markets such as the USPP and the Schuldschein which are very largely used by companies that although unrated are generally implied investment grade. In order to avoid disincentives for institutional investors to invest in the PEPP market the European Commission should not exclude the use of suitable and existing European guarantee or risk-sharing mechanisms. This could be achieved by the extension of the scope of risk sharing schemes (such as the EIB Group - EC SME Initiative) and careful allocation of resources from the European Commission/EIB European Fund for Strategic Investment.

Removing restrictions on institutional investors

38 PEPPs may be acquired both directly by institutional investors and through fund structures. There are numerous restrictions in EU Member States for institutional investors like pension funds investing in pooled fund solutions holding illiquid assets, such as prohibitions or tax disincentives on allocating investments into Alternative Investment Funds (AIFs).

39 As in the case of ICMA's response to Q3, and taking especially into account that PEPPs can be documented in both bond and loan format, ICMA recommends that the Commission should examine further a number of obstacles that exist to non-bank lending, often at national level, including:

- the inability of funds to originate loans;
- the need for a banking licence to originate loans;
- the fact that bank liabilities are preferred in bankruptcy;
- the lack of standardised procedures for taking security, enforcement and for creating loans/ bonds, like EU company registers for registering and enforcing pledges and similar charges;
- the restrictions on the availability of credit data, which can be restricted to only actors with banking licences; and
- the different tax treatments on, for example, withholding tax on interest.

Section 4: Measures to develop and integrate capital markets

4.1 Improving access to finance

Q6: Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?

Q6: International Capital Market Association (ICMA) response

40 ICMA's recommendations on measures to improve liquidity in corporate bond markets are set out in our responses to Q30 on taxation, where we recommend that the EU should not proceed with the proposed Financial Transaction Tax (FTT); and Q31, where we discuss the calibration of the CSDR buy-in and MIFID II pre- and post-trade transparency regimes. ICMA's response to Q6 focuses on standardisation in corporate bond markets.

41 Although the bond world is much broader, including public sector agencies, supranational entities and some sovereign debt, the ICMA response to this question focuses solely on corporate Eurobonds (ie international bonds), including both financial and non-financial borrowers, in the primary markets. In addition, this response does not address other fixed income products.

42 Some investors support standardisation in the belief it can help secondary bond market liquidity (see notably BlackRock September 2014 viewpoint paper). For frequent borrowers, a smaller number of larger bonds would be easier logistically to trade and so might stimulate secondary market liquidity, and, potentially, reduce the cost of borrowing over time. It is, however, difficult to see how law or regulation can encourage larger issues, other than through facilitating the making of fungible issues – that is, further issues on the same terms as existing issues that increase the overall size of the issue. Reducing the disclosure burden for such issues (for example, by removing or reducing the requirement for a prospectus when the subsequent issue is made) could help with this.

43 From the point of view of corporate borrowers, fundamentally, the treasury function is under a corporate governance obligation to manage its funding in the best interests of the company's business. Mindful of this, standardisation is not desirable for a number of reasons.

44 Borrowers need to be able to choose maturities and coupon structures to match their cash-flows. As well as needing to be able to take advantage of *ad hoc* opportunistic funding, many borrowers tend to borrow for a specific purpose and term, and cannot be tied to certain "one size fits all" parameters which do not match their intentions. It is fundamental that borrowers have the freedom to negotiate terms that suit their own business model, their other financing obligations and documentation and their particular funding needs. Standardisation would make it harder for borrowers to achieve consistent borrowing on the best terms by restricting these fundamental capabilities and inhibiting funding flexibility. There would be significant reluctance to sacrifice this flexibility to raise capital market finance as required (subject always to market conditions), notwithstanding the intended stated benefits of standardisation.

45 While, owing to their funding profiles, very frequent, large borrowers may in principle be qualified to issue on a standard schedule, to apply a broad-brush approach to all borrowers would be to disadvantage those smaller borrowers with their own particular funding habits. This would not only be inconsistent with the Capital Markets Union objective of expanding bond market access for smaller, mid-cap borrowers, but a push towards standardisation for very frequent, large borrowers could also lead to greater market segmentation, resulting in issuance of standardised bonds, on the

one hand, while issues from the rest of the sector could come to resemble the more bespoke private placement market, on the other hand, and thus be limited in size.

46 Borrowers would seek compensation for any loss of flexibility by means of favourable pricing and liquidity for larger deal sizes: something which investors do not currently pay for and which would be hard to quantify given that liquidity is only one of many potential pricing factors. However, the causal link between the size of the deal and its liquidity remains unproven.

47 With regard to standardised maturities, large amounts of debt which become due for repayment on similar dates would concentrate refinancing risk for borrowers, and could make it more difficult for investors to establish relative values between bonds with different tenors. The fundamental principle of supply and demand would be skewed in the direction of supply, leading to an economic imbalance for price and deal size (which in turn could affect the problems associated with liquidity that standardisation seeks to address). While this could be problematic for all borrowers in terms of deal size and competitive pricing, in particular, if financial institutions find it economically inefficient, or are restricted in other ways from issuing, it would be difficult for them to manage their Liquidity Coverage Ratios with certainty and predictability. A concentration of standardised maturities may inadvertently create volatility, which would not otherwise exist with staggered maturities which appeal to a variety of investors with different holding requirements and horizons.

48 Although interest payment dates on corporate bonds in the US are often aligned to mirror interest payment dates on US government securities (albeit issued on different dates, with long or short first coupons), such practice is not so usual in Europe. Therefore, in terms of market-related practicalities, consideration should be given to the market capacity to deal with potentially large activity bunching around the specified quarter days. Theoretically, standardisation of issuance dates, coupon payment dates and redemption dates would equate to an entire quarter’s worth of bond activity in one day – based on Bond Radar data that 855 bonds were issued in 2013. This could therefore potentially equate to a large amount and, as already noted, would deprive borrowers of the right to choose the most advantageous issuance time to match their requirements.

49 Further, with respect to standardisation, investors can already – to an extent – influence the shape of the bond markets in that inclusion in an index goes some way to dictate benchmark size (for instance, minimum size criteria in certain indices).

50 The UK’s recent *Fair and Effective Markets Review* consultation acknowledged: “Widespread use of a particular benchmark can lead to concentration of order flows around a fixing which can provide incentives for both front running and manipulation”. There is a question whether this could become self-fulfilling, as periodic standardisation would mean large amounts of rate fixings at similar times. In a related context, when there are simultaneous redemptions of stock market index futures, stock market index options and stock options, there is generally an increase in the trading volume of options, futures and the underlying stocks, which occasionally increases the volatility of prices of related securities. It would be necessary to consider whether there would be a similar knock-on effect in terms of volatility or market disruption from the simultaneous mass redemption of bonds.

51 Standardisation would not necessarily substantiate the “intended” consequences *ex post*, leaving little incentive for borrowers to change their issuance practice. Generally, fundamental changes in issuance practice would not be easy to achieve across the board, making it all the more important to show significant, proven benefits in order to spur adoption. In order to avoid any unintended adverse consequences that could inhibit the new issuance markets, it would be necessary to examine more closely the cause and effect between deal size, standardisation and

liquidity and cost: the ultimate benefits, although ambitious, remain unproven and are therefore not necessarily clear to borrowers.

Q7 Is any action by the EU needed to facilitate the development of standardised, transparent and accountable ESG (Environment, Social and Governance) investment, including green bonds, other than supporting the development of guidelines by the market?

Q7: International Capital Market Association (ICMA) response

52 ICMA has acted as Secretary of the Green Bond Principles (GBP) since April 2014. Our comments will focus therefore more specifically on the topic of green bonds rather than on the wider topic of ESG investment.

53 In summary, green bonds are publicly listed debt securities and, as such, are extensively regulated at both the national and EU levels. ICMA believes that the self-regulatory approach represented by the GBP is preferable to any additional regulatory norm or label. The GBP result from a transparent process accountable to a representative group of market participants. This process could be further expanded to observers from the official sector to deepen existing information exchange and dialogue.

54 Green bonds enable capital-raising and investment for new and existing projects with environmental benefits. It is important to note that green bonds like any other listed bond come under the scope of existing financial regulation both at the EU and national levels. The GBP are therefore not addressing an absence of financial regulation in the market, but are providing additional and voluntary process guidelines that recommend transparency and disclosure and promote integrity in the development of the green bond market by clarifying the approach for issuance.

55 The GBP provide guidance to issuers on the key components (use of proceeds, process for project evaluation and selection, management of proceeds, reporting) involved in launching a credible green bond; they aid investors by encouraging availability or communication of information necessary to evaluate the environmental impact of their green bonds; and they assist underwriters by moving the market towards standard disclosures which will facilitate transactions.

56 The GBP take the form of a regularly updated document based on a broad consensus of market participants. The GBP bring together a community of approximately 130 members and observers that are consulted on the GBP. These comments feed into the annual review by the GBP Executive Committee (GBP Excom) – a representative body of the key issuers, intermediaries and investors in the market.

