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INTERNATIONAL CAPITAL MARKET ASSOCIATION

Market Update to Asia Securities Forum
November 2019

In 2019 ICMA has been working on multiple market practice and regulatory policy activities in the cross-border debt securities markets. This report serves as a snapshot of some of the topics that will affect or have sparked interest in the Asia market.

The **transition to risk-free rates** is a global challenge. To help organise the transition, the authorities have set up a series of risk-free rate working groups. ICMA participates in the Risk-Free Rates Working Groups in the UK, the euro area and Switzerland, and ICMA is in regular contact with the equivalent group in the US Alternative Reference Rates Committee. In Asia, there has been an increasing interest from the market in this important and complex transition. ICMA has taken various opportunities to update members on the transition from LIBOR to risk-free rates in the bond market; bond market conventions for the adoption of risk-free rates; bond market documentation, particularly fallbacks for legacy bonds; and the transition to euro risk-free rates.

Brexit is also calling attention of financial market participants. The cliff-edge risks associated with Brexit and potential implications for market fragmentation are of concern to ICMA and will be analyzed in this report.

A traditional area of expertise at ICMA has been the EU regulations with cross-border implications. The **Central Securities Depositories Regulation (CSDR) buy-in rules** and the extensive new reporting requirements under the **Securities Financing Transactions Regulation (SFTR)**, both to be implemented in 2020, have extra-territorial impacts. ICMA has delivered workshops in Asia, to help the market ready itself for the step change in reporting requirements and explain how market participants will need to comply.

Green and sustainable finance is gaining remarkable momentum in Asia. ICMA has been actively communicating with national regulators to exchange information and share latest developments in the Green and Social Bond Principles and the EU Action Plan on Sustainable Finance, where ICMA is a member of the Technical Expert Group.

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1. Transition to risk-free rates

Background

In July 2017, Andrew Bailey, the Chief Executive of the FCA which regulates LIBOR, said that the FCA would no longer intend to persuade or compel banks to submit contributions for LIBOR after the end of 2021, and the authorities want financial markets to transition away from LIBOR and the other IBORs to near risk-free rates. In all the main jurisdictions, the chosen risk-free rates are overnight rates: ie SONIA in the UK; SOFR in the US; €STR in the euro area; SARON in Switzerland; and TONA in Japan.

A common objective is to make risk-free rates as robust as possible, with robustness measured primarily by the volume of underlying observable transactions. For example, in the first quarter of 2019, there were on average only 9 deposits a day underpinning six-month sterling LIBOR, with a total daily value of £81 million. SONIA is underpinned by transactions worth about £40 billion a day.

Adoption of overnight rates

In the bond market, considerable progress has already been made with adoption of SONIA in new public issues of FRNs over the past year:

- £32 billion has been issued in total, of which £25 billion has been issued this year.
- There have been 63 new FRN transactions referencing SONIA in total of which 51 have been completed this year.
- There has been a wide range of SSA, bank and building society issuers, and the first corporate issuer – BMW Finance – in the past few weeks;
- and over 180 investors.

As a result, new public issues of FRNs referencing sterling LIBOR maturing beyond the end of 2021 have all but ceased.
The market in securitisations referencing SONIA has also made a good start with 16 distributed deals amounting to over £7 billion in total.

Market conventions

The same market conventions have been used in all bond market transactions referencing SONIA so far: overnight SONIA compounded daily in arrear for the relevant interest period. This requires observing SONIA on a daily basis over a period corresponding to an interest period, and compounding it over that period, with the margin for the interest period added to the compounded SONIA rate for the same period. The period over which SONIA is observed begins typically 5 London Banking Days before the relevant interest payment date and ends typically 5 London Banking Days before the next following interest payment date.

Overnight SOFR has been used in the US FRN market. But simple averaging, rather than compounding, has been used in the SOFR market; and different mechanisms have been used in the SOFR market for interest accrual periods. Predominantly, the lock-out mechanism has been used, which operates such that interest is fixed for the last few (typically, 4) days of the interest period at the previous day's rate. That fixed rate is then applied for the final 4 days of the interest period with the actual rate for those last 4 days being entirely disregarded and not rolled-over to the next accrual period.

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Also, some recent SOFR-linked FRNs have used compounded SOFR with a 5 day lag, one has used compounded SOFR with a 2 day lag and others have used another mechanism, where interest is paid 2 days after the end of the interest period.

While there appears to be a basis for consistent conventions across SONIA products based on existing conventions, further work could be done to achieve the call for alignment across jurisdictions.

In the Eurobond market, the majority of the new SONIA issuances have been issued off debt issuance platforms which have been updated to include the infrastructure for the issuance of the new risk free rate products. A handful of issuers have started to incorporate provisions which are flexible enough to allow for issuance of bonds referencing other RFRs, such as SOFR.

