

INTERNATIONAL CAPITAL MARKET ASSOCIATION

**Market Update to Asia Securities Forum
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THE ASIA-PACIFIC CROSS BORDER CORPORATE BOND SECONDARY MARKET

In recent years, secondary bond markets have undergone significant change, with post-crisis regulatory reforms, extraordinary monetary policy, and new technologies and innovation impacting market dynamics and reshaping market structures. ICMA, through the Secondary Market Practices Committee (SMPC), has been actively engaged with its members in monitoring market evolution, particularly with respect to the European investment grade corporate bond market. The SMPC has published two reports on the state and evolution of the European corporate bond market (2014¹ and 2016)², as well as reports on the European credit repo market (2017)³ and the European single name credit default swap market (2018).⁴ These reports are intended to provide market participants, regulators, policy makers, and other stakeholders with a deeper understanding of evolving market structure, and the dynamics shaping market quality and liquidity, as well as identifying potential risks for market efficiency and resilience.

During this time, ICMA has also expanded its work in the Asia-Pacific (APAC) region, significantly increasing its membership, creating an Asia-Pacific Regional Committee of members, as well as working collaboratively with a range of regional associations to promote the development of regulatory and market best practice initiatives. As part of its remit and commitment to serving its APAC members, and given that many of the current themes in the European markets have potential relevance in APAC as well, it was felt that a report on the state and evolution of the cross-border APAC secondary bond markets would be a valuable contribution to ICMA's members and partners, complementing ICMA's work on European credit markets and leveraging ICMA's international expertise in this field.

The [report on the state and evolution of the Asia-Pacific cross border corporate bond secondary market](#) is available on ICMA's website. Key findings include:

- The research points to the rapid rise in issuance and the size of the G3 (in particular US\$) corporate bond market since around 2010-11, and which has accelerated further in the past two years, driven primarily by Chinese financial and non-financial issuers coming to the market. From 2011 to 2017, annual G3 APAC corporate issuance has more than trebled to over US\$930bn, with Chinese names accounting for more than 40% of total issuance in 2017, compared with less than 20% in 2011.
- A number of participants pointed to what one dubbed the 'Asia-fication' of the APAC markets, with regional investment funds and life insurers beginning to dominate buy-side flows in G3 credit. Again, China is a large part of the story, with a spate of Chinese investment firms and securities companies opening offshore offices (primarily in Hong Kong).
- The interviews paint a mixed picture with respect to secondary market liquidity. Many participants suggest that, in general, liquidity for IG G3 corporates tends to be relatively good, although this is very much a function of the underlying issue size. Some also suggest that this has improved in the past two-to-three years. However, other respondents state that while bid-side liquidity is generally good, offer-side liquidity is much thinner, and that it is usually difficult to find offers in decent size clips. Some also note that relative to the

¹ ICMA, 2014, [The current state and future evolution of the European investment grade corporate bond secondary market: perspectives from the market](#)

² ICMA, 2016, [Remaking the corporate bond market: ICMA's 2nd study into the state and evolution of the European investment grade corporate bond secondary market](#)

³ ICMA, 2017, [The European Credit Repo Market: The cornerstone of corporate bond market liquidity](#)

⁴ ICMA, 2018, [The European Corporate Single Name Credit Default Swap Market](#)

increase in overall G3 corporate issuance and outstandings, secondary market trading volumes have lagged.

- A common topic raised by both sell-side and buy-side firms is the lack of development in underlying repo and securities lending markets for APAC G3 credit. To a large extent this seems to limit secondary market growth and activity. Participants explain that many regional investors do not lend their holdings back into the market, and that supply is largely contingent on hedge funds and international real money investors.
- Respondents report that there is generally little interest from investors in corporate SN-CDS, either as a hedging instrument or an alternative investment vehicle, particularly with the diminution of hedge fund involvement in the regional market.
- In terms of regulatory impacts, these are mostly imported from US and European regulation. Basel III has put pressure on the balance sheets and trading books of international banks, as has the Volcker Rule, while MiFID II/R is being 'globalized' by a number of European and international investment firms. Perhaps more significantly, regional regulators appear to be watching the impacts of MiFID with a view to introducing their own regulatory initiatives around transparency and best execution.
- While in many respects the Asia region leads the US and Europe in terms of financial technological innovation and adoption, the interviews, for the most part, point to a relatively slow uptake of trading platforms in the cross-border bond markets. The major global incumbent platforms also tend to lead in the APAC markets, with a handful of international and regional platforms carving out geographical and product niches. However, overall levels of e-trading, at least anecdotally, appear to be low compared to the US and Europe.
- The internationalization of LCY markets in the APAC region is of key interest to interviewees, in particular the opening up of the CNY domestic corporate bond market. While there remain a number of barriers to entry, in particular concerns around the transparency of issuers' balance sheets, the absence of reliable credit ratings, and uncertainty around Chinese bankruptcy and tax law, the general view is that international inflows into the CNY bond markets are set to accelerate.

