

# ICMA Regulatory Policy Newsletter

## Quarterly Assessment – Issue No. 13: April 2009

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## Corporate bonds: stable yields in unstable times

*Foreword by Martin Lee-Warner, ICMA Board member and Chairman of the Committee of Regional Representatives*

We are in the midst of a global recession, which is clearly having a significant effect on the capital markets. Although there does appear to be some light at the end of the tunnel (or is this purely optimism?), there are some signs of a more positive trend in the credit markets, particularly in high-grade issuance. The impact of subdued activity in global economies is becoming increasingly clear in manufacturing, with the consequence of many companies compensating declining sales by scaling back investment and reducing personnel.

In the current situation, many companies are paying increasing attention to bondholder interests, rather than shareholder interests. This year's principal business priorities include obtaining sufficient liquid funds, generating strong free cash flow and reducing debt levels. Particularly positive for bondholders are plans that many companies must deleverage. On the other hand, numerous companies have stated that they intend to reduce or even cancel dividends, and temporarily suspend share buy-back programmes; such measures having negative effects on shareholders. For 2009, corporate bonds are likely to be a more attractive asset class in comparison to equities. While stock indices have reached lows not seen in decades, corporate credit non-financial indices have remained stable, and indeed managed to post positive performances in the first quarter.

The main factor behind this favourable trend on the credit market is brisk activity

on the primary market. In the first quarter, close to €120 billion in non-financial corporate bonds has been issued in the euro area (under €25 billion in same period of 2008). Globally the figure is triple this and well in excess of what is due to be repaid in the first quarter. The most active sectors with the largest issue volumes have been utilities, telecoms and the auto industry, even though there has been a strong repricing of credit risk. This has helped to relieve refinancing pressure on companies; indeed some of these funds are to build war chests for acquisitions and some to cover debt repayments in extended time horizons. Newly issued corporate bonds offer a significant launch premium, thereby reflecting new pricing benchmarks for the market, as the post-Lehman era gets underway. As we move ahead it is highly unlikely that companies will be able to refinance themselves at the comparably low costs obtainable during the boom from 2004 to



*Martin Lee-Warner*

mid-2007. Any further deterioration in the macro-economy would, of course, lead to even higher risk premia.

Nonetheless, we expect to see more brisk issuing activity this year, as companies still have massive refinancing needs. Over €140 billion in euro non-financial corporate bonds remain due for redemption in 2009, and it appears highly unlikely that companies will refinance these debts entirely from their own cash flows. Companies will, therefore, have to issue bonds, as the credit market is currently the only viable means to tap fresh capital. From an investor's viewpoint, such issues on the primary market offer a substantial pick-up for an asset class that is already looking quite attractive.

Whilst the refinancing of companies with good credit ratings (investment-grade enterprises) appears to be in no serious danger, companies with weaker credit ratings (high-yield enterprises) could run into some refinancing problems. Some

bonds of such companies are already being quoted at prices which theoretically reflect default and recovery rates. Every financial crisis, of course, has victims. Amongst non-financials, no major victims have been registered to date, but it may well be only a matter of time before a global player does default.

In the meantime, the market is pricing in much lower credit-worthiness for bonds, compared to what may be expected on the basis of company ratings. As a frequently heard criticism, rating changes lag indicators and do not necessarily point to a softer patch in the economy before it occurs; rating agencies are actually supposed to assign a rating over an entire cycle of the economy. Despite this, we have observed a massive rise in the number of rating downgrades since the outset of the crisis. More recently, the pace of this negative rating drift has accelerated considerably. Financials have borne the brunt of this trend, and even

companies, which used to have excellent AAA ratings, have not been spared reviews for downgrades.

The ramifications of the recession will become increasingly tangible in the months ahead, certainly in the form of accelerating default rates. This notwithstanding, we believe that a great deal of "doom-and-gloom" has already been priced in for corporate bonds. Positive signs of a recovery will initially become apparent on the capital market, and thereafter in the real economy. From an allocation point of view, with risk aversion having faded, corporate bonds are likely to remain an attractive asset class this year, with yields very much higher than what government bonds will offer. Equities on the other hand exhibit much higher volatility.

**Martin Lee-Warner**

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<sup>1</sup> This article is based on some research observations by RZB Research ([www.raiffeisenresearch.at](http://www.raiffeisenresearch.at))

## The future shape of financial regulation in Europe

Following the Group of 20 (G20) Summit in London on 2 April, the immediate priority remains to recover from the international financial crisis by restoring confidence:

- There is a consensus that monetary easing and fiscal stimulus are needed to end the global recession, though views differ about whether enough has been done already or more needs to be done.
- The second objective is to stabilise the financial system through government involvement, where necessary, in restructuring banks (by insuring or purchasing “legacy” assets to clean up bank balance sheets) and recapitalising them (by providing sufficient equity to withstand future losses if the market is not willing to provide it), as well as by providing guarantees on future lending until confidence is restored.
- The third objective is to devise an exit strategy through the eventual sale of government-owned shares and tightening monetary and fiscal policy again when economic conditions permit.

But the longer term issue is how to prevent another crisis on a similar scale in future. It is clear from both the de Larosière and Turner Reports that there will be a new approach by the authorities in Europe – working within a global context – to financial regulation, the supervision of financial institutions and the stability of the financial system as a whole in future. What can the market expect and what issues need to be resolved?

### *What can the market expect?*

The main elements of the new system have not yet all been agreed, but the proposals include the following:

- Prudential supervision will be more “intrusive” in future, in the sense that supervisors will want to know in more detail what is going on so that they can assess the systemic implications, rather than relying on a “light touch” regime, as in some countries in the past.