Fallbacks

Market participants should prepare for the potential nonexistence of LIBOR after 2021. From ICMA's point of view, the best solution is not to issue new bonds linked to LIBOR. But if LIBOR is unavoidable or preferred in new issuances, then robust fallbacks to risk-free rates in these new issuances are recommended.

Since new public issues of sterling FRNs are already referencing SONIA, rather than LIBOR, there is no longer a need for fallbacks from sterling LIBOR to SONIA in new bond market documentation. In the US dollar FRN market, we have seen significant new issuance directly linked to SOFR. However, we are still of course in parallel seeing new issuance in USD LIBOR. For the USD LIBOR market, the ARRC (Alternative Reference Rates Committee) has produced fallback language for new USD LIBOR FRN contracts. The language recommended by the ARRC is applicable only to new USD denominated FRNs.

In the European market, we have generally seen more "currency and benchmark agnostic" fallbacks – meaning that the legal language for the fallback does not refer to a specific new risk free rate. Instead, it typically envisages the issuer appointing an independent adviser to select (or to advise the issuer in the selection of) an alternative or replacement rate and an adjustment spread to be applied to such rate, in each case, on the basis of: any recommendations made by relevant official bodies or, if no such recommendations have been made, customary market practice.

Legacy bonds

The adoption of SONIA instead of LIBOR in new bond issues helps to cap the scale of the legacy sterling LIBOR bond problem but does not solve it. Market estimates indicate that legacy bonds referencing LIBOR due to mature beyond the end of 2021 are at least $864 billion globally: around 80% denominated in US dollars and 9% in sterling. Maturing bonds will reduce the scale of the problem in time, but there is a significant volume of maturities beyond 2030, and some bonds are perpetual, with no maturity date.

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Most of these legacy bonds, maturing past 2021 and with no robust fallbacks in place, will fall back to a fixed rate when LIBOR is permanently discontinued. This clearly gives rise to potential commercial and even litigation risks.

One way of addressing the legacy bond problem is to amend the interest rate provisions in bond contracts through consent solicitation. Associated British Ports launched the first example of a consent solicitation involving the replacement of LIBOR by compounded SONIA plus a fixed spread earlier this year. Successful consent solicitations or other liability management exercises – such as bond exchanges or buy-backs – will help to reduce the amount of legacy LIBOR bonds outstanding.

Even so, the use of consent solicitations to transition the whole of the legacy bond market – involving FRNs, covered bonds, capital securities and securitisations – would be a long, complex and costly process and would not necessarily be successful. This is because individual bonds are often held by many investors, and consent thresholds are generally high (and commonly 100% in the US).

Additionally, there is a question of what the interest rate would be amended to: a term rate or an overnight rate, and what credit market adjustment spread to use to address the differences between LIBOR and SONIA.

If and when LIBOR is declared to be no longer representative of its underlying market, LIBOR will no longer be expected to be used for new transactions. But the FCA has stated that "the potential solution of allowing continued publication of LIBOR for use in legacy instruments that do not have mechanisms to remove their dependence on LIBOR could help to prevent otherwise unavoidable disruption in cash markets."

In certain circumstances, the EU Benchmarks Regulation (BMR) may permit continued publication and use of a benchmark to allow for orderly cessation and to avoid frustration of financial contracts. If LIBOR can continue to be used for legacy bonds when it is no longer representative of its underlying market, this will reduce the amount of legacy bonds outstanding by giving them more time to mature.

Th last option is to let the bonds operate according to their terms – and revert to fixed rate – even if this was never the issuers' or investors' intention.

Overall, there are several other issues that need to be considered affecting the transition in the bond market:
- risks of hedging mismatches
- recharacterization risk of capital instruments
- regulatory reporting requirements
- potential misselling or conduct risks

International market awareness of the need to prepare for the transition to risk-free rates is crucial for this global challenge. Awareness of not only market firms, but also their clients, is called for. The authorities themselves are playing a major role in raising market awareness: e.g. through public speeches, events and their supervisory role. ICMA and other trade associations play a complementary role in raising market awareness among their members and in the market: e.g. through published articles, conference calls and events.

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2. Brexit and capital market fragmentation

Please note that the update on Brexit below reflects the situation as of the end of September 2019 and may not reflect more recent developments. Further updates will be available on the Brexit webpage of the ICMA website.

https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/brexit-implications-for-icma-members-of-the-uk-vote-to-leave-the-eu/

There appear to be three possible outcomes on Brexit by 31 October 2019: either (i) the UK leaves the EU with a deal with the EU27 by 31 October; or (ii) the UK leaves by the same date without a deal; or (iii) there is a further extension of Article 50. In the absence of agreement on a deal by 31 October, or agreement on a further extension of Article 50, the default position is for the UK to leave the EU on 31 October without a deal.