BREXIT: CLIFF-EDGE RISKS IN INTERNATIONAL CAPITAL MARKETS

Cliff-edge risks: background

Given that the UK is proposing to leave the EU Single Market for financial services when it leaves the EU, cliff-edge risks in international capital markets will arise when passporting rights between the EU27⁵ and the UK cease. Passporting rights allow firms authorised in one EU Member State to provide services in other EU Member States without requiring authorisation or supervision from the local regulator.⁶ The European Commission explains the loss of passporting rights as follows: “Many operators, including from third countries, have established themselves in the UK and operate in the rest of the Single Market based on the passporting rights enshrined in the EU financial services legislation. These passporting rights will cease to exist after withdrawal. This means that the provision of financial services from the UK to EU27 will be regulated by the third country regimes in EU law and in the national legal frameworks of the respective Member State of the EU customers. There will be no Single Market access.”⁷

When will cliff-edge risks arise?

- Cliff-edge risks will arise most immediately if the UK leaves the EU without an agreement on Brexit on 29 March 2019.
- If there is an EU27/UK withdrawal agreement, as a result of which passporting rights continue during a transition period⁸ after Brexit, cliff-edge risks will still arise if there is no EU27/UK trade agreement at the end of the transition period at the end of 2020, unless the transition period is extended.
- And, even if there is an EU27/UK trade agreement, there will be cliff-edge risks if the agreement does not preserve existing passporting rights.

Ways of avoiding cliff-edge risks in general

International capital market firms have known for some time that they need to prepare for the risks of a cliff edge on Brexit. The question is: what is the best way of avoiding cliff-edge risks? The UK originally proposed to the EU27 that there should be mutual market access when passporting rights cease. This would have involved mutual recognition of each other’s regulatory standards, taking into account that EU27 and UK regulatory standards will be the same at the outset. Under this approach, the EU27 and the UK would have recognised each other’s regulatory standards, so long as they were consistent with equivalent regulatory outcomes, which would have been agreed in advance; and

⁵ And the rest of the European Economic Area (EEA) which also includes Norway, Iceland and Liechtenstein. The British Government has so far ruled out remaining within the EU Single Market by joining the EEA.

⁶ HM Government: *Banking, Insurance and Other Financial Services if here’s No Brexit Deal*, 23 August 2018.

⁷ European Commission: *Preparing for the Withdrawal of the UK from the EU on 30 March 2019*: Communication, 19 July 2018.

⁸ The British Government refers to the transition period after Brexit as an “implementation period”. The main change during the transition period after Brexit is that the UK will no longer have any say over new EU regulatory standards.

there would have been an agreed mechanism for resolving disputes. But this approach was rejected by the EU27, on the grounds that the EU27 needs to be autonomous in its decision-making.

(i) Enhanced regulatory equivalence between the EU27 and the UK

In those circumstances, as there is no consensus on a way forward under mutual recognition, international capital market firms have two main options. One option for firms with operations in the UK is to make use of EU provisions on regulatory equivalence for third countries (ie countries outside the EEA). This is currently a patchwork:

- It applies to some parts of the EU regulatory framework, but not others; and, in EU regulations where it does apply, it is not always complete:⁹ provisions for regulatory equivalence have so far evolved piecemeal, case by case.
- It requires a judgment by the European Commission as well as a technical assessment, and it takes time to assess.
- The determination of equivalence by the Commission can be withdrawn at short notice, though this has not happened so far.
- The assessment of regulatory equivalence is based on measuring outcomes, but outcomes are not straightforward to measure, as in the case of mutual recognition.
- Unlike mutual recognition, regulatory equivalence would be determined unilaterally by the EU27 and the UK in their respective markets, not jointly by both the EU27 and the UK.¹⁰

(ii) Authorisation to operate in both the EU27 and the UK

Regulatory equivalence is useful for international capital market firms, but it is not likely to be a complete solution; and it will not be a complete solution if it is limited in scope to the regulatory equivalence available to other third countries at the moment. If it is not possible to rely solely on regulatory equivalence, the other option for international capital market firms is to ensure that, before passporting rights cease, they are authorised to provide financial services in both the EU27 and in the UK, even though this is likely to involve higher costs for them (eg in terms of extra capital and liquidity) and for their business customers than at present. Most large international capital market firms either have authorised operations in the EU27 and the UK already or are seeking authorisation to do so, as long lead-times are involved. But those which have not yet done so need to consider this option carefully, given the long lead-times involved and the shortage of time available. Market firms are likely to be in a better position to avoid cliff-edge risks after passporting rights cease if they are authorised to operate in both the EU27 and in the UK.

⁹ For example, services not covered include: wholesale lending and deposit-taking in CRD; some areas of investment firm activity in MiFID; and wholesale insurance within Solvency II: HM Government: *Framework for the UK-EU Partnership: Financial Services*, 25 July 2018.

¹⁰ See also Chancellor of the Exchequer: "Our financial regulatory frameworks are in effect identical. It is inconceivable that the mutual benefits of this relationship could be preserved by an "off-shelf" model, such as the EU's existing equivalence framework for third country financial services relationships.": *An Alternative Approach for Britain's Financial Services*: FT, 13 July 2018.