57 The GBP Excom released the first annual update of the GBP in March 2015. This work benefited from extensive coordination and dialogue with market participants, including a consultation process to which the majority of GBP members and observers responded during the summer of 2014. The update provides further clarity on what can be expected from issuers. Amongst other refinements, a comprehensive high-level definition of green bonds has been included and the refinancing of green projects has been addressed. The recognised broad categories of eligible projects have been updated, and have also been complemented, by four overarching areas of concern. These are: climate change; natural resources depletion; biodiversity conversation and/or pollution. A particular effort has also been made to elaborate on assurance that issuers may be expected to confirm their alignment with the key features of their green bonds.

58 ICMA believes that the flexible and reactive market-driven process represented by the GBP is preferable to any top-down normative approach leading for example to a green bond "label" formally recognized at a regulatory level. This would risk creating unnecessary market segmentation, as well as creating the perception of potential liabilities for issuers potentially dissuading them from entering the market. ICMA and the GBP Excom consider that, if requested, the GBP process could be further expanded to observers from the official sector to deepen existing information exchange and dialogue.

4.2 Developing and diversifying the supply of funding

Q10: What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups?

Q10: International Capital Market Association (ICMA) response

59 Broadly speaking, an institutional investor will: (i) look at its liabilities and try to find assets that match them; (ii) look at the risk adjusted return profile of a certain asset; and (iii) take into account the capital charge of the said asset before investing. Within the current zero-rate environment, in fixed income assets (a more natural match to liabilities than equities) investors are looking for returns greater than government bonds, which can carry negative yields.

60 ICMA believes that the single most important policy measure that the European Commission can undertake to incentivise long-term investment by institutional investors is to address the third point mentioned above by urgently revising the final calibrations for insurers of the spread risk capital weightings in the Solvency II Delegated Act (Commission Delegated Regulation (EU) 2015/35).

61 While it is true that the final calibrations in the Delegated Act (the "long term guarantees package") help remove obstacles to investing in long-term assets, such as infrastructure projects, SME loans or start-ups, the final calibrations are still problematic due to the focus on volatility risk as opposed to default risk.[3] For buy-to-hold investors like insurers and pension funds the impact of market volatility on spread risk is immaterial as the assets are held to maturity. The matching adjustment in Article 77b-77d of Solvency II (2009/138/EC) has helped address this fundamental concern but does not go far enough.

62 ICMA welcomes the European Commission's request on 4 February 2015 to EIOPA for technical advice on the identification and calibration of infrastructure investment risk categories in the Delegated Regulation supplementing the Solvency II Directive. This will help investors allocate more funds to infrastructure. But it is important that this work is not undertaken in a silo: instead it should be viewed in the broader long-term investment perspective. Infrastructure is only one of many real economy asset classes that need reconsideration in Solvency II. The Commission should widen the request for technical advice to other asset classes, including securitisation and private placements.

63 ICMA believes that the infrastructure investment calibration should be part of a thorough consultation process to determine whether the calibration of the current long-term guarantees package is appropriate, or whether it needs adjusting in order to incentivise investment in all long-

[3] The Commission recognises that there is an issue with the introduction of market-consistent valuation in its staff working paper (SWD(2015)13) in footnote 66 on page 33, but we reject the tentative conclusion that a negative reading "may be misplaced" in light of the recent implementing rules of Solvency II. If the Commission is looking to provide an <u>incentive</u> for long-term investment, the Solvency II calibrations <u>must</u> be revisited.

term assets. ICMA recognises that this may be difficult to achieve in the short term, but considers that the original review date of 2018 for Solvency II is too late. Given the extremely low interest rate environment and the deleterious effects this is having on long-term investors in fixed income securities, this review should be scheduled for much earlier.

64 In a second order of priority, the Commission should also consider the many national restrictions that exist for investors to invest in these illiquid asset classes. The Commission should examine and encourage the removal of national barriers which discriminate against capital market investors, such as withholding tax on loans or private placements.

65 Across EU Member States, ICMA members have also noted that there are numerous restrictions on institutional investors like pension funds investing in pooled fund solutions holding illiquid assets, such as prohibitions or tax disincentives on allocating investments into Alternative Investment Funds (AIFs).

66 The Commission has itself noted the relatively high level of fragmentation in the pension fund landscape in the EU in its staff working paper. Where possible, the Commission should consider encouraging Member States to allow pooling of occupational or personal pension funds. As similarly recognised, the demographic profile of Europe means that retirement saving will play an ever greater role for the ageing population in the EU. Economies of scale are linked to efficiency and better returns, as larger pools of pension saving can invest in projects requiring more sophisticated investment expertise.

67 With regard to specific asset classes, national restrictions on loan origination must be removed to allow capital markets to play a greater role in financing SMEs, as ICMA notes in greater detail in our response to Q4 on private placements above.

68 Furthermore, as ICMA has pointed out in our response to Q3, more work is needed to dismantle national restrictions on private, illiquid assets for pan-European fund structures like ELTIFs to be made to work properly.

69 Finally, with regard to infrastructure investment, as detailed in ICMA's response to Q12 below, there is clearly a case to be made for a tailored treatment of infrastructure projects as a discrete sub-asset class in Solvency II, with lower capital requirements to reflect the low default risks and the high recovery rates in this asset class. The European Commission should without delay commence an impact study exploring the calibrations and definitions involved.

Q12: Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets? If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?

Q12: International Capital Market Association (ICMA) response

70 While some global banks have reduced project finance lending commitments (due to deleveraging and shrinking of banks' balance sheets, together with changes in banks' lending policies as a result of regulation), the appetite of some capital market investors to invest in infrastructure has increased – a trend which is expected to continue. It is therefore vital that the project finance market in Europe is made more accessible to non-bank investors.

71 The European Commission's European Fund for Strategic Investments (EFSI) is a very welcome initiative in furtherance of this objective. However, ICMA considers that the issues articulated below also merit consideration.

ELTIFs

72 ELTIFs which would invest in illiquid assets such as, *inter alia*, infrastructure loans could help boost investment in infrastructure. ELTIFs would enjoy a pan-EU passport, allowing a fund based in one EU Member State to operate across the entire single market. At present, the EU's most popular retail investment vehicles – UCITS – are required to keep 90 per cent of their assets in listed securities, meaning they cannot channel funds into these illiquid but economically important investments. It is helpful, therefore, that the new ELTIF vehicle has been created to help channel more funds to illiquid assets like infrastructure. However, it is also important to remove obstacles to investing in AIFs. The removal of these obstacles is explored in ICMA's response to Q10 above.

Calibration of prudential framework

73 As stated, certain investors – among them, insurers and pension funds – have increased their capacity to invest in infrastructure. Insurance companies and pension funds are, in fact, "natural" investors in infrastructure assets, since the long maturity and fixed rate nature of project bonds are a good match to their long-term liabilities. The prudential framework for institutional investors such as pension funds and insurers is critical for shaping investment decisions. Certain aspects of the current EU prudential framework for insurers and pension funds, notably Solvency II, however, may be a disincentive.

74 While the current, final, calibration of the Solvency II spread risk capital weightings are not *per se* an obstacle to insurers investing in infrastructure, equally, the final calibration provides little incentive for insurers to invest. While ICMA notes that Solvency II is now finalised, the European Commission should urgently review the final calibrations for long-term investments, as ICMA has outlined in greater detail in our response to Q10 above. ICMA believes that there is a strong case, as is recognised in the Green Paper, for the creation of a sub-asset class for infrastructure investments which should benefit from re-calibrated capital requirements to reflect that these assets are held to maturity, and to reflect the low loss-given default. ICMA welcomes the European Commission's call for technical advice on the identification and calibration of infrastructure investment risk categories in Solvency II from EIOPA, and has contributed to the debate.

75 Other regulations may prevent a market in infrastructure from developing. For example, occupational pension funds, which are a significant potential source of capital, are often prevented from investing in long-term infrastructure projects by national restrictions. In 2014, the Commission proposed a Directive (IORPS II) which would, among other things, stop Member States banning occupational pension funds from investing in assets with a long-term profile such as infrastructure, unless the restrictions are justified on prudential grounds; we are supportive of this position[4].

[4] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the activities and supervision of institutions for occupational retirement provision (recast):

(33) ... Investments in shares in currencies other than those of the liabilities and in other instruments that have a long-term economic profile and are not traded on regulated markets, multilateral trading facilities or organised trading facilities should therefore not be restricted except on prudential grounds.

(34) The understanding of what constitutes instruments with a long-term economic profile is broad. These instruments are non-transferable securities and therefore do not have access to the liquidity of secondary markets. They often require fixed term commitments which restrict their marketability. These instruments

Pipeline

76 It is recognised that there is very little consistent pan-European data available with respect to transaction opportunities, the progress of transactions, the performance of those transactions once complete and the asset allocation to investors.

77 To encourage institutional investor participation in infrastructure, Member States should collate and publicise an agreed set of information based on past and current infrastructure financing, which would not only build trust among the investor community but also allow for the calculation of realistic risk weights for regulatory purposes.

78 Efforts to create an up-to-date credible and transparent pipeline in the form of a European Investment Project Portal are welcome, and are considered by ICMA to be a significant step in giving visibility on transaction flow and, therefore, highlighting investment potential. This assessment of the potential future demand for project financing would build investor confidence and in turn encourage institutional and private sector investment, which would ultimately contribute to an effective long-term investment framework.

