AMIC
The buy side voice of ICMA

AMIC Review

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Welcome

We are very pleased to welcome readers to the third edition of the AMIC Review. The purpose of this Review is to highlight the role of the buy-side community within ICMA, to remind readers of the objectives of the Asset Management and Investors Council (AMIC) and to outline the activities of its working groups.

ICMA is one of the few trade associations with a European focus that has both buy-side and sell-side representation. In order to better pursue its objective, which is to promote resilient, well-functioning, international and globally coherent cross-border debt securities markets, ICMA expanded its membership and voice to be able to represent the whole market, embracing a segment of the market which was rapidly growing in importance – the buy-side. AMIC was set up in 2008 for this purpose. While AMIC is the only independent voice for the buy-side within ICMA, broader ICMA activities are also open to buy-side participation.

The Asset Management and Investors Council

AMIC is an additional service which ICMA provides to its buy-side membership. It represents the interests of the buy-side and serves its members by providing a platform for communication between member firms on topical debt capital market buy-side policy and regulatory issues. AMIC offers a forum for member firms to (1) jointly respond to consultation papers and regulatory initiatives, (2) engage with regulators and (3) to identify and suggest solutions to practical issues for members at a technical level via its various specialised working groups.

AMIC's objective is to focus on debt capital market developments which are not covered by other buy-side trade associations, while cooperating with such associations when overlaps arise.

AMIC Executive Committee

The AMIC Executive Committee is effectively the executive arm of AMIC. The Executive Committee is responsible for setting the direction and objectives of AMIC while also being responsible for its public output, such as opinions on regulatory and market practice developments and responses to consultation papers.

The Executive Committee is led by its Chair, Robert Parker, who is assisted by two Vice-Chairs, Stéphane Janin, AXA Investment Managers GS Limited and Axel Van Nederveen, European Bank for Reconstruction and Development (EBRD), and the AMIC Secretariat team.

AMIC Conference

AMIC holds two conferences a year – one organised in the spring in a continental European city and the other in the autumn in London. The conferences allow buy-side members to meet to discuss topics of interest and to hear from specialist panels and keynote speakers. The conferences are also an opportunity for the AMIC Secretariat to find out more about the priorities of its members and to guide its future work in order to serve the interests of its membership.

AMIC Working Groups

Working groups are the core of the AMIC and are where the technical work is conducted. Some are asset class-focused (covered bonds, securitisation) and some look at industry issues (primary markets, systemic risk and corporate governance). External experts are also invited to join the working groups when relevant. A number of the articles in this publication will provide more detail about the work carried out in some of the AMIC working groups.

AMIC Secretariat

The Secretariat of AMIC responds swiftly and flexibly to the needs of its membership. In order to increase awareness of ICMA's buy-side activities we publish a weekly regulatory update, with information about key AMIC developments as well as a summary of the relevant regulatory highlights, to a broad list of market participants.

We would like to encourage all buy-side member firms to become engaged with AMIC and its working groups and to sign up to the weekly update to keep abreast of our current activities and priorities. ■

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AMIC Working Groups

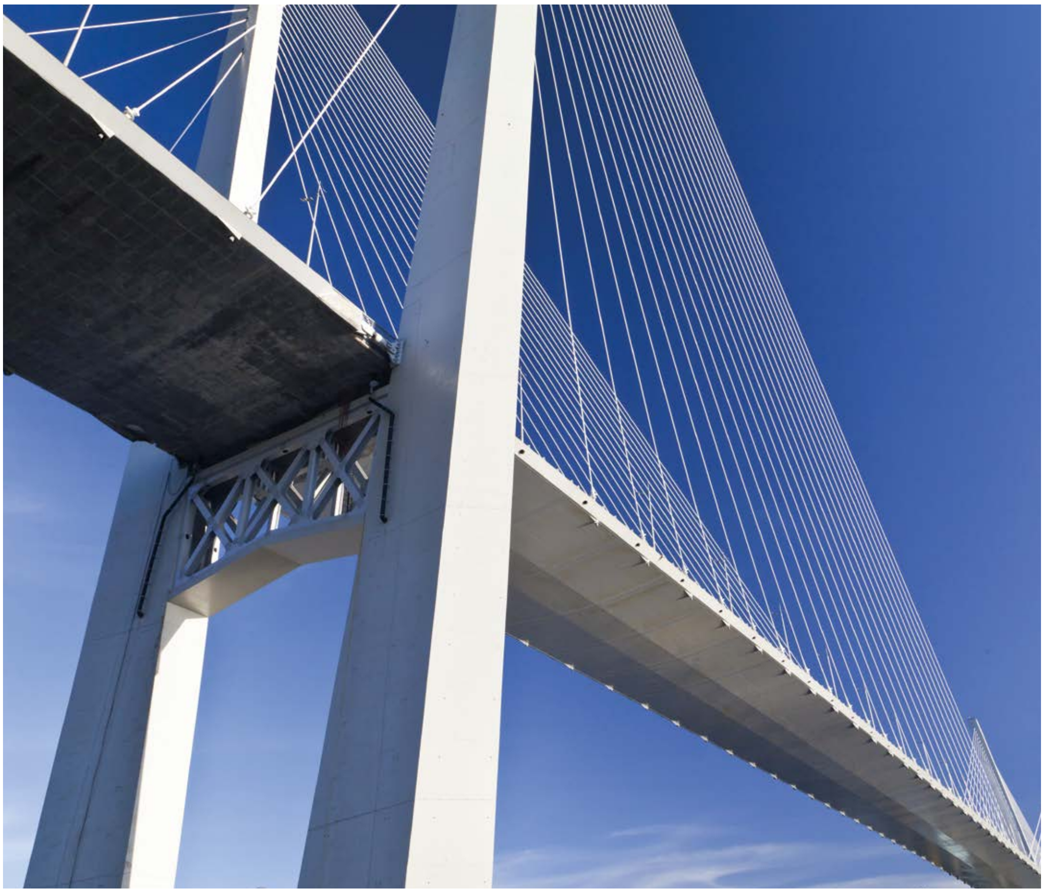
- Bail-in Working Group
- Covered Bond Investors Council
- Corporate Governance Working Group
- Fund Liquidity Working Group
- Primary Market Investors' Working Group
- Securitisation Working Group