On behalf of the EU27, the European Central Bank (ECB), the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have all drawn attention to the need for market firms to be authorised in the EU27 in order to be able to operate there after passporting rights between the UK and the EU27 cease:

- The ECB and national supervisors “expect banks to continue to prepare for all possible contingencies, including a no-deal scenario leading to a hard Brexit with no transition. Banks are responsible for ensuring that all authorisations required for them to carry out their activities as envisaged are in place in a timely manner.”¹¹
- The EBA has asked national competent authorities to ensure that financial institutions take practical steps now to prepare for the possibility of UK withdrawal from the EU with no ratified withdrawal agreement in place, and no transition period between 29 March 2019 and the end of 2020.¹²
- The ESMA has reiterated its own concerns on the timely submission of applications for authorisation to operate in the EU27; and encouraged UK-based regulated entities to prepare for the possibility that the UK and the EU27 will fail to agree on a withdrawal agreement, with the result that there is no transition period.¹³

Specific cliff-edge risks

Apart from cliff-edge risks in general when passporting rights cease, there are a number of specific cliff-edge risks in international capital markets involving the EU27 and the UK. It appears that, on Brexit, firms will in general be able to carry out contractual obligations already agreed between UK and EU27 entities on cross-border financial contracts.¹⁴ But when passporting rights cease, market firms may no longer be able fully to service some outstanding contracts across EU27/UK borders.¹⁵ There are also a number of other specific cliff-edge risks which arise when passporting ceases. For example, specific cliff-edge risks include:

- the risk that it may not be possible for EU27 and UK parties to continue to perform some existing cross-border insurance contracts by paying claims to, or receiving premiums from, policyholders in the other jurisdiction;

¹¹ ECB: *Relocating to the Euro Area*: updated on 2 August 2018.

¹² EBA Opinion, 25 June 2018.

¹³ *ESMA Reminds UK-Based Regulated Entities about Timely Submission of Authorisation Applications*, 12 July 2018.

¹⁴ Financial Markets Law Committee (FMLC): “The FMLC is in agreement with the European Commission’s Communication of July 2018 and considers it unlikely that Brexit will give rise to issues of contractual continuity in a general sense and so far as it is a matter of English law and jurisdiction.” *UK Withdrawal from the EU: Issues of Legal Uncertainty Arising in the Context of Robustness of Financial Contracts*: August 2018.

¹⁵ See, for example, ISDA and AFME: *Contractual Continuity in OTC Derivatives: Challenges with Transfers*: “The loss of EU financial passporting rights after Brexit will have implications for cross-border OTC derivatives contracts between UK and EU27 firms and their EU27 and UK clients and counterparties respectively where those firms currently rely on an EU passport to trade cross-border in the EU27 or the UK.”: July 2018.

- the risk that EU27 and UK parties may no longer have the necessary permissions to service over-the-counter (OTC) derivative contracts with parties in the other jurisdiction;¹⁶
- the risk that central counterparties (CCPs) may no longer be recognised across borders with the result that EU27 and UK CCPs may find that they are in breach of regulation by providing clearing services in the other jurisdiction, requiring abrupt close-out of positions;
- the risk that the holding and sharing by the EU27 and UK of each other’s data may be in breach of national law, with the result that barriers to the cross-border flow of personal data disrupt the provision of financial services;
- the risk that liabilities already issued under UK law may be considered in the EU27 like any other liability governed by the law of a third country, with the effect that they no longer count towards the minimum capital requirement for own funds and eligible liabilities (MREL);
- the risk that, under MiFID II/MiFIR, data thresholds set for the EU as a whole may no longer be relevant;
- the risk that automatic recognition of resolution actions under the Bank Recovery and Resolution Directive across the EU may no longer apply between the EU27 and the UK; and
- the risk that delegation of fund management across borders between the EU27 and the UK may be restricted or suspended if there is no agreement on third country cooperation.

Ways of avoiding specific cliff-edge risks

18 If these specific cliff-edge risks cannot be avoided, the resulting fragmentation in the functioning of international capital markets, and associated market uncertainty, will damage growth in the real economy and damage financial stability. This appears to be common ground between the EU27 and the UK. However, there are different views between the EU27 and the UK about how to avoid them.

(i) Private sector approach

19 The European Commission and the EBA have both emphasised the role of the private sector in avoiding cliff-edge risks:

- In his reply to ICMA’s open letter, the European Commissioner says that he has “at this stage the impression that most of those risks can be addressed through timely adaptation by the industry”.¹⁷ (See box.)

¹⁶ Scott O’Malia, Chief Executive, ISDA: “Many other critical actions that take place during the life of a derivatives trade will be disrupted. These so-called lifecycle events include material amendments to contractual terms, the rolling over of trades and trade compression. These occur on a daily basis and are vital to the efficient functioning of the derivatives market. In fact, some – like trade compression – are important risk management techniques required by EU regulation: Letter to the FT, 4 July 2018.

¹⁷ Extract from the letter of Valdis Dombrovskis, Vice President of the European Commission to Martin Scheck, 19 July 2018.

- The EBA has given its opinion that financial institutions should take adequate steps to mitigate the impact of Brexit without relying on possible public sector solutions that may not be proposed and/or agreed in time. This involves not only ensuring that they have the correct regulatory permissions and associated management capacity in place in time, but also addressing any impact on rights and obligations of their existing contracts, in particular derivative contracts.¹⁸

(ii) Public sector approach

20 By contrast, the Bank of England Financial Policy Committee argues that “it would be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risks of disruption to households and businesses.”¹⁹ This is because it is not feasible for international capital market firms to address all the potential cross-border contractual issues – including the associated requirements for repapering – that arise when passporting rights cease through private sector negotiation alone, given the shortage of time available.²⁰

21 The UK is introducing a Temporary Permissions Regime, which will allow EEA firms and funds using a UK passport to continue to operate for up to three years after Brexit without needing to apply for authorisation at this stage. The UK has also made a commitment to legislate, if necessary, to ensure that contractual obligations (such as under insurance contracts) between EEA firms and UK-based customers that are not covered by the Temporary Permissions Regime can continue to be met.²¹ And the UK is proposing Temporary Recognition Regimes for CCPs, central securities depositories, credit rating agencies, trade repositories, data reporting service providers, systems currently under the Settlement Finality Directive and depositories for authorised funds.²²

(iii) A joint approach?