- There will be much more emphasis on the effective regulation of liquidity.
- The regulation of capital adequacy will change. Banks will in due course need more capital and of higher quality, particularly against risk taking on the trading book: ie less leverage will be permitted than in the past, and a maximum gross leverage ratio may be imposed as a back-stop.
- A counter-cyclical capital regime is likely to be introduced, with capital buffers being built up in good times so they can be drawn down in difficult times. Turner proposes that published accounts should include buffers in good times which anticipate potential future losses in difficult times. De Larosière proposes a debate on mark-to-market principles.
- The authorities are seeking powers to collect information on all significant unregulated financial institutions to allow assessment of overall system-wide risks; and to extend prudential regulation of capital and liquidity to “bank-like institutions”, if they threaten financial stability.
- Host supervisors are likely to rely less on home supervisors, following the Lehman insolvency; and host supervisors are likely to insist on having more control over foreign branches, or to convert foreign branches into subsidiaries, following the Landsbanki case.
- Banks will be encouraged to tie pay to long term performance rather than short term profit, where that is not already the case.
- There will be pressure for more transparency, though much of the financial system is transparent already.
- Financial markets will become more resilient by increasing the role of central counterparty clearing houses, and reducing reliance on credit rating agencies.

### *What issues need to be resolved?*

These proposals leave a number of important issues still to be resolved. First, what is systemically significant? Traditionally, there has always been an element of constructive ambiguity about this. But since the insolvency of Lehman Brothers, almost all significant financial institutions – and not just banks – in trouble have potentially had systemic implications: in other words, in a crisis, they are too large or too “interconnected” to fail.

Second, how should the authorities deal with financial institutions that are too large to be rescued by the small countries in which they are based? In the current crisis, as the Governor of the Bank of England has pointed out, financial institutions which have been global in life have become national in death. This is a particularly difficult issue in the case of banks operating cross-border in the euro area, where there is a single central bank, but national ministries of finance are the effective lenders of last resort, and it is not clear how the burden is to be shared between them. The valuation of “legacy” assets and the growing divergence in accounting standards between the EU and the US are other difficult issues to be resolved.

Third, how can a counter-cyclical policy be devised to regulate the growth of the financial system? If it does become possible to rely on counter-cyclical policy as a “third leg of the stool” alongside monetary policy and fiscal policy, then financial crises may be less likely in future and economic recessions less severe. But are the authorities in practice prepared to “lean against the wind” in an economic upturn? After all, some regulators and central banks warned in advance about the risk of the current crisis (though none foresaw its scale), but they were not able to agree on what action to take, and might have faced political resistance had they done so.

## The future shape of financial regulation in Europe - continued

Fourth, how is it possible to marry the “top down” assessment of systemic risks with the “bottom up” supervision of financial institutions? This has proved difficult enough between ministries of finance, central banks and regulators at national level. But national authorities cannot easily act on their own. Regulation of the EU single market is at European rather than national level, and financial markets are global.

Fifth, related to this, is a new set of supervisory authorities needed at European level, and if so how many and of what kind? De Larosière proposes three (to succeed the three Level 3 Committees) initially, and possibly two later. Turner proposes one now. Should any such authority be independent, as Turner proposes, and if so how should it be accountable? Should it have some powers over national supervisors, as de Larosière

proposes but Turner opposes? A key issue is how to prescribe standard setting powers at European level, while keeping supervision at national level and cooperating globally through colleges of supervisors in the case of large cross-border firms.

Sixth, how quickly should proposed new regulations be implemented? Banks may need more capital in future, but imposing new capital requirements now is likely to limit their ability to lend and delay the recovery.

Seventh, can the market play a role by regulating itself? The de Larosière Report draws attention to the opportunity for the market to play such a role, so long as it implements its own proposals.

Finally, is it sufficient to assume that all financial crises are essentially the same, or

could the next one be different? That risk is not a reason for failing to do what we can to learn the lessons from the current crisis in an attempt to make the next one less severe than it otherwise might be.

This edition of our quarterly Regulatory Policy Newsletter assesses the de Larosière and Turner Reports in more detail in the context of the G20 Summit in London on 2 April, and describes new regulatory and market practice developments in the primary markets, secondary markets, asset management and the financial infrastructure.

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## Regulatory implications of the G20 Summit in London

The Summit of the Leaders of the Group of 20 (G20) in London on 2 April concluded that “a global crisis requires a global solution” and includes a pledge to do whatever is necessary to: restore confidence, growth, and jobs; repair the financial system to restore lending; strengthen financial regulation to rebuild trust; fund and reform our international financial institutions to overcome this crisis and prevent future ones; promote global trade and investment and reject protectionism, to underpin prosperity; and build an inclusive, green and sustainable recovery.

The Leaders of the G20 stated: “Our actions to restore growth cannot be effective until we restore domestic lending and international capital flows. We have provided significant and comprehensive support to our banking systems to provide liquidity, recapitalise financial institutions, and address decisively the problem of impaired assets. We are committed to take all necessary actions to restore the normal flow of credit through the financial system and ensure the soundness of systemically important institutions, implementing our policies in line with the agreed G20 framework for restoring lending and repairing the financial sector.”

In order to strengthen financial supervision and regulation, the G20 issued a Declaration, *Strengthening the financial system*. In particular, the G20 agreed:

- to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain and the European Commission;
- that the FSB should collaborate with the International Monetary Fund (IMF) to provide early warning of macro-economic and financial risks and the actions needed to address them;
- to reshape the regulatory systems of the G20 so that the authorities of the G20 are able to identify and take account of macro-prudential risks;
- to extend regulation and oversight to all systemically important financial institutions, instruments and markets. This will include, for the first time, systemically important hedge funds;
- to endorse and implement the FSF's tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms;
- to take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system. In future, regulation must prevent excessive leverage and require buffers of resources to be built up in good times;
- to take action against non-cooperative jurisdictions, including tax havens. The G20 stands ready to deploy sanctions to protect its public finances and financial systems. The era of banking secrecy is over. The G20 notes that the Organisation of Economic Cooperation and Development (OECD) has published a list of countries assessed by the Global Forum against the international standard for exchange of tax information;
- to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high quality global accounting standards; and
- to extend regulatory oversight and registration to credit rating agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.

The leaders of the G20 have instructed their Finance Ministers to complete the implementation of these decisions in line with the timetable set out in the Action Plan agreed after the previous Summit in Washington in November 2008. The G20 has asked the FSB and the IMF to monitor progress, working with the Financial Action Taskforce and other relevant bodies, and to provide a report to the next meeting of Finance Ministers in Scotland in November this year.

