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Assessment of Market Practice and Regulatory Policy

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New issues in the international debt markets

Foreword by Håkan Wohlin

When Ben Bernanke announced on 22 May 2013 that the US Federal Reserve might begin to scale back its bond purchasing activities – or taper its quantitative easing – analysts were quick to predict dark days ahead for the international debt capital market.

Commentators lined up to warn of soaring volatility and plummeting issuance as rates rose, bringing the thirty year bull market for fixed income to an end. In fact, the international debt markets have proved remarkably resilient. Over $761 billion of international bonds were issued over the summer and early autumn including the largest ever corporate bond and the second largest ever high yield bond.

As we look ahead to 2014, market conditions continue to look favourable. Yields have risen – with European sovereign yields up about 80 basis points from their lows – but they remain at the very bottom of the historic range. At the same time, the range of paper available to investors is becoming ever more diverse as more borrowers from more countries issue bonds in a wider range of currencies than ever before. The scale of this trend is sometimes overlooked. Over the past 24 months, 2,100 issuers from 104 different countries have issued international bonds in 40 different currencies: double the number just a decade ago. Private placement volumes are soaring too.

With banks coming under pressure to reduce their balance sheets in response to tougher regulatory rules on capital, the number of corporates using bonds as an alternative to loans to finance themselves is likely to rise further. This will not be the only regulation-driven change to our market next year. There will be several and, given their potentially significant implications, it is worth considering them in detail.

In the four years since the G20 leaders set out their regulatory reform agenda in 2009, significant progress has been made to improve the stability of the financial system particularly in the fields of capital and liquidity (via Basel 2.5), derivative market transparency (through the OTC reforms) and recovery and resolution. Corporate governance has improved with tighter risk management and better alignment of incentives to risk taking. More recently, however, momentum has slipped from the global G20 regulatory reform effort as detailed rules have been drawn up jurisdiction by jurisdiction. As a result regulation has increasingly been developed in isolation and rules have become more fragmented internationally. Differences in rules relating to the treatment of OTC derivatives, bank capital requirements and recovery and resolution risk creating friction between regions and undermine the cross-border aspect of capital markets.

Lack of coordination on timing for the implementation of new regulatory frameworks further risks fragmenting global financial markets, which in turn will trap liquidity and increase funding costs. New proposals are being produced faster than agreed rules are being implemented – eg Liikanen proposals for structural reforms to address risks inherent in risky trading activities and to tackle too big to fail have been brought forward before new capital requirements of a recovery and resolution regime can be implemented in Europe.

Whilst effective regulation is essential to deliver financial stability, it is critical that that financial stability does not come at the expense of financial activity which delivers real social benefit (eg management of payment systems; provision of trade finance; market making; provision of credit and efficient allocation of capital). The aim of regulation should be to provide counter-cyclical buffers to militate against future volatility, not to render specific business models obsolete/uneconomic with the risk that socially useful activity is lost as a consequence.

There is a risk that some of the regulatory proposals on the table at the moment will do just that – whether it is through overly burdensome retention rules applying to securitization; capital requirements which disincentivise holding of corporate debt; proposals for structural separation with the potential to significantly reduce market making activity in future; or new collateral requirements which will take hundreds of billions of euro of collateral out of circulation.One side-effect of Basel III will be to make primary dealing in government bonds an increasingly unattractive proposition. We have already seen a number of firms withdraw from this activity, and it seems likely more may follow. This will inevitably impact liquidity, particularly at the longer end, pushing up yields for many issuers.

Ultimately a stable financial system which cannot fund growth is no use to society. Regulators have to balance the need to manage system risks with the need to ensure the financial sector can provide the rest of the economy with the products it needs. Ongoing dialogue between market participants, policy makers and regulators is essential to ensure cumulative impact of proposals and their interactions with each other is understood.

If the right balance can be found, the future of the international debt market looks exceptionally bright.

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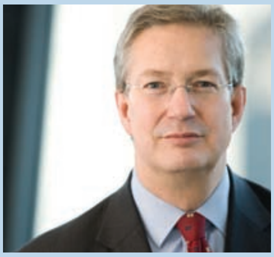

Message from the Chief Executive

Part of ICMA's *raison d'être* is to improve the functioning of the international debt capital markets. We work on behalf of our members, whether issuers, investors or intermediaries to ensure that the cross-border securities market is able to fulfil its core task, namely to channel capital effectively from those who have it to those who need it, for projects in both the private and public sector which will ultimately contribute to economic welfare and help create growth in the economy.

In this context one of our key objectives has been to help policy makers, regulators, legislators and other authorities understand the important role that the capital markets play in the economy and the alternatives they provide to bank financing. We published a paper on this, *The Economic Importance of the Corporate Bond Markets*, earlier this year, and have spent significant time discussing this precise point with many different authorities, the press and other opinion leaders. Generally the point has been well accepted.

This is of course encouraging. But challenges remain. For example much of the recently enacted legislation, whilst mitigating systemic risk and protecting investors, has unfortunately constrained the ability of the markets to provide financing and investment opportunities. Moreover the raft of forthcoming proposed regulation individually and in particular collectively has the propensity to stifle the capital markets still further. What can we at ICMA do about this?

First, we work actively with our members on forthcoming issues which will impact their day-to-day businesses through our many committees and councils. Using the expert input from our members on those committees we can make sure the market impact is fully understood and discussed with the relevant authorities. We do this in a number of ways – responding to all relevant consultation papers, and by taking in senior market individuals from our committees and councils to meet regulators directly and share information. We also hold conference calls, round tables, seminars, conferences etc, all with the aim of ensuring that there is enhanced information flow between market participants and the official sector. In addition we commission research, write papers on selected topics, update our rules, recommendations, guidelines and standard documentation, as well as continually adapting our suite of education courses to ensure they are relevant and up to the minute.

Second, we alert the authorities to cases where they need to "join the dots". One of the problems of the re-regulation phase since 2008 is that most regulation is being developed in silos – either product silos or national silos. This leads to a situation where the way the various new regulations interact with each other and their cumulative impact on the market is simply not well enough understood and taken into account. Consider the deleterious impact that regulation has had on secondary market liquidity.

At ICMA we take each relevant new piece of regulation and assess with our members not only its specific features, but its overall impact in all areas of the market. How will it fit together with other regulations? Are there ways to achieve the same goal but without any damaging side effects? We are in an unusually strong position to do this given our membership mirrors the full spectrum along a debt security's life cycle, from issuance, through distribution and trading to investment and ultimately repayment along with the associated underlying infrastructures.

A particular concern is that, as we review the regulatory framework, we note that there are many strands of overlapping and in some cases even contradictory regulation. For example, on the one hand regulators have been mandating the use of collateral to mitigate counterparty risk, whilst on the other the critical role of repo in facilitating the efficient movement of collateral is under threat from a range of proposed new measures, and there seems to be a lack of understanding of just how integral repo really is to a financial system which can play a full role in financing the real economy. ICMA can help resolve such issues through well informed research and we will be finalising a high-level paper in the near future highlighting a number of these. We remain committed to working constructively with the market and with regulators to achieve the right balance.

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Capital market practice in response to the crisis

Quarterly Assessment by Paul Richards

It is already clear that the post-crisis world in the international capital market will be very different from the pre-crisis world.

Introduction

It is now five years since the collapse of Lehman Brothers, and it is still not clear beyond doubt whether the international financial crisis is over. There are many remaining uncertainties, particularly about the prospects for economic recovery in Europe, the implications of the economic recovery in the US for emerging markets, and the political situation in the Middle East. But it is already clear that the post-crisis world in the international capital market will be very different from the pre-crisis world, in various ways. The purpose of this Quarterly Assessment, which covers the period until the end of the third quarter of 2013, is to identify the main changes affecting international capital market practice in response to the crisis, focusing on cross-border markets in Europe and the global implications.

Market changes in response to the crisis

2 There have been a number of important market changes in response to the crisis. For example:

- *The interest rate environment* has changed since the beginning of the crisis: short-term interest rates, which were reduced substantially at the start of the crisis, have been kept very low as a result of quantitative easing by central banks and their management of market expectations through forward guidance, though recently there have been signs – from a rise in bond yields – that the market is looking ahead to the tapering of quantitative easing and its eventual withdrawal, as the international economy begins to recover, led by the US.
- *Central bank balance sheets* have increased substantially in size as a result of the purchase

of financial assets, particularly sovereign bonds, and in some cases corporate bonds and pools of mortgages, to keep interest rates low; and also as a result of central bank lending to, and deposits from, commercial banks, particularly when they are not willing to lend direct to each other, though recently net lending to commercial banks by the ECB has fallen as its initial Longer-Term Refinancing Operations (LTROs) have begun to be repaid.

- *Five debtor governments in the euro area* – Greece, Ireland, Portugal, Spain (for its banks) and Cyprus – have had to be bailed out by other euro-area governments, mainly in conjunction with the IMF. The European Stability Mechanism has been established in the euro area both to fund debtor governments and potentially to help break the link by which debtor governments become financially dependent on their banks and vice versa; and the ECB has announced that it is willing to undertake Outright Monetary Transactions (OMTs) in the secondary market to support debtor governments in the euro area if they agree to policy conditions in exchange for an official bail-out. This follows the statement by the ECB's President in July last year that the ECB is ready to do "whatever it takes" to preserve the euro.
- *Assessment of financial risk* has changed: there is a much greater awareness in the market of risk as a result of the crisis. The balance between "credit" risk and "rates" has shifted, with some sovereign issuers previously treated in the market as "rates" being reclassified as "credit" risk. In response to official bail-outs of debtor governments, accompanied in the case of Greece by rescheduling of government debt, sovereign risk – particularly in parts of the euro area – has been reassessed. This has led to much higher yield differentials over "safe" assets (like German bunds) for some sovereigns now than before the crisis, though differentials have narrowed significantly since their crisis peak. There have been concerns in the market about the scarcity of "safe" financial assets, as a result.
- In response to the focus on risk, *the use of collateral* has become of much greater importance. Secured borrowing has been preferred in the market – and in general by regulators – to unsecured borrowing, in particular in the case of banks which have had difficulty in borrowing without it. Consequently, the level of asset encumbrance has become an increasingly significant measure of stress in funding bank balance sheets.
- While the supply of bank finance to *the corporate sector* has been constrained as a result of the crisis, there is considerable scope for corporate bond issuance to support the economic recovery in Europe, where the contribution of bond issuance to the financing of the corporate sector has historically been significantly lower than in the US.

Regulatory changes in response to the crisis

3 In addition to these market changes, one of the most important changes in response to the crisis has been the introduction of more intrusive financial regulation intended to prevent another crisis in the future by making the financial system safer now. The new wave of regulation affects the international capital market in Europe in three main ways:

4 First, *prudential regulation* of banks operating in the international capital market has been tightened by: increasing risk capital requirements, particularly for large banks regarded as being systemically

One of the most important changes in response to the crisis has been the introduction of more intrusive financial regulation.

significant; increasing liquidity requirements; and imposing supplementary leverage ratios. While capital requirements are a measure of the ratio of bank equity to risk-weighted exposure, leverage is a measure of the ratio of bank equity to exposure, but without taking account of the risk-weights which are included in measures of capital requirements. Banks which do not currently meet the new capital and leverage requirements can meet them in future by raising more capital or by deleveraging so as to shrink their balance sheets through a reduction in exposure. Regulators have given banks a transition period in which to meet the new requirements, but there is pressure from the market for banks to demonstrate that they are financially robust by meeting the new requirements early. Proposals have also been made in the US and in some countries in the EU to separate large banks' wholesale trading activities from their retail activities, in slightly different ways. In terms of the potential impact on the capital market, it is important to allow banks to keep their market-making activities alongside their underwriting activities rather than separating them.

5 Second, *conduct of business regulation* is intended to make the financial system safer: by changing the structure of the capital market to discourage over-the-counter (OTC) transactions and encourage transactions on exchanges or electronic trading platforms; by promoting market transparency, even at the expense of market liquidity; and by providing more protection to retail investors as distinct from institutional investors:

- *New issuance:* Prospectus requirements have become much more extensive for corporate and financial issuers, as a result of the review of the EU Prospectus Directive, particularly where new bond issues are being sold to retail investors. Sovereign issuers themselves are exempt, leading in some cases to less transparency in their contractual terms than available from corporate and financial issuers, even though sovereign transparency is equally important, particularly in view of the renewed emphasis on sovereign risk as a result of the crisis.
- *Trading:* Regulators are encouraging a shift in market structure (eg under the MiFID II package) from OTC trading to trading on exchanges and electronic trading platforms on the grounds that they are more transparent, even though the effect is to make markets less liquid, especially as capital requirements for market firms holding inventory have increased. In addition, the European Commission's proposal for a Financial Transaction Tax would effectively represent a tax on liquidity, if it were to be introduced in its original form.
- *Clearing:* Under EMIR, standardised OTC derivatives contracts, which will have to be traded on exchanges or electronic platforms, need to be cleared through central counterparties (CCPs), which guarantee that payment is made to the payee even if the payer becomes insolvent. CCPs therefore need not only sufficient capital but also sufficient margin from their counterparties to ensure that they remain solvent themselves. Significant margin requirements are also being required for remaining OTC derivatives contracts.
- *Settlement* discipline is being tightened under the proposed CSD Regulation through a mandatory requirement to enforce settlement two days after trade date, with penalties for late payment.
- Automatic reliance on *credit rating* agencies (eg through the "hard wiring" of credit ratings in official requirements) is being reduced as a result of the CRA Regulation so as to increase market participants' awareness of risk. And credit rating agencies in the EU now need to be registered with ESMA to ensure that they meet acceptable standards.
- *Trade repositories* are being established (eg under EMIR) to collect data – eg on OTC derivatives contracts, which need to be reported to trade repositories – so as to provide early warning to the authorities of developments affecting market risk. In an attempt to prevent overlapping requirements for information from market firms, it has been proposed that a central public body should be established to ensure consistency of standards between different trade repositories.

6 Third, the *scope* of regulation is being extended both to a wider range of financial institutions and a wider range of financial products. For example:

- *Institutions:* While asset managers have been regulated for some time, hedge funds have now become regulated under the AIFMD. Insurance company regulation is in the process of being updated (under Solvency II) to make it more consistent with changes in bank regulation, though there are serious industry reservations about the consequences.

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If financial institutions still fail in future, the authorities’ objective is that they should be resolved without cost to the taxpayer (ie by bailing financial stakeholders *in* rather than bailing them *out*).

- *Products:* Regulation of products for retail investors (eg UCITS and PRIPs) is being tightened. And allied to the Financial Stability Board’s work on “shadow banking”, the European Commission has regulated securitisation and proposed a new Regulation on Money Market Funds, accompanied by a Communication on other market-based sources of finance, including repo and securities lending.

7 All these new regulatory measures are intended to make the financial system safer and thereby enhance financial stability. But if financial institutions still fail in future, the authorities’ objective is that they should be resolved without cost to the taxpayer (ie by bailing financial stakeholders *in* rather than bailing them *out*). There are three main elements to the authorities’ proposals:

- *Bail-in of financial instruments:* In order for the cost of failure to be borne by investors and creditors rather than by taxpayers, agreement is needed on the hierarchy of stakeholders to be bailed in. The bail-in hierarchy proposed in the EU starts with equity investors, then junior debt holders, then senior debt holders and finally uninsured depositors. Uninsured deposits from large companies are to be bailed in before depositors from small companies and individuals. Insured depositors (up to €100k in the EU) are guaranteed not to be bailed in.
- *Systemically important financial institutions:* Previously, the largest banks and insurance companies were treated as “too important to fail”. In other words, they were regarded as carrying an implicit government guarantee. And in a number of cases during the crisis, they were bailed out by government (ie by the taxpayer). Regulatory changes in response to the crisis are designed to resolve banks which fail in future *without* recourse to the taxpayer, while ensuring that their “essential” activities supporting the real economy (such as payment systems and retail deposits) continue to function. Two main resolution mechanisms are contemplated: a single point of entry (SPE) for integrated banks; and a multiple point of entry (MPE) for banks with locally capitalised subsidiaries. Under SPE, the bank’s publicly held equity and debt are issued by the group holding company. If the bank is in trouble, the group writes down its equity and imposes losses on its debt holders (ie by bailing them in) to avoid the need for bail-out by taxpayers. But the bank’s critical functions are held in an operating company, which can continue to serve the real economy, even if the group becomes insolvent. Under MPE, the bank has to ensure that its subsidiaries around the world have sufficient local capital so that they can be sold off, if the bank is in trouble, isolating the bankrupt part of the business by writing down equity holders and imposing losses on debt holders. In each case, banks are required to write “living wills” to demonstrate to regulators how they can be resolved without recourse to the taxpayer.
- *Systemic risk in markets:* At the beginning of the crisis, markets froze, and concerted central bank action was needed to keep them functioning (eg by intermediating between the banks when the banks were unwilling to lend to each other). The crisis has therefore increased the authorities’ awareness of the systemic risk in financial markets, as well as in financial institutions. While some of the measures that the authorities have taken are designed to make markets safer, there is also a risk that new

institutions (like CCPs) created in response to the crisis carry systemic implications for markets. Recent cyber-security threats and exchange outages have drawn attention to an additional element of risk.

8 The cost of implementing all these new regulations falls on market participants, and is likely to be passed on to customers. Market efficiency will be adversely affected by the additional regulatory burden and there is a risk that innovation will unnecessarily be stifled as a result. But the authorities consider that this is a price worth paying to help prevent another crisis. There may also be implications for economic growth if an appropriate balance is not struck between financial activity and financial stability. (See the Quarterly Assessment for the Third Quarter).

Changes in the global regulatory architecture

9 Apart from the regulatory changes affecting the international capital market in response to the crisis, there has also been a change in the regulatory architecture itself. Globally, the initiative for regulatory reform has been taken at political level by the G20 and coordinated at technical level by the Financial Stability Board. Specific changes in the regulation of banks have continued to be coordinated through the Basel Committee on Banking Supervision. And IOSCO has played an increasingly important role in coordinating the regulation of the securities markets. But these global regulators continue to depend on governments around the world to implement their recommendations.

10 In the EU, new financial legislation is proposed (at Level 1) by the European Commission, and agreed with the European Parliament and Council of Ministers (in the 28 EU countries). An increasingly important role (at Level 2) is now played by the three European Supervisory Authorities (ESAs) – ie the EBA, ESMA and EIOPA. Their role is to establish a Single EU Rulebook by setting binding technical standards, approved by the Commission, with which market firms need to comply by a deadline. The current review of the ESAs by the European Commission is not expected to lead to substantial changes in their responsibilities, as it is too early to judge.

11 However, the regulatory architecture in the EU – and in particular in the euro area – is not yet complete. In particular, the architecture for European Banking Union is still on the drawing board. It has been agreed that the ECB will take overall responsibility for banking supervision in the euro area – and any non euro-area countries in the EU which opt in – through the Single Supervisory Mechanism next year, after conducting, jointly with the EBA, an asset quality review of the banks. The European Commission has also proposed a Single Resolution Mechanism for resolving banks at euro-area level rather than national level, but this is not yet agreed.

12 When there are differences in regulation between jurisdictions, there is scope for regulatory arbitrage by market firms. Within the EU, increasing use is made of Regulations, which apply directly in EU Member States, rather than Directives, which have to be transposed into the law of each Member State, in order to create a level playing field within the EU by ensuring consistent application across the EU as a whole. However, the impact of the legislative process on the international capital market is still complicated by inconsistencies arising from conflicts and overlaps between different EU regulatory initiatives and their unintended consequences. This is accompanied in some cases by uncertainty in the market about exactly what the authorities intend. More work is also needed to ensure greater consistency in supervision and enforcement.

13 To ensure consistency between regulation in the EU and the US, mutual recognition or “substituted

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compliance” is being considered as one potential way of creating a level playing field. Under mutual recognition, securities market regulators recognise each other’s regulation and supervision of financial markets, products or services as an adequate substitute for their own, once they are deemed to be sufficiently comparable to each other’s standards under an agreement between them. A number of agreements on mutual recognition have already been reached in Asia. At global level, IOSCO may have a role to play in encouraging mutual recognition of regulatory standards in securities markets.

14 For global firms, regulatory consistency at global level is important, but it is not easily nor always achieved, especially on the same timescale:

- Examples of the difficulty of achieving regulatory consistency between the EU and the US include: Basel III; Dodd-Frank in the US and EMIR in the EU; and accounting standards, which are set in the EU by the IASB and in the US by the FASB.
- There are a number of new regulations proposed by both the EU and US which are intended to have an extra-territorial impact: including, for example, the Financial Transaction Tax (proposed by 11 Member States in the euro area) and FATCA (in the US).
- However, there may also be legitimate differences in approach between different jurisdictions. For example, the inclusion of, and the terms for, Collective Action Clauses are mandatory in new sovereign issues in the euro area, but they are not necessarily mandatory in other parts of the world, and the contractual terms may not be the same as in the euro area.