The best way to address cliff-edge risks is through a joint statement by the EU27 and the UK in, or in a side letter alongside, the withdrawal agreement. This should include provision for continuity of cross-border financial contracts between the EU27 and the UK by “grandfathering” all such financial contracts outstanding at the point at which passporting ceases.²³ Something similar was done when

¹⁸ EBA: “While the political agreement on a transition period is welcome, it will not be given legal effect until there is a ratified withdrawal agreement in place. This is not guaranteed, and in any event, it will only come at the end of the Article 50 process.”: Opinion, 25 June 2018.

¹⁹ Bank of England Financial Policy Committee minutes: Minutes of the meeting on 19 June 2018, published on 3 July.

²⁰ Scott O’Malia, Chief Executive of ISDA: “The problem is not the notional figure but the substantial number of contracts that would have to be transferred and the number of counterparties that would individually have to agree to the transfer in a short period of time. A transfer of this scale has never before been attempted and is operationally unlikely without regulatory and legislative support from the EU and the UK.”: Letter to the FT, 4 July 2018.

²¹ Some cross-border contracts have been transferred by large insurance companies from the UK to the EU27: FT, 27 August 2018.

²² HM Government: *Banking, Insurance and Other Financial Services if There’s No Brexit Deal*, 23 August 2018.

²³ See, for example, ISDA and AFME, *op. cit.*: “The withdrawal agreement should contain appropriate provisions both facilitating contract transfers or novations to EU entities and allowing firms to continue to

several EU national currencies were replaced by the euro on 1 January 1999. If it is not possible to use the withdrawal agreement, a separate agreement is needed between the EU27 and the UK, or alternatively the EU27 could make a commitment to provide its own Temporary Permissions Regime, as the UK has already done: the sooner the better; and the sooner there is a joint statement of intent by the EU27 and the UK, the better, given the shortage of time available.

Conclusion

When passporting rights between the EU27 and the UK under the Single Market in financial services cease, there are cliff-edge risks for international capital market firms operating cross-border between the EU27 and the UK, particularly in cases in which they are not yet authorised to operate in both the EU27 and the UK and they rely on the Single Market for access. These cliff-edge risks will arise on Brexit, if there is no withdrawal agreement which includes a transition period after Brexit; and even if there is a transition period, they may still arise at the end of it, depending on the form of the trade agreement negotiated between the EU27 and the UK. The best way of avoiding these risks is by agreement between the EU27 and the UK. To remove uncertainty and prevent instability in international capital markets, agreement is needed as soon as possible.

service legacy contracts after the end of the transition period at least to the extent such transfers or novations cannot be effected within an appropriate amount of time. However, there should also be coordinated backstop arrangements that apply if a withdrawal agreement is not concluded.”: July 2018.

THE TRANSITION TO RISK-FREE RATES IN THE BOND MARKET

The problem with LIBOR

In a speech in July last year, the Chief Executive of the UK Financial Conduct Authority (FCA) said that the FCA would no longer intend to use its powers to persuade or compel banks to submit contributions for LIBOR after the end of 2021; and would not in any case be in a position to compel banks to submit contributions indefinitely under the EU Benchmark Regulation.²⁴ There are three related reasons why there has been a problem with LIBOR:

The first reason why there has been a problem with LIBOR is that the underlying structure of financial markets has changed since the financial crisis. As the Governor of the Bank of England has explained: “LIBOR has not kept up with market developments. LIBOR is meant to measure the short-term unsecured funding costs of banks. But the reality is that, since the financial crisis, LIBOR really has become the rate at which banks do not lend to each other. Bank funding markets have changed enormously. Banks no longer take sufficient short-term wholesale deposits to form the basis for a robust transaction-based LIBOR benchmark. As a result, LIBOR is overly reliant on expert judgment rather than actual transactions. And global markets remain overly reliant on LIBOR, a benchmark that may not exist beyond 2021. That reliance is neither desirable nor sustainable.”²⁵

The second reason why there has been a problem relates to the implications of LIBOR for financial stability. As the President of the Federal Reserve Bank of New York has said: “The essential problem with LIBOR is the inherent fragility of its “inverted pyramid”, where the pricing of hundreds of trillions of dollars of financial instruments rests on the expert judgment of relatively few individuals, informed by a very small base of unsecured interbank transactions. So despite efforts to improve LIBOR in recent years – and there undoubtedly have been important changes that have strengthened its administration and governance – the lack of underlying market liquidity for nearly all currencies and maturities remains a problem, and there is no obvious solution.”²⁶

The third reason why there has been a problem with LIBOR relates to the scope for manipulation. As the Chair of the European Securities and Markets Authority has said: “The globally most relevant interbank interest rates benchmarks, like LIBOR and EURIBOR, were unregulated and their methodologies and governance allowed manipulation on a scale rarely seen in the financial sector.”²⁷

Risk-free rates as the alternative to LIBOR

To avoid the problems associated with manipulation of LIBOR in the past and the financial stability risks arising from LIBOR in the future, the authorities want financial markets to transition from the IBORs (eg LIBOR) to near Risk-Free Rates (RFRs). It is estimated that contracts with a total notional

²⁴ Andrew Bailey, Chief Executive of the FCA: *The Future of LIBOR*, 27 July 2017.