79 The information contained in such a pipeline should be carefully calibrated so as to be consistent between Member States, for example as regards timing of release of future investment plans, funding plans and tracking projects as they move through the procurement process towards financial close of the transaction.

80 The potential creation of a comprehensive technical assistance programme to channel investments where they are most needed under the coordination of a European Investment Advisory Hub is also welcome.

Policy changes

81 A key concern for investors in infrastructure is the risk of the decline in project tariff revenues, which would adversely impact the credit risk as well as the market value of an investment, and would ultimately dampen investor appetite for infrastructure. Regulatory uncertainty in one jurisdiction could also have a contagion effect on investor confidence in other jurisdictions.

82 A move towards transparency – as well as consistency – on the part of regulators and public sector authorities with regards to maintaining tariff-setting and/or other regulatory controls, as well as a review of their past practice of tariff reviews, including retrospective changes to tariffs against a variety of asset classes/projects, and appropriate compensation in the case of regulatory change, would help to assuage investors' concerns over the regulatory risk associated with the underlying revenues of the project.

Procurement procedures

83 ICMA supports the recommendations of the Report of the High Level Expert Group on SME and Infrastructure Financing, in particular that national PPP units should identify opportunities to strengthen the concept of "value for money" and propose relevant changes to national procurement legislation.

---

should be understood to include participations, debt instruments in non-listed undertakings and loans provided to them. Nonlisted undertakings include infrastructure projects, unlisted companies seeking growth, real estate or other assets that could be suitable for long term investment purposes. Low carbon and climate resilient infrastructure projects are often non-listed assets and rely on long term credits for project financing.

84 ICMA also agrees that national procurement authorities should be well staffed with the appropriate expertise to structure and conduct project specific transactions, and should encourage exchange of information and sharing of best practice and specialist knowledge via centres of excellence, for among other reasons, to promote consistency in the implementation of EU procurement rules at the national level.

85 For a variety of reasons, many large project financing transactions include both commercial bank facilities and project bond financing (such as the diversification of funding sources, the use of bank financing as a temporary bridge while awaiting optimal capital market financing conditions, and the need for revolving working capital finance). ICMA considers it of critical importance, therefore, that there is a level playing field between bank financing and bond financing options.

86 In this regard, ICMA, together with the Association for Financial Markets in Europe (AFME), have produced a *Guide to Infrastructure Financing – through Bank Loans, Debt Private Placements and Public Bonds,* which aims to unlock the potential for infrastructure funding by informing public authorities and the private sector and, in particular, describes the relative merits of the bond markets and bank financing, as well as considerations relevant to procurement and planning.

Extension of scope of credit enhancement vehicles

87 An investment grade rating helps to broaden the investor base and thereby increase the supply of finance, as most institutional investors have a mandate to invest accordingly. However, a balance needs to be struck between using guarantees and/or credit enhancement to improve the quality of projects that are already investment grade and thereby inciting appetite, and deterring or "crowding-out" potential bond investors who prefer the additional yield of an un-enhanced product.

88 Credit enhancement initiatives, for example through the EIB Project Bond Credit Enhancement Programme (PBCE), which is helpful for projects that face challenges in long-term financing, or might otherwise not be financeable at all, are welcomed. However, the PBCE facility is, at the time of writing, in the pilot phase and is currently restricted to certain areas. Given the number of national projects potentially struggling for funding, an expansion of the PBCE availability would be a positive catalyst to developing investor appetite.

Risk sharing measures

89 Public sector usage and demand guarantees should also be encouraged, with a view to ensuring fair risk-sharing for investors: while investors may be willing to take some risks between an agreed minimum or maximum level of usage, they are unlikely to be prepared to take all of the risk. This could be achieved by, for instance: partial guarantees for demand risk; minimum volume guarantees; cap and floor structures, which guarantee a minimum revenue commitment to the project company (a floor), which is offset by a cap agreement that revenue above the cap accrues to the public authority; and banded payment mechanisms for toll roads that reduce marginal revenue per vehicle at higher volumes.

90 An alternative way of enhancing the attractiveness of projects to investors is for specific risks to be guaranteed. Guaranteeing construction risk, as is currently done by the UK Government for the Thames Tideway Tunnel, would help many investors allocate funds to infrastructure.

Boosting retail investment

Q19: What policy measures could increase retail investment? What else could be done to empower and protect EU citizens accessing capital markets?

Q19: International Capital Market Association (ICMA) response

Introduction

91 ICMA is addressing Q19 mainly from the perspective of retail investment in non-financial corporate “vanilla” (fixed rate, floating rate or zero coupon) bonds. Much of the commentary involves non-exhaustive generalisations, but this seems appropriate in terms of helping flag drivers that may be of general relevance to EU retail capital markets. In this respect, it is worth noting that the EU’s demographic changes are likely to result in an increase in private savings as citizens are encouraged (eg by tax breaks) not to rely on pay-as-you-go state support (or unfunded company pensions) for their retirement and old age provision. Enabling effective retail participation in the EU’s capital markets will add a further significant option to compete with the available investment choices for investors considering such increases in their savings. Simply seeking to move existing retail savings from bank accounts seems likely to be economically neutral as the net household financing of the EU economy would remain unchanged.

Non-regulatory challenges to direct retail bond market participation

92 Section 5 of the European Commission Staff Working Document cites 5% as the number of euro-area households holding a direct investment in bonds and suggests a few aspects that may be potential challenges to household investment in capital markets (including a substantive real estate focus, which also may presumably be in part due to the generic desire for home ownership). From the retail investor perspective, there may also be national language and cultural preferences/traditions (including local recognition of borrower brands) and/or state saving incentives (eg in the context taxation and/or pension rules) that may require tailoring of capital market investment options and so result in nationally fragmented retail markets.

93 From the corporate borrower perspective, such fragmentation can increase transaction/funding costs. The maximum amount that can be borrowed (up to a few hundred million euro per country through two/three banks and with some institutional investor involvement) will necessarily be lower than if such fragmentation did not exist. At the same time retail distribution can be complex in terms of logistics and require some time between formal prospectus/final terms publication and closing of an order book, as the marketed investors are numerous individual human beings operating in their personal (non-working) time. This can be a couple weeks, though current retail demand in parts of the EEA (eg Belgium, the Netherlands and Italy) is such that retail order books can in practice be opened two days after prospectus/final terms publication and then closed that same day. This compares to the institutional/wholesale Eurobond markets (which are international and not fragmented along national lines), where established borrowers can simply and swiftly (within just a few hours intra-day) announce a transaction and close an order book in the many hundreds of millions or even billions of euro through even just one bookrunning bank (avoiding overnight risk for borrowers and investors alike)[5]. Furthermore, in terms of ongoing investor relations, a few hundred professional investors are logistically simpler/cheaper to engage with than the many thousands of individuals operating in their personal (non-working) time (particularly if borrowers subsequently

[5] Formal prospectus/final terms drafting and publication is generally not required by the market or legislation until later.

encounter the unthinkable and need to negotiate a restructuring of their debt)[6]. Consequently, the cost/benefit proposition for borrowers in approaching retail markets can often be weaker compared to the institutional/wholesale markets (though note the next paragraph). In this respect, it may be as interesting to think of borrowers as representing the "supply" of *investments* and of investors as representing the "demand" as of the converse in respect of *funding* (which is what the Green Paper does) – particularly given the long-running current bull market in bonds.

94 There have been some arguments that retail markets may be advantageous to borrowers as a more stable/less volatile investor base compared to institutional/wholesale markets. Indeed developments/considerations that are unrelated to the economic condition of a particular borrower can influence (and even potentially limit or reverse) institutional/wholesale capital flows – for example, movements in exchange/currency rates, sovereign solvency concerns, political risk, etc. However, this factor does not seem to have weighed substantially in the long-running current bull market in bonds.

95 Furthermore, retail investors have tended historically to have absolute coupon (rather than relative yield) preferences for *minimum* headline returns (often 5% though reportedly decreasing slightly as investors adjust their expectations), which has generally exceeded the market rate for most blue-chip borrowers. Conversely, much higher yielding credits may be commercially seen as too risky for most retail investors (regardless of any MiFID suitability or similar regulatory restrictions). This may be the case for many SME entities. Bonds issued by larger, higher-rated borrowers may also be seen as more liquid/less illiquid – which may also be a related consideration. As a result the range of potential borrowers that might realistically approach retail investors directly is relatively slim.

96 On the other hand, it is difficult to assess the possible effect on pricing, should access to retail investors by investment grade borrowers be made easier and less costly. Significant investor demand, combined with continuing low yields on other income generating assets such as bank deposit accounts, could reduce the returns expected by retail investors on corporate bonds. And it may be that some investment grade borrowers will be willing to make retail issues for other reasons, such as increasing their brand recognition, even though the costs of doing so are slightly higher than those for making a wholesale issue.