15 Other national differences which complicate global coordination include:

- the extent to which corporate tax rates and methodologies are a matter for competition between different jurisdictions or need to be coordinated; and
- the extent to which exchange rates are treated as a means of ensuring national competitiveness and the extent to which they are internationally accepted as a matter of common concern.

Good international market practice

16 While cost-effective regulation has an important role to play in making the financial system safer, the regulatory changes which have been introduced since the crisis began will not be sufficient on their own to prevent another crisis without good management by regulated financial institutions and without effective supervision and enforcement by the regulators themselves. This is not just a question of enforcing criminal sanctions against illegal activity or “naming and shaming” individuals who fail to meet required standards, but also a question of promoting good corporate governance and good risk management in firms.

17 Trade associations can help promote a “socially useful” culture in the capital market:

- by encouraging dialogue between market participants and the authorities: eg relating to the impact on the real economy of new regulatory initiatives affecting the capital market;
- by helping market firms to comply with new regulations in a cost-effective way;
- by promoting guidance, and the use of documentation, on good market practice within the new regulatory framework; and
- by providing education and training to help improve standards.

18 For over 40 years, ICMA has helped to set standards in the international capital market through its Primary Market Handbook and Secondary Market Rules and Recommendations, and master documentation such as the Global Master Repurchase Agreement, backed by annual legal opinions. Consistent with the new regulatory requirements, we are working with our members to continue to set standards of quality in the cross-border securities market.

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In brief

- It is already clear that the post-crisis world in the international capital market will be very different from the pre-crisis world, in various ways.
- There have been many market changes in response to the crisis: the interest rate environment; the increase in central bank balance sheets; government bail-outs; a shift in the assessment of risk; more use of collateral; and more scope for corporate bond issuance in place of bank finance.
- One of the most important changes in response to the crisis has been the introduction of more intrusive financial regulation intended to prevent another crisis in the future by: tightening prudential regulation; extending conduct of business regulation; and broadening the scope of regulation by institution and by product.
- All these regulatory measures are intended to make the financial system safer. But if financial institutions still fail in future, the authorities' objective is that they should be resolved without cost to the taxpayer (ie by bailing financial stakeholders *in* rather than bailing them *out*).
- Besides changes in regulation, there has also been a change in the regulatory architecture. Global regulators depend on governments to implement their recommendations. When there are differences between jurisdictions, there is scope for regulatory arbitrage.
- The regulatory changes which have been introduced since the crisis began will not be sufficient on their own to prevent another crisis without good management by regulated financial institutions and without effective supervision and enforcement by the regulators themselves.

Practical initiatives by ICMA

The purpose of the following list is to summarise practical initiatives on which ICMA is currently, or has recently been, engaged with, and on behalf of, members.[1]

Short-term markets

1 *Interoperability:* A Memorandum of Understanding (MOU) on Triparty Settlement Interoperability was signed on 15 July at a ceremony hosted by the ECB in Frankfurt and witnessed by the European Commission. The signatories are the ICMA European Repo Council (ERC), Clearstream, Euroclear and Eurex Clearing. The MOU involves a joint project enabling their systems to work together to increase the efficiency of the repo market for triparty transactions.

2 *Guide to repo best practice:* ICMA is due shortly to publish a *Guide to Best Practice in the International Repo Market.* This consolidates and refreshes ICMA's existing repo trading practice guidelines and various other published statements.

3 *Financial Transaction Tax (FTT):* Following the publication of ICMA reports on the impact of the FTT on the repo market and on the systemic importance of collateral, ICMA has continued to explain to the relevant authorities in Europe, not just why the FTT as originally proposed would have a damaging impact on the repo market, but also on markets generally, with costs for the real economy and implications for economic growth, the transmission of monetary policy and the safety of financial markets.

4 *Leverage ratio:* The ICMA ERC has responded to the consultation by the Basel Committee on Banking Supervision on the revised Basel III leverage ratio, focusing on the implications for the repo market.

5 *Shadow banking:* The ICMA ERC is planning to respond to the Financial Stability Board's consultation on *Strengthening Oversight and Regulation of Shadow Banking*, and is also considering the European Commission's Communication on *Shadow Banking.*

1. ICMA responses to consultations by regulators are available on the ICMA website.

6 *Russian repo:* For the benefit of international money market participants, ICMA and the National Settlement Depository have held a workshop on recent developments in the Russian repo market.

Primary markets

7 *Public Sector Issuer Forum (PSIF):* Following the PSIF meeting at the EBRD in London on 24 June, at which the PSIF had an exchange of views with Adam Farkas, Executive Director of the EBA, a further meeting of the PSIF is due to be held at the World Bank in Washington in October.

8 *Prospectus Directive and PRIPs:* In implementing the new Prospectus Directive regime and proposals on PRIPs, ICMA is continuing to work with members in its Legal & Documentation Committee to obtain clarity from regulators about how they should be interpreted or applied.

9 *ICMA Primary Market Handbook:* A fundamental review of ICMA's Primary Market Handbook is continuing, with its structure being reorganised to follow the timeline of transactions.

10 *Collective Action Clauses:* With help from Clifford Chance, ICMA is in the process of updating the Collective Action Clause (CAC) in the ICMA Primary Market Handbook, focusing on its potential use outside the euro area.

Secondary markets

11 *Liquidity survey:* ICMA is planning to consult its Secondary Market Practices Committee and other market experts on secondary market liquidity through a liquidity survey.

12 *MiFID II/MiFIR:* ICMA is exploring how best to cooperate with other trade associations on assessing forthcoming Level 2 measures relating to MiFID II/MiFIR.

13 *ICMA Secondary Market Rules and Recommendations:* ICMA's Secondary Market Rules and Recommendations will need to be updated when there is a clear outcome from the EU negotiations currently taking place on MIFID II/MiFIR, which will affect the dealer model, and the CSD Regulation, which will affect the regulation of settlement discipline.

Asset management

14 *Covered bonds and the ECB:* The ICMA Covered Bond Investor Council (CBIC) has responded to an ECB questionnaire on covered bonds.

15 *Covered bonds and credit rating agencies:* The ICMA CBIC has sent a statement to the credit rating agencies relating to covered bond rating methodologies in a challenging environment.

16 *Charter of Quality:* At the IOSCO Self-Regulatory Organizations Consultative Committee in Luxembourg on 15 September, Jean Guill, the Head of the CSSF, encouraged other national associations and wealth managers to sign the ICMA Private Wealth Management Charter of Quality, following the example set by Luxembourg.

Other initiatives

17 *ESFS review:* ICMA has submitted a response to selected questions in the European Commission's consultation on the review of the ESFS.

18 *Banking structure:* ICMA has submitted a response to the European Commission's consultation on the securities market implications of reforming the structure of the UK banking sector.

19 *Central banks and regulators:* With the chairs and senior representatives of its Market Practice and Regulatory Policy Committees, ICMA continues to hold regular meetings with senior representatives of central banks and regulators.

20 *Regulatory grid:* A further updated version of ICMA's grid of new financial regulations affecting the cross-border securities markets has been posted on a password-protected section of the ICMA website for ICMA members.

Regulatory Response to the Crisis

by David Hiscock

G20 financial regulatory reforms

On 16 July 2013, the FSB published three guidance papers to assist authorities and firms in implementing the recovery and resolution planning requirements under the *Key Attributes of Effective Resolution Regimes for Financial Institutions* endorsed by the G20:

- *Guidance on Developing Effective Resolution Strategies*;
- *Guidance on Identification of Critical Functions and Critical Shared Services*; and
- *Guidance on Recovery Triggers and Stress Scenarios*.

The guidance was issued for public consultation in November 2012 and has been revised in light of the comments received during that consultation.

A communiqué was issued following the 19-20 July 2013 Moscow meeting of Finance Ministers and Central Bank Governors. In summary, the points concerning financial regulation include:

- Additional jurisdictions have adopted final rules to implement Basel III and others have committed to do so as soon as possible in 2013. The recent BCBS *Report on the Regulatory Consistency of Risk-Weighted Assets* is welcome and further work to improve comparability of regulatory capital ratios is anticipated. The BCBS should finalise its work on the remaining components of the Basel III framework – the leverage ratio by early 2014 and NSFR by end 2014.
- Work to establish robust resolution regimes and resolution plans is strongly supported; and any legislative and other steps needed to enable authorities to resolve financial institutions in an effective manner, including in a cross-border context, will be undertaken. Structural banking reforms can facilitate resolvability; and work will be done to assess cross-border consistencies and global financial stability implications, taking into account country-specific circumstances.
- Publication of the initial list of global systemically important insurers (G-SIIs), to which resolution planning and group-wide supervision will initially apply, is welcome; as are the International Association of Insurance Supervisors (IAIS) plans to develop a simple, group-wide capital requirement to be finalised

by the time of the G20 Summit in 2014 and that will serve as a foundation for higher loss absorbency requirements for G-SIIs.

- There is commitment rapidly to complete the remaining legislative frameworks and regulations for OTC derivatives' reforms; and the recent EU-US announcement on cross-border issues related to OTC derivatives reforms is a major constructive step forward. Jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identically outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes.
- There is support for the LEI Regulatory Oversight Committee's (ROC's) efforts to launch the global LEI Foundation as soon as possible.
- The FSB's policy recommendations for the oversight and regulation of the shadow banking system would be presented to the G20 Leaders' St. Petersburg Summit in September; to be followed by work towards their timely implementation.
- The IASB and FASB should finalise their work on key outstanding projects for achieving convergence on a single set of high-quality accounting standards, by the end of 2013.
- Following the recent G20 high-level seminar on benchmarks and CRAs, the FSB progress report on steps to reduce reliance on CRA ratings is anticipated for the St. Petersburg Summit. Completion of *IOSCO's Principles for Financial Benchmarks* is welcome; as is the establishment of the FSB's Official Sector Steering Group to coordinate work on the necessary reforms of interest rate benchmarks and guide the work of a Market Participants Group.
- Continued progress made by G20 economies on closing information gaps, under the FSB and IMF G20 Data Gaps Initiative, is welcome; and implementation of the recommendations in this initiative is encouraged.

> “a comprehensive set of guidance on recovery and resolution for different kinds of systemically important FMI

On 12 August 2013, the FSB launched public consultations (for comment by 15 October) on: (i) the application of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "Key Attributes") to non-bank financial institutions; and (ii) principles governing information sharing for resolution purposes.

The objective of the proposed guidance in the first of these FSB papers is to assist jurisdictions and authorities in implementing the Key Attributes with respect to resolution regimes for financial market infrastructures (FMIs), insurers and firms with holdings of client assets. The guidance complements and should be read in conjunction with the Key Attributes. The proposed guidance on FMI resolution accompanies the consultative report on FMI recovery (for comment by 11 October) published on 12 August by CPSS/IOSCO to provide a comprehensive set of guidance on recovery and resolution for different kinds of systemically important FMI; the guidance on resolution of insurers complements the policy measures for G-SIIs published by the IAIS on 18 July, which include recovery and resolution planning requirements for G-SIIs; and the guidance on client asset protection in resolution builds on IOSCO's Consultation Report on *Recommendations Regarding the Protection of Client Assets* of February 2013.

The second FSB paper relates to the fact that the Key Attributes stipulate that resolution authorities should have the power to exchange information necessary for recovery and resolution planning or implementing a coordinated resolution with foreign authorities, and that there should be no legal, regulatory or policy impediments under jurisdictions' legal frameworks that hinder the appropriate exchange of such information with both domestic and foreign authorities. Jurisdictions are also required to have in place confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

On 28 August 2013, the FSB issued a consultative document, *Assessment Methodology for the Key Atttributes of Effective Resolution Regimes for Financial Institutions*. As well as facilitating objective and consistent assessments of jurisdictions' compliance with the new international standard, the methodology can also assist jurisdictions in their legislative reforms to implement the Key Attributes.

On 29 August 2013, the FSB published policy recommendations to strengthen the oversight and regulation of the shadow banking system. These recommendations take into account public responses received on the consultative documents issued on 18 November 2012. The FSB has focused on five specific areas in which policies are needed to mitigate the potential systemic risks associated with shadow banking: (i) to mitigate the spill-over effect between the regular banking system and the shadow banking system;

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(ii) to reduce the susceptibility of money market funds (MMFs) to "runs"; (iii) to assess and align the incentives associated with securitisation; (iv) to dampen risks and pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress; and (v) to assess and mitigate systemic risks posed by other shadow banking entities and activities.

The reports published by the FSB comprise:

- *An Overview of Policy Recommendations*: setting out the FSB's overall approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and next steps.
- *Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*: setting out recommendations for addressing financial stability risks in this area, including enhanced transparency, regulation of securities financing, and improvements to market structure (re (iv) above). This paper also includes consultative proposals, for comment by 28 November 2013, on minimum standards for methodologies to calculate haircuts on non-centrally cleared securities financing transactions and a framework of numerical haircut floors.
- *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*: setting out the high-level policy framework to assess and address risks posed by shadow banking entities other than MMFs (re (v) above).

As far as other shadow banking policy areas are concerned, the BCBS will complete its work in area (i) above in 2014, and IOSCO has already set out final policy recommendations for areas (ii) and (iii) above in its reports *Policy Recommendations for Money Market Funds* and *Global Developments in Securitisation Regulation*. Most of the policy measures on shadow banking developed by the FSB have now been finalised and will be adopted by FSB members in an internationally coordinated manner and the FSB, in coordination with the relevant standard-setting bodies, will monitor their implementation. The FSB will also continue to review the progress of the remaining work to develop policy recommendations and report on progress to the G20 in November 2014.

In November 2012, the FSB was asked to undertake diagnostic work, together with other relevant international organisations (IOs), to assess factors affecting long-term (LT) investment financing. In February 2013, the FSB reported initial findings to the G20 on the financial regulatory factors affecting the availability of LT investment finance, as part of broader diagnostic work undertaken by IOs. Ministers and Governors welcomed the report by IOs and established a new Study Group on Financing for Investment to consider issues raised in the report. In addition, Ministers and Governors asked the FSB to "continue to monitor the possible effects of regulatory reforms on the supply of long-term financing" as one important component of this work. To support the response to the request, the FSB organised a workshop in June 2013 to identify specific financial regulatory factors that may be impeding the provision of LT finance and that may warrant a policy response at the international level, without compromising global financial stability objectives. The main conclusions of the workshop and the implications for future monitoring are summarised in an FSB note published on 29 August 2013.

As highlighted in the FSB's initial findings, the most important contribution of financial regulation to LT investment finance is to promote a safe, sound and resilient financial system; and it should also be noted that promotion of LT investment itself is conducive to financial stability. If implemented in a timely and consistent manner, reforms to financial regulation will help rebuild confidence in the global financial system, which will enhance its ability to intermediate financial flows through the cycle and over different investment horizons; and for this reason the G20 regulatory reform programme is supportive of LT investment and economic growth. Albeit that the regulatory reforms do not specifically target LT finance, nonetheless financial regulation affects market structures and the incentives of different types of financial institutions to participate in different markets, as well as the costs of different types of transactions. As the balance of incentives changes, participants in the capital market and institutional investors which are the most natural providers of LT finance in the financial system will need to assume a greater role in the provision of LT finance.

The FSB Chairman's 30 August letter to the G20 Leaders takes stock of the progress over the past five years and outlines the major outstanding issues which demand the attention of Leaders. It makes three main points:

- FSB members have made major progress correcting the fault lines that caused the crisis. We are building more resilient financial institutions and more robust markets through substantially strengthened international standards. We are addressing the problem of too-big-to-fail. We are working to prevent regulatory arbitrage, so that tightening regulation in one sector or region does not lead to risky activity migrating elsewhere. And we are building a framework for robust market-based finance so that markets will remain continuously open.
- Our work is not yet completed. It is crucial that the G20 stay the course in implementing reforms in a consistent manner. More remains to be done to build the resilience of institutions. The G20 should also concentrate in particular on completion of three crucial areas of reform: ending "too big to fail"; reforming shadow banking; and making derivatives markets safer.
- The G20's response will ultimately dictate the openness of the global system and consequently the strength and sustainability of global growth. Only the G20 can decide whether the necessary institutions and co-operative cross-border mechanisms are built in order to realise fully the benefits of an open, integrated and global financial system. Strong, sustainable and balanced growth will not ultimately be achievable without such a system.

Alongside this letter, the FSB has provided the G20 Leaders with a *Narrative Progress Report on Financial Reform*; an *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*; and a status report on *Progress in Implementing the G20 Recommendations on Financial Regulatory Reform* (traffic lights scoreboard).

Following the 5-6 September 2013 G20 Leaders' Summit in St. Petersburg a G20 Leaders Declaration has been published. Concerning financial regulation, the declaration starts by covering points under the heading of "achievements to date and a road ahead". This section notes that in the past five years there has been substantial progress in implementing internationally consistent reforms to financial systems, but also that there is more work to do; and that the G20 Leaders "are committed to maintain the momentum of reform until the job is done." The next points come under the heading, "towards a financial system that supports strong, sustainable and balanced economic growth". This section concludes by noting that, besides seeing the financial reforms through to completion the G20 Leaders "will also continue to monitor and assess the impact of financial regulatory reforms on the robustness of the financial system, stability and on economic growth, and on the availability of long-term finance for investment."

Then there are points under the heading of "building resilient financial institutions and ending 'too-big-to-fail'". This section reiterates the commitment to implement Basel III according to internationally agreed timelines, noting the BCBS's updated progress report on Basel III implementation; and the need for finalisation of the harmonized leverage ratio and the net stable funding ratio. The FSB's report on the progress made and next steps towards ending "too big to

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In the past five years there has been substantial progress in implementing internationally consistent reforms to financial systems.

> “an opportunity for IOSCO to confirm its position as the key global reference point on securities regulation

fail” is welcomed, alongside a renewed commitment to make any necessary reforms to implement fully the FSB's *Key Attributes of Effective Resolution Regimes* for all parts of the financial sector that could cause systemic problems.

The following points come under the heading of "promoting transparent, continuously functioning financial markets". This section welcomes the FSB's report on *Progress in OTC Derivatives Reforms*, including members' confirmed actions and committed timetables to put the agreed OTC derivatives reforms into practice. National authorities and standard setting bodies are called on to accelerate progress in reducing reliance on CRAs, in accordance with the FSB roadmap. The establishment of the FSB's Official Sector Steering Group to coordinate work on the necessary reforms of financial benchmarks is supported and IOSCO's *Principles for Financial Benchmarks* are endorsed. The importance of continuing work on accounting standards convergence is underlined; and encouragement is given for further efforts by the public and private sector to enhance financial institutions' disclosures of the risks they face, including the on-going work of the Enhanced Disclosure Task Force. Finally in this section, the G20 Leaders reiterate their call for further progress and encourage adherence to international cooperation and information exchange standards for financial supervision and regulation.

Points are then made under the heading of "addressing risks posed by the shadow banking". The G20 Leaders welcome the progress achieved in developing policy recommendations for the oversight and regulation of the shadow banking system, as an important step in mitigating the potential systemic risks associated with this market while recognizing that non-bank financial intermediation can provide an alternative to banks in extending credit to support the economy; and state that they will work towards timely implementation of the recommendations while taking into account country-specific circumstances. The respective FSB reports are welcomed and a straightforward roadmap has been agreed for work on relevant shadow banking entities and activities, with clear deadlines and actions to progress rapidly towards strengthened and comprehensive oversight and regulation appropriate to the systemic risks posed. The financial regulation segment of the declaration then concludes with some points on "tackling money laundering and terrorism financing".

The next G20 Leaders meeting is scheduled to be held in Brisbane in November 2014, under the Australian Presidency.

On 18 September 2013, IOSCO announced that meetings during its Annual Conference in Luxembourg were an opportunity for IOSCO to confirm its position as the key global reference point on securities regulation for policy makers, industry and global regulators, in ensuring investors are confident and informed, markets are fair, efficient and transparent and systemic risk is reduced. The IOSCO meetings progressed work in a number of areas of global regulatory reform, with members discussing how to move forward with work requested by the G20 on key issues for securities markets, including OTC derivatives, financial benchmarks, credit rating agencies and shadow banking. Amongst other things, members:

- confirmed their determination to work together to identify emerging risks in a proactive and forward-looking way;
- committed to IOSCO playing an increasingly active role in promoting the finance of long-term investment through capital markets – in areas as diverse as corporate bond markets, securitization, SME finance and Islamic finance; and agreed to begin work on crowd funding;
- highlighted the growing importance of implementing IOSCO principles and recommendations to promote well regulated markets;
- considered proposals to strengthen cross-border cooperation among regulators; and
- approved new measures to ensure full compliance with the IOSCO Multilateral MOU on cooperation and exchange of information.