²⁵ Mark Carney, Governor of the Bank of England: *Staying Connected*: Markets Forum 2018, Bloomberg Headquarters, 24 May 2018.

²⁶ Bill Dudley, President of the Federal Reserve Bank of New York: *The Transition to a Robust Reference Rate Regime*: Bank of England’s Market Forum 2018, Bloomberg Headquarters, 24 May 2018.

²⁷ Steven Maijor, Chair of ESMA: *Towards Benchmark Stability and Integrity*: ICMA Annual Conference, Madrid, 31 May 2018.

value of around \$350 trillion are referenced to the IBORs: mainly in the derivatives markets; but the cash markets in the form of loans and bonds, representing the real economy, constitute a significant proportion of the overall total.

RFRs have been chosen in the UK (SONIA), US (SOFR), Switzerland (SARON) and Japan (TONAR), and the choice of an RFR is currently being considered in the euro area.²⁸ All the RFRs are overnight rates. Some are secured (like SOFR in the US) and some unsecured (like SONIA in the UK). In the UK, the choice of SONIA has three main benefits over LIBOR: it represents conditions in a deep underlying market; its design is robust to future changes in money markets because, if necessary, SONIA's data inputs can evolve; and it is a better reflection of the general level of interest rates than LIBOR, which is affected by fluctuations in the perceived credit quality of banks.²⁹

A common objective is to make the RFRs as robust as possible. For this purpose, robustness is measured primarily by the volume of observable transactions.³⁰ The authorities want to prevent a repetition of the main problem with LIBOR: banks submitting quotes have had to rely on "expert judgment" owing to an insufficient volume of observable transactions. In the UK, one of the main advantages of reformed SONIA (as from 23 April 2018) is that the average daily volume is over three times larger than the SONIA rate it has replaced.

Interest rate benchmarks are now regulated by the European Benchmarks Regulation (BMR), which originally entered into force in June 2016, and will apply fully from January 2020. Globally, the BMR is the only binding set of rules covering all types of indices. It governs the provision as well as the use of benchmarks by supervised entities in the EU, including those provided in third countries. Under the BMR, the most significant interbank interest rate benchmarks – EONIA, EURIBOR and LIBOR – are critical benchmarks supervised by supranational colleges.³¹

To make the transition from IBORs to RFRs work well, the authorities and market participants need to work together. Risk-Free Rate Working Groups have been set up in all the five main IBOR jurisdictions. ICMA is involved in the Risk-Free Rate Working Group in the UK (working with the FCA and the Bank of England); the Euro Risk-Free Rate Working Group (organised by the ECB, ESMA, the European Commission and the FSMA); and the Swiss National Working Group (chaired by the Swiss National Bank and ZKB).

The authorities recognise that the cash markets – ie loans and bonds – need to be represented in the RFR Working Groups, and not just the derivatives markets. In the UK, for example, new Sub-Groups have been formed to cover loans – chaired by LMA – and bonds, chaired by ICMA. The Bond Market Sub-Group is representative of the sterling bond market as a whole, including public sector, corporate sector and financial sector issuers, asset managers and investors, banks involved in the

²⁸ No decision has yet been taken about a euro RFR to replace EONIA by the end of 2019, but the ECB has announced its intention to use the statistical data it has been collecting since 2016 to provide an unsecured euro overnight rate (ESTER), probably in the second half of 2019.

²⁹ See Mark Carney, Governor of the Bank of England: *Staying Connected*: Bank of England Markets Forum 2018, Bloomberg Headquarters, 24 May 2018.

³⁰ Bill Dudley, President of the Federal Reserve Bank of New York: "[SOFR] is entirely transaction-based, and the underlying market is robust, with current daily volume of more than \$700 billion. (By comparison, unsecured three-month US-dollar wholesale borrowing totals roughly \$1 billion per day.)": *The Transition to a Robust Reference Rate Regime*: Bank of England Markets Forum 2018, Bloomberg Headquarters, 24 May 2018.

³¹ See Steven Maijor, Chair of ESMA: *Towards Benchmark Stability and Integrity*: ICMA Annual Conference, Madrid, 31 May 2018.

primary and secondary markets, four law firms (working together), and trade associations with an interest, with the FCA and Bank of England providing the Secretariat.

The transition to risk-free rates in the bond market

In the sterling bond markets, LIBOR is used as a reference in floating-rate notes (FRNs), securitisations and also capital securities, where LIBOR is used to reset an earlier fixed rate coupon to a floating rate at the end of a fixed period of time. In each case, the key issues that need to be addressed relate to: adoption of risk-free rates; conversion of legacy transactions; coordination between cash and derivatives markets and between different IBOR jurisdictions; and the need to raise awareness in the market of the proposed change.