Cliff-edge risks arising from Brexit

Current British Government policy is still to leave the EU Single Market in financial services when the UK leaves the EU. If the UK leaves the EU Single Market, the EU Single Market will become two separate markets when passporting rights between the EU27 and the UK cease: either on Brexit, if there is no deal; or at the end of the transition period after Brexit, if there is a deal. The end of the transition period specified in the Withdrawal Agreement is the end of 2020. Following the delay in Brexit from 29 March to 31 October, there is a case for extending the transition period, which could be extended until the end of 2022, if both sides agree.

When passporting rights cease, cliff-edge risks between the UK and the EU27 markets will arise as a result of restrictions on market access. The UK is proposing to address these cliff-edge risks through a Temporary Permissions Regime (TPR), which has been extended to the end of 2020, but there is no equivalent of the TPR in the EU27. While the authorities in the UK and the EU27 have made progress in addressing cliff-edge risks case by case, there are still unresolved issues, and potential gaps, and in some cases the equivalence decisions made by the EU27 are conditional and temporary, with short deadlines before they lapse. On 5 August, the European Commission stated that it would provide no further help relating to a no-deal Brexit beyond the contingency measures already agreed, and no guarantee that these contingency measures would be extended, despite the short deadlines. (See Box A.)

Legislative preparations in the UK for Brexit also need to be completed. The UK authorities' objective is to onshore all EU legislation into law in the UK on Brexit. If a Withdrawal Agreement is reached between the EU27 and the UK, the British Government will need to secure the passage of a Withdrawal Agreement Implementation Bill to enable the Withdrawal Agreement to be ratified in the UK, and the European Parliament will need to approve the deal in the EU27. In the event of a no-deal Brexit on 31 October, it appears that there is still some outstanding legislation that needs to be approved by Parliament before 31 October;[1] and it is not yet clear

[1] "We [the FCA] have been working closely with the Treasury and the Bank of England to make sure that EU financial services legislation is effectively on-shored by exit date. To date, over 50 statutory instruments have been made to achieve this. This Is most of what needs to be done on

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whether and to what extent "in flight" EU legislation will continue to be taken into law in the UK after Brexit, in the event of no deal.

Addressing cliff-edge risks on a no-deal Brexit

ICMA's understanding of the current position on addressing cliff-edge risks in capital markets in the event of a no-deal Brexit can be summarised as follows:[2]

Memoranda of Understanding: The UK authorities have concluded new cooperation agreements with the EU markets, insurance and banking authorities, which will take effect in the event of a no-deal Brexit. These MOUs provide a framework for the sharing of confidential information, which will assist in carrying out functions; allow UK or EU-based firms to delegate or outsource certain activities to firms based in the other jurisdictions; and support future market access and equivalence decisions.

Banking: The British Government has legislated to ensure that UK households and businesses can continue to be served by EU-based banks after Brexit. EU authorities have not taken similar action. As a result, major UK-based banks are transferring their EU clients to subsidiaries in the EU so that they can keep providing services to them. The Bank of England reports that all material subsidiaries are now authorised, fully operational and trading, but that some operational risks remain, including if many clients seek to migrate to EU entities at the last minute, which could amplify any other disruption in the market.

OTC derivatives (cleared): The British Government has legislated to ensure that UK businesses can continue to use clearing services provided by EU-based clearing houses for three years from Brexit. The European Commission has provided a temporary and conditional equivalence decision for UK CCPs. ESMA has subsequently announced the recognition of three UK CCPs until end-March 2020 in a no-deal Brexit and agreed the cooperation arrangements to support this with the Bank of England. Without greater clarity on the regulatory status of UK CCPs after this date, the contracts that EU members clear with UK CCPs will need to be closed out or transferred by then. This process would need to begin by the end of 2019 and would impose significant costs on EU firms as well as potentially straining market capacity. Further action may therefore be necessary to prevent this. Ultimately, the best solution in the view of the UK authorities is for the EU to grant permanent recognition to UK CCPs.

OTC derivatives (uncleared): The British Government has legislated to ensure that EU banks can continue to perform lifecycle events on contracts they have with UK businesses. The European Commission does not intend to reciprocate in the case of UK-based banks' contracts with EU businesses. The Bank of England reports that most EU27 Member States with material uncleared derivatives activity have implemented legislative measures which seek to address this risk at national level, but the scope and

this front – only a small number of SIs remain outstanding.": Andrew Bailey, Chief Executive of the FCA, *Preparing for Brexit in Financial Services: the State of Play:* Bloomberg, 16 September 2019.

[2] Source: Bank of England Financial Stability Report, July 2019; and Andrew Bailey, Chief Executive of the FCA, *Preparing for Brexit in Financial Services: the State of Play:* Bloomberg, 16 September 2019.