The IOSCO Board agreed to begin work on a strategic plan for 2015-2020 (*IOSCO 2020*) that would define the outcomes IOSCO would seek to achieve by 2020 and lay down the roadmap for meeting those outcomes. Amongst other things, the Board also:

- discussed the activities of its policy standard-setting committees and the initiatives to monitor the implementation of existent policy principles and recommendations;
- discussed progress on reform work mandated by the G20 Leaders and

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coordinated by the FSB;

- reviewed a draft report on IOSCO´s work on developing methodologies to identify non-bank SIFIs;
- agreed in principle to progress proposals to establish a cross-sectoral working group on securitization;
- heard updates on implementation of OTC derivatives reforms and the work of the OTC Derivatives Regulators Group on cross-border issues;
- was updated on the revision to the IOSCO *Code of Conduct Fundamentals for CRAs* and discussed how IOSCO could support reduction of reliance on credit ratings;
- approved in principle a proposal to conduct a review requested by the FSB of the application of the *Principles of Financial Benchmarks* to EURIBOR, LIBOR and TIBOR;
- recognized the important contribution IOSCO and its members can make to ensuring capital markets play a leading role in supporting long term investment;
- approved a joint statement by IOSCO and the IFRS Foundation outlining the protocols for their cooperation on the development and implementation of IFRS;
- agreed to shortly publish the IOSCO *Risk Outlook* prepared by the Committee on Emerging Risks and the IOSCO Research Department; and
- approved the creation of a Capacity Building Resource Committee tasked with developing a proposal for a new Capacity Building Development Fund aimed at addressing IOSCO's work in meeting the capacity building needs of emerging market jurisdictions; and with progressing the establishment of the IOSCO Foundation in the medium term.

The IOSCO Task Force on Cross-Border Regulation held its first meeting on 16 September. Created in June, the Task Force will carry out a survey this year aimed at taking stock of how regulators deal with cross-border issues. It aims to issue a consultation paper and hold industry round tables in the first quarter of 2014.

On 25 September 2013, the BCBS published the results of its Basel III, capital and liquidity, monitoring exercise. A total of 223 banks participated in this study, comprising 101 large internationally active banks ("Group 1 banks", defined as internationally active banks that have Tier 1 capital of more than €3 billion) and 122 Group 2 banks (ie representative of all other banks). The results of the monitoring exercise assume that the final Basel III package has been fully implemented and are based on data as of 31 December 2012.

Concerning liquidity, the weighted average LCR for the Group 1 bank sample was 119% and for Group 2 banks it was 126%. For banks in the sample, 68% reported an LCR that met or exceeded a 100% minimum requirement, while 90% reported an LCR at or above a 60% minimum requirement. Basel III's longer-term structural liquidity standard – the NSFR – is currently under review by the BCBS to address any unintended consequences prior to its implementation by 1 January 2018. The study results give an indication of the impact of the standard's calibration based on the December 2010 text. The weighted average NSFR for the Group 1 bank sample was 100% and for Group 2 banks it was 99%.

On 30 September 2013, IOSCO published the final report on the *Thematic Review on the Implementation of Principles 6 and 7 of the IOSCO Objectives and Principles of Securities Regulation*. IOSCO included Principles 6 and 7 in the IOSCO Principles in 2010 as part of its response to the global financial crisis. IOSCO Principle 6 requires regulators to have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to their mandate; and IOSCO Principle 7 requires regulators to have or contribute to a process to review the perimeter of regulation regularly. The objective of this review was to provide a snapshot of implementation of these Principles in IOSCO member jurisdictions and to identify and share good practices. It was also intended to be a call to action for all IOSCO Members about the importance of implementing these Principles.

The review found that 31 of the participating jurisdictions had made significant efforts to implement these Principles. There is good progress in developing processes and procedures to identify systemic risks, but further work is needed to develop processes to manage and mitigate systemic risks. Many jurisdictions have developed processes to review the regulatory perimeter, albeit that many of these processes are informal – which leaves scope for IOSCO members to better articulate their responsibilities, powers and objectives to achieve the outcomes sought by Principle 7. The report makes ten recommendations to assist IOSCO members in developing and embedding systemic risk and regulatory perimeter review processes.

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European financial regulatory reforms

On 8 July 2013, the new Lithuanian Presidency highlighted that it will focus on strengthening the ground for financial stability and sound public finances, which are necessary preconditions to fully restore EU's economic credibility. The top priorities in the area of economy and finance include the developing of the Banking Union, timely approval of European Union Budget for 2014, taking effective steps in the fight against tax evasion and fraud. The published programme of the Lithuanian Presidency elaborates on the Presidency's approach to the creation of a credible, growing and open Europe. In specific relation to the agenda of the Presidency in respect of Economic and Financial Affairs the programme covers EU Budget 2014; Strengthening the Economic and Monetary Union; Banking Union; Strengthening the Regulation of Financial Markets; Tax; Combating Smuggling and Other Types of Illegal Trade; and Representation of the European Union at the G20.

In further detail on financial regulatory reforms, the Presidency will seek progress in establishing the Banking Union by working on proposals on Bank Recovery and Resolution, Deposit Guarantee Schemes and Single Resolution Mechanism. The Presidency will also continue working on strengthening the regulation of financial services by:

- seeking a final agreement with the European Parliament on the Directive and Regulation on the Markets in Financial Instruments;
- seeking progress in negotiations regarding the Regulation on Central Securities Depositaries;
- seeking progress in reviewing the Laundering and Terrorist Financing System that would implement the recommendations by the FATF at the EU level;
- renewing negotiations in the insurance field concerning the Omnibus II Directive;
- initiating negotiations once the European Commission submits a proposal on structural bank reform; and
- seeking progress in the Council on negotiations regarding the proposal on bank accounts.

In the area of tax, the Presidency will focus on issues related to combating tax evasion and tax fraud. The Presidency will also continue discussions regarding the draft Directives on common consolidated corporate tax base, financial transactions tax and energy taxation.

On 10 July 2013, the European Commission proposed a Single Resolution Mechanism (SRM) for the Banking Union. The mechanism is intended to complement the Single Supervisory Mechanism (SSM) which, once operational in late 2014, will see the ECB directly supervise banks in the euro area and in other Member States which decide to join the Banking Union. The SRM would work as follows:

- The ECB, as the supervisor, would signal when a bank in the euro area or established in a Member State participating in the Banking Union was in severe financial difficulties and needed to be resolved.
- A Single Resolution Board (SRB), consisting of representatives from the ECB, the European Commission and the relevant national authorities (those where the bank has its headquarters as well as branches and/or subsidiaries), would prepare the resolution of a bank. It would have broad powers to analyse and define the approach for resolving a bank: which tools to use, and how the European Resolution Fund should be involved. National resolution authorities would be closely involved in this work.
- On the basis of the SRB's recommendation, or on its own initiative, the Commission would decide whether and when to place a bank into resolution and would set out a framework for the use of resolution tools and the fund. For legal reasons, the final say could not be with the SRB.
- Under the supervision of the SRB, national resolution authorities would be in charge of the execution of the resolution plan.
- The SRB would oversee the resolution. It would monitor the execution at national level by the national resolution authorities and, should a national resolution authority not comply with its decision, it could directly address executive orders to the troubled banks.
- A Single Bank Resolution Fund would be set up under the control of the SRB to ensure the availability of medium-term funding support while the bank was restructured. It would be funded by contributions from the banking sector, replacing the national resolution funds of the euro-area Member States and of Member States participating in the Banking Union, as set up by the draft Bank Recovery and Resolution Directive (BRRD).

The Commission's role would be limited to the decision to trigger the resolution of a bank and the decision on the resolution framework, thereby ensuring its consistency with the Single Market and with EU rules on state aid, and safeguarding the independence and accountability of the overall mechanism.

At the 27-28 June European Council, EU leaders set themselves the target of reaching agreement on the SRM by the end of 2013 so that it can be adopted before the end of the current European Parliament term in 2014. This would enable it to apply from January 2015, together with the BRRD.

In Issue 30 of the ICMA Quarterly Report (see pages 16-17) we reported the on the European Commission's *Consultation on Structural Reform of the Banking Sector*. On 11 July 2013, ICMA submitted a short response, reiterating the associated important viewpoint expressed in its November 2012 response to the Commission's earlier consultation on the Liikanen high-level, expert group's report. ICMA believes that, in a thriving and efficient capital market, primary and secondary market trading activities play symbiotic roles. A healthy flow of primary market origination helps to stimulate secondary market trading, whilst improved liquidity in secondary markets helps to underpin investor confidence and thus boost conditions for new issuers. Hence, ICMA considers that there should not be a required separation of securities trading activity, because the banking safety which such separation would seek to promote would run contrary to the efficiency of the debt capital market.

Also in Issue 30 of the ICMA Quarterly Report (see page 16) we reported on the European Commission's consultation on the review of the ESFS. On 31 July 2013, ICMA submitted its short responses to selected questions. Much of the substance of this response was taken from a 17 January 2012 letter regarding timeframes for ESA drafting of technical standards, which ICMA co-signed with six other trade associations.

On 4 September 2013, the European Commission published a Communication in respect of its *Roadmap for Tackling the Risks Inherent in Shadow Banking* and proposed new rules for MMFs. The Communication, which is a follow-up to last year's Green Paper on *Shadow Banking*, sets out the issues at stake in relation to the shadow banking system and the measures already taken to deal with the risks related to shadow banking such as the rules governing hedge fund activity and reinforcing the relationship between banks and unregulated actors (the provisions related to securitisation exposures in the revised Capital Requirements legislation). It outlines the priorities identified on which the Commission intends to take initiatives in areas such as:

- *provision of a framework for MMFs:* the proposed new rules cover MMFs that are domiciled or sold in Europe and aim to improve their liquidity profile and stability;
- *transparency of the shadow banking sector:* to be able to effectively monitor risks and intervene when necessary, it is essential to collect detailed, reliable and comprehensive sectoral data;
- *securities law and the risks associated with securities financing transactions:* these transactions can contribute to an increase in leverage and strengthen the procyclical nature of the financial system, which then becomes vulnerable to bank runs and sudden deleveraging. Furthermore, the lack of transparency of these markets makes it difficult to identify property ownership rights, monitor risk concentration and identify counterparty exposures;
- *provision of a framework for interactions with banks:* the high level of interconnectedness between the shadow banking system and the rest of the financial sector, particularly the banking system, constitutes a major source of contagion risk. These risks could notably be addressed by tightening the prudential rules applied to banks in their operations with unregulated financial entities.

Furthermore, particular attention will be paid to the supervision arrangements of shadow banking entities/activities in order to ensure that specific risks are adequately addressed. Certain areas such as the set-up of resolution tools for non-bank financial institutions and a structural reform of the banking system require further analysis and will be clarified later. The Commission's Communication is in line with the FSB's recommendations.

On 12 September 2013, MEPs gave a green light to the establishment of the SSM. The new oversight system involves the transfer of considerable bank supervisory powers from national to euro-area level. MEPs and various national parliaments therefore insisted that such a transfer of powers required commensurate democratic control of the new supervisor. According to the legislation, and the accompanying inter-institutional agreement between the European Parliament and the ECB, the European Parliament will have far-reaching access to information. Most importantly, this would include receiving a comprehensive and meaningful record of Supervisory Board meetings. The Chair of the Supervisory Board will also be required to appear at regular hearings before the European Parliament. To enhance accountability the European Parliament will have the joint power with Council to approve the Chair and Vice-Chair of the Supervisory Board as well as

"The new oversight system involves the transfer of considerable bank supervisory powers from national to euro-area level."

> The peer review has also identified a number of challenges that need to be addressed in order to make further progress in implementing the Principles.

to request their removal. The European Parliament will also be able to launch investigations into possible errors by the supervisor. Finally, individual MEPs will be able to question the supervisor in writing and receive a reply rapidly.

On 25 September 2013, the EBA published its fourth report of the Basel III monitoring exercise on the European banking system. This exercise monitors the impact of the implementation of the Basel III capital and liquidity requirements in the EU, based on the assumption of a full implementation of the Basel III framework as of 31 December 2012 and static balance sheets data. A total of 170 banks participated in the exercise on a voluntary and confidential basis, of which there were 42 Group 1 banks (with a Tier 1 capital exceeding €3 billion and internationally active) and 128 Group 2 banks (ie all other banks). Concerning liquidity, the LCR results show that, by end of December 2012, the average LCR of Group 1 banks would have been 109%, already above the 100% requirement to be reached by 2019. In addition, the exercise reveals a shortfall of liquid assets of €225 billion for all banks in the sample.

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Credit Rating Agencies (CRAs)

On 10 July 2013, ESMA issued a Discussion Paper (DP), for comment by 10 October 2013, dealing with the implementation of the CRA3 Regulation, which entered into force on 20 June 2013. This new Regulation, which complements the existing regulatory framework for CRAs, requires ESMA to draft Regulatory Technical Standards (RTS) on:

- disclosure requirements on structured finance instruments (SFIs);
- the European Rating Platform (ERP); and
- the periodic reporting on fees charged by CRAs.

The aim of this DP is to assist ESMA in its preparation of the draft RTS to be published for consultation in early 2014. ESMA must submit the draft RTS to the European Commission by 21 June 2014.

On 30 July 2013, IOSCO published its final report on Supervisory Colleges for CRAs, which recommends establishing supervisory colleges for internationally active CRAs, and provides preliminary guidelines on how to constitute and operate them. The recommendations are aimed at improving CRAs' integrity. IOSCO defines a supervisory college as a collaborative arrangement between supervisors that seek to promote information sharing, consultation, and cooperation in order to enhance risk assessment of internationally active CRAs and to support effective supervision of such CRAs.

On 29 August 2013, the FSB published a progress report on *Reducing Reliance on and Strengthening the Oversight of CRAs*. The progress report is accompanied by the interim peer review report on national implementation of the FSB *Principles for Reducing Reliance on CRA Ratings.* The progress report includes a summary of the main findings and recommendations of the peer review, describes on-going work by standard-setting bodies to reduce references to CRA ratings in international standards, and provides an update on work by IOSCO to improve transparency and competition among CRAs.

The interim peer review report includes a structured stock-taking of references to CRA ratings in national authorities' laws and regulations and of actions taken and underway to reduce those references. A few FSB jurisdictions have not yet completed a stock-taking, and the peer review recommends that they do so by end-September 2013. While recognising the progress made in implementing the Principles, the peer review has identified several areas where accelerated progress is needed, including that, FSB jurisdictions should: (i) provide incentives to financial institutions to develop their own independent credit assessment processes; and (ii) encourage or continue to enhance disclosures on financial institutions' internal credit risk assessment practices (drawing on guidance from standard-setting bodies where available). The peer review has also identified a number of challenges that need to be addressed in order to make further progress in implementing the Principles. These include reducing undue reliance on CRA ratings in international standards as well as in private contracts or private sector investment decisions; identifying suitable alternative standards of creditworthiness; and addressing constraints in the development of internal risk assessment systems, particularly for smaller firms. The second stage of the peer review will analyse these challenges in more detail. The FSB intends to issue the final peer review report in early 2014.

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OTC (derivatives) regulatory developments

On 11 July 2013, the European Commission and the CFTC announced a common *Path Forward*, regarding their joint understandings on a package of measures for how to approach cross-border derivatives. As the market subject to new derivatives regulations is international, it is acknowledged that, notwithstanding the high degree of similarity that already exists between the respective requirements, without coordination, subjecting the global market to the simultaneous application of each other's requirements could lead to conflicts of law, inconsistencies, and legal uncertainty. The CFTC and the European Commission share the view that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulation and enforcement regimes. Both sides aim to conclude these discussions as soon as possible, at which stage the substance of relevant relief awarded by the CFTC will be reflected in its guidance relating to substituted compliance, as approved by its principals, while the EU equivalence decisions will have been in place, and where necessary, amended to reflect this partnership. Other countries are invited to join this approach to make sure that the G20 commitments will be applied in a sensible and rigorous way to cross-border derivatives trades.

On 12 July 2013, ESMA launched a Discussion Paper to prepare the regulatory technical standards (RTS) which will implement provisions of EMIR regarding the obligation to centrally clear OTC derivatives. The consultation is aimed at assisting ESMA in developing its approach to determining which classes of OTC derivatives need to be centrally cleared and the phase-in periods for the counterparties concerned. EMIR introduced provisions to improve transparency, establish common rules for CCPs and for trade repositories (TRs) and to reduce the risks associated with the OTC derivatives market. It provides for the obligation to centrally clear OTC derivative contracts or to apply risk mitigation techniques such as the exchange of collateral.

On 12 July 2013, the European Commission adopted a Delegated Regulation to include the central banks and debt management offices of Japan and the United States in the list of exempted entities under Article 1(4) of EMIR, in line with the report adopted by the European Commission on 22 March 2013.

On 17 July 2013, ESMA launched a Consultation Paper (CP) on draft RTS aimed at implementing the provisions of EMIR related to OTC derivative transactions by non-EU counterparties in certain cases, and aimed at preventing attempts by non-EU counterparties to evade EMIR's provisions. The CP clarifies the conditions where EMIR's provisions regarding central clearing or risk mitigation techniques would apply to OTC derivatives by two non-EU counterparties which have a direct, substantial and foreseeable effect in the EU. On 26 September, ESMA reported that the European Commission had extended the deadline within which ESMA should deliver its draft technical standards on the cross-border application of EMIR to 15 November 2013. The extension was granted in order to give ESMA more time to fully analyse and take account of the responses received to its public consultation.

EMIR entered into force on 16 August 2012, following which stipulated Regulatory Technical Standards were prepared and entered into force on 15 March 2013. With respect to the continuing implementation of EMIR, ESMA published an updated *Questions and Answers* document on 5 August 2013. ESMA's information page on EMIR exists to provide access to the key documents and information about the regulation.

On 6 August 2013, ESMA sent a letter asking the Commission to consider an amended Implementing Technical Standard (ITS), in order to allow for a later start date for reporting of exchange-traded derivatives (ETDs) trades to TRs. There is a risk currently that reporting of ETDs will not be harmonised unless further regulatory guidance is issued. Based on the need to ensure the consistent implementation of EMIR, ESMA considers that guidelines and recommendations should be developed in relation to this issue. A delay in the reporting date for ETD transactions will allow sufficient time for the development of the relevant guidelines and their implementation by counterparties, TRs and regulators. The European Commission has three months to decide whether to endorse ESMA's draft ITS.

On 2 September 2013, ESMA sent the Commission a technical advice letter on third-country regulatory equivalence under EMIR; and enclosing ESMA's advice for the US, Japan, Australia, Hong Kong, Singapore and Switzerland. ESMA considers third-country regimes equivalent where the legal provisions and the level of supervision and enforcement is similar to that of EMIR. ESMA finds the regulatory regimes of Australia and Switzerland for CCPs equivalent to EU rules. Conditional equivalence is

> "will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions

proposed to the following regimes:

- Hong Kong, Japan, Singapore, and the US for CCPs;
- the US and Japan for central clearing, requirements for non-financial counterparties and risk mitigation techniques for uncleared trades; and
- the US for TRs.

At this stage ESMA is not delivering its technical advice regarding CCP requirements in respect of India or South Korea and its technical advice regarding the requirements for the clearing obligation, reporting obligation, non-financial counterparties and risk mitigation techniques for uncleared trades in respect of Canada. The European Commission is expected to use ESMA's technical advice to prepare possible equivalence decisions. Where it adopts such a decision, certain provisions of EMIR may be disapplied in favour of equivalent third-country rules.

On 2 September 2013, the BCBS and IOSCO jointly released the final framework for margin requirements for non-centrally cleared derivatives. Under these globally agreed standards all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives will have to exchange initial and variation margin commensurate with the counterparty risks arising from such transactions. The framework has been designed to reduce systemic risks related to OTC derivatives markets, as well as to provide firms with appropriate incentives for central clearing while managing the overall liquidity impact of the requirements.

The final requirements have been developed taking into account feedback from two rounds of consultation (a July 2012 consultative paper and a February 2013 near-final proposal) as well as a Quantitative Impact Study that helped inform the policy deliberations. Compared with the near-final proposal, the final set of requirements includes the following modifications:

- The framework exempts physically settled foreign exchange (FX) forwards and swaps from initial margin requirements. Variation margin on these derivatives should be exchanged in accordance with standards developed after considering the BCBS supervisory guidance for managing settlement risk in FX transactions.
- The framework also exempts from initial margin requirements the fixed, physically settled FX transactions that are associated with the exchange of principal of cross-currency swaps. However, the variation margin requirements that are described in the framework apply to all components of cross-currency swaps.
- "One-time" re-hypothecation of initial margin collateral is permitted subject to a number of strict conditions (see 5(v) at pages 20-21). This is meant to help mitigate the liquidity impact associated with the requirements.

A number of other features of the framework are also intended to manage the liquidity impact of the margin requirements on financial market participants. In particular, the requirements allow for the introduction of a universal initial margin threshold of €50 million below which a firm would have the option of not collecting initial margin. The framework also allows for a broad array of eligible collateral to satisfy initial margin requirements (see below), thus further reducing the liquidity impact. Finally, the requirement to collect and post initial margin on non-centrally cleared trades will be phased in over a four-year period, beginning in December 2015 with the largest, most active and most systemically important derivatives market participants.