(i) Adoption

Considerable progress is already being made towards the adoption of risk-free rates in the derivatives market, starting with the choice of overnight risk-free rates. Adoption of risk-free rates represents a challenge in the cash markets. The bond market currently references term LIBOR, with a floating rate which is normally reset for periods of three or six months in advance:

- One option is to replace term LIBOR in new bond market transactions with a forward-looking term rate derived from SONIA as the RFR. Forward-looking term SONIA would be the nearest RFR-based equivalent to forward-looking term LIBOR. Interest payments would be known in advance. There would be only one main change: from an interbank offered rate to a risk-free rate, which is economically not the same. But forward-looking term RFRs would take a considerable period of time to develop. They would also be unlikely to be as robust as an overnight RFR, as the volume of observable transactions would be likely to be lower.
- Another option is to replace term LIBOR with backward-looking SONIA, compounded overnight in arrears.³² As this is an overnight rate, which has the largest volume of observable transactions, it would be a more robust rate than a forward-looking rate, and the market convention would be the same as is already used in the swap market. But under a backward-looking RFR, interest payments on term transactions would not be known in advance, and users would need to make two changes: a change from a forward-looking rate to a backward-looking rate as well as a change from an interbank offered rate to a risk-free rate. Making the change to a backward-looking rate would take time and cost money. It is not yet clear to what extent the sterling bond market would be willing to use backward-looking rates.
- A third option is for the market to be offered a choice between forward-looking and backward-looking rates, though this might split liquidity between them. Some market participants may also be reluctant to spend time and money preparing for backward-looking rates first in the expectation that they may be able to use forward-looking term RFRs, if and when they become sufficiently robust, later.

In the meantime, new bonds are still being issued referencing LIBOR with maturities beyond the end of 2021 (ie the date after which the availability of LIBOR is no longer guaranteed). If LIBOR were no longer available, the documentation for many existing FRNs specifies that the interest rate would become fixed at the most recent LIBOR rate for the issue concerned, though alternatives have been

³² A margin (or spread) would be added, but not compounded. This would make it as easy as possible for a table of compounded rates to be published each working day for market use.

used in some other cases. A fixed rate fall-back was originally designed in case LIBOR was temporarily unavailable. It was not designed with a view to the permanent cessation of LIBOR.

Users of the bond market need to be aware of the risks involved in issuing, selling and buying new bond issues referencing LIBOR with maturities beyond 2021, in case LIBOR ceases to be available after that date. Sell-side firms may need to consider the suitability of selling such products to certain investors and the duty of care they owe to their customers. It is also important to find a new workable fall-back for any new LIBOR transactions in place of current fall-back provisions.³³

(ii) Conversion

In the cash markets, conversion of legacy bonds would be more complex than converting derivatives. Indeed, in the derivatives market, ease of conversion was one of the reasons for choosing reformed SONIA in place of LIBOR. Unlike the derivatives market, which uses protocols to amend large volumes of contracts, protocols are not – and may not be able to be – used in the bond market. In general, amending the terms of bond issues requires bondholder consent. The threshold for bondholder consent is generally set at a high level, so it would be very difficult, time-consuming and expensive to obtain bondholder consent to make the changes that would be necessary for conversion. The outcome could not be guaranteed, without legislative intervention, which would need to be coordinated across different jurisdictions internationally.

The difficulty with conversion is not so much a problem in the case of short-dated legacy bond issues, which will mature while LIBOR continues to be available, as long as they can continue to be hedged effectively in the meantime: ie when the bond is referenced to LIBOR, but the associated derivative is referenced to SONIA. But it is much more of a problem in the case of longer-dated bond market issues, which are due to mature after the date when LIBOR may no longer be available, and which are likely to fall back to a fixed rate in those circumstances.

In addition, there is a question about whether a credit adjustment spread would need to be applied as a result of the replacement of LIBOR (which includes bank credit risk) by risk-free rates (which do not). Any such credit adjustment spread would need to treat both issuers and investors fairly, so as to avoid the risk of creating winners and losers.

18 The task of converting legacy bond issues from LIBOR to SONIA will grow in scale, so long as new continue to reference LIBOR, unless there are changes to documentation in the meantime to make conversion easier, including provision for a new fall-back. And if LIBOR continues to exist after 2021 in whatever form, it is likely that LIBOR will continue to be used for legacy bonds, even if the fall-back provisions have been modified on new transactions. This is because current fall-back provisions will not be triggered unless or until LIBOR ceases to be available.

(iii) Coordination

There is general agreement that international coordination is needed between the bond markets and the derivatives markets during the transition from the IBORs to risk-free rates, as new bond issues are frequently hedged in the derivatives market. It would also help if there is international coordination both in agreeing fall-backs on new contracts referencing RFRs, in case LIBOR ceases to be published, and in setting the triggers under which the fall-backs would be used.

³³ See the letter to ISDA from the Financial Stability Board Official Sector Steering Group (OSSG) Co-Chairs, Sub-Group on Contractual Robustness, 18 April 2018: “ISDA should develop a methodology for fall backs in the 2006 ISDA Definitions that could be used in the absence of suitable term rates. We strongly suggest that the ISDA Sub-Group focuses on calculations based on the overnight rates selected by the RFR working groups.

In addition, coordination is important between the different IBOR jurisdictions. The authorities already work together through the Official Sector Steering Group of the Financial Stability Board.³⁴ There are some differences between plans for the use of RFRs in the IBOR jurisdictions. As regards timing, risk-free rates have already been chosen in the US and the UK, but in the euro area work is still being undertaken on choosing a risk-free rate. And there are some differences of approach: some overnight risk-free rates are secured and some unsecured; in the term market, it is not yet known whether term RFRs in some jurisdictions will be forward-looking while RFRs in other jurisdictions will be backward-looking; and in the UK, term LIBOR is due to be replaced by SONIA, whereas in the euro area it is not yet clear whether EURIBOR will be reformed or whether it will need to be replaced. However, the question is how much these differences matter, given that the underlying direction of travel towards risk-free rates is the same in all jurisdictions.