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effectiveness of these measures will vary between jurisdictions: there is particular uncertainty about half of the notional value of outstanding contracts.

Ability of EEA firms to trade on UK trading venues: The EU's Trading Obligations require EU investment firms to trade EU-listed or traded shares, and some classes of OTC derivative, on EU trading venues. The UK will also have reciprocal trading obligations when it leaves the EU.

Asset management: The cooperation agreements agreed between the FCA and EU NCAs enable EU asset managers to delegate the management of their assets to the UK after Brexit. The British Government has legislated for EU asset management firms to continue operating and marketing in the UK after Brexit. To continue to operate in the EU, the Bank of England reports that the largest UK asset managers have completed their establishment of EU authorised management companies.

Insurance contracts: The British Government has legislated to ensure that the insurance policies that UK households and businesses have with EU insurance companies can continue to be serviced after Brexit. The Bank of England reports that UK insurance companies continue to make good progress in restructuring their business in order to service EU liabilities after Brexit.

Increased prudential requirements: EU regulations subject EU banks' and insurance companies' non-EU exposures to stricter capital and liquidity requirements, as well as imposing some restrictions on holdings of non-EU assets. UK legislation is aligned with EU rules. Secondary legislation passed in the UK allows regulators to delay the impact for UK firms.

Personal data: The British Government has legislated to continue to allow the free flow of personal data from the UK to the EU. The European Commission has indicated that it does not intend to take similar action to ensure the free flow of personal data from the EU to the UK in a no-deal Brexit. There are risks in the event of disruption to cross-border flows of personal data from Brexit day.

Contract repapering: Progress on repapering has been gradual. The absence of repapering may have an impact on business in the EU post-Brexit. Several EU Member States have legislated to allow UK firms to continue temporarily to provide certain services in their jurisdiction following a no-deal Brexit. But these access provisions are not EU-wide, and they vary in respect of the activities and durations they cover. There is therefore uncertainty around how some of these provisions will be applied.

Regulatory equivalence between the EU27 and the UK after Brexit

Both the EU27 and the UK will have the same rules regulating financial services after Brexit at the outset. So there should in principle be scope for the EU27 and the UK to negotiate regulatory equivalence between them. This is the EU's preferred method of negotiating market access with third countries, which the UK will become when it leaves the EU.

EU equivalence policy has three objectives: (i) reconciling the need for financial stability and investor protection in the EU, on the one hand, with the benefits of maintaining

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open and globally integrated EU financial markets, on the other; (ii) promoting regulatory convergence around international standards; and (iii) establishing or upgrading supervisory cooperation with relevant third-country partners. In some instances, this can enable a coherent prudential regime to apply to EU banks and other financial institutions operating outside the EU, thus lowering the cost of EU firms' investments and exposures in third countries by facilitating capital management in particular. An equivalence decision is a unilateral and discretionary act of the EU, conducted and concluded by the Commission, in accordance with EU priorities and the interests of EU financial markets. Third-country regimes do not need to be identical to the EU framework, but they do need to ensure in full the outcomes as set out in that framework.

Equivalent outcomes

As London is a global financial centre, the UK does not intend to be a "rule taker" from the EU27 after Brexit.[3] Senior UK officials have emphasised the importance of equivalent outcomes between the EU27 and the UK (eg ensuring financial stability, market integrity[4] and investor protection) rather than the same rules.[5] After Brexit, this approach would enable the UK authorities to seek ways of improving onshored EU legislation in the UK so as to achieve the same outcome as the EU27, but in a way that is more effective in the UK.

It is clear that the European Commission is also concerned to achieve equivalent outcomes.[6] In addition, some EU27 regulators have indicated that new EU rules should be more flexible in future, particularly at Level 1. But even with a greater degree of flexibility, this does not mean that negotiations between the EU27 and the UK on equivalence would be successful without trust and reliance on both sides. And even when EU27 and UK rules are the same, the way in which these rules are supervised is critical to delivering the same outcomes.

There is also a risk that the Commission will withdraw its determination of regulatory equivalence at short notice. That could happen if EU27 and UK rules diverge after Brexit, even though the UK may argue that outcomes remain the same. One key part of the EU approach consists of more frequent monitoring and review of equivalence decisions to detect emerging differences between EU and non-EU frameworks on time.[7] For example:

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[3] Prime Minister: "When the UK leaves the EU and after any transition period, we will leave the single market and the customs union. Although we will remain committed to world-class environmental, product and labour standards, the laws and regulations to deliver them will potentially diverge from those of the EU: Letter to the President of the European Council, 19 August 2019.

[4] Ie "orderly, resilient, transparent and clean markets".