Developments in infrastructure capital markets

Robert Parker,

Chair of the Asset Management and Investors Council (AMIC)

There has been a clear increase in fixed income and equity capital flows into the infrastructure markets. The predominant investors are sovereign wealth funds, pension funds, private equity funds and insurance companies. Equity capital has been invested either directly or as limited partners in infrastructure funds or as co-investors with funds. The trend, particularly by pension funds, is co-investment, notably as funds have built up their own in-house expertise. The investor base is mainly institutional and retail investors have only had a limited participation in this market. Since infrastructure assets are illiquid and longer term, funds, correctly, have avoided providing liquidity via mutual funds. Fixed income investment has typically been in long maturity bonds including private placements and in securitised vehicles backed by the cash flows from infrastructure projects. The rationale for this increased investor appetite has been the need for higher yields in the low yield environment of the last 10 years, the demand for long term assets to meet liabilities, the security of cash flows from infrastructure, the prudent use of leverage and in most cases, the protection from a possible increase in inflation. Most investors target a time horizon of 15 years or more in this asset class and in virtually all cases investors have no need for short term liquidity. Governments have encouraged the market as a way to attract private sector funds into “quasi public” projects, thereby reducing pressure on fiscal budgets, while the World Bank has estimated that the positive growth effect on economies from infrastructure developments averages five times the amount originally invested.



Infrastructure covers a number of sectors but the most prominent are transport, technology and telecoms, energy and healthcare. The transport sector encompasses toll roads, train, boat and aircraft leases, airport ownership and ports. The energy sector ranges from investments in pipelines, refineries, energy utilities, hydro facilities and increasingly in wind farms, solar installations and in battery storage. Technology investments cover a wide range of assets but there has been a clear increase in investment in data storage facilities, cabling networks and communications transmission. Healthcare infrastructure typically involves the construction of private sector hospitals. One relatively new sector has been education with investment in schools, colleges and universities. However, infrastructure funds and investors tend to purchase existing assets with a view to developing and enhancing their value rather than building new projects or developing "green field' sites. The rationale for this approach is that investors want to achieve inflation protected cash flows with an element of capital gain from infrastructure rather than taking the open-ended risks of new projects. Therefore, in the case of new projects, investors typically rely on support or guarantees from Governments or supranational institutions. This support is more evident in projects in emerging economies.

While investment in infrastructure is regarded as relatively low risk, obviously there are a number of risk factors that can damage investment returns. The most prominent risk is that of asset failure or damage, for example in the transport sector, safety to prevent accidents is critical and as recently demonstrated by the Italian Autostrada bridge collapse, immediate risks can be significant with longer term contagion risks also evident. Train and aircraft accidents can involve economic, human and legal costs, while in the energy sector, pipeline and refinery failures have led to major economic and environmental costs. Infrastructure failure can lead to increased regulation and in extreme cases, Government requisition. Regulation will cover not just the management of existing assets but also development and can involve lengthy planning delays as evidenced by the long process of agreement for the construction of an additional runway at London's Heathrow airport and the failure to get planning permission for another runway at Gatwick airport. In the energy sector, the development of shale fields and wind farms near areas of population density have proved difficult. Political risks have to be monitored notably where infrastructure assets have a high public profile and where cash flows may be vulnerable to regulatory control, increased taxation or partial or total nationalisation. Investors in the UK are concerned about the Opposition Labour Party's threats to nationalise the railway and water industries. Political risks can be pronounced in emerging economies and notably those whose rankings on the Transparency International index is poor. One area of political criticism has been where leverage has been elevated and has been used as a source of dividend pay-outs.

Despite these risks, future trends in the infrastructure markets remain robust: Firstly as existing infrastructure notably in transport and energy need to be replaced and upgraded, secondly as capital is increasingly channelled into infrastructure technology and thirdly as capital is employed into the service sectors such as education. These trends will need a larger pool of capital with more sophisticated but transparent capital market techniques and instruments. ■

ESRB and IOSCO reports on liquidity and leverage risks in investment funds

Stéphane Janin,

Head of Global Regulatory Development, AXA Investment Managers, Vice-Chair of AMIC and Chair of the AMIC Fund Liquidity Working Group

During the last few years, both the International Organization of Securities Commissions (IOSCO) at global level and the European Systemic Risk Board (ESRB) at European level have been working on the topics of liquidity and leverage risks in investment funds.