The following documents have been published following the Summit: [Summit Communiqué](#); [Declaration on Strengthening the financial system](#); [Declaration on Delivering resources through the International Financial Institutions](#); and [Progress Report on the actions of the Washington Action Plan](#).

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## The de Larosière Report: financial supervision in the EU

On 25 February, the Jacques de Larosière High-Level Group released its [Report on financial supervision in the EU](#). This was launched, together with a [Summary of the Report](#), by Commission President Barroso who made some [introductory comments](#).

Established in November 2008 by Commission President Barroso, the Group primarily had a [mandate](#) to consider:

- how to organise the supervision of EU financial institutions and markets;
- how to strengthen European cooperation on financial stability oversight, early warning and crisis mechanisms; and
- how EU supervisors should cooperate globally.

The Group began its work in mid-November and held 11 full day meetings. It received oral evidence from key individuals and representatives of European financial services associations and international institutions. One of the Group's meetings was with securities' industry representatives, including ICMA's Executive President, René Karsenti. His comments at the meeting were supported by a [two page letter](#), one of many written submissions provided to the Group.

The Report now presented by the Group sets out the perceived causes of the financial crisis and then examines how to repair regulation and supervision at both the EU level and globally. Priority areas for regulatory change are identified as being: (i) stronger macro-economic policy and macro-prudential analysis; (ii) reforming expeditiously the Basel II capital requirement process for bank capital; (iii) credit rating agencies; (iv) accounting; (v) insurance; (vi) sanctions/supervisory powers; (vii) parallel banking system; (viii) securitized products/derivative markets; and (ix) investment funds, with specific recommendations made in respect of each. 31 specific recommendations (listed in the [Summary of the Report](#)) are made, most of which include a number of sub-points.

The Group's Report echoes a lot of what has preceded it, including much debated aspects of EU regulatory development, such as calls for regulation of credit rating agencies (CRAs), retention on securitisation and an EU central counterparty (CCP) for credit default swaps (CDS). Beyond this the Report picks up on other themes that are being developed, including:

- increase in certain capital requirements and common definition of capital;
- tackling pro-cyclicality, including dynamic provisioning and the broader reconsideration of regulatory and accounting requirements;
- far greater focus on rules for maturity mismatches and liquidity;
- extension of regulation to all systemically relevant entities and products; and
- improvements to aspects of governance and risk management.

It also strongly supports a drive to a fully harmonised EU set of core rules, alongside the development of consistent supervisory powers and sanctions.

The Group's Report makes recommendations for ambitious reforms to EU supervision:

First, setting up a new EU macro-prudential supervisory function called the European Systemic Risk Council (ESRC). The Group proposes that this new body should be set up under the auspices of the ECB, and chaired by the President of the ECB. It will be composed of the members of the General Council of the ECB (which, unlike the Governing Council, includes the "outs"), together with the Commission plus the Chairs of the three Level 3 (3L3) Committees (Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR)). Insurance and securities supervisors will be brought in where necessary. Its role will be to gather information on all macro-prudential risks in the

EU. It will have access to all necessary macro and micro information and issue risk warnings on which there will be mandatory follow-up and monitoring by EU supervisors. If the risks are very serious they will be taken up by the Economic and Financial Committee, working with the Commission, to address the risks. The ESRC will work closely with the International Monetary Fund (IMF), Financial Stability Forum (FSF), and G20 at global level.

Second, working towards a new European System of Financial Supervision (ESFS), integrating the existing 3L3 Committees. This will cover micro-prudential supervision (the supervision of firms). The 3L3 Committees will respectively be transformed into three new European Authorities (the European Banking Authority; the European Insurance Authority; and the European Securities Authority). These Authorities will have a considerably expanded role compared to the current 3L3 Committees, including some legal powers. The ESFS should be set up in a 2 stage procedure: Stage 1 – preparation (2009-2010); and Stage 2 – the establishment of the ESFS legal system (2011-2012).

In addition to the competences of the existing 3L3 Committees, the Group proposes that these Authorities should have the following key-competences:

- legally binding mediation between national supervisors;
- adoption of binding supervisory standards;
- adoption of binding technical decisions applicable to individual institutions;
- oversight and coordination of colleges of supervisors;
- licensing and supervision of specific EU-wide institutions (eg credit rating agencies and post-trading infrastructures);
- binding cooperation with the ESRC to ensure adequate macro-prudential supervision; and

## The de Larosière Report: financial supervision in the EU - continued

- a strong coordinating role in crisis situations.

National supervisors remain fully responsible for the day-to-day supervision of firms.

The target is to achieve a more cohesive position in future, based on the ESRC and the ESFS delivering integrated macro and micro-prudential supervision. It is argued that this will be both more effective and efficient, whilst also being more realistic than any notion of a single European regulator taking over the role of national supervisors (a concept that the Report does not recommend).

Finally the Report turns its focus to the global dimension. Its main proposals are:

- the FSF should be put in charge of converging international financial regulation to the highest level, linking closely with the macro-focused IMF;
- the establishment of global colleges of supervisors as soon as possible;
- for macro-prudential surveillance, the IMF should develop a global financial stability early warning system; with a global risk map and credit register;
- all IMF member countries should also commit to its Financial Sector Assessment Programme (FSAP) – and provide reasons if they do not comply with the recommendations;
- IMF resources should be enhanced to strengthen its capacity to deal with finance on balance of payments distress;
- to organise coherent EU representation in the new global architecture; and
- for the EU to deepen its bilateral financial relations with all its major partners.

Following from the Report's publication, the Commission, on 4 March, published a first assessment and response to its main conclusions. This came in the form of a [speech by Commission President Barroso](#) and a Communication, *Driving European recovery* (together with a [more detailed annex](#)),

setting out the Commission's intentions on how to proceed. This was followed on 10 March by the launch of a formal [consultation on the Report and the Commission's Communication](#). The Commission intends to come forward by the end of May 2009 with a Communication setting out its proposals on the future of the EU supervisory architecture followed by specific legislative measures in autumn 2009.