[5] For example, see Andrew Bailey, Chief Executive of the FCA: *The Future of Financial Conduct Regulation,* 23 April 2019.

[6] Stephen Maijoor, Chair of ESMA: "EU equivalence decisions taken in financial markets have been overwhelmingly outcome-based resulting in reliance on home country regulation and supervision.", June 2019.

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- The recent Swiss case on share trading – under which the EU allowed the grant of equivalence for trading of Swiss shares in the EU to lapse rather than agree to an extension – is regarded by some market commentators as a potential precedent.
- Another potential precedent is the Commission decision at the end of July that Argentina, Australia, Brazil, Canada and Singapore no longer meet EU standards under the Credit Rating Agencies Regulation, with the result that equivalence has been withdrawn.

The UK will want to ensure that processes for making assessments for reviewing and, if necessary, withdrawing equivalence are predictable and work in in a similar way for both sides, drawing on the experience of other recent cases with third countries.

Deal or no-deal?

There is a much better prospect of an EU27/UK deal on regulatory equivalence if the EU27 and UK reach a deal on the Withdrawal Agreement with a sufficiently long transitional period thereafter than if there is a no-deal Brexit. While UK and EU27 rules would be virtually identical on Brexit, and both the EU27 and the UK would be in a position to negotiate on equivalence at the outset, a no-deal Brexit would in practice make the question of whether to negotiate into a political issue on both sides. It is not yet clear whether a no-deal Brexit would lead to a political standoff or whether it would swiftly lead to a resumption of negotiations.

[7] Stephen Maijoor, FESE Convention, Dublin, 4 June 2019.

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3. EU regulations: CSDR buy-in rules and SFTR

CSDR mandatory buy-ins

From 13 September 2020, the mandatory buy-in rules under the EU Central Securities Depositories Regulation (CSDR) will apply. Entities settling trades on EU/EEA CSDs and ICSDs will legally be required to initiate a buy-in process against any counterparty failing to settle a sell transaction for more than a few days. This legal obligation is intended to apply regardless of the jurisdiction of the trading parties. The intention is to improve settlement discipline by disincentivising settlement fails, effectively transitioning “best effort” delivery markets closer to a “guaranteed delivery” regime.

The Regulation aims to improve settlement discipline by making it compulsory for purchasing parties to initiate a buy-in process against a seller who fails to deliver securities in a timely manner. It is important to note that this legal obligation to buy in a failing counterparty applies directly to the purchasing entity, which in many cases will be the end-investor (such as an asset manager or a pension fund), and not to the custodian bank, settlement agent, or any other intermediary in the settlement chain. The regime also affords little flexibility. Purchasing parties must initiate the buy-in process once a trade has failed for four business days in the case of liquid equities, or seven business days in the case of all other securities (including bonds). Furthermore, the buy-in must be completed (ie initiated, executed, and settled) again within four or seven business days, depending on the underlying security. The regulation allows for the purchasing party on more attempt at the buy-in process before cash compensation becomes obligatory. In the event that the buy-in cannot be executed, the original trade must be cancelled, and a prescribed cash compensation process is triggered. The amount of cash compensation payable is based off a determined market reference price for the underlying security, although it can also be determined by a pre-agreed formula.

Since the Regulation applies to transactions intended to settle on an EU/EEA regulated CSD or ICSD, the extraterritorial scope is likely to be significant. The regulatory technical standards (RTS) provide that all parties in the settlement chain must have contractual arrangements in place that not only require the relevant counterparties to comply with the regulatory obligations of the buy-in, but that also ensure that the Regulation is enforceable in all relevant jurisdictions. Thus an asset manager located in Singapore or Hong Kong, settling trades on an European ICSD, will still be required to buy in a failing counterparty, whoever and wherever they may be.

Buy-in mechanisms in the non-centrally cleared markets are nothing new. Participants in the international bond markets have relied upon the ICMA buy-in rules for decades. The ICMA buy-in rules are part of the ICMA Secondary Market Rules and Recommendations which apply automatically between ICMA members transacting in international securities (ie a security intended to be traded on an international, cross-border basis and capable of settlement through an international central securities depository or its equivalent). The ICMA buy-in rules, however, are a contractual right, not a mandatory obligation, and are designed to protect parties to a transaction in the event of a settlement fail, rather than to penalise them.

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ICMA buy-in rules can provide not only a legal framework and market best practice for its implementation, but also mitigating some of the risks created by the new regime, continuing to play a protective role with the introduction of CSDR mandatory buy-ins.

As the implementation date approaches, ICMA remains in ongoing discussions with ESMA and the European Commission with respect to a number of questions:

- *Solving for the buy-in/cash compensation asymmetry:* ICMA is hoping that the asymmetry in the price differential payment process in CSDR, related to both buy-ins and cash compensation, can be "fixed" through contractual arrangements between trading parties (such as by using the ICMA buy-in rules). This will be essential to ensure that both sellers and lenders of securities do not face additional undue risks as the result of what appears to be an error in the Level 1 Regulation.