While the work currently carried out by IOSCO seems sensible so far, the Asset Management and Investors Council (AMIC) of ICMA is more concerned about the impact of the Recommendation on Investment Funds issued by the ESRB in February 2018 and remains cautious on the future consultation of IOSCO on fund leverage. AMIC will undertake more work as it already did with significant success vis-à-vis IOSCO in the recent past.

The IOSCO work on fund liquidity and fund leverage has been rather reassuring – up to now

Following the financial crisis, the Financial Stability Board (FSB) gave a mandate to IOSCO to tackle the systemic risks potentially involved in Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs). As this concept was challenged by the asset management industry, FSB and IOSCO changed their approach and focused instead on "structural vulnerabilities" of asset managers, culminating in a report by the FSB in 2017.

Following that FSB report, IOSCO received new mandates from FSB to work in particular on two specific issues, i.e. fund liquidity and fund leverage (as considered part of these structural vulnerabilities).

AMIC decided to pro-actively engage on these two topics, to demonstrate to IOSCO that at least from a European perspective a significant series of existing regulatory provisions at EU level had already been successfully introduced following the financial crisis, in particular through the Alternative Investment Fund Managers' Directive (AIFMD), which have proven resilient during significant market turmoil in the last few years (euro currency crisis; Brexit referendum, etc.).

This pro-active educational approach of AMIC was largely successful vis-à-vis IOSCO regarding fund liquidity: in its final Report issued on 1 February 2018, IOSCO referred to many provisions already embedded in European legislation or in national European frameworks (swing pricing, gates, anti-dilution levies, etc.) as had been highlighted by AMIC in its educational paper published with the European Fund and Asset Management Association (EFAMA) on 18 April 2016.

Regarding fund leverage, AMIC followed a similar pro-active approach, by issuing an educational report, again published with EFAMA, on 19 July 2017 demonstrating that the EU provisions on fund leverage in AIFMD and UCITS Directive were rightly balanced and efficient in practice following post-crisis market events.

AMIC expects that IOSCO, in its consultation on fund leverage expected by the end of 2018, will take on board the AMIC arguments when proposing the building of a high-level common regulatory framework at global level.

Concerns regarding the consequences of the ESRB's Recommendation on liquidity and leverage risk in investment funds

On 14 February 2018, the ESRB published a Recommendation on liquidity and leverage risks in investment funds, that it had adopted on 7 December 2017. The Recommendation is supplemented by an Annex I "Compliance criteria for the recommendations" and an Annex II "Economic rationale and assessment". The Recommendation contains five policy recommendations addressing liquidity management tools, liquidity mismatches, stress testing, UCITS reporting and leverage limits, directed at either the European Commission to change the UCITS Directive and AIFMD legislation or to ESMA to create guidelines for firms and/or to national competent authorities (NCAs).

ESRB proposes significant changes to EU legislation for the fund sector:

- Recommendation A (liquidity risk tools) requires that the Commission change primary legislation to include additional liquidity management tools and to use the power to suspend redemptions;
- Recommendation B (liquidity mismatches) requires the Commission to change primary legislation to mandate ESMA to create a list of "inherently less liquid assets" and subject funds investing in such assets with additional supervisory controls;
- Recommendation C (stress testing) requests ESMA to develop guidance for firms for the stress testing of liquidity risk for individual AIFs and UCITS funds;
- Recommendation D (UCITS reporting) requires the Commission to change legislation in order to require UCITS and UCITS management companies to regularly report data, especially regarding liquidity risk and leverage, to their competent authorities; and
- Recommendation E (leverage limits) requires ESMA to produce guidance on the design, calibration and implementation of leverage limits.

This ESRB report took the European fund industry by surprise.

In terms of process, while the EU fund industry is used to public consultations by the European Supervisory Authorities (ESAs), and by ESMA in particular, there was no such public consultation by the ESRB.

In terms of content, considering the granularity of the proposed recommendations as developed in the Annexes, this first ad hoc public document from the ESRB targeting specifically EU investment funds also raised a question: to what extent, on the ground of macro-economic risk, can macro-prudential supervisors enter the field of micro-economic regulation of financial market players and the scope of action of European and national securities regulators? It is important to remember that currently the voting membership of the ESRB General Board is composed primarily of national central banks, while the official regulators and supervisors for fund managers and investment funds are national securities regulators.

The lack of public consultation, the introduction of macro-risk supervisors into the field of micro-regulation, and the unbalanced composition of the board of the macro-prudential supervisor justifies an improvement of the functioning and composition of the ESRB. As early as 2016 AMIC stressed such concerns in its official response to the European Commission's consultation on the EU macro-prudential framework. Two years later, this specific report of the ESRB now illustrates in practice the risk of unintended consequences due to the current functioning and composition of the ESRB.

In addition, on the substance, considering the work carried out by IOSCO on leverage and liquidity topics, the release of the ESRB's report in February 2018 appeared premature.

In particular, it appears that the ESRB goes beyond what is required at worldwide level by IOSCO. If followed and applied by the Commission and ESMA, it would then weaken EU-based fund managers facing stricter rules compared to their non-EU competitors. This is even more worrying when some regions are re-examining their own regulatory frameworks in a more pragmatic way (e.g. see US Treasury report on Asset Management issued on 26 October 2017).