On 20 March the European Council considered the issue and [published its conclusions](#). The Council agreed on the need to improve the regulation and supervision of financial institutions in the EU and that the de Larosière Report should be the basis for action. The Council is instructed to examine the Report, as well as the proposals from the Commission, with a view to first decisions at the June 2009 Council meeting.

ICMA submitted a [response](#) to the Commission on 8 April.

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# The Turner Review: a regulatory response to the global banking crisis

The [Turner Review](#) was published by the FSA on 18 March. It identifies the following proposals for change:

Current position/assumption	Proposals for change
Financial markets are both efficient and rational and a key goal of regulation is to remove the impediments which might produce inefficient and illiquid markets.	Regulation must strike a balance between the benefits of market competition and liquidity and the potential disadvantages which may arise from inherent instabilities in liquid markets. The optimal balance may be different for securitised credit markets versus equity or commodity markets.
Value-at-risk (VAR)-based methodologies can be relied upon to measure and manage position taking risks.	Significant changes must be made in the application of VAR-based methodologies. Stress tests should be defined by both regulators (considering macro-prudential issues) and firms (considering idiosyncratic issues).
Market discipline can play a key role in incentivising banks to constrain capital and liquidity risks.	Market discipline cannot be expected to play a major role in constraining risk taking. The primary constraint must come instead from regulation/supervision. More effective institutional shareholder influence over corporate strategies may be possible (being considered by the Walker Review).
Financial innovation is beneficial and regulators should not judge the value of different financial products and should avoid direct product regulation. Customer protection is best ensured, not by product regulation or direct intervention in markets, but by ensuring that wholesale markets are as unfettered and transparent as possible and that the way in which firms conduct business is appropriate.	Regulators may need to become more involved in direct product regulation. FSA will shortly publish a paper on mortgage market reform which considers product regulations limiting mortgage loan-to-value or loan-to-income ratios.
Inadequate capital against trading book positions allowed excessive leverage.	Regulators must consider the implications of bank capital structure on the behaviour of banks and the implications of that behaviour for the whole economy. Banks must hold sufficient capital to absorb losses without being under excessive pressure to constrain lending to the real economy and they cannot be so highly leveraged relative to common equity as to create incentives for excessive risk taking.
The current capital regime requires only very light levels of capital against trading books on the grounds that the risks are low, assets can rapidly be sold and positions rapidly unwound.	Major changes to trading book capital are needed. A fundamental review of the whole methodology of assessing trading book risk is also essential, including (a) the definition of assets appropriately booked in trading and banking books; (b) use of VAR, stressed VAR and other measures of risk; and (c) the extent to which approaches should vary by trading book activity to reflect different liquidity characteristics.
Capital ratios – Basel II capital regime is criticised for having pro-cyclical effects.	<ul style="list-style-type: none"> <li>• Overt counter-cyclical measures should be introduced to offset the impact of unavoidable pro-cyclicality. FSA proposes to set capital buffers based on a predetermined metric such as growth of the balance sheet: buffers of 2% – 3% of weighted risk assets (WRA) might be appropriate at the peak of the cycle.</li> <li>• The counter-cyclical approach to bank capital should be reflected in published accounts which should anticipate possible or probable future events.</li> <li>• Capital ratios should be buttressed by applying a maximum gross leverage ratio (total assets to capital) as a back-stop control measure.</li> <li>• FSA is considering the merits of other counter-cyclical measures such as minimum levels of haircut in OTC derivatives contracts and securities financing transactions.</li> </ul>



The Turner Review: a regulatory response to the global banking crisis - continued

Current position/assumption	Proposals for change
<p>Inadequate regulatory attention has been given to measuring and managing bank liquidity risk.</p>	<p>Liquidity regulation and supervision is vital – see FSA’s Consultation Paper 08/22: <i>Strengthening liquidity standards</i>. FSA is also considering whether to buttress those proposals with a “core funding ratio”.</p>
<p>Inadequate regulatory attention has been given to “shadow banks”.</p>	<p>Regulation must focus on economic substance and not legal form.</p> <ul style="list-style-type: none"> <li>• Off-balance sheet vehicles which create substantive economic risk (either to an individual bank or to total system stability) must be treated as on-balance sheet for regulatory purposes.</li> <li>• Regulators must have powers to obtain information and identify new forms of financial activity which are developing bank-like characteristics and if necessary extend prudential regulation to them or to restrict their impact on the regulated community.</li> <li>• Offshore financial centres must be brought within the ambit of internationally agreed financial regulation.</li> </ul>
<p>Deposit insurance, prior to the failure of Northern Rock, was inadequate to prevent a retail deposit run.</p>	<p>The UK Government has acted to ensure that retail depositors in UK banks have not suffered loss. FSA recognises the need to ensure that the benefits to banks of deposit insurance are not used to cross-subsidise risky activities.</p>
<p>Credit ratings are a reasonably effective prediction of the relative credit risk of different bonds. Many institutions have embedded ratings-based rules in operational procedures.</p>	<p>FSA supports the aims of the proposed EU credit rating agency legislation. However, there must also be compatible global standards. FSA is working through IOSCO to achieve this.</p>
<p>Too little attention has been paid to remuneration structures within banks and how this impacted on excessive risk taking.</p>	<p>FSA risk assessment of firms will additionally focus on the risk consequences of remuneration policies. FSA will consult on a code of principles. FSA is also involved in a Financial Stability Forum working group looking for an international approach to integrating analysis of remuneration issues into overall risk assessment.</p>
<p>The growth of the OTC CDS market creates the danger that the failure of one party could produce market disruption.</p>	<p>FSA supports the objective of central clearing house arrangements for CDS clearing and has been working with US and European authorities and potential market infrastructure providers.</p>
<p>There has been a lack of a system-wide macro-prudential perspective and failure to use macro-prudential levers to offset systemic risks.</p>	<p>Macro-prudential analysis must be done by both Bank of England and FSA. The resulting analysis must be challenged externally. Challenge also must take place at the international level.</p>
<p>The FSA supervisory approach has assumed:</p> <ul style="list-style-type: none"> <li>• markets are generally self correcting; market discipline is a more effective tool than regulation or supervisory oversight;</li> <li>• primary responsibility for managing risks lies with senior management who are better placed to assess business model risk than bank regulators.</li> </ul>	<p>There must be a fundamental shift in supervisory approach:</p> <ul style="list-style-type: none"> <li>• a significant increase in resources devoted to supervision of high impact firms;</li> <li>• a shift from focusing on systems and process to focusing on key business outcomes and risks and the sustainability of business models/strategies;</li> <li>• FSA supervision will include macro-prudential analysis;</li> <li>• a shift in the role which FSA plays in relation to published accounts and accounting judgments.</li> </ul>