97 The above drivers do not seem obviously susceptible to European Commission intervention.

Regulatory challenges to direct retail bond market participation

98 Against the above background, minimising unnecessary regulatory disincentives to retail offerings is essential. Furthermore, national consumer protection regulations are in any case likely to be beyond the European Commission's securities regulation remit. Therefore the Commission's focus should be to ensure that pan-EU securities regulation within its remit (eg MiFID, MAD, TD, PD, UCITS, PRIIPs) is approached *holistically* as a whole to minimise unnecessary regulatory disincentives to retail offerings. In this respect, the "reduction of administrative burdens" and the "protection of investors" could be seen as two ends of a seesaw, with the Commission's role being to calibrate the appropriate point of balance to maximise society's benefit.

[6] In this respect collective representation of investors is not statutorily prescribed in many jurisdictions, is likely to be outside the European Commission's securities regulation remit and is subject (whether statutory or contractual) to logistical constraints such as representative remuneration and liability indemnification.

99 Even disregarding national differences, retail investors are not a homogenous group and could perhaps be seen as a savings spectrum, with each level involving potentially higher returns for investors but also potentially higher risks:

- there are some who have only very small savings (excluding home ownership) and should perhaps keep these in more basic forms than the capital markets (such as bank savings accounts);
- there are some who have some savings and should perhaps be directed to "very simple" products, potentially involving an element of direct regulatory intervention in product design (including adoption of existing product structures), generic investor guidance/education and price supervision (see for example the UK's Simple Financial Products initiative);
- there are some who have significant savings and who may be best served through properly-supervised intermediation that is affordable at this level (see further below) – be it MiFID suitability, pooled UCITS (to the extent not already within the preceding bullet) and/or similar concepts;
- there are those who have substantial wealth (and can contribute greatly to the EU's economy) and who arguably need no protections beyond what is accorded to professional market participants (because they have the means to employ full time staff to manage their investments, in family offices for example).

100 The above could minimise the societal challenges arising from behavioural biases (including retail savers' general unwillingness to read documents that are more than a few pages long) and financial illiteracy (including retail savers' general inability to comprehend documents fully that *only* a few pages long).[7] Policy decisions on the above, and the fourth bullet in particular, are the starting point for then considering how to calibrate conduct of business, disclosure and other regulatory tools.

- The disclosure tool (initial prospectuses, ongoing/periodic reporting transparency and punctual announcements) could then be prepared with the needs of professional "readers" in mind. Prospectuses could also be shortened/simplified if their general disclosure obligation were simplified, from addressing "all information material to informed investment decisions", to just information on the borrower's business relevant to (i) the borrower's ability to honour its payment obligations under the bond or (ii) the bond's market value prior to repayment: conceivably just terms, risks and financial statements. And financial statements could also be incorporated by reference only in the light of the general public availability of other disclosure information – including annual reports under company law (and the Transparency Directive's periodic reporting obligations) and other sensitive information under the Market Abuse Directive's *ad hoc* reporting obligations. Short-form disclosure (such as key information documents or prospectus summaries) would serve as a "quick sorter" for retail investors to decide what products to pursue further with their intermediaries.[8]

- The conduct of business tool involves professional intermediaries being subject to effective supervision/enforcement in terms of knowing their products generically (cf also the US Series 7 exams) and specifically (from the disclosure tool), knowing their clients and then

[7] Circa 30% misunderstanding rate indicated by the Commission's 2009 UCITS Disclosure Testing Research Report (eg #4.7).
[8] As recommended by the Commission's 2009 UCITS Disclosure Testing Research Report, #9.26.

matching the two – with related regulator compensation powers, prudential insurance obligations and residual industry compensation funds.

101 In this respect, the developing PRIIPs Regulation regime has focused since its inception on demystifying "packaging" and accordingly "vanilla" (fixed rate, floating rate or zero coupon) bonds seem, correctly, out of its scope (as the amount received from and thus "repayable" to a retail investor is *not* "subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor")[9]. However, were vanilla bonds to be brought into scope, there is a substantial risk that corporate borrowers would avoid EU retail offerings altogether. This is because the PRIIPs KID's unclear purpose continues to be concerning, given some residual ambiguity within the PRIIPs Regulation (namely between Articles 1 and 8(2) and Recitals 15, 22 and 26) together with public statements by EU authorities that the KID must contain sufficient information to allow consumers to make an informed investment decision[10]. Combined with the KID's three page length cap, this could make it practically impossible to disclose the borrower's credit "story" without radically simplifying it and so risk failing to include "sufficient information for an informed investment decision". This would create a de facto investor put: an effective right for investors to claim reimbursement (if not damages) on all borrowings at any time – which would be fundamentally incompatible with corporate borrowers' need for certainty of funding (borrowers cannot simply liquidate half-built factories to repay borrowings ahead of schedule). In this respect, the practical extent of the ability to cross-reference information in the prospectus (under Article 6.2 of the PRIIPs Regulation) may be significant.

102 The Green Paper notes that CMU should also be seen as a way to help markets develop at national level. In the respect, the above approach to pan-EU regulation could be complemented by an option (only) for individual Member States to implement a national regulatory regime for securities that are offered only within their own jurisdiction. This would enable a parallel development of national and pan-EU retail markets, according to the balance of non-regulatory drivers discussed above.

No disruption to institutional/wholesale markets

103 Whatever steps are taken in an attempt to minimise retail market disincentives, care also needs to be taken not to disrupt the institutional/wholesale markets which have been reliably providing trillions in financing to the EU's economy over the years.

[9] This basis in the PRIIPs Regulation's operative definition of what is a PRIIP is (i) reinforced in the PRIIPs Regulation's recitals by the fact that vanilla bonds do not "intercede between the retail investor and the markets through a process of packaging or wrapping" and (ii) consistent with "deposits solely exposed to interest rates" and "Assets that are held directly, such as corporate shares or sovereign bonds" being stated as out of scope.

[10] Which is the substance of the current PD prospectus test and inconsistent with the recommendation of the Commission's 2009 UCITS Disclosure Testing Research Report, #9.26.

Attracting international investment

Q21: Are there additional actions in the field of financial services regulation that could be taken [to] ensure that the EU is internationally competitive and an attractive place in which to invest?

Q21: International Capital Market Association (ICMA) response

104 ICMA's mission is to promote resilient and well-functioning international debt capital markets. Such markets are necessary for economic growth, and benefit market participants and their clients alike, the primary reason for the existence of capital markets being to channel investment from savers for use to enable companies/business to function and grow. Therefore, ICMA is itself highly supportive of the CMU initiative and considers that the fundamental point which the Commission should be considering in trying to develop CMU is how CMU can help to make the business environment better for companies/business in the EU – both from the perspective of EU companies as well as non-EU companies looking to invest in the EU. Changes which help to reduce business risks – political, legal, regulatory, tax and others – will make a positive contribution, as will other changes which make it easier to conduct business.

105 ICMA also considers it to be clearly evident that capital markets in the EU need to be globally competitive. If EU capital markets are not globally competitive, there is always a risk that the market firms which help to finance them will transfer new investment, or parts of their existing operations, out of the EU to the US or Asia. Conversely, a globally competitive EU capital market will attract investment from elsewhere. This global dimension needs to be taken into account when new measures are being considered within the EU. Third country equivalence – between the EU, America and Asia – matters.

106 Hence, one key question to consider is the extent to which Capital Markets Union should involve more regulation. A great deal of capital market regulation – both prudential regulation and conduct of business regulation – has been introduced in the EU already. The original EU Financial Services Action Plan was left incomplete when the crisis struck. But since the crisis, the Single EU Rulebook has in response introduced capital market regulation which is much more intrusive and wider in scope (eg through CRD IV, MiFID II and EMIR). A significant number of EU legislative measures, begun under the previous European Parliament, remain to be implemented during the mandate of the new European Parliament. The Commission has estimated that over 400 Delegated and Implementing Acts (eg relating to MiFID II, Solvency II, BRRD and CRD IV) remain to be adopted.

107 The President of the new European Commission has decided to put its most senior Vice President in charge of "better regulation". This gives an opportunity for the authorities to take stock, not only by assessing the impact of individual regulatory measures, but also by assessing their cumulative impact on capital markets as a whole. It also requires a change of culture within the Commission: away from assessing individual performance on the basis of the number of new regulatory measures passed into law; and towards assessing their effectiveness under the "better regulation" agenda. The main tests should be whether regulatory measures improve efficiency, liquidity and stability, and whether they help to integrate capital markets or whether they have unintended consequences. A proper assessment of the impact of regulatory measures on capital markets would help determine whether the right balance has been struck between reducing risk and encouraging growth. Where new regulatory initiatives are undertaken, the capital markets are looking for more certainty about what is proposed and why it is needed: new initiatives should be proportional; and they should be consistent across the EU as a whole and internationally.

108 One option would be to establishing a Better Regulation Board, independent of the European Commission, to review the accuracy and completeness of new impact assessments. This could contribute materially to the "better regulation" objective. Impact assessments could also include a growth test to detail how a new measure will contribute to economic growth or else justify anti-growth measures on the basis of other desirable objectives. Finally, impact assessments could be made more "user-friendly" by splitting them into assessments applicable to (i) companies and (ii) investors. This would facilitate better dialogue with the industry and individuals, ensuring policy aims are better understood and mitigating unintended consequences.