It should be remembered that the existing EU regulatory framework applicable to EU investment funds and their EU-based fund managers (the UCITS and the AIFM Directives) is already today ahead of the curve at worldwide level in terms of regulatory safety for investors. Furthermore, the AIFM Directive was explicitly initiated by the European Commission to tackle systemic risks related to asset managers and funds, in the context of the regulatory actions launched at worldwide level at that time following the financial crisis.

As no market failure has occurred in Europe in the area of investment funds since the implementation of AIFMD, AMIC does not see the need to launch a new set of rules while the EU is already a regulatory leader at global level. As the joint AMIC and EFAMA reports on liquidity risk and leverage referred to above made clear, the UCITS Directive and AIFMD contain a very comprehensive regulatory framework with tools for fund managers and regulators to address risks – including systemic risks.

The AMIC Fund Liquidity Working Group will continue to analyse the detailed proposals in the ESRB report and will engage if necessary with policy makers on specific issues when they are raised. However, we believe in any case that before any new policies are planned to be proposed, formal consultation with industry should be undertaken and that the existing regulatory framework is sufficiently taken into account.

Conclusions

It remains to be seen how the European Commission and ESMA will address the IOSCO reports and the ESRB Recommendation.

Regarding fund liquidity, we know that ESMA has already started working on stress testing, having invited AMIC permanent staff and members to participate in a workshop on this topic in July 2018. The objective of AMIC is to remain fully committed to both keeping the door open to ensure a high level of dialogue and trust with ESMA, while in parallel reinforcing our advocacy and educational arguments to make sure that ESMA's work takes into account the measures already carried out and implemented by fund managers in Europe – without reinventing the wheel or creating a competitive regulatory disadvantage vis-à-vis non-European players.

The European Commission or the European Parliament should not try to unnecessarily change the current Level 1 (framework) provisions of AIFMD and UCITS Directive on technical aspects that would be clearly better tackled by expert regulators at Level 2 (technical standards) or Level 3 (guidance).

Regarding fund leverage, AMIC will respond to the forthcoming IOSCO consultation. AMIC has two important priorities. Firstly, IOSCO should recognise that the EU regulatory framework is already efficient, safe and tested and not add new requirements which could be useless or even counterproductive. Secondly, the ESRB should not put further pressure on European institutions to change the current EU provision, so risking repealing an efficiently tested model by adopting an unknown approach which ultimately might create new risks in practice and so harm the global competitiveness of European-based fund managers. ■

New European securitisation regulations

time will tell...

Henry Cooke,

Partner, Gryphon Capital Investments and Chair of the AMIC Securitisation Working Group

Securitisation has been in the regulatory spotlight since the global financial crisis started in 2008. In Europe, this has culminated this year in the finalisation of new European securitisation regulations (SR) that come into effect in January 2019. The Asset Management and Investors Council, through its Securitisation Working Group has been active in helping to shape the regulations over the past few years by engaging with regulators and has worked closely with other industry organisations to coordinate responses and suggestions to regulators as much as possible.

The stated goal of the regulations is to revitalise the European securitisation market and to create simple, transparent and standardised (STS) securitisations. Only time will tell as to how effective the regulations are, and we will need to compare developments in the European market with those in the rest of the world, including even a post-Brexit UK.

The new regulations will have a significant effect on the European securitisation market as they come into force because they have effectively created two classes of transactions – those that comply with the new regulatory requirements, and those that do not. Some underlying asset classes are excluded from qualifying as STS, such as commercial mortgages, so CMBS transactions, for example, cannot be STS as it stands. Only European institutions can issue products that qualify as STS, immediately excluding securitisations from the rest of the world.

The benefits of compliance are essentially either eligibility or reduced capital charges, although even the highest quality compliant transactions remain significantly penalised relative to comparable credit transactions such as covered bonds.

Additionally, the regulations have differing effects on different types of investor. For example, UCITS schemes can only invest in qualifying STS from 2019. Also, while capital charges for banks are low enough to mean that bank investors are likely to continue to invest in qualifying STS, insurance companies have been effectively excluded from the market as the capital charges levied by EIOPA on both qualifying and non-qualifying STS mean the return on capital will be too low to be attractive to the entire sector. There has been a significant improvement in the capital allocation from the previous Type 1/Type 2 approach from EIOPA, however the failure to encourage EIOPA to move its capital charges in line with those for banks is probably the greatest disappointment to come out of the regulations as it means that European markets have potentially lost almost 50% of the natural investor base for the product.

In order to qualify as STS under the European regulations there are a number of requirements that apply to issuers and also due diligence requirements for investors. We absolutely agree that investors in securitisations need to undertake significant due diligence in understanding ABS investments, and are happy that STS certification will be monitored by ESMA who will maintain a website listing all STS compliant transactions.

There will be no grandfathering for transactions issued before the new rules come into effect, however transactions that comply with the STS rules in terms of qualifications will be able to apply for STS certification if the issuer so desires. To date no transactions have been identified that would qualify without changes to the legal structure. How UCITS holders of existing transactions are expected to handle their legacy non-compliant holdings is somewhat open to interpretation.