The Turner Review: a regulatory response to the global banking crisis - continued

Current position/assumption	Proposals for change
<p>No separation is made between “narrow” banking and “investment” banking.</p>	<p>The new approach will not require separation, but the benefits to banks of deposit insurance, lender of last resort access and “too big to fail” status must not be used to cross-subsidise risky proprietary trading activities. Thus, FSA favours:</p> <ul style="list-style-type: none"> <li>• a regulatory regime for trading book capital which combines significantly increased capital requirements with a gross leverage ratio rule which constrains total balance sheet size;</li> <li>• a major intensification of the supervision of liquidity risks, which will limit the ability of banks to hold potentially illiquid assets funded by short term liabilities, with appropriate internal pricing to reflect liquidity risk;</li> <li>• remuneration principles which require the calculation of profits to include adequate allowance for the different riskiness of different activities.</li> </ul>
<p>The FSA approach to large cross-border wholesale banks and investment banks assumes that primary responsibility for ensuring prudential soundness lies with the home country supervisor (though with extensive information sharing between home and host supervisors). It also assumes that it is appropriate for firms to gain efficiency benefits from a global approach to managing liquidity, allowing significant flexibility in the use of legal entities to book transactions across borders and to move liquidity between legal entities.</p> <p>Additionally, at a European level, the underlying philosophy is that a single market in banking services should be based on the same market access principles which apply in markets for non-financial services. EU single market rules require that banks which are recognised by their home country supervisors as sound have a right to operate as branches in other Member States. Accordingly, depositors in one country can be vulnerable to the failure of banks in another country if the home country concerned lacks the supervisory resources to ensure bank solvency or the fiscal resources to fund bank rescue and if the deposit insurance cover is low and unfunded.</p>	<p>International cooperation: FSA supports FSF proposals for: (1) colleges of supervisors; (2) increasing international coordination in crisis conditions, involving supervisors, and fiscal and monetary authorities.</p> <p>European arrangements: FSA favours the creation of a new EU institutional structure to replace the Lamfalussy committees. The new body would be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision and would be involved, alongside central banks, in macro-prudential analysis while leaving the primary responsibility for supervision at Member State level.</p> <p>Additionally, FSA favours:</p> <ul style="list-style-type: none"> <li>• gathering more extensive information from banks and home country supervisors on the whole bank liquidity of banks operating in the UK, including those operating as branches;</li> <li>• imposing tougher local liquidity requirements on branches and subsidiaries if there are regulatory concerns;</li> <li>• requiring major international banks to operate as subsidiaries in the UK, to increase capital requirements on local subsidiaries and to impose other restrictions on business operation if required.</li> </ul>

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## EU Regulation on Credit Rating Agencies

As also discussed in our [Newsletter of January 2009](#), the Commission presented, on 12 November, its proposal for a [Regulation on Credit Rating Agencies](#). Industry participants have detailed a number of concerns and suggested amendments. These persist and are summarised further below.

The incoming Czech Presidency has made completion of the work on the Credit Rating Agency (CRA) Regulation one of the priorities for its term. It has solicited Member State opinion on various possible policy options and has led discussion of these in the relevant Council Working Group. These discussions have now concluded with the position reviewed in the EU Committee of Permanent Representatives (COREPER) on 4 March. The European Parliament has also prepared its report, led by Jean-Paul Gauzès as rapporteur. This has been reviewed and a dossier compiled including 453 proposed amendments. Initial examination of these on 9 March was followed by a vote in ECON on 23 March, with a European Parliament plenary planned for 23 April.

ICMA supports the principle of creating a robust EU regulatory framework for CRAs that seeks to restore confidence in CRAs and their ratings. There are four aspects of the proposal which would require suitable compromises to avoid potential adverse consequences for EU investors, lenders and markets:

- Uncertain scope.* The scope of the regulation is uncertain, and also broad. More certainty would limit the potential for inconsistent implementation, inconsistent supervision, and market instability and would avoid significant compliance problems. More certainty would also limit the potential for inconsistent implementation, inconsistent supervision and market instability and would avoid significant compliance problems.
- Different treatment of EU and non-EU ratings.* The provisions on use of non-EU CRAs and non-EU ratings could cause confusion; limit the investment flexibility of EU investors to gain exposure to entities outside Europe; and impose a burdensome compliance obligation on EU firms. We place priority on an endorsement mechanism as a means to enable CRAs to continue to provide third country ratings; and encourage pursuit of the future possible alternative option of an equivalence regime.
- Need for consistent supervision and regulatory approach.* There is significant risk of an inconsistent application of the proposed supervisory framework within the EU, and for an inconsistent approach to the regulation of CRAs globally. Such inconsistency would make comparison of ratings more difficult for investors, and raises the potential for politicisation of ratings. We continue to propose improved arrangements to ensure effective supervisory co-operation, both between Level 3 Committees within Europe and with third country regulators.
- Market instability.* The provisions in the current proposal on withdrawal and suspension of ratings create a risk of financial instability caused by disorderly sell-offs of securities resulting from the exercise of such provisions. We suggest broader use of disclosure, rather than outright ban or withdrawal.

ICMA continues to working closely with other associations and the authorities on this issue.