109 ICMA recognises the importance of financial stability, investor protection and market integrity, which all require appropriate regulations and robust market practices. Even so, ICMA considers that a practical agenda for achieving Capital Markets Union should involve reviewing existing EU legislation affecting capital markets. Such a review should be designed to ensure that market participants critical to the development of capital markets are not prevented by inconsistencies in EU legislation, or its unintended consequences, from doing so. For example:

- Penalties on financial institutions have become disproportionately large so that there is a risk that the penalties – in the form of fines – have the unintended effect of undermining the viability of the financial institutions concerned. Where penalties are justified, they should focus on the individuals responsible rather than on shareholders as a whole.

- Bank structural reform should be designed in such a way as not to discourage secondary market trading, which would risk reducing growth by disrupting markets.

- As discussed in ICMA's response to Q27, market discipline measures under CSDR, intended to improve settlement efficiency, should not be so penal in their effect as to damage market liquidity by making it uneconomic to offer fixed income cash and repo market making services.

- As also discussed in ICMA's response to Q31, the finalisation of the technical standards for MiFID II/R, with respect to the pre- and post-trade liquidity calibrations, runs the risk of further harming fixed income market liquidity, rather than enhancing it, with the effect of deterring participation in fixed income markets.

- Capital requirements under CRD IV and Solvency II should not have the unintended consequence of making it prohibitively expensive to invest in securitisations.

- As outlined in greater detail in ICMA's response to Q10, solvency requirements on insurance companies under Solvency II should encourage long-term financing rather than having the opposite effect.

- The proposed Financial Transaction Tax should not be implemented in its original form, as it would drive financial services business out of the markets affected by making them less competitive (this point is elaborated on in ICMA's response to Q30).

110 These changes would all be consistent with "better regulation". And more generally, care is needed to ensure that EU regulations not only take account of EU requirements, but are also consistent with those in North America and Asia within the G20 framework so to maintain the EU's global competitiveness. The reality is that today there is more regulation than ever, with associated costs to business, and in the EU context the complexity of this is amplified as a result of EU

legislation being implemented in different ways across the 28 Member States. And, in some cases, the EU has tried to steer its own path independent of international initiatives, in contradiction of the need for greater regulatory harmonisation and convergence in an increasingly global business world.

111 Furthermore, removal of remaining cross-border barriers to capital markets within the EU should be designed to complete relevant parts of the EU Financial Services Action Plan, which was interrupted by the crisis, and to ensure that EU legislation is implemented at national level in a consistent way. Many of these barriers have in the past proved politically difficult to remove and this is likely to remain the case. Nevertheless, coupled with appropriate refinement of the EU regulatory environment and the targeted promotional development of selected capital market products, incremental progress in relation to these cross-border barriers would contribute to making the EU internationally competitive and an attractive place in which to invest; and thus help deliver the objectives of CMU. ICMA's answers to various other questions posed in this CMU Green Paper build on these points.

112 Finally, it is important to re-emphasise that these various concerns cross both national and EU boundaries. An important contributing factor in achieving the full benefits that can be gained from capital markets lies in their global nature. Avoiding problems at this level requires meaningful coordination of regulation across international boundaries and the ICMA is pleased to note the efforts which have been being made to develop workable solutions for third country interaction. Nevertheless, it is clear that there is a vast amount of international coordination required to resolve differences, of both substance and timing, before outcomes are achieved which will positively assist, rather than impede, international investment. The work of IOSCO's cross-border task force, which is supported by ICMA and others through the cross-border regulatory forum, is a positive step which needs to be energetically followed through and built upon.

4.3 Improving market effectiveness – intermediaries, infrastructures and the broader legal framework

Q23: Are there mechanisms to improve the functioning and efficiency of markets, particularly in the areas of bond market functioning and liquidity?

Q23: International Capital Market Association (ICMA) response

Please see ICMA's response to Q27, Q30 and Q31 below.

Q25: Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a Capital Markets Union?

Q25: International Capital Market Association (ICMA) response

113 ICMA recognises that an important question is whether Capital Markets Union should involve giving an EU institution more powers for closer supervision of the capital markets. For example, should the EU establish the equivalent of the SEC in the US, with binding mediation powers over national regulators as a first step? To some extent allied to this, there is also an outstanding question about whether to eliminate the potential overlap between the role of the three existing European Supervisory Authorities (ESAs), the supervisory role of the ECB, the European Systemic Risk Board (ESRB) and the proposed Single Resolution Board for resolving failing banks.

114 ICMA perceives that one of the key planks of the new European supervisory framework, established responsive to the financial crisis, was the establishment of the new ESAs. These bodies have endured a baptism of fire since their inception in 2011, being faced from the outset with a rapidly evolving set of tasks and responsibilities. Yet they have been responsible for much good work and have received broadly positive evaluations by the IMF, European Commission and European Parliament.

115 The recent European Commission review of the European Securities and Markets Authority (ESMA) and the other two ESAs has not proposed radical changes, though it pre-dates the commitment to CMU. ESMA already has some direct supervisory powers (eg over Credit Rating Agencies and Trade Repositories). More use is already being made of EU Regulations (eg EMIR, CSDR, MiFIR and MAR), which apply directly in all 28 Member States, instead of Directives, which have to be transposed into national law. Closer supervisory convergence (ie consistent application of the same rules using similar approaches and with the same outcomes) between national regulators in the 28 EU Member States is both important and possible without a further transfer of supervisory powers from national level to EU level. And the Commission has indicated that it wishes to "make full use of the current supervisory framework to improve supervisory convergence."

116 There is also a limit on the extent to which supervisory powers can be centralised further without a change in the EU Treaty. A Treaty change does not appear to be politically practicable, at least for the time being. Nor is it clear why more centralised supervisory powers would help maximise the benefits of capital markets for the real economy. Consequently, there is a strong case that the EU principle of subsidiarity should apply. Naturally, it follows from such an approach that, as was determined in relation to the case of the regulation of CRAs, there may be further cross-border cases where it would be more appropriate to allocate responsibility for supervisory competence at EU level than at Member State level; and in such cases ESMA should then take on these incremental responsibilities.

117 ICMA considers that more can be done, and indeed is being done, to ensure consistent supervision within the existing framework and recognises that there are constraints on how further developments can pragmatically be achieved. One evident factor is going to have to be a resolution to the debate regarding how the ESAs are funded. The ESAs are stretched to fulfil all their tasks and responsibilities within existing budgets and are having to give a lower priority to certain tasks, in order to develop work programmes which fit within the budgetary limit imposed on them – which is less than the amount which they themselves believe they need to budget for. Acting under such tight budgetary constraint not only threatens to extend the practical timelines for completing the new EU financial regulatory regime, but also leads to the establishment of sub-optimal standards – which may weaken the effect of reforms and is likely to adversely impact the concurrent desire to advance CMU.

118 Indeed, there are some regards in which the ESAs could, given the budget, go even further than they have thus far planned. In particular it makes sense that they should be able to play a fuller role in contributing their views to inform the formulation of new Level 1 EU legislation. This would help to ensure that requirements which then come to be handed to them for subsequent Level 2 work are fully understood, have an adequate amount of time for their orderly adoption and are more likely to be framed in a way which leads to effective regulation, in a manner which is simultaneously more conducive to objectives of CMU. There must also be sufficient time for Level 2 work to be properly considered, and delays in Level 1 should not contribute to rushed rule-making in Level 2. Where new regulations are brought into force and problems then become evident, consideration should also be given to allowing the ESAs to promptly propose some form of no-action relief, subject

to approval from the European Commission and a process for reporting and oversight designed to properly respect the authority of the co-legislators. And, as well as conducting peer reviews to help identify areas for harmonisation of best supervisory practices, ESAs could work more proactively with NCAs, both during their implementation of new supervisory powers and during the course of their ongoing supervision, thus maximising the scope to encourage the adoption and pursuit of common supervisory practices. A specific example is Article 9 of the ESAs Regulations[11], which empowers the authorities to undertake EU internal market product initiatives which have so far been under-utilised. Fundamentally, these steps are contingent on the ESAs having sufficient resources, skills, authority and legislative tools to fulfil their mandate.

Q27: What measures should the EU take to improve the cross-border flow of collateral? Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

Q27: International Capital Market Association (ICMA) response

Collateral fluidity

119 ICMA prepared a paper for policy makers, published on 8 April 2013, entitled *Economic Importance of the Corporate Bond Markets*. This outlined why corporate bond markets are so important for economic growth, for investors, for companies, and for governments, around the world; and why it is therefore essential that laws and regulations that affect them avoid any unintended adverse consequences that could inhibit those markets. In response to widespread concerns that the cumulative impact of current and proposed regulatory reform threatens to undermine core aspects of the economic functions of trading in the European repo and fixed income markets, ICMA then produced a paper, published on 29 October 2013, entitled *Avoiding Counterproductive Regulation in Capital Markets*.

120 A core theme running through ICMA's October 2013 paper was the importance of collateral and the extent to which changes to financial regulatory rules risk impeding the functioning of the European repo market, which serves as a primary channel for the circulation of collateral. In light of this, a further ICMA European Repo Council (ERC) paper, *Collateral is the New Cash: the Systemic Risks of Inhibiting Collateral Fluidity*, was published on 3 April 2014. This describes the increasing importance of collateral and how it effectively underpins the functioning of capital markets which provide the basis for economic growth. It calls for regulators to consider the impact of financial regulation on the movement of collateral, highlighting the potential systemic risks of inhibiting collateral fluidity and the negative impact this could have on the stability and efficiency of capital markets.