The new rules have consolidated and clarified the recent plethora of rules, and some sensible steps have been taken along the way to enhance the regulations and we do believe that there should be an active market in new STS qualifying transactions, however we note that non-qualifying transactions are likely to suffer reduced liquidity and the lack of insurance companies as a potential investor base is probably the single biggest challenge to the success of the new regulations in promoting a vibrant European securitisation market. We also believe the lack of alignment with the treatment of covered bonds is a missed opportunity. AMIC will continue to monitor the market, responding to investor requirements and actively campaigning for any changes that will help drive further positive growth in the sector. ■

A look back

Developments in the AMIC Primary Market Investors' Working Group (PMIWG) in 2018

Ketish Pothalingam,

Portfolio Manager in UK Credit, Executive Vice President, PIMCO

In April 2018, ICMA established the AMIC Primary Market Investors' Working Group (PMIWG) composed of buy-side firms to discuss current market practices. The objective was to identify any issues that investors may have with the status quo and propose potential solutions or changes to address those issues. These discussions are intended to run in parallel to ICMA's Primary Market Practices Committee (PMPC) which involves the market's syndicate managers. The ultimate goal of AMIC's PMIWG is to be the venue for buy-side firms to express views to the PMPC, or issuer committees such as the Corporate Issuer Forum (CIF), Financial Institution Issuer Forum (FIIF) and the Public Sector Issuer Forum (PSIF).

The European primary markets have a large universe of lead managers, a deep pool of potential members of new issue syndicates, a broad base of frequent issuers and an increasing number of new issuers. Buy-side firms are presented with different approaches by different issuers, different syndicate managers and frequently by large groups of syndicate members of the same deal. Therefore, investors are faced with heterogeneous sets of information flow when looking at new issue details. It was clear from the first meeting of the PMIWG on 13 June 2018 that a greater degree of standardisation in (1) new deal announcement, initial terms and (2) deal identifiers, would be issues that deserved attention. Given that the objective of the PMIWG is to provide suggestions to and open regular dialogue with the broad issuer groups (ICMA's CIF and FIIF) and the broad syndicate group (ICMA's PMPC), it was determined by the group that these two issues could be addressed without significant challenges.

Ahead of the second meeting of the PMIWG, suggestions for the actual initial terms for new deals were circulated. Additionally, ICMA invited a representative from Euroclear and the Association of National Numbering Agencies (ANNA) to address the practical challenges of providing ISINs for new issues as early as possible.

At the second meeting on 5 September 2018 both deal terms and ISINs were discussed in detail. Regarding the allocation of an ISIN to a deal early in the process of launching, it became clear that a combination of numerous moving parts of information submission as well as the idiosyncratic regulatory requirements associated with new or infrequent issuers posed challenges for early disclosures of ISINs. For regular borrowers and those with programmes, these problems were deemed to be less of a challenge. It was determined by the group that greater automation and more coordination between issuers, syndicate desks and clearing agencies would make this timing issuer easier. Additionally, the group requested that ICMA relay these views to the issuer groups (CIF and FIIF). It was agreed to ask both issuers and syndicate desks to attend future PMIWG meetings to address these issues.

With respect to the list of initial terms for new deals, there was a good degree of consensus on what would facilitate the investor/buy-side firms new issue set-up processes. A list of what was determined as a minimum set of information (now termed "announcement terms") was proposed by the group and ICMA will submit this list for final consideration by the PMIWG while discussing the fields with representatives from the PMPC at a third meeting on 19 November 2018.

It has become clear after the first meetings of AMIC's PMIWG, that we have a useful group of representatives from investor/buy-side firms that will be able to offer practical suggestions to the broader PMPC and issuers groups to consider. The requirement for such a working group was clear, given the commonality of the issues raised the various members of the group. I believe the practical suggestions of change of current practices would provide positive improvements. The existence of the group also provides the sell-side and issuers with a venue to address some of their own issues. ■

An end-investor perspective on central clearing

Looking back to look forward

Joanna Cound,

Head of Global Public Policy, EMEA, BlackRock and ICMA board member

This year's tenth anniversary of the Global Financial Crisis (GFC) has spurred many of us to reflect upon the events that precipitated the GFC and to contemplate how the over the counter (OTC) derivatives markets have changed since then.

The global post crisis regulatory response centred on two core factors: (1) strengthening the resiliency of dealer-banks through rigorous reform of the prudential framework, and (2) moving bilateral derivatives trades into a centrally cleared framework. The result of this has been a significant shift from bilateral to cleared derivatives.

BlackRock is supportive of central clearing. The reduction in bilateral counterparty credit risk, increased market transparency, together with the improved efficiency in trade execution outweigh the significant operational costs incurred by market participants and end-investors to comply with clearing mandates. However, it is important to recognize that this market structure was not fully designed to handle the diverse set of clients or the range of market risks inherent in OTC products.

While central clearing of OTC derivatives as a concept and market practice matures, the framework to incentivise clearing through resilient CCPs, that protect the interests of all stakeholders in times of stress, is still a work in progress. We observe some evidence of market participants clearing voluntarily (e.g. clearing trades not subject to a mandate), though we believe this trend may stall unless the market and the regulators address certain shortcomings. Indeed, the recent losses incurred in the Nordic power markets revealed that CCPs are not immune to market disruptions.