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### International Centre for Financial Regulation

The International Centre for Financial Regulation (ICFR), an independent global research institute located in London, was launched in January 2009. The ICFR, which is a cooperative venture between 19 financial institutions, the City of London Corporation and the UK Government, aims to provide objective research, debate and training on financial regulation. It will commission research to move forward thinking on regulatory matters and also commission training to improve regulatory understanding, compliance and risk management, working with existing training providers to create tailored provision for market participants. [www.icfr.org](http://www.icfr.org)

### Institut Francophone de la Régulation Financière

The Institut Francophone de la Régulation Financière (IFREFI) was created in 2002 by the financial markets regulatory authorities of French speaking countries. IFREFI supports collaboration and knowledge exchange between its 16 members who represent a total of 28 individual countries. Its activities include a regular annual meeting of the presidents of the regulatory authorities to co-ordinate market practice and discuss current issues affecting financial markets and financial regulation and the organisation of seminars for professional training of the personnel of its member organisations. The composition of its membership, drawn from Europe and Africa, ensures that the IFREFI is a forum for a profitable North-South dialogue. [www.ifrefi.org](http://www.ifrefi.org)

## Personal view

### *The financial crisis: what next?*

For almost two years the financial world has been experiencing a stream of bad news. Owing to colossal losses arising from financial products, many banks are now showing a net worth close to zero and requiring the backing of their national governments.

Large insurance companies are also suffering substantial losses. Pension funds are suffering too, although they are not obliged to publish their figures. And finally, private portfolios have lost a substantial part of the value of their assets. We have only to look at the latest Forbes rich list.

It is recognised that the origin of this situation is closely linked to the proliferation of structured products which were created on the basis of quantitative theories and distributed very widely throughout the world to banks, insurance companies, pension funds and private portfolios. These instruments have become progressively more illiquid since mid 2007. To add to this, the complexity of their product structure has made them very difficult to unwind.

Unlike the period 1929-1934, governments have injected a very large amount of liquidity into the system, trying at the same time both to support the banking system in the West and to reflate the real economy in the three main economic zones: North America, Europe and Asia. Today, western banks are surviving on a short term lifeline provided mainly by the Federal Reserve and the European Central Bank, and the weakness of the financial system has triggered an amazing fall in the value of stock markets, hedge funds and private equity portfolios.

Confidence in the world banking system is at an historical low. Most banks have had their

lending capacity reduced and the interbank market has come almost to a standstill. The world economy, which had been leveraged for more than twenty years by a low interest ratio policy and an abundant money supply, is now undergoing a huge deleveraging phenomenon, making the life of the real economy much more difficult.

What could be the possible next steps to restore the real economy to normal?

First of all, confidence in the banking sector should be rebuilt. The banking system is the equivalent of the blood circulation system in the human body. Where there is no blood circulating, there is no life. Bank balance sheets should become totally transparent again.

The total outstanding amount of structured products represents today a multiple of the value of the real economy. Transparency is key for these products. When you buy packaged food products, you receive a clear description of the ingredients. It should be the same for all financial products. Many structured products should be listed and traded on central exchanges and cleared and settled through a central counterparty clearing system.

Accounting rules should be (temporarily) smoothed a little. Under pressure from the European Commission, the International Accounting Standards Board (IASB) has recently shown some flexibility in its attitude.

To sort out toxic products in the banks' balance sheet, the possibility should be considered of ring-fencing those products in a "bad bank" within each bank's balance sheet. This the "bad bank" could be financed either by the "good" part of the bank, or by a government guarantee system. A flexible equity ratio could be applied to the "bad bank" (for instance 3% or 4%).

Another subject of great importance is transparency in asset management. Many individual portfolios have been filled with synthetic products. Today, valuation of those products appears very difficult. The liquidity of many instruments is under strong pressure. Respecting investors' profiles is more important than ever. Sooner or later, authorities are going to focus on those matters. ICMA has recently instituted a major initiative to represent investors' concerns through its Asset Management and Investors Council (AMIC).

The short term "trading culture" of today's banking world should be replaced by the concept of servicing the real economy. By adopting this approach, banks' profits will be somewhat more modest, but much more stable.

The excellent de Larosière Report provides us with a good financial framework for the medium term future. But action will be needed for many months to come.



Jean-Pierre Wellens

*Jean-Pierre Wellens is ICMA's Chief Representative in Brussels. He was Chairman of the International Primary Market Association (IPMA), one of ICMA's predecessor organisations, from 1992 to 2000.*

## Prospectus Directive review

On 10 March, ICMA submitted a [response](#) to the European Commission's consultation on its review on the working of the [Prospectus Directive](#) (PD). The consultation included a [Consultation Paper](#) setting out formal proposals for amendments to the PD and a [background document](#) addressing further issues on which the Commission was seeking feedback.

The response notes the PD's contribution to the development of the single market (although some difficulties remain) and institutions' general comfort with the PD regime, having substantially invested in adjusting to it. The response builds on various "tweaks" mentioned in the [January edition](#) of this Newsletter. The salient points are summarised below, together with some additional aspects which ICMA subsequently noted to the Commission.

Perhaps most importantly, the response addresses the "retail cascade" concept whereby an issuer sells its securities to investment banks who in turn sell them to financial intermediaries acting as retail distributors – a process that can last from several days to several months. In this context, the response suggests that a third party offeror, unconnected to the issuer, should not be required to prepare a prospectus where the [Transparency Directive](#) (TD) and [Market Abuse Directive](#) (MAD) regimes already provide for the market to receive the relevant information from the issuer (who will have previously published a prospectus relating to its own initial offer). Such an unconnected offeror's prospectus disclosure can only repeat (but without verification as the offeror's knowledge of the issuer is intrinsically not authoritative) potentially stale TD/MAD regulatory disclosures and potentially inaccurate third party (eg press) reports – at best this is superfluous and at worst misleading to investors. ICMA subsequently noted that simultaneous sales of the same security are currently subject to inconsistent treatment in some EU Member States, depending on whether the sales are made on or off exchange – an investor

purchasing the security on exchange would do so without a prospectus but the same investor would receive a prospectus if purchasing that security from an intermediary off exchange. The response also suggests that paragraph 5 of Annexes V and XII of the [PD Regulation](#) be clarified to refer only to the issuer's initial offer and not to any third party offers, except where the relevant information is known to the issuer and can reasonably be included in the prospectus.