³⁴ The OSSG is chaired by Andrew Bailey, Chief Executive of the FCA, and Jerome Powell, Chair of the Federal Reserve Board. In addition, the Bank of England, Bank of Japan, Swiss National Bank, European Central Bank, European Commission, FSMA and ESMA and many other official institutions are involved.

GREEN, SOCIAL, AND SUSTAINABILITY BONDS

Market performance

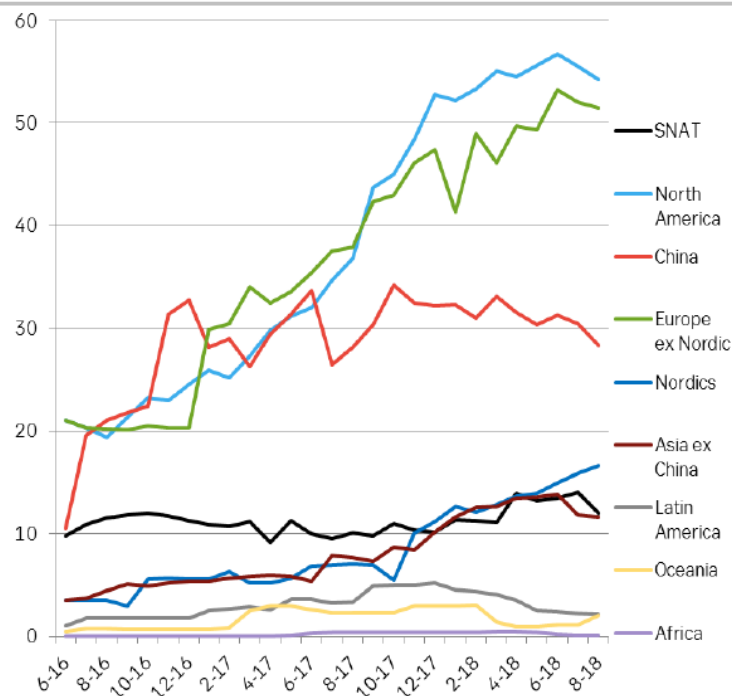
Global issuance of green bonds continues to grow strongly. Preliminary data for H1 2018 indicates that compared to H1 2017 global issuance grew 21% to US\$85 billion (source: SEB, unless stated). Growth was robust in early Q3, with issuance at end August passing \$97 billion (+19% year-on-year). Significantly, cumulative green bond issuance closed around US\$500 billion at end August, reflecting improving liquidity and portfolio diversification opportunities.

In H1, issuance from corporates and financials grew especially well (+40% to US\$44 billion and more than double to US\$27 billion respectively). So far this year, issuance volume has become more evenly balanced between SSAs and corporate/financial issuers, although agency ABS/MBS tips the balance in favour of SSAs. Fannie Mae, which in June announced a new green bond framework aligned with the GBP, led securitisation and wider green bond market volumes in H1 with issuance of a remarkable US\$10.2 billion.

Renewable energy continued to be the largest use of proceeds at 48%, followed by green buildings and sustainable transportation at 26% and 14%, respectively.

Geographically, issuance remained diverse, coming from no less than 34 jurisdictions (as of end-August), including three new countries - New Zealand, Iceland and Lebanon. The top five slots were obtained by the US, China, supranationals, France and Belgium. The regional picture shows impressive growth in issuance, on a rolling 12-month basis, in multiple regions – including North America, Europe and Asia ex-China (see Figure 1 below).

Figure 1: Last Twelve Months Analysis by Region (US\$ billion)



Source: SEB analysis based on Bloomberg and SEB data.

Leading issuance currencies were correlated with the geographic picture set out above as well as global bond market flows, with EUR (40% year to end-August) and USD (34%) dominating, followed

by CNY (13%). The exceptional role of Scandinavian issuers was reflected by SEK taking fourth place (6%).

The social and sustainability bond segment has also been growing, with amounts outstanding now at \$44 billion by end H1. Social bond flows in H1 2018 totalled US\$ 4.7 billion, with outstandings reaching US\$15 billion, whilst sustainability bonds were somewhat more popular, with flows of US\$7.5 billion, taking outstandings up to US\$29 billion.

GBP SBP Executive Committee priorities

The GBP SBP Executive Committee held a physical meeting, kindly hosted by the EBRD in London on 20 September 2018, to consider its 2018/19 priorities. The forthcoming annual consultation's main themes and timelines were identified during the session. GBP SBP members and observers will be asked for their feedback by the second half of November 2018. The Executive Committee also discussed potential updates to the governance of the Principles.

It was confirmed that the six following working groups and taskforces will pursue their tasks during the next months: Index and Database; Green Projects Eligibility; Impact Reporting; Social Bonds; New Markets and Research. The Terms of References of those working groups and their expected deliverables will be made publicly available in the coming weeks.

Additional feedback on the themes of this meeting have been given to GBP SBP members on a conference call held on 5 October 2018.