Concerning eligible collateral for margin the framework says:

"National supervisors should develop their own list of eligible collateral assets based on the key principle [that these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress], taking into account the conditions of their own markets. As a guide, examples of the types of eligible collateral that satisfy the key principle would generally include cash; high-quality government and central bank securities; high-quality corporate bonds; high-quality covered bonds; equities included in major stock indices; and gold. This illustrative list should not be viewed as being exhaustive, so additional assets and instruments that satisfy the key principle may also serve as eligible collateral. Also, in different jurisdictions, some particular forms of collateral may be more abundant or generally available due to institutional market practices or norms. Eligible collateral can be denominated in any currency in which payment obligations under the non-centrally cleared derivatives may be made, or in highly liquid foreign currencies subject to appropriate haircuts to reflect the inherent FX risk involved." (pages 16-17)

"The BCBS and IOSCO have established a standardised schedule of haircuts [that can be used in lieu of model-based haircuts] for the list of assets appearing above. The haircut levels are derived from the standard supervisory haircuts adopted in the Basel Accord's comprehensive approach to collateralised transactions framework, and can be found in Appendix B." (page 17; Appendix B at page 26).

The OTC Derivatives Regulators Group (ODRG) published a report, as provided to the G20 Leaders' Summit of 5 - 6 September 2013, on agreed understandings to resolving cross-border conflicts, inconsistencies, gaps and duplicative requirements. Recognising that differences in regulation can result when laws and regulations are developed within distinct legal structures, understandings have been reached within the context of complex regulatory differences. The principals involved have reached a number of substantive understandings:

- consultation and communication when equivalence or substituted compliance assessments are being undertaken is essential;
- a flexible, outcomes-based approach should form the basis of final assessments regarding equivalence or substituted compliance;
- a stricter-rule approach would apply to address gaps in mandatory trading or clearing obligations;
- there is a framework for consultation among authorities on mandatory clearing determinations;
- jurisdictions should remove barriers (i) to reporting to trade repositories by market participants with particular attention to removing barriers to reporting counterparty data and (ii) to access to trade repository data by authorities; and
- there should be appropriate transitional measures and a reasonable but limited transition period for foreign entities.

It has been agreed that further work will be conducted relating to authorities' access to registrant information; and foreign bank branches and guaranteed subsidiaries.

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Financial Transaction Tax

The FTT proposal, for implementation by 11 EU Member States (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain) under enhanced cooperation, was set out by the Commission on 14 February 2013. An important challenge to this proposal has arisen in the form of an EU Council legal opinion, dated 6 September 2013, the conclusion of which quite pointedly contradicts the legal validity of the scope of the Commission's FTT proposal (details of this can be read at: EU legal opinion against the FTT).

In the course of working party proceedings doubts were expressed regarding the compatibility of Article 4(1) point f) of the proposal with Article 327 TFEU, equal treatment, proportionality and the principles governing the internal market, in particular the free movement of capital. It was contended that Article 4(1) point f) of the proposed Directive would fail to respect fiscal competences of non-participating Member States as there would be an insufficient link between the taxing Member State and the non-resident person liable to pay FTT pursuant to that provision in order to justify the exercise of prescriptive fiscal jurisdiction over that non-resident person. The opinion of the Council's legal service was sought on these issues.

The opinion (which is not itself legally binding) constitutes the answer of the Legal Service regarding this particular matter and is not intended to cover other issues or other provisions of the proposal. The opinion concludes that:

"It is the Legal Service's view that the criterion for deemed establishment of an institution which Article 4(1) point f) of the proposed Directive contains:

1. exceeds Member States' jurisdiction for taxation under the norms of international customary law as they are understood by the Union;
2. is not compatible with Article 327 TFEU as it infringes upon the taxing competences of non-participating Member States;
3. is discriminatory and likely to lead to distortion of competition to the detriment of non-participating Member States."

Other criteria to determine the applicability of the tax regime, be they already present in the proposal or otherwise conceivable, are not the subject of the discussion in this opinion.

Interestingly, the legal analysis contained in this opinion appears supportive of important points raised in the UK's legal challenge to the FTT, which was reported on in Issue 30 of the ICMA Quarterly Report (see pages 18-19).

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Avoiding counterproductive regulation in capital markets

ICMA is preparing a paper for the authorities on the impact of current and forthcoming regulatory changes on the ability of European fixed income and repo markets to fulfil their essential economic role of helping to lubricate and sustain economic recovery and growth.

This paper explains how these markets work in harness with general economic and monetary policy, in particular by supplementing stressed bank funding with market funding; and by supporting regulators' drive towards collateralisation of risk. These markets facilitate the flow of assets around the economy to those who can most efficiently deploy them, but they depend on high levels of liquidity and available collateral.

The paper will aim to identify specific examples where the market is concerned that aspects of the reform of regulation give rise to inconsistencies, conflicts, overlaps, and unintended consequences which may undermine core aspects of these markets and the economic functions they perform, and so put at risk the shared policy objectives of regulatory reform.

There is widespread concern that some of these problems, and their cumulative impact, are in danger of doing serious harm to European fixed income markets and the real economy which they service.

The paper will highlight the need to agree practical, consistent, and directed ways of resolving these problems so that the authorities and markets can, in harness, achieve the aims of regulatory reform, financial stability, and renewed growth.

Short-Term Markets

by David Hiscock

European repo market

Leverage ratio: On 26 June 2013, the BCBS published its *Revised Basel III Leverage Ratio Framework and Disclosure Requirements* for consultation, with a comment deadline of 20 September; and the ICMA ERC has submitted a response elaborating its concerns about the proposed treatment for securities financing transaction (SFT) exposures. In particular the ERC believes it is important that changes be made to allow for the recognition of legal enforceable counterparty netting, under master agreements and in the context of CCP exposures. In case this is not done, the gross treatment of SFTs proposed by the BCBS will very quickly precipitate a significant contraction in this important market. The ERC is concerned that there will then be adverse consequences from the repo market's reduced capacity to play its various essential roles. Negative consequences in such a case would be a less liquid government bond market, increasing the cost of government funding; less efficient transmission of monetary policy; more expensive or drastically reduced access, for both financial institutions and firms in the real economy, to the repo tool for the management of cash position; risks to financial stability, as the push into collateralising financial transactions under the new regulatory framework will be undermined; and increased systemic operational risk.

In parallel with the consultation on the proposals, the BCBS is also undertaking a Quantitative Impact Study to ensure that the calibration of the leverage ratio, and its relationship with the risk-based framework, remains appropriate. Implementation of the leverage ratio requirement has begun with bank-level reporting to supervisors of the leverage ratio and its components from 1 January 2013, and will proceed with public disclosure starting 1 January 2015. Any final adjustments to the definition and calibration of the leverage ratio will be made by 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

Shadow banking: On 27 May 2013, the CGFS published a report on *Asset Encumbrance, Financial Reform and the Demand for Collateral Assets*. The executive summary starts by stating: "The use of collateral in financial transactions has risen in many jurisdictions in the aftermath of the financial crisis, and is likely to increase further. This is driven by both market forces and regulatory changes, and has triggered concerns about real or perceived collateral scarcity and excessive asset encumbrance. Taking a system-wide perspective, this report examines how greater collateral use and asset encumbrance may impact the functioning of the financial system and draws lessons for policymakers." In summarising the implications for policy, the report concludes with the statement: "Concerns over procyclical demand for collateral assets lend support to efforts targeting strict standards for collateral valuation practices and through-the-cycle haircuts." Section 6 of the report lays out the full implications for policy, with section 6.2 including a segment entitled *Strengthening Standards in Securities Financing Markets*. This particularly refers to the familiar topics under consideration in the FSB's shadow banking workstream on securities lending and repos.

In context of the on-going official projects considering repos under the umbrella of work on shadow banking, a study entitled *Shadow Banking – Minimum Haircuts on Collateral* was published. This document was prepared in response to a request from the European Parliament's Committee on Economic and Monetary Affairs (ECON).

On 29 August 2013, the FSB published policy recommendations to strengthen the oversight and regulation of the shadow banking system. The reports published by the FSB included *Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, which sets out recommendations for addressing financial stability risks in this area, including enhanced transparency, regulation of securities financing, and improvements to market structure. This paper also includes consultative proposals, for comment by 28 November 2013, on minimum standards for methodologies to calculate haircuts on non-centrally cleared securities financing transactions and a framework of numerical haircut floors (as described in Annex 2 of the report).

Concerning securities lending and repos, the FSB has produced 11 finalised recommendations (Annex 1 of the report), of which five are related to improvement in transparency; four are related to regulation; and two are related to structural aspects of the securities financing market. These recommendations, including those under further consultation, take into account public responses received on the consultative documents issued on 18 November 2012 and the results of a first stage QIS (QIS1) which took place in April-June 2013. (This consisted of collecting detailed historical haircut data from a small pool of large financial intermediaries globally so as to calibrate the FSB's proposed minimum haircut recommendations; and also included a set of qualitative questions asking participating firms to provide a general description of the factors they take into account and the approach they follow when setting haircuts). In refining its policy recommendations the FSB focused on addressing financial stability issues and clearly linked the policy recommendations to the risks identified. In addition, the FSB has endeavoured to ensure that its recommendations minimise the risk of regulatory arbitrage as well as undue distortion of markets, and are consistent with other international regulatory initiatives. Application of the policy recommendations may vary in details across jurisdictions, depending on existing regulatory frameworks. The implementation of recommendations and their consistency across jurisdictions will be monitored through the FSB after they are finalised.

The intention of the FSB's policy recommendations is to address perceived financial stability risks in the securities lending and repo markets. These risks can be split into:

- *"pure" shadow banking risks* (ie maturity/liquidity transformation and leverage outside the banking sector): (i) using repo to create short-term, money-like liabilities, facilitating credit growth and maturity/liquidity transformation outside the banking system; and (ii) securities lending cash collateral reinvestment; and
- *risks that span both banking and shadow banking*: (i) tendency of securities financing to increase procyclicality of system leverage; (ii) risk of a fire sale of collateral securities; (iii) re-hypothecation of unencumbered assets; (iv) interconnectedness arising from chains of transactions involving the re-use of collateral; and (v) inadequate collateral valuation practices.

The FSB will undertake further work on some recommendations contained in this document. A new FSB data experts group on securities financing markets has been established to take forward recommendations on data collection and aggregation at the global level (recommendations 2 and 3). This group will develop proposed standards and processes for data collection and aggregation at the global level to ensure consistent data collection by national/regional authorities by the end of 2014. Meanwhile, the FSB is conducting the second stage of the QIS (QIS2) to assess the impact of its proposed recommendations on minimum haircut standards described in Annex 2, and in particular the proposed numerical haircut floors; and is inviting comments responsive to its further consultation.

On 4 September 2013, the European Commission published a Communication in respect of its *Roadmap for Tackling the Risks Inherent in Shadow Banking* and proposed new rules for MMFs. The Communication, which is a follow-up to last year's Green Paper on *Shadow Banking*, sets out the issues at stake in relation to the shadow banking system and the measures already taken to deal with the risks related to shadow banking. It outlines the priorities identified on which the Commission intends to take initiatives in areas such as:

- *provision of a framework for MMFs:* the proposed new rules cover MMFs that are domiciled or sold in Europe and aim to improve their liquidity profile and stability. Concerning repos:
    - it is proposed that (alongside a few other forms of eligible assets) reverse repurchase agreements could be used by MMFs as a means to invest excess cash on a very short-term basis, provided that the position is fully collateralized (with a security which itself would be an MMF eligible asset) and subject to the limit that one reverse repurchase agreement counterparty cannot account for more than 20% of the MMF's assets;
    - use of all other efficient portfolio management techniques, including securities lending and borrowing, is prohibited for MMFs, as they are likely to impinge on achieving the investment objectives of the MMF.
- *transparency of the shadow banking sector:* to be able effectively to monitor risks and intervene when necessary, it is essential to collect detailed, reliable and comprehensive sectoral data. Within section 3.1 of the Communication there is a specific bullet point covering "the need to increase transparency of securities financing transactions" (SFTs) – this notes related FSB, ESRB and ECB work and reserves the right to propose appropriate measures in case transparency at the EU level does not improve sufficiently.
- *securities law and the risks associated with securities financing transactions*: these transactions can contribute to an increase in leverage and strengthen the procyclical nature of the financial system, which then becomes vulnerable to bank runs and sudden deleveraging. Furthermore, the lack of transparency of these markets makes it difficult to identify property ownership rights, monitor risk concentration and identify counterparty exposures. Section 3.3 of the Communication specifically covers the topic of "reducing the risks associated with SFTs" – an EU securities law proposal in 2014 (or beyond) is being considered as the legislative solution to the perceived problems.

The Commission's Communication is in line with the FSB's recommendations.

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ICMA-ERC 25th European repo market survey

ICMA's ERC released the results of its 25th semi-annual survey of the European repo market on 18 September 2013. The survey, which computes the amount of repo business outstanding on 12 June 2013, sets the baseline figure for market size at €6,076 billion. This represents an increase of 8.6% in the size of the market since the last survey in December 2012 (measured using a constant sample of survey respondents).

This recovery in the European repo market is in marked contrast to the contraction in the US repo market which was widely reported in July. The revival in repo activity in Europe appears to be driven by banks in the euro area returning to the market for funding as they start to repay the exceptional assistance of over €1 trillion provided to the market via the ECB through the Longer-Term Refinancing Operations (LTRO) liquidity of December 2011 and February 2012. The LTRO repayments have contributed to tighter market conditions and a steepening money market yield curve. The higher rates and greater market confidence have attracted lenders away from the ECB deposit facility (which pays zero per cent) and back into the market.

The survey also reveals that the market share of euro-denominated repo has recovered over the same 6 month period since December 2012, and now comprises 64.8% of the survey total, providing further evidence for the role of the LTRO repayments in promoting recovery in the European repo market.

The next survey will take place in December 2013. All financial institutions participating in the repo market are encouraged to submit a response. All individual responses will be kept entirely confidential.

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Triparty Settlement Interoperability

On 15 July 2013, the Triparty Settlement Interoperability (TSI) MOU, which crystallises work which the ERC has discussed for many years, was formally signed at a ceremony hosted by the ECB and witnessed by the European Commission. The TSI participants (the ERC, Euroclear, Clearstream Luxembourg, Clearstream Frankfurt and Eurex Clearing) announced this in their joint press release: *European Organisations Aim to Boost Triparty Repo Settlement Interoperability by 2015*. The speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the signing ceremony for the TSI MoU has been published by the ECB, together with an associated ECB press release. The ERC Chairman and ICMA's Chief Executive, Martin Scheck, signed the TSI MOU on behalf of the ERC.

The TSI MOU engages the three post-trade infrastructure providers in a joint project enabling their systems to work together to increase the efficiency of the repo market. The project primarily creates the opportunity for Eurex Clearing to extend the connected settlement locations for its secured funding market GC Pooling with Clearstream Banking to include Euroclear Bank. Pending completion of detailed feasibility studies and market consultation, triparty settlement interoperability is envisaged to be delivered by the end of 2015.

A triparty repo is a transaction for which collateral selection and substitution, valuation, settlement and custody during the life of the repo transaction is outsourced by the two trading parties to a third-party agent. Eurex Clearing is a central counterparty (CCP), which defines the eligible securities for repo baskets (eg GC Pooling) and clears triparty basket trades directed to it by repo trading venues.

Establishing triparty settlement interoperability with both triparty service providers will improve the movement of collateral between the connected settlement locations in Europe. It will also reduce collateral pool fragmentation, which currently can cause technical fails, while allowing banks to supply liquidity to the real economy through the intervention of the repo markets. The initiative will increase the efficiency of collateral management for repo basket trading throughout Europe and will boost the fluidity of collateral across the euro area.

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ECP market

Money market funds (MMFs): On 4 September 2013, the European Commission published its proposed *Regulation for MMFs*. This proposed new MMF rules cover MMFs that are domiciled or sold in the EU. The aim is to improve their liquidity profile and stability:

- *Liquidity management:* MMFs would be required to have at least 10% of their portfolio in assets that mature within a day and another 20% that mature within a week. This requirement is intended to allow the MMFs to repay investors who want to withdraw funds at short notice. In order to avoid that a single issuer bears undue weight in the net asset value (NAV) of an MMF, exposure to a single issuer would be capped at 5% of the MMF's portfolio (in value terms). For standard MMFs, a single issuer could account for 10% of the portfolio.
- *Stability:* to take account of the constant NAV (CNAV) and MMF's propensity to require sponsor support to stabilise redemptions at par, the new rules would require this type of MMF to establish a predefined capital buffer. This buffer would be activated to support stable redemptions in times of decreasing value of the MMF's investment assets.

MMFs are of great importance to the ECP market, as they are an important part of its investor community. This relationship is even more significant in relation to ABCP, where MMFs provide a large majority of the investments made. Accordingly, any ways in which the proposed MMF Regulation leads to a contraction in MMFs, as may indeed be the case if the requirements it proposes – such as capital for CNAV funds – prove to be too onerous, will be of concern to the ECP market. It is very important that the valuable financing which CP can offer is not impeded by measures which overly restrict investment in the product, cutting off the link to investor funds which should be channelled to help meet real economy needs.

Besides more general concerns about how the proposed MMF Regulation will impact the MMF sector, there are also a few specific points in the proposal concerning CP:

- The limited range of eligible assets for MMFs includes "money market instruments" – which are defined to include commercial paper – insofar as they comply with maturity limits and are considered by the MMF to be of high credit quality. (See Recital 22.)
- ABCP should be considered an eligible money market instrument to the extent that it respects additional requirements. Owing to the fact that during the crisis certain securitisations were particularly unstable, it is necessary to impose maturity limits and quality criteria on the underlying assets. Not all categories of underlying assets should be eligible because some are more unstable than others. For this reason the underlying assets should be exclusively composed of short-term debt instruments that have been issued by corporates in the course of their business activity, such as trade receivables. Instruments such as auto loans and leases, equipment leases, consumer loans, residential mortgage loans, credit card receivables or any other type of instrument linked to the acquisition or financing of services or goods by consumers should not be eligible. ESMA should be entrusted

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It is very important that the valuable financing which CP can offer is not impeded by measures which overly restrict investment in the product.

with drafting regulatory technical standards to be submitted for endorsement by the Commission with regard to the conditions and circumstances under which the underlying exposure or pool of exposures is considered exclusively to consist of corporate debt and the conditions and numerical thresholds determining when corporate debt is of high credit quality and liquid. (See Recital 23.)

Meanwhile in the US, the consultation period in respect of the SEC's proposal for MMF rules closed during September. This proposal was described in Issue 30 of the ICMA Quarterly Report (see page 33). It includes two principal alternative reforms:

- to require a variable NAV (VNAV) for prime institutional money market funds (but allow the use of CNAV for government funds); and/or
- to allow the use of liquidity fees and redemption gates in times of stress.

An important point to note is that this is distinctly different from the newly proposed EU MMF Regulation, with its focus on establishing capital buffers in CNAV funds. Unless more is done to align the proposals it is quite clear that the differences in regulation will become a driver of future decisions. When deciding which MMFs to place money in, treasurers will need to conduct a risk benefit analysis which may be heavily influenced by the regulatory environment of the MMF. It is quite easy to conceive that if a particular regulatory regime is perceived to create more cost than benefit large sums of cash will be redirected. Were a flow away from Europe to occur, this would reduce the amount of productive short-term investment funding available to meet Europe's pressing economic needs.

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The importance of ABCP

ICMA believes that ECP, including in the form of Asset-Backed Commercial Paper (ABCP), plays an important role in providing much needed funding for the benefit of issuers and investors. With the economy currently in clear need of access to sufficient sources of funding, as efforts continue to stimulate economic growth, the case for an efficient and effective CP market is more evident than ever.

ABCP is a particular form of CP issuance which has benefits for both issuers and investors; and whilst it forms a relatively small proportion of the total ECP market, it is currently the source of €30 billion of relatively cheap funding.

The financial crisis called into question the use of securitisation, of which ABCP is a particular example, structured flexibly to meet shorter-term financing requirements. In November 2012, AFME published *The Economic Benefits of High Quality Securitisation to the EU Economy*, which in summary highlights that there are a wide variety of very sound economic reasons why high quality securitisation can provide significant benefits to European growth. So, notwithstanding the problems and concerns associated with securitisation, it is quite clear that it is a valuable tool and many efforts are under way to capture this value whilst at the same time avoiding the problems of the past. The EU itself has implemented specific new regulations governing securitisation which help to underpin this.

As further measures, such as the proposed EU MMF Regulation, are put into place, it is important that they are calibrated in such a manner that they do not stifle the securitisation product by unduly constraining its investor base. For ABCP, which is largely bought by MMFs, this is particularly pertinent. It is true that the financial crisis showed certain ABCP structures, most particularly structured investment vehicles, to be badly designed, and therefore entirely appropriate that suitably designed regulations be established to protect against this – albeit that the market itself has entirely moved away from these problematic structures.

Nevertheless, it is important to note that it remains true that no investor has suffered defaulted European or US ABCP issued by a multi-seller conduit. Multi-seller programmes were more resistant to the crisis because of strong bank sponsorship, funding costs passed through to underlying customers, limited exposure to sub-prime and collateralised debt obligations of asset-backed securities, and additional backstop liquidity and credit enhancement when required.