The response also addresses the Article 16.2 withdrawal right, suggesting that it be clearly stated to be exercisable within a fixed time of two working days after the publication of a supplement to the prospectus that includes adverse information disclosable under MAD (as likely to have a significant negative effect on the price of the securities concerned). It was noted that under the current regime, even a technical supplement, containing no material new information, would trigger a withdrawal right. ICMA subsequently noted that allowing issuers to publish supplements without an automatic put right should encourage maximum information flow to investors.

In relation to length of the prospectus and its summary, the response notes prospectuses are intrinsically (particularly due to legal liability regimes), and quite literally, "full" of information; the summary serves as an introduction to investors (or their advisors) reading the full prospectus. ICMA subsequently noted that there is a tension between (i) requiring very extensive issuer disclosure (under the PD), (ii) imposing significant issuer liability for that disclosure (under national liability laws) and then (iii) imposing restrictions on format and length of the prospectus (which some appear to want). Those charged with a duty, and liable for not doing so properly, should be given a free hand as to how they go about discharging that duty. Many prospectuses may be long and/or complex (and appropriately so in the case of complex products), but the PD already requires prospectuses to be "clear" so competent authorities can and should require unclear prospectuses to be corrected. Similarly, the 2,500 summary word

limit should be clarified as being indicative so that competent authorities not hesitate to allow more words where this is necessary (for example in the case of a complex product). In this respect, adopting a "key investor information" (KII) approach is inappropriate (it has been argued that the UCITS product concept that the KII is based on is far more harmonised and targeted to specific investor types). Allowing several product-specific summaries in the context of multi-product base prospectuses would be a helpful move.

The response welcomes several of the Commission's proposals – namely the changes to the definition of qualified investors, the Article 10 annual update and the €1,000 threshold. It also suggests:

- clarifying that disclosure on taxes withheld at source relates only to withholding in the hands of issuers or their agents;
- establishing a central public repository for passport information (also noting certain national impediments to a fully effective passporting process);
- equalising the application of the disclosure obligation under paragraph 4.2.2 of Annex XII of the PD Regulation to index owners and others;
- removing the cash-flow statement disclosure requirement under paragraph 11.1 of Annex XI that is anomalous in relation to IFRS accounting requirements;
- removing the Article 15.5 requirement (on information provision where no prospectus is required) that is anomalous in the context of private transactions;
- removing the requirement in paragraph 9.2 of Annex IV (on estimates necessitating an accountant's report) that is excessive in the context of debt transactions; and
- extending the scope of Annex XVII of the PD Regulation (currently applicable to issuers guaranteed by OECD Member States) to cover issues guaranteed by the regional and local authorities of OECD Member States.



## Prospectus Directive review - continued

The response does not include detailed comments in relation to some issues raised by the Commission (public offer definition, liability aspects, rights issues and government guarantees) that are particularly complex, currently evolving and/or outside ICMA's immediate focus. It however endorses the specific responses of another industry body in relation to employee share schemes and small quoted companies. Finally, the response makes some more detailed technical comments in relation to several of the above points.

ICMA understands the Commission intends to adopt a proposal by July for

consideration by the next European Parliament as soon as it is able (which could be as early as the autumn). Now more than ever, the simplification of the PD regime is essential to enhancing the vitality of the European capital markets. It is crucial that the Commission devotes, if anything, more resources to its review of the PD now than it might have done prior to the financial crisis. ICMA will continue to support the work of the Commission, CESR and others as the review progresses.

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## Pre-sounding of transactions

ICMA has published a new Recommendation 1.30 entitled *Pre-sounding of transactions*. The new Recommendation is available to ICMA members and IPMA Handbook subscribers on the [ICMA website](#).

The new Recommendation relates to the advance sounding of investors in relation to potential new issues of debt instruments. It is intended to facilitate the efficiency of the new issues process.

Issuers frequently seek to maximise certainty of an issue's successful uptake prior to publicly approaching the markets. Amongst other things, this may involve some investors being privately "sounded" – consulted on market appetite for a potential issue – by one or more banks retained by the issuer. Regulatory "inside information" considerations may arise where such soundings involve disclosure of non-public price sensitive information.

In this respect, the UK's FSA discussed some of the underlying considerations in

its *Thematic review of controls over inside information relating to public takeovers* in [Issue 21](#) (updated in [Issue 27](#)) of its *Market Watch* publication. Although nominally relating to the UK equity context, the review may also be of interest to market participants outside the UK or in the debt markets.

As is often the case, firms may have differing internal approaches to managing "inside information" considerations should they arise. When several banks conducting a particular sounding are members of a syndicate retained by an issuer, the efficiency of the transaction process may be helped if the firms concerned are aware of, or even coordinate, their various approaches. The new Recommendation is intended to facilitate prior discussion by syndicate members of their internal approaches and thus increase awareness and favour potential coordination.

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# Towards a common euro area government bond market?

The ongoing financial crisis has again raised the idea of a common euro area government bond market, as a possible way of assisting those euro area governments which have recently experienced a sharp increase in spreads on their debt relative to Bunds, without breaching the “no bail-out” clause (Article 103) in the EU Treaty. The “no bail-out” clause prevents governments from taking over each other’s debts.

There are a number of questions that would need to be addressed in issuing common euro area government bonds, and amongst them are the following:

- Would the scheme relate to the funding of all 16 governments in the euro area, or only those of them wishing to participate? How would the scheme be governed?
- Would it relate to all their government funding or only a proportion: eg 60% might be jointly funded and 40% funded by each government separately; or Treasury bills might be financed jointly, while government bonds would continue to be financed separately?
- In the case of the joint funding, what exactly would be the nature of each government’s guarantee?
- How would each government’s contribution be determined? Would contributions be fixed in advance on the basis of a formula, or would the proportions vary from year to year?
- Would governments whose debt currently carries a low yield like Germany be compensated for reducing the cost of financing of governments whose debt currently carries a relatively high yield like Greece?
- Would there be any conditions attached to the provision of funding under the scheme?
- How would the scheme be managed? Would a new euro area government debt management agency be created?