Below we elaborate on the aforementioned shortcoming and provide recommendations on what we believe would help the clearing market develop further.

Increasing participation in clearing

Having more participants is good for market quality because it gives them more counterparties to trade with when getting in and out of a position, and could potentially lead to better execution quality. To bring a greater number of OTC participants into clearing and to evolve the clearing models, we recommend:

1. Industry takes the lead in a number of key areas:
   - CCPs should offer increased opportunities for netting offsets. These could incentivise clients to clear more positions voluntarily through the CCP. Such offerings should be carefully constructed and regulated to avoid a race to the bottom in risk management.
   - Pension funds should be able to post securities as variation margin to the CCP. This would be an industry led solution that could, over time, removes the need for the EMIR pension fund exemption in the EU and bring additional participants into clearing.
   - Market participants as a whole can improve co-ordination and address inconsistencies. Private sector stakeholders should better co-ordinate participation across end-users, clearing members and CCPs when launching new products. Also, addressing inconsistencies around the costs of clearing (which ultimately are borne directly or indirectly by the end-investor) could help to facilitate broader participation.
2. Policy makers renew their focus on cross border equivalency for CCPs and consider granting equivalency for clearing members. A view on regulatory equivalency between CCPs and clearing members is required. Various jurisdictional requirements that restrict access to extraterritorial CCPs or CMs impede the ability for end-users to efficiently access clearing services.

Enhancing CCP and ecosystem resiliency

The global mandate to clear derivatives has given rise to the systemic importance of many CCPs, making resiliency a key aspect of financial market stability. To strengthen their resiliency – and to reinforce end-investor confidence in clearing - we recommend:

3. Policy makers redouble their efforts to enhance CCP resiliency, by for example:
    - Taking a view on the appropriate level of CCP capital. Despite their systemic importance, CCPs are not currently subject to rigorous regulatory capital requirements.
    - Adopting, implementing and supervising CCP disclosure standards. This process should be accompanied by the introduction of formal audit requirements to help ensure the accuracy of information released.
    - Ensuring end-investor representatives are included in relevant CCP stakeholder groups. While investors are major users of CCPs, they have limited input into governance or operations. CCP rulebooks can be meaningfully altered without end-investor consultation today, which can be disadvantageous.
4. To enhance the markets' resiliency, intermediary risks should be actively addressed, including a targeted review of the feasibility of porting customer positions from a failed CM. We urge policy makers to address account structures and legal frameworks that could impede the movement of positions and collateral.

Protecting the end-investor in clearing

End-investors have a direct interest in ensuring an effective and fair regime for recovery and resolution of CCPs without resorting to a taxpayer bailout. An effective regime for central clearing can strengthen investor confidence underpinning financial stability. A loss of confidence leads to reduced investment and causes investor flight which can exacerbate a crisis.

To protect the end-investor from bearing losses due to the failure of CCPs, we reiterate our objection to the use of variation margin gains haircutting (VMGH) and request regulators formally limit its application.

5. VMGH should be removed from CCP rule books. It should only be available to resolution authorities. Where the resolution authority has the ability to use VMGH, it should be subject to the following constraints:
    - VMGH losses should be capped and limited to one round of haircutting. This would allow for appropriate measurement and management of CCP risk exposure.
    - VMGH losses incurred by end-investors should mandatorily be shared with clearing members. This would ensure full alignment of interests of stakeholders towards prompt and effective resolution of the CCP.
    - Participants subject to VMGH should receive a senior claim against the CCP and its successors for the full amount of the variation margin taken from them. This reflects the way in which a CCP would hold a claim over defaulting participants

Conclusion

We applaud regulators' efforts to make the financial system safer in the wake of the global financial crisis. Today the financial system is safer, in as much as additional capital requirements and the shift to centrally clear OTC derivatives, has insulated the financial system from shocks of the like witnessed 10 years ago. Market participants have worked alongside regulators to deliver clearing access, increasingly competitive services and products contributing to the success of the reform efforts to date.

While much work has been done already to develop central clearing and by so doing underpin global financial stability, more work needs to be done to improve the operational efficiency of clearing, incentivise a wider range of participants to move into clearing and ultimately to protect the end-user whose products are centrally cleared. The importance of continued regulatory focus was emphasized by the large mutualised loss experienced in the Nordic power markets earlier this year, with two-thirds of a CCP's default fund consumed by one single clearing member default. While the CCP proved resilient, the loss allocation defied expectations and should challenge assumptions. Extreme market moves happen at unexpected intervals and in unexpected places.

Importantly, attention should re-focus on equivalency, as this represents a regulatory roadblock that ultimately complicates a process that is designed to reduce systemic risk.

We look forward to working with regulators, market participants such as CCPs and CMs, and our clients to address the challenges that lie ahead, and to promote an effective and well-functioning marketplace that allows our clients to meet their investment objectives. ■

Mandatory buy-ins

5 reasons why the buy-side should care

Andy Hill,
Senior Director, ICMA

CSD Regulation, which came into law in 2014, is not normally a headline grabber when it comes to the key challenges facing financial markets. Given that the regulation mostly focuses on the prudential, organisational, and business standards of central securities depositories (CSDs), it has largely fallen off the radar of most traders and would seem unlikely to have any direct implications for market efficiency, stability, or liquidity. However, hidden in its detail are provisions to address settlement fails which have significant market-level relevance; not least, a mandatory buy-in requirement.