121 Conclusions from this ICMA ERC paper include the following:

- Even with more stringent regulation and greater demand for collateral, so long as collateral is still free to move around the system we may feel comfortable with the assumption that financial markets will continue to function, even if somewhat inefficiently, at least under benign conditions. However, if collateral fluidity is inhibited, this poses a risk to the overall functioning of the markets, which will become more pronounced under conditions of market stress. This could not only freeze funding and capital markets, but would have serious repercussions throughout the whole economy.

[11] Regulations (EU) No 1093-1095/2010.

- If banks find it economically inefficient, or are restricted by regulation from supporting the critical functions of sourcing, pricing, managing, and mobilizing collateral, and the infrastructure is not in place for the efficient mobilization of collateral, then the basic intermediation roles of banks and financial markets – that of maturity, risk, and credit transformation – would be undermined. For all the good work and best intentions of financial regulation, we would be embedding systemic risks.
- Sound regulation is essential for the efficient and stable functioning of the global funding and capital markets that support our economies. So is collateral. In this respect, regulation should not only avoid inhibiting collateral fluidity, but, where possible, it should aim to enhance it.

122 ICMA believes that the aforementioned papers have clearly articulated the importance of efficient and effective fixed income markets and identified that there are significant risks in case well intentioned regulation inadvertently leads to undesirable detrimental effects on the functioning of fixed income markets. ICMA calls for more work to identify and remediate such problems, particularly taking into account the cumulative effect of regulations. From an EU perspective this will be an important foundation upon which to build for the achievement of a desirable CMU; and more generally it is of fundamental importance to underpin investment flows, economic growth and the creation of jobs. With collateral, and the securities financing markets which serve to transport collateral about markets, being impacted indirectly and directly by a wide range of regulations, both of a prudential and conduct of business nature, this needs to be a broad effort. Recalibration of aspects of new capital rules, particularly the leverage ratio, liquidity rules (LCR and NSFR), trading rules (MiFID II/R), clearing rules (MiFIR) and settlement rules (CSDR, as more specifically detailed further below) are all pertinent examples.

123 Furthermore, responsive to an initiative proposed by the ICMA ERC, on 15 July 2013, the Triparty Settlement Interoperability (TSI) Participants, namely the ICMA ERC, Clearstream Banking S.A. (CBL), Clearstream Banking AG (CBF), Euroclear Bank SA/NV and Eurex Clearing AG, signed – in a ceremony hosted by the European Central Bank (ECB) and observed by the European Commission – the TSI Memorandum of Understanding (MoU). Pursuant to this MoU the TSI Participants have agreed to engage in a project with the aim of establishing a comprehensive framework for TSI between the TSI Participants.

124 In the first instance, this project primarily creates the opportunity for Eurex Clearing to extend the connected settlement locations for its secured funding market GC Pooling product, to include Euroclear Bank alongside CBL/CBF; but it is also intended to create a framework suited for extension to include other participants. Whilst the timing of TSI has been adjusted from that envisaged at the time the MOU was signed, this project remains important and needs to be driven to conclusion, along with inter-related work necessary to upgrade the settlement "bridge" between CBL and Euroclear Bank. This work to upgrade the bridge is itself a very important project, which needs to be realised so that advantage can be taken of modern technology allowing for close to real-time processing, rather than being constrained by the limits of older batch processing methodology. Both cash securities and securities financing markets will benefit from this development; and the realisation of the TSI initiative is dependent upon the prior achievement of an adequate degree of bridge enhancement.

125 Additionally, led by the direct involvement of its long-standing Chairman, Godfried De Vidts, the ICMA ERC has also been actively participating in the work of the ECB's Contact Group on Euro Securities Infrastructures (COGESI), which has itself been coordinating significant efforts focussed on

enhancing the understanding of collateral requirements and the effectiveness of the Collateral Market.

126 Pertinently, on 15 July 2013, the ECB published a report entitled *Collateral Eligibility Requirements: a Comparative Study Across Specific Frameworks*. This report provides a comparison of the rules for the eligibility of collateral, covering: (i) the collateral policies followed by different central banks (including European central banks, as well as the central banks of the United States and Japan); (ii) the regulatory frameworks in place; and (iii) the practices of central counterparties (CCPs). It was prepared by COGESI in cooperation with the ECB's Money Market Contact Group (MMCG); and is aimed at improving transparency by highlighting the differences between, and similarities in, the collateral requirements faced by the financial industry.

127 Subsequently, three reports promoted by the *Ad hoc* Group of COGESI on Collateral (composed of members of COGESI and the MMCG) were published on 7 July 2014:

- Collateral eligibility and availability: Follow-up to the report on "Collateral eligibility requirements - a comparative study across specific frameworks";

- Euro repo market: improvements for collateral and liquidity management; and

- Improvements to commercial bank money (COBM) settlement arrangements for collateral operations.

128 This COGESI-led work is important to the improvement of the euro area collateral market and when complete, together with the ECB's May 2014 removal of the repatriation requirement and its September 2014 introduction of the use of cross-border triparty collateral management services, will much improve the euro area collateral market.

129 ICMA clearly perceives that collateral is a topic of great importance and that it is essential to encourage the existence of efficient and effective Collateral Markets in the EU. In this context, ICMA applauds associated public sector efforts which have been made to date; and recommends a thorough review of the above mentioned programme of private and public sector efforts to enhance Collateral Markets.

130 ICMA believes that there is a significant opportunity to further coordinate efforts in this arena, both by bringing the efforts of the ICMA ERC to the attention of the public sector and by seeking to ensure that there is full cooperation across the public sector, not only with regulators but also including a close harmonisation of the respective efforts of the Bank of England's SLRC and the ECB's market contact groups – the BMCG, COGESI, the MMCG and the MFCG. The ECB's recent commencement of a significant programme of euro public sector debt, commonly referred to as quantitative easing (QE), further underscores the need for such coordinated efforts. By removing a large amount of euro area government securities from the market, the ECB's programme will further squeeze liquidity in the market for the applicable securities. Associated securities lending, to make such securities available to the market, can help alleviate this additional liquidity strain, but much work is needed to develop how this is done – as the initial process of lending through the euro area NCBs is uneven in application and has a fragmenting effect on what should be an integrated market.

Collateral re-use

131 The ICMA European Repo Council (ERC) is concerned about the persistent suggestion that procedures need to be developed to allow the tracking of collateral in securities financing transactions. This concern stems first and foremost from the fact that, given the fungibility of

securities from within a single securities' issuance, such tracking is simply not feasible; but, furthermore, it is unclear why attempting to track reuse is really necessary and what benefits such an endeavour would bring.

132 One widely discussed point of concern which appears to colour thinking regarding the need to track collateral is a perceived need to keep track of where other people's assets have got to. This has led some to call for re-use to be monitored, but in the context of the European repo market the term re-use is itself a misnomer. In a repo effected using the EU's legal construction of a title transfer collateral arrangement[12] (as occurs in repos under ICMA's Global Master Repurchase Agreement (GMRA)), the buyer becomes the owner of the collateral at the start of the transaction and can dispose of the collateral when and as he wishes. (The GMRA includes detailed provisions to govern what happens if a party fails to deliver collateral in a repo, including under a range of default scenarios – the robustness of these arrangements has been put to the test on a number of occasions over the years and the GMRA has proven itself to be fit for purpose).

133 In a GMRA repo the buyer's right of "re-use" is not a right granted by the seller, but is rather an automatic right arising from property ownership. In other words it is a right of "use", as would apply to any other fully owned property and not really a matter of re-use. This is very different from the legally distinct case of rehypothecation (or re-pledging), which is widely used by prime brokers involved in the collateralisation of derivatives transactions with hedge funds. It is this activity of rehypothecation which, quite rightly, is the subject of the FSB's recommendation #7, which calls for regulations governing re-hypothecation of client assets in order to ensure that there is appropriate transparency and control over this particular activity

134 A second point of concern which appears to lead to the belief in a need to keep track of collateral involves the risk of default triggering interconnected collateral liquidation risks through a chain of re-use. This however is not the case, as a default only gives rise to a liquidation requirement on the part of the directly impacted party, whilst all other contracts throughout a chain of re-use remain fully valid and enforceable. Hence there is no need to track collateral back through the chain to see where it came from.

135 As also called for by the FSB in August 2013, the EU is pressing ahead with putting in place a detailed regime for the transparency of SFTs, through the EU SFT Regulation. This will mean that authorities have the information about which SFTs are taking place and can monitor where any risk concentrations are building up in the market. Wherever collateral is being re-used in a subsequent SFT this will already form part of the reported information, as that subsequent SFT will itself fall to be reported. This should provide authorities with more than adequate information. Concerns over interconnectedness and potential contagion at a systemic level should be monitored based on periodic reporting of positions between the largest global banks, broken down by types of collateral. The need to track individual pieces of collateral through the system does not arise.