- *Applying the buy-in framework to securities financing transactions (SFTs):* ICMA would expect that open-SFTs (and "open-like" SFTs), are deemed out of scope the mandatory buy-in regime on the basis that either party can effectively terminate such transactions with less than 30 business days' notice (in most cases only one business day is required). ICMA is also recommending that basket SFTs (including triparty and delivery-by-value structures) are also deemed out of scope, even if the transactions are termed for 30 business days or longer. This is on the basis that attempting to buy-in multiple, substitutable securities underlying such transactions is impractical.

- *Finding buy-in agents:* ICMA is concerned that it may be difficult for firms to appoint buy-in agents, particularly within the tight timeframes for buy-ins prescribed by the regulation. Appointing willing buy-in agents is a challenge in today's international bond markets, and this is the reason for ICMA's revision to its buy-in rules in 2017 which allows initiating firms to execute the buy-in (or sell-out) themselves, within specific criteria that protects that failing party. The feedback from ESMA seems to confirm that a buy-in agent must be appointed by the initiating party (in the case of transactions not cleared by a CCP) as part of the buy-in process, and so parties cannot execute the buy-in themselves.

- *Utilising pass-ons:* Pass-on mechanisms, such as under the ICMA buy-in rules, allow for a single buy-in to settle an entire failing transaction chain, and are therefore important from both a market efficiency and stability perspective. CSDR does not provide for a pass-on, however the regulatory recitals suggest that pass-ons may be possible. ICMA is currently holding the pen on a cross-industry initiative to design a potential pass-on mechanism to complement CSDR, which will be put to the regulators for consideration.

- *Updating the ICMA buy-in rules:* Once there is some clarity on these and a number of other critical issues related to the application of the CSDR buy-in framework, ICMA will, in consultation with its members, look to update its buy-in rules to provide a contractual framework and market best practice to support compliance with, and implementation of, CSDR.

SFTR implementation

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The EU Securities Financing Transactions Regulation (SFTR) was proposed in 2014 to foster transparency in repo and other SFT markets in Europe. In order to achieve this, SFTR is set to introduce, among other things, extensive transaction reporting requirements for SFTs. While many of the SFTR provisions already apply today, the reporting regime itself is still being specified in Level 2 technical standards. Reporting is currently expected to go live in April 2020.

By definition in the regulation, the STFs include repo and reverse repo, buy/sell backs, securities lending (and borrowing), commodities lending (and borrowing) and margin lending. The SFTR level 1 text stipulates the following reporting requirements:

- Both counterparties to report the details of all SFTs concluded (as well as any modifications) to a trade repository specifically authorized under SFTR.
- Reporting no later than on the working day following the conclusion (or modification) of the transaction (T+1) except where collateral allocation not available.
- Backloading of trades concluded prior to and still open on the go live date.
- Minimum list of reporting requirements defined in level 1.

These reporting requirements apply to the following entities:

- EU based financial or non-financial counterparties incl. all branches (EU and APAC);
- Third country firms, where SFT "concluded in the course of the operations" of an EU branch;
- Certain public bodies are excluded: Central Banks, DMOs, BIS;
- SFTs with EU Central Banks are exempt from SFTR reporting but captured under MiFIR; and
- The reporting obligation may be delegated to a third party --"mandatory delegation" in case of small NFCs (to the counterparty) & AIFs/UCITS (to the fund manager).

In addition, regarding separate collateral reuse requirements, a broader scope applies to third country firms where the "reuse concerns financial instruments provided under a collateral arrangement by a counterparty established in the Union" (or any EU branch).

In 2015, the ICMA ERCC created a dedicated SFTR Task Force. Over the past years the group has grown significantly in size, reflecting the scale of the challenge that SFTR poses to Repo and other SFT markets. The Task Force now includes representatives from over 120 ICMA member firms covering the whole spectrum of the market, including buy-side, sell-side, market infrastructures, but also Trade Repositories and other service providers looking to develop solutions to help reporting firms comply with SFTR. The main objective of the ERCC SFTR Task Force is to develop a common understanding of the requirements and to develop market best practices in relation to SFTR reporting to complement guidance provided by regulators. The work is undertaken in close collaboration with other trade associations and the relevant regulators, in particular ESMA.

Following the finalisation of the SFTR technical standards earlier this year, ESMA is now fully focused on important additional implementation guidance that they are mandated to provide, the so-called level 3 measures. This includes detailed Reporting Guidelines and Q&As. On 27 May, ESMA published a first draft of the Guidelines for public

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consultation. The final ERCC response was submitted to ESMA by the deadline on 29 July, following extensive discussion with members. Alongside the detailed response, the ERCC also shared with ESMA an overview for the reporting of repo lifecycle events and the latest version of SFTR sample reports that the group has been developing over the past months.