Tokyo conference

ICMA and the Japan Securities Dealers Association (JSDA) will hold their second joint Conference on Developments in [second joint Conference](#) on Developments in Green and Social Bond Markets on 11 December 2018 in Tokyo. This follows the exceptional response to the first such conference last year, with around 500 registrations. It also responds to the momentum of the market in this region. In Asia, the Asia-ex-China region has grown most rapidly in the past 12 months, with issuance growing almost 300% to US\$14 billion (to end-August 2018). China remains the largest market in Asia, with close to US\$30 billion issued in the last 12 months.

European Technical Expert Group on Sustainable Finance

The European Commission released on 8 March an [Action Plan on Sustainable Finance](#) that follows many of the recommendations of the [High Level Expert Group \(HLEG\) on Sustainable Finance](#). In order to support the implementation of its Action Plan, the Commission further announced on 13 June the establishment of the [Technical Working Group on Sustainable Finance](#) (TEG) of which ICMA, represented by Nicholas Pfaff, has been nominated following a highly selective process. The main tasks of the group are to assist the Commission in the development of:

- an EU taxonomy of environmentally sustainable economic activities;
- an EU Green Bond Standard;
- a category of "low carbon" indices for use by asset and portfolio managers as a benchmark for a low carbon investment strategy;
- metrics allowing improving disclosure on climate-related information.

In addition to ICMA, the [members of the group](#) represent a wide variety of financial and economic actors as well as non-governmental agencies and academics. Several European and international

institutions contributing to the development of sustainable finance have also been invited as members or observers to the group. They include among other representatives from the European Supervisory Authorities, the European Central Bank, multilateral development banks (such as the European Investment Bank and the European Bank for Reconstruction and Development), the Central Banks and Supervisors Network for Greening the Financial System and the Organisation for Economic Co-operation and Development.

The TEG has held three plenary meetings since its inception in early July 2018. Its mandate will run until 30 June 2019, with possible extension until the end of 2019. At this early stage and with reference to its published [status](#), the progress and orientations of the TEG can be summarised as follows:

- The future EU taxonomy, commencing with definitions of environmentally sustainable activities will build on similar, existing market-led and Member State-based initiatives. Its objective among other is to facilitate the achievement of the EU's mid- and long-term greenhouse gas (GHG) emissions targets and environmental policy objectives by encouraging capital flows to environmentally sustainable economic activities. The taxonomy will serve as the basis for the future establishment of standards and labels for sustainable financial products.
- The EU Green Bond Standard (GBS) will draw on the EU taxonomy and will refer to an external verification process envisaged, as is common practice for green bonds in the EU market already today. Discussions regarding the granularity of requirements placed upon the verification process and the scope of the EU GBS are ongoing. Given the relatively well-developed EU market for green bonds, the EU GBS could focus on maintaining and reinforcing market integrity and establishing the basis for a recognised international standard.
- Benchmarks play a central role in the price formation of financial instruments and provide a useful tool for investors, as they allow tracking and measuring performance and for allocating assets accordingly. Existing ESG benchmarks are seen as lacking transparency with regards to their methodologies and fund managers pursuing a low-carbon or Paris-aligned investment strategy may lack a reliable index to benchmark their performance against. The work on the low carbon benchmarks is focused on selection criteria, data needs, and weighting methods for underlying assets of such benchmarks. This includes determining the key elements of minimum standards for low-carbon and positive carbon impact benchmarks. The importance of ensuring the comparability and reliability of data used for the construction of these benchmarks has also been underlined. The proposed low-carbon benchmark (LCB) would be used for risk diversification and the positive carbon impact benchmark (PCIB) for investing with impact.
- The starting points for the work on climate related disclosures are the existing guidelines to the [Non-Financial Reporting Directive](#) (NFRD) and the recommendations of the [Task Force on Climate-related Financial Disclosures](#) (TCFD). The work of the TEG will build on and further develop the TCFD recommendations. For example, the group has also taken up the challenge of identifying disclosure metrics that could give meaningful information about the impact a company has on climate change. Both climate change mitigation and adaptation are part of the scope.

Reflecting its engagement and support for the Green, Social and Sustainability Bond market and its key role in providing the Secretariat for the GBP & SBP, ICMA is involved as a priority in the

discussions on the future EU GBS and on its link with the EU Taxonomy. We are stressing, among other things, that the work on the EU GBS should avoid accompanying regulatory initiatives that could have possible unintentional negative outcomes such as the crystallization of liabilities and/or additional costs. It is important to underline that the international green, social and sustainable bond market already benefits from a very effective global self-regulatory initiative, coordinated by the Executive Committee of the GBP & SBP, that provides a full range of guidance for market participants including guidelines for issuance, reporting and external reviews.

In parallel, ICMA is monitoring aspects of the Commission's plans such as for [investor duties](#) that may impact more particularly its buy-side members. The Commission held a public consultation on this topic that closed in January 2018. The Commission aims now to prepare delegated acts regarding the duties of institutional investors and asset managers. EIOPA and ESMA have been invited to provide [technical advice](#) for these delegated acts by 30 April 2019. The delegated acts for which the Commission seeks technical advice by EIOPA and ESMA would introduce level 2 amendments under UCITS, AIFMD, MiFID II, Solvency II and IDD with "the aim of incorporating sustainability risks, ie environmental, social and governance risks in the decisions taken and processes applied by financial market participants subject to those rules". ICMA's Asset Management and Investors Council is creating a sustainability contact group to follow specifically these potential developments as well as others related to the Commission's Action Plan.