Mandatory buy-ins

136 Of particular concern to the European bond and financing markets is the provision in the Level 1 text of CSDR for "mandatory buy-ins", which would mandate that any failing settlement in cash securities would automatically trigger a buy-in after four days in most instances, and after seven days for the least liquid securities. In the case of securities financing transactions, this will apply to the end-leg of any SFT and to the start-leg of all SFTs apart from very short-dated or open

[12] As provided for in the Financial Collateral Directive (2002/47/EC), which sought to harmonise and clarify the collateral process.

transactions. This effective exemption threshold for certain SFTs is based on the impracticalities of executing and settling a buy-in against the start-leg of an SFT that would have already matured.

137 To illustrate the liquidity and pricing impacts of imposing a mandatory buy-in regime on both bond and repo markets, ICMA conducted an impact study, which was published in February 2015. In conducting the study, market-makers for both European bonds and repos were asked to report how they would adjust their offer-side pricing for different asset classes, and different liquidity profiles (as defined by CSDR), in a mandatory buy-in regime. The results were then aggregated and reflected in terms of the new, wider, bid-offer spreads post-CSDR.

138 This ICMA study illustrates that if, or when, mandatory buy-in regulation is implemented (scheduled for early 2016), liquidity across secondary European bond and securities financing markets will reduce significantly, while bid-offer spreads will widen dramatically. The results suggest that even the most liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. The survey further suggests that, for many less liquid bonds, including sovereign and public issues, market-makers will retrench from providing liquidity altogether. The study also highlights the potential costs of these impacts, that will be borne by investors and issuers (public and private), and so constitute a cost to the real economy.

139 Given that the risk of experiencing settlement difficulties, and therefore being impacted by CSDR's settlement discipline provisions, is greater in cross-border transactions (as a consequences of the greater complexities associated with cross-border settlements), the overly penal effect of CSDR mandatory buy-ins will not only generally harm the market, but will also particularly impede cross-border flows. Revisiting CSDR to alleviate these problems is a matter in need of priority action, both for the overall benefit of enhancing fixed income markets, by better calibrating the understandable desire for settlement efficiency against the market liquidity effects of discipline provisions and to help improve cross-border flows. Today, EU fails are not excessive and the majority of fails are of a technical nature. T2S (the Eurosystem solution for central bank money securities settlement) is due to be phased in up to mid-2017. Given this and the concerns articulated above, CSDR mandatory buy-ins should be deferred at least up until the time T2S is fully implemented and further analysis of the incidence of fails is then done; and modalities of application of mandatory buy-in need recalibrating.

Stays

140 Finally, the transposition of the Bank Recovery and Resolution Directive (BRRD) is under way across the EU, providing a harmonised legislative framework for the resolution of banks in Member States. One of the powers provided for in the BRRD enables resolution authorities to temporarily suspend termination rights and impose stays which would override specific provisions of certain agreements to which a resolved entity is party, including the Global Master Repurchase Agreement (GMRA). It is essential that the implementation of the BRRD is undertaken in a consistent manner, without unintended consequences, particularly in relation to the efficacy of netting.

141 With the legislative overlay of the BRRD in place, recognition of Member States' resolution regimes will, at least within the EEA, be provided for as a matter of law. However, this does not necessarily deal with scenarios where there is a relevant extraterritorial element. In such scenarios, a contractual solution has been requested by the regulators to plug the legislative gap. It is understood that regulations will be developed in the "Home Authority" jurisdictions (UK, France, Germany, Japan, Switzerland and the US) to support contractual solutions, requiring regulated entities to provide for contractual recognition of the Home Authorities' resolution regimes in given circumstances. Whilst the policy aims of the regulators are well understood in this regard, it is

important that any contractual solution is sensibly calibrated, taking into account the documentation and structure of the securities financing market.

Q30: What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

Q30: International Capital Market Association (ICMA) response

142 ICMA considers that a practical agenda for achieving Capital Markets Union should involve removal of remaining cross-border barriers to capital markets within the EU, in a manner designed to complete relevant parts of the EU Financial Services Action Plan, which was interrupted by the crisis, and to ensure that EU legislation is implemented at national level in a consistent way. Many of these barriers have in the past proved politically difficult to remove, which very much tends to prove the case when considering tax matters, since unanimity is required among the 28 Member States in order to give effect to harmonised tax changes.

Giovannini barriers

143 An applicable example of such a barrier in the field of taxation is withholding tax, where national regimes on withholding tax differ. A topical, practical application of this is the UK HM Revenue & Customs pronouncement of an exemption from withholding tax for interest on private placements, contained in a technical note dated 10 December 2014. ICMA is hopeful that successful implementation of this in the UK will encourage other European countries to introduce similar exemptions in their respective jurisdictions, but whether this will happen, or not, remains to be seen.

144 Indeed, the Giovannini Group's *Second Report on EU Clearing and Settlement Arrangements*, April 2003, identified that there were two barriers in the field of taxation; and that the removal of these two barriers was the exclusive responsibility of government. As per the *Second Report*:

- Giovannini barrier 11 relates to domestic withholding tax regulations. The majority of Member States restrict withholding responsibilities to entities established within their own jurisdiction. In consequence, foreign intermediaries are disadvantaged in their capacity to offer at-source relief from withholding tax by the significant extra cost of using a local agent or local representative in the discharge of their withholding obligations. The Giovannini Group recommended that national governments should take immediate steps to allow foreign intermediaries to act as withholding agents in all of the EU Member States; and that national governments should co-operate closely with the private sector in implementing this recommendation.
- Giovannini barrier 12 relates to the collection of transaction taxes through a functionality that is integrated into a local settlement system. In these circumstances, the foreign investor's choice of provider for securities settlement is reduced because it is necessary to link up with the local settlement system that operates the tax collection functionality. To ensure a level playing field between domestic and foreign investors, the Giovannini Group recommended that any provisions requiring that taxes on securities transactions be collected via local systems should be removed. Again, national governments should co-operate closely with the private sector in implementing this recommendation.

145 Yet, still today, these two barriers have not been comprehensively addressed, so this should now be done. That will involve building on the progress that has been made, including by ensuring that the recommendations set out in the 2013 Report of the Tax Barriers Business Advisory Group (T-BAG) are fully implemented in EU Member States.

Financial Transaction Tax

146 Another significant concern of ICMA's in the field of taxation relates to the European Commission's proposals for a Financial Transaction Tax (FTT), which were published in September 2011. Whilst this was posited as a harmonising measure, the effect of implementing FTTs clearly runs directly counter to the objectives of CMU; and quite a number of reports have been published which are highly critical of the proposal, which is seen to be unlikely to fulfil the Commission's objectives and could cause the EU economy significant harm.

147 After a number of Member States announced that they would not support an EU-wide FTT, 11 Member States decided in 2012 to take forward the proposal under the enhanced co-operation procedure. Yet this too has remained contentious and the FTT participants have yet to reach agreement on the form and scope of the tax, although their most recent pronouncement, on 27 January 2015, declares that they remain committed to an FTT coming into force from January 2016.

148 It remains to be seen what scope of FTT may emerge from this continued debate, yet the latest pronouncement refers to an ambition to proceed with FTT "on the principle of the widest possible base and low rates". The more transactions are subject to FTT and the higher the effective rate of any FTT that is imposed, the more this will serve to impede the effective use of the affected transactions in order to advance the objectives of CMU. Whether the FTT is on fixed income securities, equities or derivatives, study after study shows that there will be a significant negative impact as a result of increased economic financing costs which will largely have to be borne by investors. In ICMA's opinion, the necessary focus on investment, economic growth and jobs, which is manifest in the CMU project, should presage an end to the counterproductive notion of introducing FTT.

Debt and equity

149 A different tax matter flagged by the European Commission is the "tax bias in favour of debt in corporate taxation, due to the deductibility of interest payments on debt without a similar treatment for equity-financing." This is not a European phenomenon, IMF staff having observed in their work that most tax systems today contain a "debt bias," offering a tax advantage for corporations to finance their investments by debt. Yet it would be inappropriate to focus in isolation on this one aspect of tax regimes. Both issuer and investor tax treatments need to be considered on a cross-border basis in order to appreciate where tax may play a role in decision making regarding financing costs; and factors such as tax rates and allowances also interact with the more direct question of which financing costs are, or are not deductible for the issuer (eg whilst reducing or eliminating the deductibility of interest would effectively raise corporate tax rates, that move could be offset by a lower marginal corporate tax rate).

150 IMF staff work has considered the question of what can be done to mitigate any debt bias in the tax code. "In a nutshell, this will require either reducing the tax deductibility of interest or introducing similar deductions for equity returns. A number of countries have already opted to reduce interest deductibility. But such restrictions on deductions do not eliminate debt bias altogether, and they bring considerable new complexities and opportunities for tax avoidance. Abolishing interest deductibility would indeed eliminate debt bias, but it would also introduce new

distortions into investment, and implementing it would be very difficult. For these reasons, no country has moved toward eliminating the deduction.