In terms of next steps, ESMA is currently reviewing the draft Guidelines in light of the consultation feedback received and has promised to deliver the final Guidelines in early Q4. From an industry perspective, timing remains a key challenge. With only 6 months left until reporting go-live firms are under pressure to conclude the necessary IT system developments and start industry testing as soon as possible in order to get ready in time for the April 2020 deadline.

Market participants in Asia are recommended to stay abreast of these EU regulations and analyze the direct impacts and secondary impacts (in-scope vs transacting with in-scope) on themselves and their businesses.

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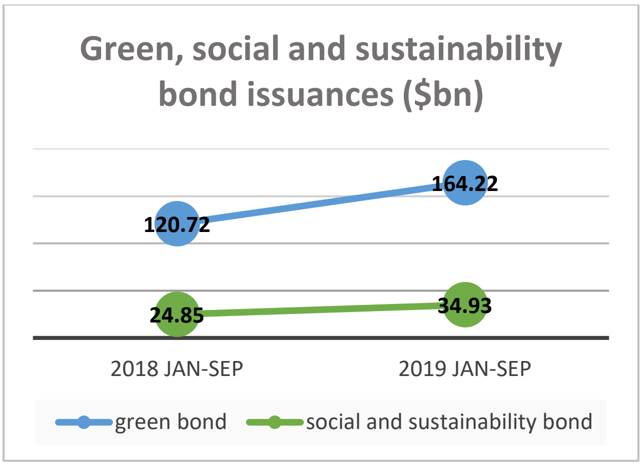
4. Green, social, and sustainability bonds

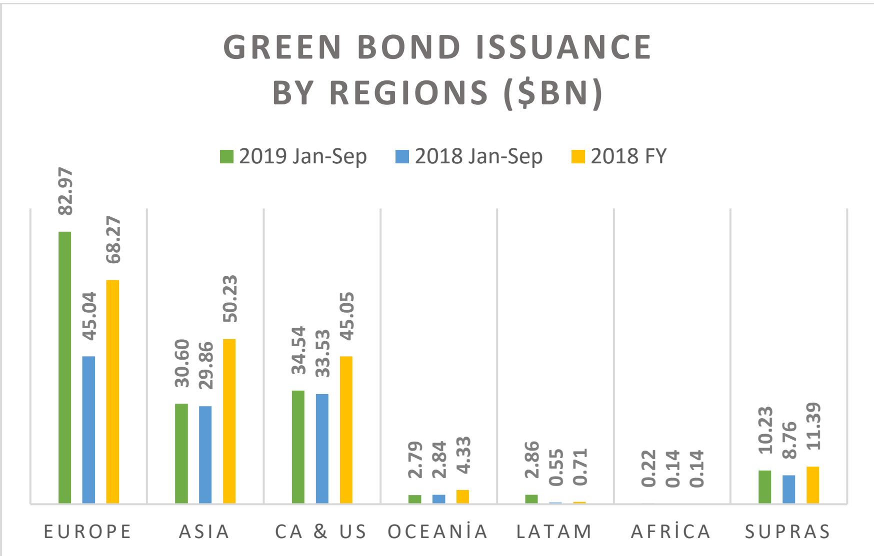
Market update

In 2019, green, social and sustainability bond supply has continued to expand considerably with the market expectations pointing to year-end numbers between USD210-240 billion for 2019. In this respect, the green bond issuance as well as social and sustainability bonds issuance have seen 36% and 41% growth in volume, respectively, for the first 9 months of 2019 compared with January to September in 2018.



Source: ICMA (based on Environmental Finance Database)

Regionally in the first 3 quarters of 2019, green bond issuance continues to be dominated by European issuance with a growing momentum where the region has seen 84% year-over-year increase already surpassing the total issuance of 2018. Supply from Asia and North America are in line with last year's track while Latin America has started to signal an increasing interest with issuance to date representing a fourfold increase (in volume) over the total in 2018.