As described in Issue 30 of the ICMA Quarterly Report (see page 34), ABCP provides benefits for both issuers and investors. Accordingly, given the need to promote financing of the economy, appropriate ABCP structures such as multi-seller programmes should be encouraged rather than constrained.

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LIBOR and other benchmarks

On 17 July 2013, IOSCO published the final report on *Principles for Financial Benchmarks*, which provides an overarching framework of principles for benchmarks used in financial markets. The principles establish guidelines for benchmark administrators and other relevant bodies in the areas of: governance; benchmark quality; quality of the methodology; and accountability mechanisms. In addition to a set of high-level principles, the framework offers a subset of more detailed principles for benchmarks having specific risks arising from their reliance on submissions and/or their ownership structure. The principles provide for benchmark administrators publicly to disclose their compliance with the principles within twelve months of the publication of the report, with the intention of IOSCO reviewing within an 18 month period the extent to which the principles have been implemented.

Chapter three of the report clarifies a number of points that surfaced during public consultation on the intended scope and implementation of the principles. Although its scope remains broad, the final report recommends that the application and implementation of the principles should be proportional to the size and the risks of each benchmark and/or administrator and the benchmark setting process. The Data Sufficiency Principle provides that a benchmark should be based on prices, rates, indices or values that have been formed by the competitive forces of supply and demand and anchored by observable transactions entered into at arm's length between buyers and sellers in such an active market. The final report clarifies that this does not mean that individual benchmark determinations must be constructed solely or even predominantly by transactions or that data must be used in a certain order. A principle was added to disclose to what extent and on what basis expert judgment was used, if any, in each benchmark determination.

The official sector has an essential role to play in ensuring that widely-used benchmarks are held to appropriate standards of governance, transparency and reliability. The measures proposed by national regulators, international standard setting bodies and central banks – including the Wheatley Review of LIBOR, and reviews by EBA/ESMA, IOSCO, and Economic Consultative Committee Governors of reference rates as a whole – to restore the governance and oversight processes of benchmark rates need to be implemented with high priority and urgency. In this context, the FSB has been tasked by the G20 to promote consistency in these assessments and to ensure that national/regional authorities adopt a coordinated approach: and within its broader mandate, the FSB will also promote widespread support, dissemination and adoption of any principles and good practices that emerge regarding the benchmark setting process.

As reported in a 29 August 2013, FSB progress report, to take the work forward, the FSB has established a high-level Official Sector Steering Group (OSSG) of regulators and central banks. The OSSG is responsible for coordinating and maintaining the consistency of reviews of existing interest rate benchmarks and for guiding the work of a Market Participants Group (MPG) which will examine the feasibility and viability of adopting additional reference rates and potential transition issues. The FSB has decided that the OSSG shall focus its initial work on the interest rate benchmarks that are considered to play the most fundamental role in the global financial system. The MPG has been asked to provide an interim report and draft recommendations to the OSSG by end-December 2013 and its final report to the OSSG by mid-March 2014. The OSSG will assess the feasibility and viability of the reformed and alternative benchmark rates proposed by the MPG, and identify any issues that may arise in transitioning to reformed or new proposed interest rate benchmarks and make recommendations

"The official sector has an essential role to play in ensuring that widely-used benchmarks are held to appropriate standards of governance, transparency and reliability.

for addressing them. Where appropriate, the OSSG will set out methods for encouraging a transition to the alternative/complementary rates recommended by the MPG.

The FSB asked the OSSG to review the standards and principles for sound benchmarks developed by the relevant standard setting bodies, with a view to recommending to the FSB whether adoption or endorsement of a single consolidated set of principles would be desirable. Following the recommendation of the OSSG, the FSB has endorsed the IOSCO *Principles for Financial Benchmarks* published in July 2013 which cover the important issues of benchmark governance, integrity, methodology, quality and accountability. The FSB has also accepted the OSSG recommendation that IOSCO be commissioned to conduct an initial review of the most widely used benchmarks against its Principles. The OSSG will report back to the FSB on the outcome of these reviews by June 2014 and findings will be publicly disseminated.

Complementary to the Commission's proposals, agreed by the European Parliament and Council in June 2013, to make the manipulation of benchmarks a market abuse offence subject to strict administrative fines, on 18 September 2013 the Commission proposed a draft Regulation to help restore confidence in the integrity of benchmarks. The proposal is in line with the principles recently agreed at international level by IOSCO and covers all benchmarks that are used to reference financial instruments admitted to trading or traded on a regulated venue, such as energy and currency derivatives, those that are used in financial contracts, such as mortgages and those that are used to measure the performance of investment funds. It seeks to address possible shortcomings at every stage in the production and use of benchmarks. In particular the proposal:

- improves the governance and controls over the benchmark process;
- improves the quality of the input data and methodologies used by benchmark administrators;
- ensures that contributors to benchmarks provide adequate data and are subject to adequate controls;
- ensures adequate protection for consumers and investors using benchmarks; and
- ensures the supervision and viability of critical benchmarks.

Central banks that are members of the ESCB are excluded from the scope as they already have systems in place that ensure compliance with the objectives of this draft Regulation. Benchmarks whose input data is provided by regulated venues are released from certain obligations to avoid dual regulation.

With respect to ICMA's key concern with respect to implications for the continuity of benchmarks in existing financial contracts, Article 7.1 provides reassurance that, whilst there is a preference for the use of transaction, other input data may be used. The text states that provision of a benchmark shall be governed by the requirements in respect of its input data and methodology which include that:

- "The input data shall be sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure"; and
- "The input data shall be transaction data. If available transaction data is not sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure, input data which is not transaction data may be used provided that such data is verifiable."

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by Ruari Ewing
and Charlotte Bellamy

Primary Markets

Market Abuse Regulation

On 10 September 2013, the European Parliament adopted a Level 1 text for the new Market Abuse Regulation (MAR) which will replace the existing Market Abuse Directive (MAD), reflecting the outcome of trilogue negotiations, reached in July between the European Parliament, the Council and the European Commission.

There are some new potential implications of the European Parliament text specific to new bond issuance, beyond those arising in relation to the 5 December 2012 Council general approach and preceding 3 September Presidency compromise proposal (commented on respectively in the First Quarter 2013 edition and Fourth Quarter 2012 edition of this Quarterly Report and which largely also apply to the European Parliament text):

- *Scope:* MAR will extend the scope of the market abuse framework beyond financial instruments traded on EEA "regulated markets" (RMs) so that, in evaluating whether non-public information relating to an upcoming bond issue potentially constitutes inside information, price impact consideration will need to extend beyond only those related instruments that are traded on RMs.
- *Definition of inside information:* The definition of inside information has been amended by stating that information is significantly price sensitive if a reasonable investor would likely use such information as part of the basis of its investment decision. While some may worry that such reasonable investor test might erode the assessment of price sensitivity as such, the test may be seen as merely an import from MAD's existing Level 2 Implementing Regulation – particularly since other "significant price sensitivity" references in the European Parliament text can only be interpreted on that literal basis. Some may also feel that reasonable investor interest, in turn, necessarily involves price sensitivity.
- *Stabilisation:* Stabilisation will no longer be subject to prior regulatory approval as was worryingly envisaged in the European Parliament's October 2012 report on MAR (and reported in the First Quarter 2013 edition of this Quarterly Report).

The implications of the European Parliament text will hopefully become clearer over the next few weeks and months as regulatory lawyers digest it further.

In the meantime, publication in the *Official Journal* (following correction of any typographic errors and consequential alignment with the ongoing MiFID

review) should hopefully follow later this year, with the new MAR then coming into effect in late 2015. Industry focus will now have also to encompass MAR's Level 2 measures and ensuring that such measures are properly consulted on and finalised and published to allow the markets sufficient notice of their requirements before they come into application.

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PRIPs: key information documents

Following the European Council's 24 June general approach (reported in the Third Quarter edition of this Quarterly Report), the European Parliament's ECON Committee continues to work towards adoption of its report to enable trilogue negotiations with Council and the European Commission to begin. Timing is now a particularly relevant consideration as trilogue will need to complete with sufficient time to spare for a subsequent Parliamentary plenary vote (currently scheduled for 24 February 2014) before the Parliamentary elections scheduled for May 2014. Extension of scope to vanilla products seems to be one of the major elements at this stage – any such extension certainly needing to be properly studied with actors in the relevant vanilla markets being formally consulted (something which has not happened so far). Even if this dossier is not completed under the current outgoing Parliament or picked up by the next incoming Parliament, the key information document (KID) concept is here to stay – with multiple ongoing national and global initiatives. Consequently, the point (articulated in prior editions of this Quarterly Report) that short form disclosure *inter alia* cannot include, in words, all information for an informed investment decision (at least on the likelihood of a specific issuer of bonds being able to honour its related obligations) remains pertinent.

In this respect, it is worth most recently noting the Consultative Document on *Point of Sale Disclosure in the Insurance, Banking and Securities Sectors* published in August by the Joint Forum (which gathers IOSCO and its banking and insurance sister bodies) with a comments deadline of 18 October (the Joint Associations Committee that ICMA supports is considering a possible response). The Consultative Document acknowledges that concise point of sale disclosure cannot be exhaustive and is not a cure-all (noting the need for strong requirements on advice). Also of interest is the update report on the work to support the implementation of the G20 high-level principles on financial consumer protection (Principles 4, 6 and 9) published by G20/OECD Task Force on Financial Consumer Protection in September. This somewhat confusingly contemplates disclosure that is short and complete for "informed" assessments, whilst also acknowledging that transparency is not sufficient – needing to be complemented *inter alia* with business conduct measures. Last, but not least, and in the retail structured products context, is ESMA's July *Economic Report on Retailisation in the EU*, the tentative conclusions of which may need to be further reviewed (particularly given the relatively limited sample of products analysed).

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Stabilisation will no longer be subject to prior regulatory approval as was worryingly envisaged in the European Parliament's October 2012 report on MAR.

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Short form disclosure cannot serve as the basis for an informed investment decision.

A question arises as to whether numbers might be able to convey, in the much touted “synthetic risk indicator” concept, what cannot be conveyed in words – with credit ratings, credit default swaps (CDS) and value at risk (VaR) measures being the most obvious sources to consider.

Credit ratings, however, though now subject to various recent and ongoing legislative and regulatory measures, are unlikely to be acceptable to a policy establishment that is seeking to reduce, rather than increase, reliance on them. Many issuers, incidentally, are not rated as solicited ratings are costly both to establish and then to maintain. Numbers derived from CDS markets do not seem appropriate either, *inter alia* because CDS markets only exist for the largest names and are impacted by factors unrelated to an entity’s actual credit quality (such as general market sentiment and liquidity). Finally, VaR measures effectively seem to rely on extrapolating indications of future return from past performance (by looking at standard negative deviations from average values in historic data) – a concept that many consider inappropriate. The VaR approach may indeed be of value as one (informal) tool for a fund manager when making short-term decisions for a large diversified fund that naturally incurs losses as well as gains. This logic cannot apply to an individual investor managing a much smaller and more limited individual portfolio for his or her own retirement. In any case, it is unclear what data might be useable, or even available, for single company credits in this respect – be it past defaults, past profitability, etc.

The resulting conclusion continues to be that short form disclosure cannot serve as the basis for an informed investment decision. An articulation of the KID concept that might therefore be suggested to the European Parliament, Council and European Commission is:

“A Key Information Document shall be drawn up in order to aid investors to decide which offers of securities to consider further by reading the relevant prospectus or, failing which, the relevant contract or contracts relating to the product or by taking appropriate advice. Civil liability attaches to those persons who have drawn up the Key Information Document, but only if it is misleading, inaccurate or inconsistent when read together with any related prospectus or, failing which, the relevant contract or contracts.”

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Prospectus Directive

The Euromoney 4th Prospectus Directive Conference was held on 24 and 25 September 2013 in London, with regulators, lawyers, compliance officers, accountants and other market participants in attendance. A number of interesting points on the impact of the amendments to the Prospectus Directive were raised.

- Aside from some gold-plating of the amended Prospectus Directive (PD II) (eg the Q&A format introduced for some retail prospectuses), the extent to which PD II has achieved its goal of increasing investor protection is questionable. New requirements for the drafting of final terms, summaries and supplements seem to have generally made documents more complex, longer and harder to understand. In particular, issue specific summaries are often longer than the final terms themselves, and retail base prospectus summaries are now often more difficult to understand than wholesale base prospectus overviews.
- There is doubt surrounding the appropriateness of the emphasis placed upon prospectus/disclosure regulation to achieve investor protection more generally. In one jurisdiction at least, the sale by an issuer of its own securities is considered to be

> One should certainly not confuse a regime for vetting the quality of disclosure with product regulation.

outside the scope of MiFID, with some officials seemingly wanting to use prospectus approval as a product regulation tool (and to raise the PD high-denomination threshold accordingly) as a consequence. Whilst ensuring proper and consistent application of MiFID remains the obvious solution in such cases, any establishment of a product regulation regime needs to be clear and transparent to mitigate the related risk of moral hazard. One should certainly not confuse a regime for vetting the quality of disclosure with product regulation.

- The full picture of the market impact of the PD II changes is still unclear. In order to better understand the impact, it would be useful to analyse the number of approvals of standalone prospectuses, base prospectuses, drawdown prospectuses and supplements; filings of final terms; and passporting of final terms in the years prior to PD II implementation and since. Competent authorities have already collected data relating to the number of final terms filings, although it would be helpful if competent authorities could extend that to include the range of documents described above and also give colour on: (i) the number of documents relating to non-exempt offers, regulated market admissions or both; and (ii) the number of documents relating to issuance of securities in nominal amounts which are less than €100 million, between €100 and €500 million or over €500 million.
- While some areas of uncertainty remain, there generally seems to be greater clarity for market practitioners on the practical application of PD II. Inconsistencies among competent authorities' approaches seem to be tapering, although a degree of inconsistency remains, with different markets and documentation demographics applicable in different jurisdictions cited as a reason for this. For example, nearly 2 million final terms are being filed annually with one regulator, as opposed to a matter of hundreds of final terms filed annually elsewhere.
- It seems the proposed Regulatory Technical Standards (RTS) on situations that require the publication of a supplement to the prospectus will contain a list of specified events which require the publication of a supplement, rather than guiding principles as suggested by ICMA in its response to the ESMA consultation concerning supplements described in the Third Quarter 2013 edition of this Quarterly Report (at page 25). Regulators will need to allow a period of time to elapse between publication of the RTS and its entry into force, to allow market participants time to read and adapt to the new RTS. Separately, ESMA's continuing work in the Prospectus Directive area might enable it to consider supplements which amend terms and conditions in 2014.
- Use of the EEA's exchange regulated markets (ERMs) seems to have risen following PD II. It is important to continue to bear in mind the rationale behind the original creation of ERMs in the face of some apparently increasing tendencies for legislators to systematically extend EEA-regulated market rules to ERMs.

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FATCA

IRS Notice 13-43 (issued on 12 July 2013) extended various deadlines under FATCA by six months from 1 January 2014 to 1 July 2014, and included a statement that the definition of grandfathered obligation will be revised to include obligations outstanding on 1 July 2014 (as opposed to 1 January 2014).

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Bail-in recognition clauses in cross-border debt issuance

by Katie Kelly

The Bank of England has recently been working with various firms and other stakeholders on resolution planning, with a particular focus on making bail-in a feasible and credible resolution tool. To this end, firms must have sufficient loss-absorbing capacity in the form of equity or debt that can credibly be written off or converted into equity. This requires that debt issued by firms is capable of being bailed in by national resolution authorities in line with the FSB's standards on resolution of financial institutions. In this context, cross-border debt issuance poses particular legal challenges in relation to the extra-territorial application of national resolution powers. This may be overcome through the inclusion of "recognition clauses" in foreign debt documents. This article discusses the rationale for such clauses and how they might operate.

Under the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*, a resolution authority should be able to exercise bail-in powers under a statutory framework. The statutory resolution regime would give the resolution authority the power to write down or convert (to equity) a firm's debt in circumstances where the firm becomes undercapitalised, with a view to recapitalising and stabilising the firm prior to post-resolution restructuring. Creditors of the firm whose rights are affected by the bail-in are generally protected by statutory safeguards, which may provide compensation to creditors where they are left worse off than if the firm had been subject to a standard insolvency process.

Where a firm has issued debt governed by the laws of its home jurisdiction, and its home resolution authority seeks to bail in that debt, the legal enforceability of the bail-in should be unambiguous.

However, where a firm has issued debt governed by foreign law, there is a risk that a statutory bail-in of the debt would not be recognised in foreign jurisdictions. This would compromise the efficacy of the statutory bail-in. This is because, under the principles of private international law, the statutory powers exercised by the home resolution authority of the firm may not have extra-territorial effect on debt issued under foreign law.

The risk of non-recognition is perhaps greatest in jurisdictions where there is a territorial approach towards bank resolution and insolvency, and where no statutory bail-in regime is in place, creating unpredictable inconsistencies and consequences.

Given these challenges, resolution authorities need *ex ante* certainty that foreign law-governed debt may be bailed in so as to ensure effective resolution. To address this issue, the Bank of England has given consideration to the inclusion of a bail-in recognition clause (Recognition Clause) in firms' debt documentation governed by foreign law.

A Recognition Clause seeks to ensure that parties to a debt contract agree to recognise and give effect to a home resolution authority's exercise of a bail-in power over the debt, including the possible variation of contractual rights and obligations if bail-in were applied. A court faced with a question as to whether to give effect to a bail-in applied under a foreign statute would instead address the issue of whether to give effect to an agreement between parties as a matter of contract law. This overcomes much of the argument against giving extra-territorial effect to a foreign bail-in based on private international law principles.

The inclusion of a Recognition Clause already has the backing of policy makers. For example, in the EU context, Article 50 of the draft *Bank Recovery and Resolution Directive* addresses the issue by prescribing the inclusion of a Recognition Clause in an EU firm's debt documentation governed by the law of a non-EU jurisdiction. This should be accompanied by a legal opinion confirming the effectiveness of the Recognition Clause in that jurisdiction.

As more countries adopt a bail-in regime to align with the international best practice in resolution, the development of a uniform Recognition Clause for use in standard debt documentation would serve to enhance the recognition and efficacy of bail-in by a home resolution authority in foreign jurisdictions. Courts in different countries would be able to refer to a common practice in the debt market as to the use of a Recognition Clause, and would understand the common objective of ensuring the efficacy of statutory bail-in on a cross-border basis. Inclusion of a Recognition Clause in debt documentation is likely to eliminate variations in pricing foreign law-governed debt that would otherwise result from inconsistencies across different jurisdictions over the enforceability of a statutory bail-in, thereby preventing "arbitrage" across the different governing laws a firm issues debt under.

In this context, it is important to bear in mind that the use of a Recognition Clause is to ensure the efficacy of statutory bail-in, as distinct from contractual bail-in (which refers to the use of contractual provisions which write down or convert debt, independently of resolution, as a "recovery" action prior to failure) and as distinct from contractual subordination.

This issue will continue to be of importance to policy makers and regulators as they progress dialogue on resolution planning and firm resolvability. In this context a number of international bodies are looking to progress thinking. For example, relevant guidance may be forthcoming from the EBA, and the latest FSB report to the G20 on progress and next steps towards ending "too big to fail" indicates that the FSB will develop proposals to enhance legal certainty in cross-border resolution, including by the use of recognition clauses in debt documentation. ICMA is keen to support and engage with the Bank of England on this issue, notably with the assistance of the members of the Financial Institution Issuer Forum (FIIF).

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> "The development of a uniform Recognition Clause for use in standard debt documentation would serve to enhance the recognition and efficacy of bail-in by a home resolution authority in foreign jurisdictions.

Moody's methodology for corporate hybrid instruments

On 31 July 2013, Moody's published a methodology for assessing the debt and equity treatment of hybrid instruments issued by speculative-grade non-financial companies, *Debt and Equity Treatment for Hybrid Instruments of Speculative-Grade Non-Financial Companies.*

Under the new methodology, a hybrid issued by a company rated Ba1 or below will now be treated as either pure debt or pure equity, which is a move away from Moody's previous approach where it used five baskets to give instruments equity credit ranging from zero to 100%. Preference shares and long-dated shareholder loans – which have debt form but equity characteristics – will receive equity treatment, while everything else will be treated as debt.

The reason for the change of approach is that in Moody's view there is a higher risk of default and bankruptcy for speculative-grade non-financial companies relative to investment-grade companies, and that such companies have shorter-dated and more complex capital structures, and carry debt with more covenants. In addition, when under stress they often voluntarily defer on preferred stock and other hybrid instruments, since they can contractually do so without triggering a default.

The new methodology is consistent with Moody's loss-given default model, which is used to assign debt ratings to speculative-grade companies, and complements Moody's Hybrid Tool Kit, which is used for investment-grade companies.

The changes will force investment-grade issuers to reconsider the structure of any potential hybrids to try to obtain the full 100% equity credit, and, owing to inconsistency of bankruptcy laws across Europe, will require hybrid structurers to look at the relevant legal jurisdictions to determine what would qualify as a debt or an equity claim.