151 The second option, introducing a deduction for corporate equity, has better prospects. This involves, for example, granting firms a deduction for the normal return on equity equal to the rate of government bonds. Apart from eliminating debt bias, such an allowance would bring other important economic benefits, such as increased investment, higher wages, and higher economic growth. The main obstacle is probably its cost to public revenues, estimated at around 0.5 percent of GDP for an average developed country. This cost could be reduced in the short run by granting the allowance only to new investment. In the long term, the budgetary cost is expected to be significantly smaller, since the favourable economic effects of the policy change would broaden the overall tax base. And in fact, a number of countries have successfully introduced variants of the allowance for corporate equity, suggesting that it is not only conceptually desirable but also practically feasible."

Base Erosion and Profit Shifting

152 Another important current stream of tax related work concerns the Organisation for Economic Cooperation and Development's (OECD's) Base Erosion and Profit Shifting (BEPS) initiative. BEPS, which is considered to be a global problem requiring global solutions, refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. Fifteen specific actions are being developed in the context of the OECD/G20 BEPS project, to equip governments with the domestic and international instruments needed to address this challenge.

153 ICMA supports the overall BEPS project; however, the details of its implementation clearly matter and could have significant consequences. To take one example, ICMA understands that for investment funds, in particular, those investing in real assets such as infrastructure, real estate, and renewable energy, current BEPS proposals would lead to a significant fall in cross-border flows and investment. Yet it should prove possible to find solutions that meet the objectives of policy makers and retain the utility of cross-border investment funds. Accordingly the authorities should continue careful efforts to progress BEPS in close coordination with industry, in order to avoid unnecessary adverse consequences, counter to the objectives of CMU.

Other concerns

154 Finally, it is worth recognising that not only is tax a direct cost for business but also it imposes significant indirect costs, since tax legislation is complex and creates risks to doing business. This is particularly so for business within the EU, where there are 28 distinct Member State tax regimes to contend with; and this then contributes to a relative lack of international attractiveness of the EU as a place to do business. Even apparently quite small details of tax regimes can have major effects on the ways in which business and markets develop across borders – this is a point of great resonance for ICMA, which was itself established almost 50 years ago following the creation of the Eurobond market, which was inspired by changes to US withholding tax rules.

Q31: How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

Q31: International Capital Market Association (ICMA) response

155 In November 2014, ICMA published the report: *The Current State and Future Evolution of the European Investment Grade Corporate Bond Secondary Market: Perspectives from the Market*. This study explores a number of themes, mainly related to deteriorating liquidity conditions in the European corporate bond markets, including changing business models and the evolution of electronic trading.

156 ICMA's response to Q31 focuses primarily on new technologies and business models related to Europe's fixed income markets, in particular for corporate bonds, and draws on the ICMA study.

Changing business models

157 The European bond market is structurally very different to equity markets. While there are approximately 6,000 shares traded on regulated markets in Europe, there are more than 150,000 different debt securities. Furthermore, while a firm's equity structure is generally limited to one or two classes of shares, a firm's debt structure usually consists of multiple, often hundreds, of different tradable lines. Furthermore, these bonds, even with the same issuer, will have different maturities, coupons, issue sizes, covenants, and characteristics related to the seniority and security of the debt, as well as different ratings.

158 While most shares will trade several times, if not multiple times, per day, the vast majority of bonds will not trade on a daily basis, and may not trade for weeks or even months. Essentially, unlike equities, bonds, as a distinct asset class, can and should be considered illiquid. Thus the traditional model for trading bonds is very different to that of equities. While most equities trade actively and visibly, on exchanges, bonds have tended to trade off-exchange, in the over-the-counter market, with liquidity being provided by intermediary market-makers (usually banks or broker-dealers). These market-makers for specific debt securities (usually the same financial institutions that were part of the syndicate for the security's primary issuance) provide investors with bids, where they will take the bonds onto their own trading books, or offers, where they will sell the bonds via a short-sale with a view to covering the position with a subsequent market purchase or via the repo market. Given the inherent illiquidity and trading infrequency of corporate bonds, the market-making model provides ready liquidity in the absence of the 'coincidence of want' between matching buyers and sellers of any particular bond at any given time.

159 Buy-side firms obtain quotes from market-makers by contacting them directly, usually via a sales contact, either over the phone or using electronic messaging. Alternatively, some market-makers provide electronic trading platforms which their clients can access to request quotes or to transact on firm (executable) prices.

160 The market-making model is dependent on a number of elements available to the market-making firm: (i) sufficient balance sheet to warehouse long and short positions; (ii) an efficient and liquid hedging market; (iii) an efficient and liquid repo market; (iv) the requisite trading and risk-management skills. What the ICMA study confirms is that all of these factors are being seriously constrained in the current regulatory and market environment. Basel III, CRR/D and Leverage Ratio

provisions have made balance sheet for banks and broker-dealers far more expensive; EMIR has raised the cost of accessing the CDS market; repo market liquidity is reducing (see ICMA's response to Q27); and trading and sales desks are experiencing an ongoing process of "juniorization" and an attrition of talent. Further regulatory initiatives, such as CSDR mandatory buy-ins and MiFID II/R pre- and post-trade transparency requirements, will only serve further to render the market-making model impractical and obsolete.

161 Accordingly, ICMA has seen a move away from the traditional market-making model for corporate bonds, as banks and broker-dealers adopt more of a broking role: working client orders to find opposing sellers and buyers, rather than providing firm two-way pricing and so avoiding taking positions onto their own trading books. This requires finding ready buyers and sellers of the same (or similar) security, and so identifying the coincidence of want.

Electronic trading of the European bond markets

162 The ICMA study highlights an increasing trend in the adoption of trading in corporate bonds on electronic platforms. Traditionally the e-trading model has been "sell-side-to-buy-side", where banks and broker-dealers show prices (usually indicative) in a range of securities to which buy-side firms can react via a request-for-quote (RFQ) mechanism, asking the dealer (or a number of dealers) to show a firm price for their specific inquiry. In this model, only the requesting counterparty is able to see the firm prices provided by the dealers, and individual executed transactions are not reported to the market. Some platforms, however, provide firm quotes on which clients can transact, while others are hybrids providing both firm dealer prices and RFQ functionality. Others are "dealer-to-dealer" only, where dealers can post and execute firm prices anonymously (essentially an order book model).

163 A raft of new e-trading platforms are entering the European fixed income space, offering a variety of trading protocols, as well as new models of connectivity, including "buy-side-to-buy-side" or "all-to-all", or providing "dark pools" of liquidity. In many cases, these are a response to the liquidity gap being caused by the demise of the market-making-model. Other e-platforms, whether internally developed or purchased off-the-shelf, are designed to support the new agency model of intermediation, offering "big data" solutions to service clients.

164 Currently it is estimated that around 40-50 per cent of corporate bond transactions in Europe are executed on electronic platforms, although as a percentage of overall trading volumes this is likely to be much smaller, as platforms tend to be used for smaller ticket sizes (usually less than €5 million nominal), while larger trades are still transacted OTC. This is a corollary of the fact that corporate bond markets are illiquid, and so larger transactions tend to be negotiated privately. However, the indications are that the proportion of transactions on platforms will continue to increase, relative to OTC, while ticket sizes will also increase.

165 While the ICMA study highlights the continued adoption of electronic trading by both sell-side and buy-side firms, the shared view by all participants in the study, including platform providers themselves, was that electronic platforms are not a substitute for the traditional market-making model. While electronic solutions will go some way to filling the liquidity gap through sourcing technology, they do not alter the fact that corporate bond markets are inherently illiquid, and that there will not always be a willing seller and a willing buyer in the same bond at the same time. In

and of itself, electronic trading does not "create" liquidity. In many respects, the suggestion is that the development of electronic ("on venue") trading for bonds could be enhanced by the market-making model.

166 A further consideration coming out of the study is that while the proliferation of trading platforms and e-commerce solutions is likely to continue in the European fixed income space, at some point we should see a consolidation, in the same way as happened with equity trading platforms.

Transparency and liquidity

167 A central theme of the ICMA study is the concept of transparency. What becomes clear is that transparency and liquidity is not the same thing, and while transparency can enhance liquidity through improved price discovery and market information, it can equally reduce liquidity through deterring trading. An accurate liquidity determination model is vital to an orderly functioning fixed income market in Europe. Forcing dealers to provide firm prices could lead to a widening of bid-ask spreads, or even the retraction of price provision entirely. The market wide reporting of large transactions can be detrimental to the dealer taking the transaction on their books, since this will immediately move the market against them ("the winners curse"). This is one of the key challenges facing the finalization of the technical standards for MiFID II/R with respect to the pre- and post-trade liquidity calibrations, and which runs the risk of further harming fixed income market liquidity, rather than enhancing it, as well as moving liquidity away from trading platforms. This is clearly something that policy makers and regulators will need to consider carefully in terms of supporting the development of new technologies in the European bond markets.

Conclusion

168 New technologies and business models will continue to develop and evolve in the European fixed income space. Some will survive, while others will fall by the wayside. Those that do succeed will be the ones with superior execution and that provide solutions to support connectivity, promoting the sourcing of liquidity between buyers and sellers or enhanced intermediation. However, given the structure of corporate bond markets, this will never be enough to provide true liquidity in the sense of an executable price at any time. If this is the goal of CMU, then regulation to support market-making will need to be a key consideration. This will include closer attention to pre- and post-trade transparency requirements, a review of mandatory buy-in regulation, and possibly the provision for capital relief for market-makers.