Source: ICMA (based on Environmental Finance Database)

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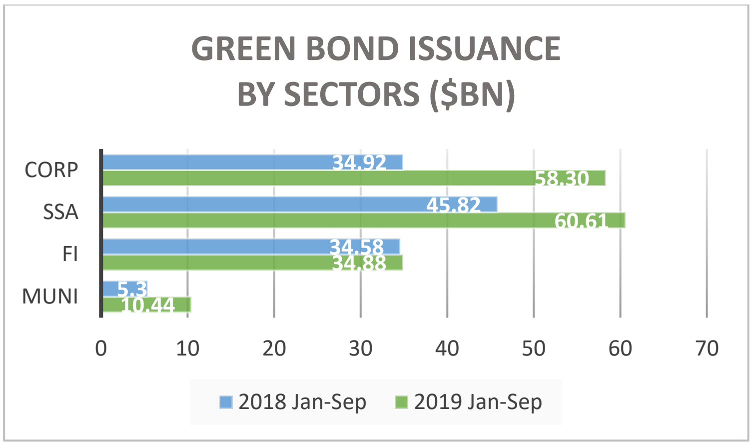
As for the sectoral breakdown, green bonds supply from corporates and SSAs has remarkably grown year-over-year, ie by 67% and 32% respectively. Issuance from FIs has been very close to volumes in 2018 for the same period.



Source: ICMA (based on Environmental Finance Database)

Notable transactions

Looking to wider developments in sustainable finance, Enel, the Italian energy company, launched on 6 September 2019 a "General Purposed SDG Linked Bond" by placing a USD1.5 billion bond on the US market. The bond issue, intended to meet Enel's ordinary financing needs, is linked to the group's ability to achieve, by the end of 2021, a percentage of installed renewable generation capacity (on a consolidated basis) equal to or greater than 55% of total consolidated installed capacity departing from today's figure of 45.9%. The operation has been structured as a single tranche issue of 1.5 billion US dollars paying a rate of 2.650% maturing in September 2024. The issue price has been set at 99.879% and the effective yield at maturity is equal to 2.676%.

The specificity of the bond is that the interest rate mechanics are linked to the achievement of the renewable generation capacity target. In other words, the interest rate will remain unchanged to maturity subject to achievement of the sustainability target indicated above as of 31 December 2021. If that target is not achieved, a step-up mechanism will be applied, increasing the rate by 25 basis points starting from the first interest period.

It's important to note that the structuring of this innovative Enel transaction draws from precedents in the loan markets and especially the Sustainability Linked Loan Principles (SLLP). The SLLP were published in March 2019 by the Loan Market Association, together with LSTA and APLMA, and with the support of ICMA. Sustainability linked loans are loan instruments and/or contingent facilities which typically incentivise through pricing the borrower's achievement of ambitious, predetermined sustainability performance objectives.

European Action Plan on Sustainable Finance

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The European Commission established the Technical Working Group on Sustainable Finance (TEG) in June 2018 following the publication in March 2018 of the Action Plan on sustainable finance. ICMA, with the support of the GBP SBP Executive Committee, was nominated on the TEG following a highly selective process. The TEG published on 18 June 2019 reports and guidelines relating to its 4 key deliverables (see here) on which ICMA has provided a summary review with comments. The TEG's mandate has been extended until the end of 2019 and continues its work especially with respect to the Taxonomy, the EU Climate Benchmarks and the EU Green Bond Standard.

EU Taxonomy

The report on the EU Taxonomy for sustainable activities published in June 2019 sets out the basis for a future EU Taxonomy in legislation. The TEG held a subsequent call for feedback on this report from 3 July until 16 September 2019. ICMA with the GBP Executive Committee provided a response to the consultation.

Our feedback through this consultation focused especially on usability issues raised by the Taxonomy for the green, social and sustainability bond market. We continue to emphasize that this market operates by identifying sustainable projects rather than activities.

ICMA also expressed concerns related to the applicability of the proposed Do No Significant Harm (DNSH) criteria. Issuers of Green Bonds will indeed likely be concerned about the potential legal liability/litigation risks of attesting DNSH especially outside the EU. The proposed DNSH requirements also involve quantitative thresholds based on EU legislation as proposed and may therefore be challenging for issuers with activities and/or projects largely based outside of the EU. Thus, ICMA recommends implementing DNSH criteria at the issuer level and not the project level, ie issuers must demonstrate that they have the right ESG policies in place to mitigate DNSH risks.

EU Green Bond Standard

The report on the EU Green Bond Standard proposes that the Commission creates a voluntary, non-legislative EU Green Bond Standard. It requires (i) alignment with EU-taxonomy, (ii) publication by the issuer of a Green Bond Framework confirming among other the voluntary alignment of green bonds issued with the EU GBS, (iii) mandatory reporting on use of proceeds (allocation report) and on environmental impact (impact report), and (iv) mandatory verification of the Green Bond Framework and of the allocation report by an external reviewer.

EU Climate Benchmarks

The TEG report on EU climate benchmarks and benchmarks' ESG disclosures published in June 2019 recommends a list of minimum standards for the methodologies for the EU Climate Transition Benchmark (EU CTB) and an EU Paris-Aligned Benchmark (EU PAB). The report's recommendations aim to address perceived risks of greenwashing and include disclosure requirements to improve transparency and comparability of information across benchmarks not only regarding climate-related information but also on a variety of ESG indicators.

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