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Secondary Markets

by John Serocold

ICMA's secondary markets work in context

The core purpose of the ICMA Secondary Market Practices Committee (SMPC) is to oversee the continuing development of the ICMA Secondary Market Rules and Recommendations, ensuring that they are fresh and relevant. In adapting our rules to the changing European landscape, it will be important to remain close to members in the Asia-Pacific region, who may have different needs. The changes will need to fit closely with final regulations in this area, expected in 2014. The changes will need to cover new and developing market structures and other regulatory changes.

In addition to this important work, SMPC will be overseeing two initiatives supported by the ICMA Board.

Measuring liquidity in secondary bond markets

The first initiative is to develop a project to measure liquidity in secondary bond markets. While some other instruments in the financial market enjoy relatively good transparency as to price levels and volumes, there is thought by some to be insufficient information in bond markets, including the cross-border markets which are ICMA's particular interest. Often, prices are indicative and larger volume orders can be difficult to execute. Therefore in order to explore liquidity in a dynamic way, the research is being designed to provide answers to two questions:

- How is secondary market liquidity changing? and
- How can we best measure secondary market liquidity on a regular basis now and in future?

We are developing a set of questions, both quantitative and qualitative, to send to ICMA member firms. We are continuing to build support for the project in the current quarter, and planning to complete the process of gathering and analysing data by the end of the year; we would aim to publish during the first quarter of 2014, assuming all goes well. In addition, we envisage that there will be a suitable lag between the gathering of the data and publication, and that only aggregated, anonymised data will be published, as with the well-established survey of the repo market. It is furthermore very important to work closely with commercial data providers as well as market infrastructure providers who can provide outlines of how they measure liquidity in the markets with which they are most closely involved. This would supplement the findings of the primary research.

When we surveyed the market some time ago, a number of respondents indicated that they would be interested to participate in a survey of this nature, while a greater number felt a survey would be valuable and useful. We are asking ICMA members with buy-side

In brief

This article puts ICMA's secondary markets work in context. It describes our research into bond market liquidity and the establishment of a working group of experts on electronic trading from across the market.

> The survey should ideally be designed so that it can continue to deliver regular secondary market liquidity data, presented on an aggregated, anonymised basis.

as well as sell-side businesses to complete the survey, and questions should be tailored for both types of participants. The survey should ideally be designed so that it can continue to deliver regular secondary market liquidity data, presented on an aggregated, anonymised basis.

As a first step we intend that the research will cover: (i) investment grade corporate debt, divided into financial and non-financial issuers, including covered bonds; and (ii) sovereign, supranational and agency bonds issued on a syndicated basis. A focus on dealer inventories and the turnover ratio should allow us to estimate liquidity by relatively objective measures, which are consistent over time. Survey participants, of which we expect the majority to be ICMA members, would also be asked to provide detailed statistics to support this analysis. In addition, we should be able to analyse the speed with which turnover in new issues declines over time, and understand the relationship between deal size and trade size. We are also considering including a section on corporate bonds actively traded by member firms, to gather information on typical bid-ask spreads, and frequency of quotations; the latter is expected to be more relevant to buy-side participants. Respondents would be asked to answer qualitative questions as well regarding the state of the market and how liquidity can be improved.

To start with, we are intending that the answers to some questions will be compared between the present and one year ago, to establish a time series of data. In seeking to establish bi-annual data series, the second and subsequent surveys would ask for data series over the previous six months. In future, assuming bigger, richer data sets become publicly available, a possible extension to look at these measures over a longer time period could also be developed.

In the same way, this work is intended to engage with regulatory reform, seeking to ensure that the regulations now being enacted should achieve their policy goals without causing unnecessary frictional cost or adverse consequences to the functioning of the market. The research output could be used to inform the debate about trading fragmentation and transparency in Europe and should also be useful for firms in providing general "colour" about the state of the market as a whole. We believe regulators and central banks might also find the information useful, as they do with the well established repo survey which has been running twice a year for twelve years.

An expert electronic trading group

The second initiative concerns the proposed formation of an expert electronic trading group. The key debate for automated electronic trading, not dissimilar to that of bond liquidity, addressed by industry, regulators and governments is the relationship between transparency, liquidity and fragmentation. Recently, there have been a number of initiatives seeking to introduce electronic trading platforms supporting transparent public limit order books in addition to the traditional OTC market, supported by "request for quote" (RFQ) protocols. Current platforms include: NYSE Euronext BondMatch; MTS Credit; Galaxy from TradingScreen; MarketAxess; and a number of firm-based initiatives on both sides of the market, as well as developments from established providers. At the same time, regulatory change, including MiFID II and other regulatory pressures on the dealer model, increases the pressure to find durable solutions which work well in business, regulatory and technical terms.

In this context, an expert group on electronic trading should pull together experts in the field, including those that act as dealers as well as firms that provide automated electronic platforms, with the goal of identifying areas for improvement which are susceptible to collective action at industry level and mapping gaps in the landscape. As a number of new players enter the market to provide price discovery, we are encouraging members to come together to discuss the effects on overall liquidity and the implications for the dealer model.

ICMA members who have not been contacted regarding the liquidity study or the expert group on electronic trading, and who would be willing to participate, are welcome to contact the authors for further information.

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MIFID II package: new developments

As noted in previous ICMA Quarterly Reports, the trilogue process (between the Council, the European Parliament, and the European Commission) is now well under way. In addition to a large number of technical amendments which are likely to be scrutinised only if a Member State objects, the principal open issues of concern to ICMA and its members include:

- market structure, including the possible obligation in some markets to trade on a "venue" (systematic internalisers are "venues" for this purpose), the instruments for which matched principal trading is allowed, and pre-trade transparency rules;
- the question how far an obligation to clear trades will be extended beyond equities; and
- the terms on which third-country firms are able to participate in the European Single Market. In these areas it seems the Level 1 text is not yet stable.

The principal concerns across the industry are as follows. First, in extending the MiFID reforms and the benefits of choice to non-equity markets it is essential for trading systems, clearing houses and settlement systems to have the ability to access each other's structures on an open, non-discriminatory basis.

Second, in the application of transparency to non-equity markets, we believe that investors and issuers will benefit from arrangements which allow for a calibrated approach (based on instrument type, market model, liquidity, participants and other factors) with appropriate waivers, to ensure that these critical markets continue to function effectively for the investors and issuers who use them. Similarly, the measured and appropriate provision of liquidity through use of own account capital, in less liquid corporate bonds, for instance, will not increase the cost of capital or pose significant unmanageable conflicts of interest, and will thus benefit issuers and investors.

Third, the proposed landscape of competing venues, offering choice at each level, requires robust, economic and effective post-trade publication arrangements in order to work efficiently and deliver the expected benefits. The MiFID II package allows for the reintegration of market data, through the arrangements for distribution of harmonised, high quality and timely consolidated post-trade data. If delivered, this should provide an authoritative picture of the market to investors, market users and regulators, and allow users to trade with confidence. A broad coalition across the industry believes that common standards for data must be applied as a priority across the market and on vendors in the MiFID II package, and that time is of the essence. Once common standards are implemented, authoritative post-trade data at reasonable costs should develop, reflecting the diverse needs of investors. However, a strong review clause should be in place to reassess the situation if no commercial solution emerges.

There is a fourth area, equity price transparency, which is not of direct concern to ICMA and its members, where the approach in trilogue raises a risk of delay and where the drafting in relation to waivers and exemptions is becoming increasingly detailed. The possibility that compromises reached with equities in mind cannot efficiently be applied to other asset classes should also be borne in mind.

The timetable remains a concern. We understand that trilogues have been scheduled until December. Assuming agreement at that time, it would be likely to be feasible to obtain the approval of the European Parliament at its plenary session in February 2014. Assuming that can be done, it is likely that publication in the *Official Journal of the European Union (OJ)* could be achieved between June and August 2014, depending on progress by the jurist-linguists in completing the necessary work of translating the texts into the 24 official languages of the EU. The earliest date for the coming into force of the legislative texts is 24 months from publication in the *OJ*. But we understand the question of deadlines will be on the agenda for a future trilogue, so these dates can change.

ESMA's Level 2 work will also be on a tight timetable.

While ESMA has proceeded with as much early development work as it can, in areas where it seems there is broad agreement, and particularly in areas where substantial work needs to be done, there is a real risk that external pressures (for example a tight implementation deadline) will mean that there will be limited consultation on ESMA's advice on the important "Delegated Acts". These "Delegated Acts", typically covering matters of practical detail, are acts of subsidiary legislation made by the Commission on advice from ESMA.

In addition, certain aspects of the MiFID II package require uniform implementation across the EU. Therefore, in these cases, the Commission will be authorised to adopt Implementing Acts relating to the implementation of such measures.

A third area of ESMA's competence is to adopt binding Regulatory Technical Standards, addressed to the competent authorities in each Member State. In this case, we expect that ESMA's process will be to issue a discussion paper describing its approach, to be followed by a more detailed consultation paper.

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Central Securities Depositaries Regulation

In Issue 29 of the ICMA Quarterly Report, we summarised the principal provisions of the proposed European Central Securities Depositaries Regulation (CSDR), provided an update on the progress of the CSDR in the European Parliament and Council, and identified a potentially difficult policy question. In Issue 30, we reported on discussions in the European Council and explained our remaining concerns. This article reports on recent developments in Council and outlines next steps. Agreement on a "general approach" was reached on 25 September and trilogue negotiations with the European Parliament are expected to start soon, with a view to reaching an agreement at First Reading later this year. If this timetable is met, that should allow Target2-Securities to be implemented as expected, starting in 2015.

We expect that, as the trilogue process gets under way, agreement will be reached relatively quickly. This file is seen by observers as a primarily technical file, with no major political policy questions to be addressed.

A key issue which required a policy decision in Council relates to the procedure for granting and refusing authorisation to provide the "banking" type of ancillary services. This matters for ICMA and its members because settlement in commercial bank money by the ICSDs supports the cross-border bond market and its associated financing market, which are of vital importance.

According to the most recent report by the Presidency to the Council: "… there is now a broad measure of agreement on the text of the Presidency compromise. … There is nevertheless one main issue still lacking unanimous support from delegations."

This concerns the authorisation procedure in Article 53 for a CSD to provide banking services ancillary to the provision of the "core" CSD services. The Council adopted a compromise, under which a simple majority of authorities involved in the procedure for granting or refusing authorisation could agree to refer the matter to ESMA for non-binding assistance. This will allow the Presidency to start negotiations with the European Parliament urgently.

This compromise is supported by a qualified majority of delegations, although a minority of delegations are still disputing the authorisation process included in the compromise; these delegations would prefer ESMA to take a binding mediation decision as regards the authorisation, in the case where a simple majority of authorities involved in the procedure for granting or refusing authorisation, have a negative opinion and want to refer the case to ESMA.

A number of other issues of a more technical nature have been raised by delegations during the various stages of the negotiations in the Council and these have been resolved.

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Asset Management

by Annika Wahlberg

ICMA Covered Bond Investor Council

The Covered Bond Investor Council (CBIC) is one of the permanent working groups of the ICMA Asset Management and Investors Council (AMIC) and was set up in 2009 to address the interests of investors in this important sector of the capital markets. As reported in Issue 30 of the ICMA Quarterly Report, Andreas Denger has succeeded Claus Tofte Nielsen, who acted as Chairman from the CBIC's inception, as Acting Chairman.

Ratings: The CBIC actively participates in market discussions and issued a statement on 7 August 2013 to each of DBRS, Fitch, Moody's and Standard & Poor's, based on discussions within its membership. The statement called on the rating agencies to:

- review methodologies and ratings more frequently in light of pending regulation;
- exercise caution when taking action on covered bond ratings (such as automatically downgrading) following a bank senior unsecured downgrade;
- take into account factors such as systemic importance and the "dimension" of the relevant national covered bond market when assessing the starting point for covered bond ratings; and
- consider that the starting point for a covered bond rating might be subject to various parameters such as those mentioned, but also that the differential between a covered bond and issuer rating might be affected by factors such as central bank behaviour, the country of domicile, or the systemic relevance of covered bonds for a given national mortgage market.

Events: The CBIC participated in both the ECBC plenary session and the Euromoney Covered Bond Conference in Barcelona in September 2013. The next CBIC conference has been scheduled for 15 May 2014.

A new CBIC working group: The covered bond markets have shown continuing growth in recent years, both in terms of volume as well as geography. As the market keeps growing, including in terms of diversity and products, the CBIC wants to keep pace with new developments and is therefore setting up a new working group. This group will deal with existing and, if and when the need arises, new and innovative covered bond structures.

The aim of the working group is to increase the understanding of the nature of the specific innovation and to put it into context within already established structures and/or legislation.

The ultimate goal is not to come up with an individual CBIC definition of what constitutes a covered bond but to have a comprehensive set of criteria to hand for investors to decide whether a new product which calls itself a "covered bond" is eligible for their individual covered bond portfolios/mandates. Accordingly, we call our new working group "Cola" – "Covered bond look alike". The new working group is also open to a dialogue with issuers ahead of a possible launch of any product which is planned to be named a covered bond, and with the relevant bond index providers when it comes to classifying new products.

We invite all investors with a dedicated interest in this asset class to take part. The new working group will be chaired by Ralf Burmeister, bringing 14 years of experience in the industry and drawing on his research background.

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Shadow banking reform for the buy side

By Nicholas Pfaff

Both the FSB and the European Commission have further substantive plans for the reform of the shadow banking industry that go well beyond recent announcements concerning money market funds (MMFs), as covered in the ECP section of the ICMA Quarterly Report.

In its *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* published on 29 August 2013, the FSB sets out its thinking and recommendations for non-bank financial entities other than MMFs. The FSB identifies these entities as being: (i) credit investment funds; (ii) exchange-traded funds (ETFs); (iii) credit hedge funds; (iv) private equity funds; (v) securities broker-dealers; (vi) securitisation entities; (vii) credit insurance providers/financial guarantors; (viii) finance companies; and (ix) trust companies.

In order to overcome this diversity and to clarify the issues, the FSB proposes an innovative approach for regulatory intervention with an analytical framework that is based on the economic function performed by these shadow banking entities rather than, for example, their legal form or their industry denomination. The identified economic functions relate to areas of regulatory concern and are as follows:

- management of Collective Investment Vehicles (CIVs) with features that make them susceptible to runs;
- loan provision that is dependent on short-term funding leading to excessive maturity/liquidity transformation and/or leverage;
- intermediation of market activities that is dependent on short-term funding or on secured funding of client assets creating important liquidity risks;
- facilitation of credit creation that encourages excessive leverage by diluting credit risk transfer;
- securitisation-based credit intermediation and funding of financial entities enabling undue maturity/liquidity transformation and/or leverage, as well as regulatory arbitrage.

Mirroring this, the FSB also identifies specific policy toolkits available to regulators in order to curtail these activities and/or mitigate the risks that they are believed to create. The proposed tools do not in themselves appear to break new ground, as they largely draw from existing bank regulation methods and fund management industry practice. The novelty is in the systematic manner that they are defined and advocated. In summary, the toolkits are made up as follows:

- *run risk of CIVs:* redemption gates, suspension, fees, and/or restrictions; side pockets; limits on illiquid assets, asset concentration, leverage, asset maturity; liquidity buffers;
- *lending based on maturity transformation:* bank-style regulation for deposit taking entities; capital requirements; liquidity buffers; limits of leverage and large exposures; restrictions on funding instruments (eg asset-backed commercial paper);
- *market intermediation with short term or asset-backed funding:* bank-style regulation (for maturity/liquidity transformation and leverage), capital and liquidity requirements, restrictions on use of client assets;
- *credit creation:* capital requirements, restrictions on scale and scope, liquidity buffers, risk management for tail events, risk sharing (for insurance/guarantee activities);
- *securitisation and financial entity funding:* direct restrictions on maturity/liquidity transformation, as well as on eligible collateral and on exposure/funding from banks/financial entities.

The FSB's objective is that this comprehensive policy framework will allow regulators both to address current and new risks for financial stability arising from shadow banking entities, as well as promote a consistent approach across jurisdictions. Going forward this will be further supported by an information sharing process that the FSB aims to have defined by March 2014, and that will be followed by a peer review process measuring implementation by 2015.

In line with the FSB policy recommendations and in the context of the general review of the UCITS Directive, the Commission has indicated with its Communication on *Shadow Banking* that it will address wider issues concerning the fund management industry through a future global review. Its focus will be in particular on the use of certain investment techniques and strategies, especially securities financing (including repos) as further described in the repo and ECP sections of this ICMA Quarterly Report. The areas of expressed concern are liquidity risk, collateral adequacy and transmission risks to the banking system.

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Bail-in, asset encumbrance and the future of bank funding

Personal view: Tim Skeet

Though there has been much discussion around the EU Bank Recovery and Resolution Directive (BRRD), the reality of its implementation has remained somewhat vague from a practical perspective. The political and regulatory rhetoric has nevertheless been real enough and practical implementation now looms large. It is five years since the failure of Lehman Brothers contributed to a significant loss of confidence, liquidity and, ultimately, solvency across the financial system. Since then regulators have worked hard to devise a better way of winding-up financial institutions, in a way that meets the broader needs of society, taxpayers, and other stakeholders in banks, including depositors. But what might be the consequences of the current proposals and how are investors in senior bank debt going to make sense of their new role as risk bearers? Will investors bail out of the asset class in response to bail-in?

The financial services industry has broadly agreed with the central thesis that there needs to be a better way of winding up failing banks than the option of pouring in liberal amounts of taxpayer cash. Beyond this, different regulators in different jurisdictions have applied a variety of measures to prevent their financial systems from seizing up as banks get into trouble. The BRRD and other measures being debated certainly aim to bring a measure of consistency to the process. The specifics of the measures, however, remain quite fluid and there is some concern amongst investors as to what this will all mean for them. Certainly most analysts will concede that the much higher levels of capital and liquidity now maintained by banks should make them far more resilient to shocks. At one level of analysis, investors in bank paper should be confident that the probability of banks getting into trouble is, hopefully, far more remote. More exacting, intrusive levels of supervision should also give investors confidence that banks will not in future be left to their own devices unchecked.

Nevertheless, as an ICMA working group has examined in detail and debated at length, investors will need to conduct careful due diligence when reviewing their limits for bank paper and setting prices at which they will invest. Senior unsecured noteholders previously did not expect to have to suffer more than a potential mark-to-market loss, real write-downs being the domain of the capital noteholders (though many of these during the crisis did not suffer meaningful losses). In addition, asset encumbrance levels, where banks have increased the amount of secured funding, have the potential to subordinate senior unsecured noteholders' interests even further. Various drafts of the BRRD have continued to exempt secured funding from bail-in which, coupled with more recent "depositor preference" requirements, threaten to push senior unsecured noteholders even further back in the pecking order of claims. The recent suggestion that a failing bank will not be eligible for EU/central bank funds until 8% of its eligible liabilities are bailed in could make it a near certainty that not only would the various capital instruments be written off, but that the senior unsecured noteholders would suffer write-downs. This could be painful, and it appears doubtful that this has yet been fully priced into markets.

Causing investors further discomfort is the whole question of the point at which a bank fails, on what terms, how the bail-in might be calculated and by whom. The RRD makes it clear that regulators will be empowered to define and set the "Point of Non-Viability" (PoNV) which replaces the now outdated concept of insolvency or bankruptcy of banks and which should leave investors no worse off compared to a winding up. Nevertheless, questions remain surrounding investors' positions *vis-à-vis* legal redress, involvement in the process of valuing assets and setting the write-down, as well as how PoNV will be timed, defined and measured, together with widely stated concerns about the appropriateness of risk-asset weightings.

In view of the most recent developments, the uncertainty that pervades the sector, and the future funding needs of banks to service the real economy, it is important that a thorough examination is undertaken of the effects on investors of the new regime. In particular, the cost of senior unsecured funding and the availability of lines to banks for instruments that have become effectively another form of subordinated debt should be examined. ICMA will therefore be extending the work already conducted on asset encumbrance to embrace the wider concerns and issues involved in the BRRD and, in particular, the bail-in regime. A working group comprised of investors will be asked to debate and examine the proposals to help shape policy and inform opinion. It is proposed that this group be constituted as a working group of the Asset Management and Investors Council (AMIC) under ICMA, with a remit to continue the exchange of views with issuers and regulators which has already contributed much to the debate around bank funding.

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Solvency II reporting requirements

As reported previously, the plenary vote of the Omnibus II Directive by the European Parliament has been repeatedly delayed, as it was expected on 11 March 2013, then on 10 June 2013, and most recently on 22 October 2013. On 12 September 2013, however, the European Parliament brought forward the plenary vote of the Omnibus II Directive from 11 March 2014 to 3 February 2014.

On 2 October 2013, the European Commission postponed the implementation date of the Solvency II Directive to 1 January 2016.

In March 2013, EIOPA launched a public consultation on Guidelines relating to the preparations for Solvency II. The Guidelines cover: systems of governance; a forward looking assessment of undertakings' own risk (based on Own Risk and Solvency Assessment (ORSA) principles); submission of information; and pre-application for internal models.