The CSDR mandatory buy-in framework has been high on ICMA's list of market-impacting priorities for a number of years and is likely to remain so leading up to the September 2020 "go live" date. Not only will the industry need to undertake extensive work to prepare for the implementation of mandatory buy-ins, it would appear that general awareness is another challenge, particularly among buy-sides.

We suggest five reasons why the buy-side should care about mandatory buy-ins.

(1) You will have to buy in your failing counterparties – whether you want to or not

The regulation will require that in the event of an in-scope settlements fail, after four business days for liquid equities and seven business days for all other securities (including bonds), the purchasing entity must initiate a buy-in process against the failing seller. This is regardless of whether they want to or not, or even whether it makes economic sense to do so. Buying-in will be a legal obligation. Following four or seven days after the intended settlement date (called the "extension period"), the purchasing entity then has four (for liquid equities) or seven (for everything else) days in which to notify the failing entity, appoint a buy-in agent, and complete (i.e. execute and settle) the buy-in. There is no discretion as to when the buy-in process is started, nor as to when it is completed. In other words, buying-in your failing counterparty is a legal requirement and not a right.

(2) In the case of a fail, you may find your purchase being cancelled

The regulation is also quite prescriptive on what should happen in the case that a buy-in is unsuccessful. If the buy-in cannot be completed, the purchasing entity has a choice: have one more attempt at the buy-in (again subject to the four- or seven-day time horizon to complete the process) or go to "cash compensation" (noting that cash compensation is the default option). Should a second attempt at the buy-in also prove fruitless, then cash compensation becomes automatic.

In the case of cash compensation, the original transaction is cancelled, and a payment is made by the selling entity to the purchasing entity based on a cash compensation reference price. This reference price can be determined by: the previous day's closing price on the most liquid or relevant market for the underlying security; the previous day's closing price on the trading venue with the most volume in the underlying security; or by a pre-agreed methodology.

Of course, regardless of how the cash compensation reference price is determined, the purchasing entity still does not get their securities. Not only could this mean having to replace the original transaction - either by attempting to repurchase the securities or by buying similar securities - it may also mean having to unwind any contingent transactions, such as swaps, foreign exchange, CDS, or a short-sale.

(3) You may struggle to find offers

The regulation is a major problem for market-makers and liquidity providers that rely on the ability to show offers in securities that they do not own. In the event that they are not able to cover any sale, either outright or through the repo market, the relatively short time span in which to deliver securities significantly increases the probability of facing a buy-in. As buy-ins are generally executed for guaranteed delivery, this means that the buy-in price is invariably higher than the prevailing market price, and this difference (effectively the "buy-in premium") is a cost to the bought-in entity. However, the CSDR buy-in framework contains the potential for even further risks and costs to liquidity providers.

In a conventional buy-in, the difference between the original transaction price and the buy-in price is settled between the selling and purchasing parties, and can go in either direction, depending on whether the buy-in price is higher or lower than the original trade price. This ensures that the purchasing party is able to obtain their securities via the buy-in without incurring any additional costs, but it also means that they do not enjoy any additional economic benefits from being failed-to. The failing seller, meanwhile, will effectively incur any associated costs of the buy-in, mainly in the form of any buy-in premia.

Unfortunately, the drafters of the "Level 1" regulation seemed to confuse the direction of the payment of the buy-in differential. Since this error was passed into law, it could not be changed, and so it was left to the "Level 2" regulatory technical standards (RTS) to correct it. Within the constraints of the Level 1 text it was possible to affirm the correct direction for the payment in the event that the buy-in price is higher than the original transaction price (ie from the seller to the purchaser), but not in the event that it is lower. In this case the differential is "deemed paid". The upshot of this inadvertent asymmetry is that selling securities becomes akin to the simultaneous writing of an at-the-money put option that becomes active in the event of a buy-in. If the buy-in price is lower than the original trade price, the trade is cancelled and there are no payments, meaning that the seller incurs a loss equivalent to the differential (as well as the buy-in premia), while the buyer enjoys a windfall profit. The wider the difference, the greater the cost to the seller, and the bigger the windfall for the buyer.

Market-makers and liquidity providers will need to manage and price for this additional risk created by the asymmetry, meaning that where there is a risk of a sale failing, the offer price will need to be adjusted higher. The greater the risk of the fail, the bigger the adjustment and, in some cases, it may just make more sense not to offer securities unless they are held in inventory. This is borne out in ICMA's 2015 impact study of mandatory buy-ins for fixed income markets, that suggests that bid-ask spreads for even the most liquid bonds will widen significantly. Meanwhile, further down the credit and liquidity curves, it will become much harder to find offers.

(4) Being located outside of the EU does not make you out of scope

While CSDR is EU regulation, the buy-in regime applies at the CSD level, not at the trading entity level. In other words, transactions intended to settle on an EU/EEA regulated (I)CSD will be in scope, and the regulation provides that CSDs, CCPs, trading venues, and CSD participants (ie settlement agents) have in place contractual agreements to ensure that all parties in the settlement chain are in scope; regardless of their domicile or jurisdiction. You might be in New York or Hong Kong, but if your counterparty fails to deliver securities on an (I)CSD, you are going to have to buy them in.