The purpose of the Guidelines is to support national supervisors and regulated companies in their preparations for the Solvency II requirements. They follow *EIOPA's Opinion on Interim Measures Regarding Solvency II* issued in December 2012.

In its cover note for consultation on *Guidelines on Preparing for Solvency II*, EIOPA stated: "The present EU supervisory regime is not sufficiently risk sensitive and is to be replaced by Solvency II. It is in the best interests of policyholders, insurers, and supervisors to build on the steps taken already to prepare for Solvency II. Without such preparation, there is a risk that momentum is lost and the benefits of the financial and human resources already devoted to the Solvency II project are dissipated."

This consultation closed on 19 June 2013. EIOPA received over 4,000 comments. On 27 September, EIOPA published the final Guidelines for the preparation of Solvency II.

In addition, EIOPA released on 14 June 2013 its technical findings on the Long-Term Guarantees Assessment (LTGA). These measures are aimed at ensuring an appropriate supervisory treatment of these products in volatile and exceptional market circumstances. The report was commissioned by co-legislators on 27 June 2013 in an attempt to unblock the impasse in the Omnibus II trilogue negotiations in September 2013.

EIOPA concluded that the final Long-Term Guarantee package to be included in the Solvency II framework should fulfil a number of key principles in order to ensure a high degree of policyholder protection, as well as effective supervisory process. These are:

- alignment with the Solvency II framework and the economic balance sheet concept;
- full consistency and comparability in order to enhance the Single Market;
- efficient linking of all the three pillars (quantitative basis, qualitative requirements and enhanced reporting and disclosure);
- proportionality and simplicity;
- adequate treatment of transitional issues.

Finally, on 18 July 2013, EIOPA published the full report on the results of its two peer reviews which assessed the Solvency II pre-application process of internal models. The report summarises best practice in the areas of communication, reviews, planning, pre-application packages, training and colleges of supervisors and outlines a number of recommendations addressed to national supervisory authorities and EIOPA.

Concerning parallel preparations by national supervisory authorities, the French Autorité de Contrôle Prudentiel (ACP) launched a reporting trial. It requested the provision by regulated entities of a selection of prudential reports and qualitative questionnaires, as well as general feedback by 6 September 2013. This initiative was well received, with 370 individual responses returned to the ACP before the deadline. The goal of this trial is to make the best use of the years preceding implementation to capitalise on existing efforts and enable the French industry to best prepare for future Solvency II requirements.

It should be noted that ICMA's Solvency II Working Group will meet in London on 21 October with an agenda focused on reviewing recent developments.

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ICMA Private Wealth Management Charter of Quality

At the IOSCO conference in Luxembourg in September, Jean Guill, head of the CSSF, the Luxembourg regulator, said in his opening speech:

"The second example concerns the International Capital Market Association's Wealth Management Charter of Quality. This Charter of Quality was launched in Luxembourg in October 2012. The CSSF immediately expressed strong support for the Charter and recommended that Luxembourg financial institutions should sign it on a "comply or explain" basis. Almost every bank and wealth manager in Luxembourg is now a signatory of the Charter of Quality which brings together in a single document the guiding principles of best practice adopted by the cross-border wealth management industry, namely:

- *integrity:* in business relationships; of markets, financial products and services; and of staff;
- *transparency:* towards clients, and regarding the regulatory environment; and
- *professionalism:* regarding the primacy of clients' legitimate interests and efficiency.

The Charter of Quality is designed to be consistent with relevant regulation at both EU and national level, and to complement principles such as the Wolfsberg Principles on anti-money laundering and the global recommendations of the Financial Action Task Force. This is the first initiative of its kind where the private wealth management industry has joined together voluntarily to commit to common standards of quality, compliance and good market practice. I can only warmly encourage other national associations and wealth managers to sign it, following the example set by Luxembourg.

ICMA is now in the process of explaining the Charter of Quality in other jurisdictions in Europe, and in Singapore and Hong Kong, encouraging national associations and wealth managers to sign it.

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Market Infrastructure

by David Hiscock

Market infrastructure developments

ECB: Contact Group on Euro Securities Infrastructures (COGESI)

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 has been prepared by the ECB's Contact Group on Euro Securities Infrastructures (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. The report was presented and discussed during a workshop with market participants, regulators and central bank representatives, at which Benoît Cœuré, Member of the Executive Board of the ECB, gave a speech.

Meanwhile, the work of the *ad hoc* COGESI group on collateral harmonisation is continuing its work. This includes follow-up to the COGESI report on collateral eligibility requirements and the drafting of a report on the efficient functioning of the repo market.

ECB: Money Market Contact Group (MMCG)

A regular quarterly meeting of the MMCG was held in Frankfurt on 3 September 2013. The agenda included:

- a review of market developments;
- presentations by LCH.Ltd and Eurex Clearing on their respective risk management frameworks for the repo market;
- main developments in the EONIA OIS market; and
- an update on money market benchmarks and on the on-going reform process.

The next regular quarterly meeting is scheduled for 10 December.

ECB: Bond Market Contact Group (BMCG)

The ECB's BMCG is a forum for discussing issues related to the euro-area bond market – it is chaired by the Director General of the ECB Directorate General for Market Operations, Ulrich Bindseil, and ICMA's Chief Executive, Martin Scheck, is one of the BMCG's 20 members. The BMCG's third meeting took place in Frankfurt on 9 July 2013. The agenda comprised:

- review of recent bond market developments;
- bond market liquidity;
- euro-area financial integration;
- the fallout from "too big too fail" and the recovery and bank resolution of credit institutions and investment firms in Europe; and
- impact of recent regulatory changes and other structural issues from an insurance company point of view.

The agenda, together with a summary of the discussion and the supporting meeting papers are published on the BMCG's website pages. The fourth BMCG meeting is scheduled for 8 October, with an agenda which includes discussion on the subject of European banks and corporates funding models; and updates on the ABS and the covered bond markets.

ECB: TARGET2-Securities (T2S)

A dedicated Info Session, "T2S user testing and migration: an urgent matter" was held in Frankfurt on 3 July 2013. This included particular presentations on what business decisions are needed now to shape users' preparation to T2S;

and a panel discussion on the question "Is the T2S Community preparing?". The next T2S Info session is scheduled for 13 December, in Lisbon.

On 4 July 2013 T2S spotlight reported "*T2S Connectivity: the Dedicated Link Solution Will Not Need to be Developed*". The Eurosystem was invited to consider developing a Dedicated Link solution (DLS) for connection to T2S and the applicable legal documentation and price offer for this were submitted to potential counterparties in the spring, for signature by 28 June 2013 – as development of the DLS would have had to begin by this date for it to be available in time for the T2S go-live. T2S actors have instead opted to connect to T2S via one of the two value-added network providers with a licence: SIA/Colt and SWIFT.

On 23 July 2013, the ECB announced that it was making available the new edition 16 of T2S OnLine. In his editorial the ECB's Jean-Michel Godeffroy, the T2S Board Chairperson, discusses his view that "one important field in which life will become much easier with T2S is collateral management". He highlights how, in stark contrast to today's complex environment "T2S will provide an entirely new pool, in which all securities and cash accounts will be kept, with the possibility of moving funds and securities in real time." He then goes on to describe that: "This issue of T2S OnLine is a very rich one, covering a variety of important topics. Marc Bayle updates you on our progress with the project, giving a lot of good news. Mehdi Manaa addresses the topic of T2S testing and migration, with a particular focus on the preparations that need to be made now in order to be ready for testing next year. Joël Mérère, Executive Director at Euroclear and Chairman of the T2S Corporate Actions Sub-group, stresses the importance of harmonising the processing of corporate actions on pending transactions in the future T2S environment. Finally, we welcome BNY Mellon CSD to the T2S Community by featuring an interview with the CEO, Chris Prior-Willeard."

"T2S will provide an entirely new pool, in which all securities and cash accounts will be kept, with the possibility of moving funds and securities in real time

T2S has played an active part in Sibos Dubai, which ran from 16 to 19 September 2013. ECB Executive Board member Yves Mersch kicked off the Eurosystem's activities, with a speech in which he offered a broad view of the European financial outlook over the coming years, a period that will be marked by major developments in integration, both at the institutional level, with the SSM, as well as in infrastructure, with T2S progressing according to its implementation plan. On day 2, the session "Movers and shakers: TARGET2-Securities" turned into one of "T2S reassurance and comfort" as a full room considered the changes that T2S may bring. In a mini session at the Eurosystem stand on day 3, Mehdi Manaa introduced the new T2S simpleshow video entitled "T2S – a single gateway to your collateral management". And on day 4, "How can T2S help you optimise your collateral management?" and "Will T2S be beneficial beyond Europe?" were the key questions in one of the day's five T2S panels.

The T2S Advisory Group(AG) provides advice to the Eurosystem on T2S-related issues, to ensure that T2S is developed and implemented according to market; and it will next meet on 19-20 November 2013. The T2S Harmonisation Steering Group (HSG), which is supporting the AG in formulating its harmonisation agenda, will next meet on 22-23 October. The T2S Cross-Border Market Practice sub-group (X-MAP) met on 10 July. Following a debriefing from the HSG meeting of 10-11 June 2013, there was a presentation and discussion on the topic on T2S Matching Fields. This discussion was continued in an X-MAP teleconference held on 27 August, which also a discussion on "Allegement in T2S – ISO transaction codes usage"

On 26 September 2013, the Latvian CSD (LCSD) joined the T2S Community by signing the Framework Agreement, thus bringing the number of CSDs that have committed to T2S to 24. LCSD plans to start operations in T2S along with two other Baltic CSDs, in Estonia and Lithuania, on 6 February 2017.

Global Legal Entity Identifier System (GLEIS)

A note published by the LEI ROC, dated 27 July 2013, establishes the principles that should be observed by the Local Operating Units (LOUs) participating in the Interim GLEIS as pre-LOUs. Reference documents include the FSB Recommendations and High Level Principles, the six principles defined by the LEI ROC in March 2013, and other principles published in Progress Notes. Annex A sets out the process for endorsement of pre-LOUs and pre-LEIs into the Interim GLEIS.

A further note dated 23 August 2013 confirms the method be used for allocation of pre-LOU prefixes for pre-LEI issuance:

- Characters 1-4: A four character prefix allocated uniquely to each LOU.
- Characters 5-6: Two reserved characters set to zero.
- Characters 7-18: Entity-specific part of the code generated and assigned by LOUs according to transparent, sound and robust allocation policies.
- Characters 19-20: Two check digits as described in the ISO 17442 standards.

Collateral

The Joint Committee of the ESAs has published its second bi-annual *Report on Risks and Vulnerabilities in the EU Financial System* (dated 21 August 2013). This states: "The European financial system continues to face a range of interrelated, cross-sectoral risks. These risks necessitate a concerted response both at the political level and from the European System of Financial Supervision, including the European Supervisory Authorities (ESAs). Although important policy milestones have been reached, the key risks identified in the March report continue to challenge the stability of the European financial system. Subsequent developments have also highlighted some of these risks."

> Aggregate data currently do not point to substantial imbalances, although there is still a threat of local shortages.

Specifically concerning collateral, the report goes on to state: "The reliance on collateral and especially high quality assets such as governments bonds led to rising concerns about potential collateral shortages, also discussed in the March report. However, aggregate data currently do not point to substantial imbalances, although there is still a threat of local shortages. This is particularly the case if high quality collateral is concentrated in a few large institutions and if the collateral remains idle in their books. At the same time, collateral transformations, and in particular a potential lack of transparency stemming from those, are likely to increase the risks of interconnectedness, pro-cyclical effects and a lack of information in the case of an eventual resolution process for a large financial institution."

Section 4 of the report discusses "risks from increased use of collateral", noting that "one way to measure potential pressure on collateral is to focus on the European sovereign repo market"; and then elaborating on this. The report goes on to state: "Any measures designed to reduce the frictions in collateral use indicated by the low spreads between secured and unsecured debt would unlock the full potential of secured funding sources. In addition, they would help to mitigate any risks arising from collateral usage and to contribute to a sound development of the financial system while supporting the process of deepening securitisation." Section 4.1 then discusses "securitisation", followed by section 4.2 which covers "collateral transformation, re-use and interconnectedness". This latter section states: "The safety and liquidity value of collateral is increasingly being priced, providing incentives for more efficient use of collateral", before going on to describe concerns associated to collateral transformations.

At Sibos Dubai, on Wednesday 18 September, Benoît Cœuré, Member of the Executive Board of the ECB, participated in the panel on "Key challenges and opportunities for the integration of European financial market infrastructures". During his comments, Mr Cœuré announced that the abolition of the collateral repatriation requirement will come in May 2014, followed by the ECB's use of triparty as of September 2014.

Financial Market Infrastructures (FMIs)

On 12 August 2013, CPSS/IOSCO published their finalised report on *Authorities' Access to Trade Repository Data*, which reflects comments received following a public consultation. The purpose of this report is to provide guidance to TRs and authorities on the principles that should guide authorities' access to data held in TRs for typical and non-typical data requests. The report describes the expected data access needs of authorities using a functional approach complemented by an illustrative data access mapping that aligns each function to the minimum level of access authorities would typically require in support of their mandates and responsibilities. The report also sets out possible approaches to addressing procedural and legal constraints to data access as well as confidentiality concerns.

As a consultative process conducted in 2012 identified a need for more guidance, on 12 August 2013, CPSS/IOSCO published for public comment a further consultative report on the *Recovery of Financial Market Infrastructures*. This report provides guidance to FMIs such as CCPs on how to develop plans to enable them to recover from threats to their viability and financial strength that might prevent them from continuing to provide critical services to their participants and the markets they serve. It also provides guidance to relevant authorities in carrying out their responsibilities associated with the development and implementation of recovery plans and tools.

Also on 12 August 2013, CPSS/IOSCO published *Implementation Monitoring of the PFMIs* - Level 1 assessment report. This report reviews jurisdictions' self-assessed progress towards implementing the *Principles for Financial Market Infrastructures* (the PFMIs), published by CPSS/IOSCO in April 2012 and which includes risk management standards for financial market infrastructures (FMIs). The report reviews jurisdictions' progress towards adopting legislation and other regulations and policies that will allow authorities to completely implement the PFMIs into their regulatory frameworks for market infrastructures. The report indicates that whilst most jurisdictions have begun the process of implementation, few have completed the process for all types of FMIs; but many are making good progress and expect to be well advanced by the end of the year. CPSS/IOSCO will periodically publish updates to this report to demonstrate progress made towards full implementation. Future CPSS-IOSCO assessments will evaluate the consistency of implementation measures in each jurisdiction with the PFMIs and will evaluate consistency of outcomes among FMIs themselves resulting from the application of the PFMIs.

At their meeting in Basel on 9 September 2013, the central bank governors of the Global Economy Meeting (GEM) appointed Benoît Cœuré as Chairman of the CPSS. Benoît Cœuré is a member of the Executive Board of the ECB and his appointment is for a term of three years. He succeeds Paul Tucker, Deputy Governor, Financial Stability, Bank of England, who has been CPSS Chairman since April 2012.

On 27 September 2013, the ECB published a new *Framework for the Assessment of Securities Settlement Systems and Links to Determine their Eligibility for Use in Eurosystem Credit Operations*. The Eurosystem settles its credit operations based on adequate collateral using SSSs and links between SSSs operated by (I)CSDs. Defined standards for the assessment of SSSs and links between SSSs have been used (user assessments) since 1998, with a positive assessment against these standards allows SSSs and links between SSSs to be considered eligible for use in Eurosystem credit operations. In recent years, with the development of international and European regulatory and oversight standards for SSSs and CSDs/ICSDs, the Eurosystem has identified opportunities to streamline the user assessment framework by taking into account the outcomes of oversight assessments. By avoiding duplication in the conduct of oversight and user assessments against similar standards and requirements, the user assessments focus on a limited number of concerns and risks that are specific and unique to the Eurosystem user perspective. The new streamlined user assessment framework introduces considerable procedural simplifications, while also continuing to ensure a high level of protection for the Eurosystem against losses in the conduct of its credit operations.

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The safety and liquidity value of collateral is increasingly being priced, providing incentives for more efficient use of collateral.

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Macroprudential Risk

by David Hiscock

Macroprudential risk: policy and research

In July 2013, the BIS made available a set of papers under the heading *Sovereign Risk: A World Without Risk-Free Assets?* This volume presents and summarises the proceedings of a one-and-a-half day seminar on sovereign risk hosted by the BIS in January 2013. In the first panel, three central bank governors discuss sovereign risks and challenges, drawing on their own varied experiences. The second panel addresses the sovereign rating business from a number of angles. The third panel considers the polar case of financial markets without a risk-free sovereign. The fourth panel features legal experts describing how market participants have adapted to the absence of a general legal insolvency framework for the default of a sovereign. The fifth panel looks at sovereign risk management in financial institutions. In a Foreword, the General Manager of the BIS sets down his impressions from the day and a half.

Should Monetary Policy Lean Against the Wind? is a BIS working paper published in July 2013. The main result of the analysis it presents is that, even in a model in which financial stability does not represent a distinctive policy objective, leaning-against-the-wind policies are desirable in the case of supply-side shocks whenever the central bank is concerned with output stabilization, while both strict inflation targeting and a standard rule are less effective. The gains are amplified if the economy is characterized by high private sector indebtedness.

On 8 July 2013, Mario Draghi, Chair of the ESRB, attended a hearing before ECON. In his introductory statement Mario Draghi focuses first on the contribution of macro-prudential policy to fostering a resilient and growth-supporting financial system; he then moves on to the ESRB's work laying the foundations for a framework for macro-prudential oversight in the EU; and finally concludes on efforts towards greater transparency and accountability of the ESRB.

Mario Draghi notes that now that many new macro-prudential bodies are being set up, in line with the end-December 2011 ESRB recommendation, authorities in the EU have already started to use macro-prudential policies to address vulnerabilities in banks, non-banks and financial infrastructures and to foster a more resilient financial system that can support the economy. As macroprudential actions are likely to become more frequent, both outside and within Europe, the ESRB will have an important role in discussing such actions with a view to fostering common elements in the policy stance of authorities, including with regard to the need for further tightening or mitigating action.

Mario Draghi recalls that the ESRB's recommendation

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Macroprudential actions are likely to become more frequent, both outside and within Europe.

on the *Macroprudential Mandate of National Authorities* of end-December 2011 provided a list of principles that should guide authorities in developing such mandates. Following this recommendation, Member States have started setting up dedicated macroprudential authorities and in ten Member States (Bulgaria, the Czech Republic, Denmark, Germany, Greece, Latvia, Malta, the Netherlands, Slovakia and the United Kingdom) new national legislation or other measures to establish a national macroprudential authority have recently entered into force. In the other EU countries applicable legislation is either with parliament for discussion and approval, or relevant provisions are in the course of being prepared. The first recommendation on the national macroprudential mandates was followed in April 2013 by a recommendation on intermediate objectives and instruments of macroprudential policy; which identified a number of intermediate policy objectives for safeguarding the stability of the financial system and provided an indicative set of instruments that should be at the disposal of national authorities to achieve these intermediate objectives. More recently, the ESRB initiated various work streams on dedicated macroprudential instruments and it is expected that by the end of the year substantial progress will have been achieved in providing an operational framework to help macroprudential authorities use their new macroprudential tools.

Mario Draghi reported that the ESRB’s 2012 Annual Report has been published, giving a faithful account of the ESRB’s activities during its second year of existence; including a comprehensive picture of the ESRB’s assessment of systemic risks and related policy responses to mitigate these risks; and providing an overview of action taken by the ESRB to ensure implementation of its recommendations. To ensure that assessment of compliance with ESRB recommendations is based on transparent and predefined rules, the ESRB has also published a *Handbook on the Follow-up to ESRB Recommendations*. Finally, considering the forthcoming review of the ESRB, the ESRB has published a report (together with a related transmittal letter) that focuses on three main areas: the scope for streamlining the legislation establishing the ESRB; further strengthening the way in which the ESRB operates; and possible implications of the establishment of the SSM for the functioning of the ESRB.

On 16 July 2013, IOSCO published a joint Staff Working Paper, with the World Federation of Exchanges (WFE), entitled *Cyber-Crime, Securities Markets and Systemic Risk*. The report explores the evolving nature of cyber-crime in securities markets and the threat it poses to the fair and efficient functioning of markets. Importantly, it highlights the urgent need to consider cyber threats to securities markets as a potential systemic risk. The first part of the report assesses what is known of the cyber-threat so far. It also presents a framework for monitoring the extent of cyber-crime in securities markets going forward. The second part of the report provides the results of a survey to the world exchanges, which explores the experiences of exchanges in dealing with cyber-crime and perceptions of the risk. The survey revealed that a significant number of exchanges are already under attack with 53% suffering an attack in the last year, with these attacks tending to be disruptive in nature, rather than motivated by financial gain.