(5) You could be bought in yourself – even though it's not your fault

As explained, selling securities that you do not hold in inventory will become far riskier under the new buy-in regime, particularly due to the payment asymmetry. However, selling securities you do hold also comes with a risk. For instance, it may be that you have loaned out your position on repo, with a view to recalling them in the case of a sale. But what if your securities do not come back in time (say, the repo recall fails), causing your sale to fail? You could find yourself getting bought-in.

Some securities financing transactions (SFTs) are in scope of the regulation, but only those termed for 30 business-days or longer. Short-date (and presumably "open") SFTs are not in-scope. In the event of a failing SFT recall leading to a mandatory buy-in against a failing cash sale, there may be scope to pass-on any buy-in costs through the existing contractual repo or lending agreement "close-out" provisions. However, these do not cover consequential losses, such as those that could arise as a result of the CSDR asymmetry.

What is ICMA doing about it?

ICMA has long advocated that the CSDR buy-in regime is ill conceived and that there are far better regulatory and market-led initiatives that could be effective in improving settlement efficiency, such as cash penalties (as well as pointing out that contractual, discretionary buy-in frameworks, such as the ICMA Buy-in Rules, have successfully been relied upon by OTC markets for more than four decades). However, the RTS were finally passed into law in September 2018, and it would seem that the regime will come into force in September 2020. Accordingly, ICMA is now focused on both raising awareness and supporting implementation.

The ICMA Buy-in Rules are expected to play an important role in facilitating regulatory implementation and providing market best practice for buy-ins in the international non-cleared bond markets. For instance, ICMA is in discussion with the authorities about the possibility of using the ICMA Buy-in Rules as a contractual means to correct the regulatory asymmetry, which is a major source of increased risk for both sellers and lenders of securities.

In the meantime, it may be in the interest of buy-side traders to familiarise themselves with this esoteric piece of back-office regulation. ■

Work of the CBIC on the European Covered Bonds Directive

Patrik Karlsson,
Director, ICMA and Secretary to AMIC

The ICMA AMIC Covered Bond Investor Council (CBIC) is an investor driven organisation, independent of both issuers and the market, which AMIC supports with secretariat and administrative services. Covered bond issuers and traders have their own organisations to represent their views. Investors need to ensure that their views are made known and interests protected. The CBIC committee is chaired by Acting Chair, Andreas Denger from MEAG Asset Management.

On 12 March 2018 the European Commission launched their long-awaited legislative proposal on covered bonds, in the form of a directive on covered bonds and a regulation on CRR exposures to covered bonds. The proposed directive builds on detailed reports in 2014 and 2016 by the European Banking Authority (EBA).

The directive specifies the core elements of covered bonds and provides a common definition as a consistent and sufficiently detailed point of reference for prudential regulation purposes, applicable across financial sectors. It will establish the structural features of the instrument, a covered bond specific public supervision, rules allowing the use of the "European Covered Bonds" label and competent authorities' publication obligations in the field of covered bonds. The regulation mainly deals with amending Article 129 of the CRR. The amendments add requirements on minimum overcollateralisation and substitution assets.

CBIC welcomed the development of a European legislative framework for covered bonds as harmonisation will not only consolidate and codify high standards in Europe but could act as a spur for more non-EU countries to issue covered bond laws. Although CBIC may have expressed some concern in the past regarding the need for this legislation, the extensive preparatory work by the EBA and the Commission (through a consultation and an impact assessment) has helped lay the ground for a sensible proposal that should achieve the objectives sought.

The CBIC issued its position in early May 2018, focusing mostly on the directive. Investors were pleased that in many of the areas that national traditions have developed a robust national covered bond framework it can exist within this European framework. This flexibility should minimise disruption to well-functioning national covered bond frameworks that are relied on by issuers and investors.

However, this flexibility is in some areas of the text taken too far and risks lowering standards. The CBIC position paper covers concerns investors have in areas such as cover pool assets, disclosure standards, third country equivalence, extendable maturity structures, cover pool liquidity buffers, and the overcollateralisation calculation methods.

In August the European Parliament's rapporteur, Bernd Lucke MEP, issued his first reports on the directive and regulation with suggested amendments to the Commission's proposal. The debate in the European Parliament will heat up as other MEPs have tabled amendments on 26 September to the directive and regulation. Compromise positions will now be negotiated between the political groups. The Council, for its part is also negotiating a compromise position on the Commission's proposal. Both institutions will need to start trilogue negotiations as soon as possible to facilitate an agreement before the end of this parliamentary period in March 2019.

As the legislative debate continues, the CBIC has focused on (1) the need for strict asset eligibility criteria to maintain the high quality of the product, (2) clear rules for extendable maturities to prevent abuse and (3) swifter implementation of equivalence for third countries.

CBIC will continue to contribute the investors' voice to the debate on the appropriate level of harmonisation of the covered bond framework in Europe as deliberations take place in the coming months. This legislation presents an opportunity to consolidate and codify the current practices on covered bonds and ensure the continued success of this important funding tool for European banks and popular asset for European investors. ■

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