Evaluating the Net Benefits of Macroprudential Policy: A Cookbook, is an IMF staff working paper published on 17 July 2013. The paper proposes a simple, new, analytical framework for assessing the cost and benefits of macroprudential policies. It proposes a measure of net benefits in terms of parameters that can be estimated: the probability of crisis, the loss in output given crisis, policy effectiveness in bringing down both the probability and damage during crisis, and the output-cost of a policy decision. It also discusses three types of policy leakages and identifies instruments that could best minimize the leakages; and some rules of thumb for policy makers are provided.

> **The survey revealed that a significant number of exchanges are already under attack with 53% suffering an attack in the last year.**

Evaluating Early Warning Indicators of Banking Crises: Satisfying Policy Requirements, is a BIS working paper published in August 2013. Applying criteria to a set of potential early warning indicators, the authors find that the credit-to-GDP gap and a new indicator, the debt service ratio (DSR), consistently outperform other measures. The credit-to-GDP gap is the best indicator at longer horizons, whereas the DSR dominates at shorter horizons.

On 8 August 2013, the ECB published a bulletin article, *A Macro Stress-Testing Framework for Bank Solvency Analysis*. This article gives an overview of the main elements of the ECB's (top-down) macro stress-testing framework for solvency assessments and gives examples of how it is used for policy analysis. The framework is applied in forward-looking bank solvency analysis in many different contexts, such as to analyse the impact of pertinent systemic risks on broad financial stability, to challenge the results of bottom-up stress tests carried out at the supervisory level and to calculate bank capital shortfalls in order to assess the impact of conditions in the financial sector on macroeconomic developments. Furthermore, the stress-testing framework can be used for both micro and macro-prudential purposes once the ECB takes up its supervisory powers in the context of the establishment of the SSM.

On 23 August 2013, the Bank of England published *The Fractal Market Hypothesis (FMH) and its Implications for the Stability of Financial Markets*. Time series of financial market prices appear to exhibit fractal properties: that is, under magnification, their pattern becomes increasingly complex, and seems to repeat itself, with a pattern that is qualitatively similar to that of the overall structure. This paper examines why and how these fractal properties might arise, and considers their implications for understanding the causes of financial (in)stability. The paper concludes that from a practical standpoint, the FMH clearly supports the crucial role of securities regulation in maintaining financial stability. The incentives and behaviour of different types of investor are highlighted as key elements in determining the stability of markets, both under normal conditions and during times of stress. Effective securities regulation is a necessary component to ensuring that — as far as possible — all types of investor are properly incentivised, or restricted, to exhibit behaviours that are in concert with a well-functioning financial system.

On 26 August 2013, the Macroeconomic Assessment Group on Derivatives (MAGD) published a report on the *Macroeconomic Effects of OTC Derivatives Regulatory Reforms*. In this report, the MAGD focuses on the effects of (i) mandatory central clearing of standardised OTC derivatives, (ii) margin requirements for non-centrally cleared OTC derivatives and (iii) bank capital requirements for derivatives-related exposures. In its preferred scenario, the Group found economic benefits worth 0.16% of GDP per year from avoiding financial crises. It also found economic costs of 0.04% of GDP per year from institutions passing on the expense of holding more capital and collateral to the broader economy, resulting in net benefits of 0.12% of GDP per year. These are estimates of the long-run consequences of the reforms, which are expected to apply once they have been fully implemented and had their full economic effects.

The IMF's press release of 16 September 2013 reports its Executive Board's discussions of an IMF staff paper on *Key Aspects of Macroprudential Policy*. Building on recent advances, this paper proposes a framework to inform the IMF's country-specific advice on macroprudential policy. Synthesizing lessons from previous staff papers, existing research, and the international experience, the paper offers analysis of key issues arising in ensuring the effectiveness of macroprudential policy. The paper first recalls the definition and sets out the scope of macroprudential policy. It then examines interactions between macroprudential and other public policy areas; describes key steps in operationalizing macroprudential policy; and discusses issues to be considered when setting up the institutional framework underpinning macroprudential policy. The paper also examines multilateral aspects that can arise from a lack of action of national authorities, imperfectly aligned financial cycles and conflicts between home- and host authorities of cross-border institutions. The paper recognizes that developing macroprudential policy will remain work in progress in the years to come. On the same day, José Viñals, Financial Counsellor and Director, IMF Monetary and Capital Markets Department, gave a speech on *Making Macroprudential Policy Work*.

On 20 September 2013, ESMA published its second *Trends, Risks, Vulnerabilities* (TRV) report and a Risk Dashboard for the second quarter of 2013. The TRV examines the performance of securities markets in the first half of 2013, assessing both trends and risks in order to develop a comprehensive picture of systemic and macro-prudential risks in the EU, to assist both national and EU bodies in their risk assessments. The TRV finds that EU securities markets and investment conditions in the EU have improved for a second quarter in a row since the fourth quarter of 2012, although systemic risk persisted at medium to high levels. Amongst other risk factors, uncertainty remained high due to concerns over funding sources, low interest rates and recent market fluctuations, resulting in increased market risk, while liquidity, credit and contagion risk continue to be significant.

Amongst key trends identified by the TRV for the first half of 2013 in EU securities markets:

- *Securities markets:* market conditions improved moderately while issuance was subdued with equity prices declining and inter-bank lending increasing. The second quarter saw an increase in sovereign borrowing costs, and corporate bonds; covered bonds and securitised products were subdued.
- *Market infrastructures:* trading on EU venues increased in early 2013. CCP clearing of IR swaps continued to grow. Potential continuity issues around financial benchmarks give rise to concerns.

Amongst key risks identified in the report, and published separately in the Risk Dashboard:

- *Liquidity risk:* even though policy action helped to reduce liquidity risks in main market segments, others rose, leaving the overall liquidity risk at high levels.
- *Credit risk:* EU securities markets saw a reduction in issuance volumes, mainly in asset classes with higher risk and longer maturities. Despite recent debt refinancing, overall credit risk remains high.
- *Market risk:* equity and bond markets risks increased driven by rising concerns over the valuation of assets.

In addition, the TRV presents in-depth analyses on four specific topics:

- first evidence on the impact of the Short-Selling Regulation on securities markets;
- contagion risks and the network structure of EU CDS exposures;
- overview of the EU UCITS industry; and
- overview of bail-in and contingent capital securities.

On 23 September 2013, Mario Draghi, Chair of the ESRB, spoke at a hearing before ECON; noting that whilst there have been encouraging signs of a gradual turnaround in Europe's economic outlook, risks to financial stability remain. Mario Draghi then reported on the work the ESRB is undertaking to address some of these risks in the fields of insurance, banking and market infrastructures. Concerning insurance, Mario Draghi highlighted that five of the nine G-SIIs recently announced by the FSB are European; and stated that it is crucial that the EU's Solvency II package "ensures both adequate capital levels at all times and full transparency of their application."

Turning to banks, Mario Draghi observed that the forthcoming comprehensive bank assessment, conducted by the ECB, "has the potential to strengthen the confidence on the soundness of the banks within the SSM. That, in turn, would reduce banks' funding costs and lower the cost of credit for firms and households. This requires clear communication, as well as credible and effective ex-ante mechanisms, including fiscal backstops wherever needed, for absorbing any capital shortfalls that such a review might reveal." Mario Draghi then advised that the ESRB, we are looking at two structural features of the European banking system that the financial crisis has highlighted. "First, the large size of the banking system relative to the real economy and, second, the concentration of losses in certain lending segments."

“

The composite indicator of systemic stress confirms that market perception of systemic risk remains low.

Finally on market infrastructure, Mario Draghi commented that, whilst “CCPs offer a number of economic and risk-reducing benefits, they are also becoming systemically relevant nodes in the financial system. This entails a number of macroprudential risks.”: (i) the pro-cyclicality of CCPs’ margin rules and practices is a key concern; (ii) CCPs also need robust recovery plans and resolution regimes in order to avoid a disorderly insolvency; and (iii) there is also the risk of contagion, particularly across CCPs that clear the same products (under so-called interoperability arrangements).

This hearing follows on from the ESRB’s 19 September release of its Risk Dashboard Issue 5. This reports that the macroeconomic indicators show some first signs of recovery; and that the composite indicator of systemic stress confirms that market perception of systemic risk remains low, at around pre-crisis levels. Overall, financial market conditions remain buoyant. Included in points in this regard, money markets spreads and financial market liquidity indicators have been stable at low levels over the last three quarters; after a period of high volatility, uncertainty regarding euro-area short-term interest rates has recently fallen to levels similar to those in the UK and the US; and despite a recent jump, corporate bond yields, particularly for triple-A bonds, are historically still very low. Amongst points of concern, countries’ levels of indebtedness remain high; banks’ deleveraging continued during the second quarter of 2013; low profitability weighs down banks’ ability to clean their balance sheets; and banks’ credit conditions continue to tighten.

Furthermore, the ESRB has issued two new occasional papers, number 3, on 16 September, *The Structure and Resilience of the European Interbank Market* and number 4, on 17 September, *Assessing Contagion Risks from the CDS Market*; and has published a report of the Advisory Scientific Committee *The Consequences of the SSM for Europe’s Macroprudential Policy Framework*. Finally, the ESRB has also announced that Mark Carney, Governor of the Bank of England, has been elected as First Vice-Chair of the ESRB, for a term of five years. He replaces Lord King, following his retirement from the Bank of England.

Addressing Interconnectedness: Concepts and Prudential Tools is an IMF staff working paper published on 26 September 2013. The paper examines two sets of tools —network analysis, used to identify interconnectedness risk; and price-based measures covering both direct and indirect spillover channels — to identify the implications of interconnectedness in systemic risk and how these tools have been applied in IMF surveillance. The paper then proposes a preliminary framework to analyse some key internationally-agreed-upon and national prudential tools and finds that, while many prudential tools are effective in reducing interconnectedness, the interaction among these tools is far less clear-cut.

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diary

ICMA organises over 100 market-related events each year attended by members and non-members. For full details see www.icmagroup.org

ICMA Capital Market Lecture Series

ICMA is launching a series of series of lectures where distinguished financial market practitioners and regulators will speak on topical themes relevant to its members in financial centres around Europe. The following speakers have been confirmed so far:

- Verena Ross, Executive Director, European Securities and Markets Authority (ESMA), London, 11 November 2013;
- Thomas Wieser, President of the EU Economic and Financial Committee, Brussels, 18 November 2013;
- Peter Praet, Chief Economist, ECB, London, 12 December 2013.

ICMA members will shortly be receiving full details and invitations.

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15 OCT

European Regulation: An Introduction for Capital Market Practitioners, London, 15 October

Global regulation of the banking industry and the wider financial services industry still dominates the agenda. For the banking industry the emphasis is on ensuring stability and ironing out the abuses of the past, through focusing on capital, liquidity and recovery and resolution planning.

This course aims to give practitioners a keener understanding of the current regulatory environment and alert them to areas of their own activities where the highest standards of integrity and professional business conduct must be maintained.

Register here

16 OCT

ICMA European Repo Council (ERC) General Meeting, London, 16 October

The ICMA European Repo Council General Meeting covers most aspects of the operation of the European repo markets, including recent regulatory and legal developments and is open to all in the repo community. Open to all in the repo community.

Register here

05 NOV

Debt Markets and the Future of Corporate Financing, Paris, 5 November

The ICMA France and Monaco region invites financial market participants to a conference on Debt Markets and the Future of Corporate Financing. The role of debt markets in corporate financing is a key issue in a context of contracting bank balance sheets. Two panels will bring together senior industry representatives including Laurent Attali (BNPP), Anne Courrier (Federis), Marc Lefèvre

(Euronext), Stephane Malrait (SocGen), Jean Pierre Pinatton (Oddo) and John Serocold (ICMA).

Topics to be covered include: drivers of investor demand for corporate bonds in the current market; future of market making under MiFID II/MiFIR; role of new trading platforms; debt market appetite vs. corporate demand; direct market access (disintermediation) by large corporate issuers; developments of private placement market(s) in Europe; SME access to bond markets; and the potential impact of future rate rises.

A keynote speech will be delivered by Edouard Vieillefond, L'Autorité des Marchés Financiers (AMF).
(Whilst this event will mainly be conducted in French, there will be some presentations in English.)
Register here

07 NOV

The Future of the Repo Market in the New Collateralised World of Basel III and the FSB Proposals, Milan, 7 November

This half day conference will consider the Italian and European cash bond and repo markets, including an overview of the current status of various regulatory initiatives, notably the Financial Stability Board proposals for the regulation of shadow banking, the Leverage Ratio and the Financial Transaction Tax.

Richard Comotto, author of the ICMA European Repo Council's long established repo survey, will look at the changing structure of the repo market in Europe and how it has been affected by the increasing demand for high-quality collateral in the wake of Basel III. Local representatives will provide updates on the Italian market developments.
Register here

13 NOV

7th Annual ICMA Primary Market Forum, London, 13 November

The Forum is a half day conference designed to bring together borrowers, syndicate banks, investors and law firms, to discuss the business issues and regulatory developments affecting the issuance of international debt securities. Among the continuing themes in the market this year are market practices relating to prospectus disclosure, pre-sounding, bookbuilding and stabilisation and developing primary market legislation on key information documents, market abuse and conduct of business. The panel discussions will also review current legal and documentation issues and the outlook for the primary markets, including consideration of various funding options and associated challenges.
Register here

13-15 NOV

Global Master Agreements for Repo and Securities Lending Workshop, London, 13-15 November

These two separate master agreements are the essential legal underpinnings for repo and securities lending markets respectively. The workshop includes a detailed review of both legal agreements and their application, including coverage of the GMRA 2011, together with case studies; and the operational and basic legal characteristics of the repo and securities lending markets. The workshop is delivered by Richard Comotto, the author of ICMA's Repo Survey with legal and documentation professionals and representatives from ICMA, ISLA, Ashurst, Citigroup and Euroclear.
Register here

20 NOV

ICMA Asset Management and Investors Council (AMIC) Meeting & Seminar, London, 20 November

The ICMA Asset Management and Investors Council (AMIC) represents a broad range of international investors drawn from all sectors of the industry, including institutional asset managers, private banks, hedge funds, pension funds, insurance companies and sovereign wealth funds. The AMIC Council meeting is a one day conference open to international asset managers, and will review some of the major topics for the buy-side.
Register here

21 NOV

The Impact of Regulatory Reform on Capital Markets, Amsterdam, 21 November

Five years on from the collapse of Lehman Brothers and regulatory reforms intended to make the financial system safer are still in progress. This half day conference brings together regulators, policy experts and market participants to examine the ways in which new regulation will affect activities in the capital markets.

In addition to an overview of progress on the reform agenda in Europe, the event will include specific expert panels on progress with the MiFID II package, developments affecting primary markets and the impact of proposed shadow banking regulation on the repo market.
Register here

ICMA Executive Education

ICMA Executive Education is a unique venture where ICMA and the ICMA Centre, Henley Business School, University of Reading work together to deliver training courses, taught by current and former financial markets practitioners which blend practical and academic know-how.

The courses attract an international client base and present an opportunity to network with counterparts from a whole host of financial institutions. Delegates who benefit from our courses work in the top tier investment banks, stock exchanges, law firms and regulatory bodies. **Substantial discounts are available to ICMA members**

Level I: Introductory Programmes

Financial Markets Foundation Course (FMFC)
London: **6-8 November 2013**

Securities Operations Foundation Course (SOFC)
Brussels: **13-15 November 2013**

Level II: Intermediate Programmes

International Fixed Income and Derivatives (IFID) Certificate Programme
Barcelona: **27 October – 2 November 2013**

Operations Certificate Programme (OCP)
Brussels: **17-23 November 2013**

Primary Market Certificate (PMC)
London: **25-29 November 2013**

Level III: Specialist Programmes

An Introduction to Securitisation
London: **7-8 October 2013**

Collateral Management
London: **4-5 November 2013**

Fixed Income Portfolio Management
London: **25-26 November 2013**

Credit Default Swaps (CDS) - Features, Pricing and Applications
London: **27-28 November 2013**

Credit Default Swaps (CDS) - Operations
London: **29 November 2013**

ICMA Executive Education Skills Courses

Successful Sales
London: **2-3 December 2013**

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Glossary

ABCP	Asset-Backed Commercial Paper
AFME	Association for Financial Markets in Europe
AIFMD	Alternative Investment Fund Managers Directive
AMF	Autorité des marchés financiers
AMIC	ICMA Asset Management and Investors Council
BBA	British Bankers' Association
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BMCG	ECB Bond Market Contact Group
BRRD	Bank Recovery and Resolution Directive
CAC	Collective action clause
CBIC	ICMA Covered Bond Investor Council
CCBM2	Collateral Central Bank Management
CCP	Central counterparty
CDS	Credit default swap
CFTC	US Commodity Futures Trading Commission
CGFS	Committee on the Global Financial System
CICF	Collateral Initiatives Coordination Forum
CIF	ICMA Corporate Issuer Forum
CoCo	Contingent convertible
COGESI	Contact Group on Euro Securities Infrastructures
COREPER	Committee of Permanent Representatives (in the EU)
CPSS	Committee on Payments and Securities Settlement
CRA	Credit Rating Agency
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSD	Central Securities Depositary
CSDR	Central Securities Depositary Regulation
DMO	Debt Management Office
D-SIBs	Domestic systemically important banks
EACH	European Association of CCP Clearing Houses
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Redevelopment
ECB	European Central Bank
ECJ	European Court of Justice
ECPC	ICMA Euro Commercial Paper Committee
ECOFIN	Economic and Financial Affairs Council (of the EU)
ECON	Economic and Monetary Affairs Committee of the European Parliament
ECP	Euro Commercial Paper
EEA	European Economic Area
EFAMA	European Fund and Asset Management Association
EFC	Economic and Financial Committee (of the EU)
EFSF	European Financial Stability Facility
EGMI	European Group on Market Infrastructures
EIB	European Investment Bank
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ERC	ICMA European Repo Council
ESA	European Supervisory Authority
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
ETF	Exchange-traded fund
EURIBOR	Euro Interbank Offered Rate
Eurosystem	ECB and participating national central banks in the euro area
FASB	Financial Accounting Standards Board
FATCA	US Foreign Account Tax Compliance Act
FCA	UK Financial Conduct Authority
FIIF	ICMA Financial Institution Issuer Forum
FMI	Financial market infrastructure
FPC	UK Financial Policy Committee
FRN	Floating-rate note
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FTT	Financial Transaction Tax
G20	Group of Twenty
GDP	Gross Domestic Product
GMRA	Global Master Repurchase Agreement
G-SIBs	Global systemically important banks
G-SIFIs	Global systemically important financial institutions
G-SIIs	Global systemically important insurers
HFT	High frequency trading
HMT	HM Treasury
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
ICMA	International Capital Market Association
ICSA	International Council of Securities Associations
ICSDs	International Central Securities Depositaries
IFRS	International Financial Reporting Standards
IMMFA	International Money Market Funds Association
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRS	Interest rate swap
ISDA	International Swaps and Derivatives Association
ISLA	International Securities Lending Association
ITS	Implementing Technical Standards
KfW	Kreditanstalt f□r Wiederaufbau
KID	Key information document
LCR	Liquidity Coverage Ratio (or Requirement)
L&DC	ICMA Legal & Documentation Committee
LEI	Legal entity identifier
LIBOR	London Interbank Offered Rate
LTRO	Longer-Term Refinancing Operation
MAD	Market Abuse Directive
MAR	Market Abuse Regulation
MEP	Member of the European Parliament
MiFID	Markets in Financial Instruments Directive
MiFID II	Proposed revision of MiFID
MiFIR	Proposed Markets in Financial Instruments Regulation
MMCG	ECB Money Market Contact Group
MMF	Money market fund
MOU	Memorandum of Understanding
NAV	Net asset value
MTF	Multilateral Trading Facility
NCA	National Competent Authority
NSFR	Net Stable Funding Ratio (or Requirement)
OTC	Over-the-counter
OTF	Organised Trading Facility
OJ	*Official Journal of the European Union*
OMTs	Outright Monetary Transactions
PD	EU Prospectus Directive
PD II	Amended Prospectus Directive
PMPC	ICMA Primary Market Practices Committee
PRA	UK Prudential Regulation Authority
PRIPs	Packaged Retail Investment Products
PSI	Private sector involvement
PSIF	Public Sector Issuer Forum
QMV	Qualified majority voting
RFQ	Request for quote
RM	Regulated market
RPC	ICMA Regulatory Policy Committee
RTS	Regulatory Technical Standards
SEC	US Securities and Exchange Commission
SGP	Stability and Growth Pact
SI	Systematic Internaliser
SLL	Securities Law Legislation
SMEs	Small and medium-sized enterprises
SMPC	ICMA Secondary Market Practices Committee
SRO	Self-regulatory organisation
SSAs	Sovereigns, supranationals and agencies
SSM	Single Supervisory Mechanism
SSR	EU Short Selling Regulation
T2S	TARGET2-Securities
TD	EU Transparency Directive
TFEU	Treaty on the Functioning of the European Union
TRs	Trade repositories

ICMA welcomes feedback and comments on the issues raised in the Quarterly Report. Please e-mail: regulatorypolicynews@icmagroup.org or alternatively the ICMA contact whose e-mail address is given at the end of the relevant article.

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