There would be a number of potential advantages:

- A common euro area government bond market could help to create a competitor in Europe to the US Treasury market, which might attract considerable interest from investors who need to invest in safe assets.
- A common euro area government bond market should lead to a higher level of liquidity and offer more safety, owing to the same rating for all participating

countries, and to greater transparency.

- The extra liquidity might mean that the average cost of government funding in the euro area would be reduced.
- Finally, there might also be advantages in setting up a European debt management agency.

But there are also potential disadvantages. In particular:

- The proposal appears to be too complex, and the gains in liquidity are doubtful, as any savings on joint government debt might be offset by increases in the cost of government debt issued separately. In addition, reaching agreement on legal and tax issues would be difficult and require a substantial amount of work.
- In addition, it does not look as though the idea has sufficient political support within the euro area, at least for the time being.

However, it would be useful for market participants to examine from a technical point of view how the idea might work, in case political consideration is given to implementing it in the longer term.

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## The AMTE Council

AMTE (Association des Marchés de Taux en Euro – The Euro Debt Market Association) now operates as a semi-autonomous Council within ICMA, where it provides an international forum for debate and a means of articulating the collective voice of the euro-denominated fixed income and derivatives markets.

The Council’s main objective is to assist its members in working together on practical measures to improve the development and efficient functioning of the euro debt markets, specialising in (though not restricted to) the government and government-guaranteed debt market in euro. To this end it conducts research and organises consultations among its members.

The membership of the AMTE Council is representative of the major players in the euro debt markets and comprises:

- issuers, including sovereign, quasi-sovereign and supra-national issuers, frequent issuers and issuers of covered bonds;
- financial intermediaries, including primary dealers for all major issuers in euro;
- investors, including asset management and insurance companies;
- other participants such as operators of exchanges and electronic trading platforms, brokers, clearing houses and trade associations.

With the support of ICMA’s administrative facilities, the AMTE Council is in the process of revitalising its working relationship, integrating its members into ICMA working groups and developing its own working groups on subjects which are of specific interest to its members.

At the first meeting of the Council at

AMTE’s offices in Paris last month, as well as being introduced to the areas in which ICMA is currently active in the primary and secondary markets, AMTE members discussed: the AMTE SVT (ie primary dealers) working group and coordination with the Agence France Trésor; the creation of a common euro area government bond; government guarantees on new bond issues; and collateral management for French market participants.

Such meetings will be held on a quarterly basis at AMTE’s Paris office in order also to ensure smooth cooperation between ICMA and its new French members through its AMTE Council.

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## Bond market transparency

As mentioned in the [January edition of this Newsletter](#), CESR published a [Consultation Paper on Transparency of corporate bond, structured finance product and credit derivatives markets](#) on 19 December 2008. [ICMA responded](#) to the Consultation Paper, in conjunction with other trade associations. Each trade association drafted responses to those questions that fell within its expertise. Accordingly, ICMA drafted much of corporate bond section and the response to questions concerning asset-backed commercial paper (ABCP).

The response set out that, while the industry agreed with CESR that the crisis has revealed significant deficiencies in the efficient functioning of financial markets, the industry took the view that market failures were not caused by a lack of post-trade transparency and that attempts to improve existing levels of post-trade transparency would not help to address these failures. Moreover, unless carefully approached and designed, the impact of mandatory post-trade price transparency on liquidity could instead act to hamper a return to normal market conditions, thus acting counter to governments' efforts to safeguard financial stability and restore the provision of credit and lending to the economy.

The response also emphasised that the industry is of the view that the costs of introducing additional mandatory post-trade transparency would far outweigh the benefits such a regime would bring. Given that (a) there is a high level of scepticism about any positive effect of mandatory post-trade price transparency on market confidence or market failures, and (b) there is a very significant risk that a mandatory post-trade transparency regime may operate in contradiction with policy objectives to restart credit circulation by further constraining liquidity, there needs to be full clarity and understanding for both regulators and the market about not only the expected benefits of any increased post-trade transparency but also the costs that would be involved.

Finally, the response recommended that CESR set up specific working groups to

discuss whether, and if so how, greater post-trade price dissemination could contribute to strengthening the current business models around the provision of price information.

CESR has published the [responses to its consultation](#) on its website.

The FSA's Discussion Paper [DP09/2](#) (which was published in conjunction with the Turner Review) indicated that, while a lack of trading transparency did not play any major role in causing or exacerbating the crisis, there is nevertheless an "opportunity" to assess whether an enhancement to transparency for a range of non-equity markets will help to rebuild confidence, better protect investors in future and contribute to recovery. However, the FSA nevertheless recognises that it is important to recognise the specific nature and characteristics of non-equity markets, otherwise there is a risk that enhanced transparency will result in a further withdrawal of liquidity. In particular, the FSA states (page 174) that "investors for corporate bonds and structured finance products tend to adopt a buy and hold strategy with very little trading after issuance. Mandating transparency in instruments which rarely trade is unlikely to bring significant benefits."

The FSA has now set up three working groups (corporate bonds, credit derivatives and securitised products) to examine the issues of post-trade transparency. The FSA feels that there is a huge push across Europe to see greater post-trade transparency. Accordingly, the working groups are an attempt to engage with the industry and key stakeholders to start to sketch out what a sensibly calibrated post-trade transparency regime might look like. While the FSA has indicated that its ultimate aim is to examine post-trade transparency in a UK context, the views that are reached at the conclusion of the working groups will feed into the debate at both the CESR and the IOSCO level.

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## A survey of bond market liquidity

Borrowing bonds to run shorts and hedging using derivatives (including CDS) are two key factors that contribute to the liquidity of bonds: these are just some of the findings of a survey of traders carried out by Chris Golden and David Clark in a study in March 2009: *The causes of bond market liquidity – a survey of market traders*.

Shorting stock and hedging with CDS are considered paramount for liquidity by market participants, but these are the two areas which have drawn greatest public and regulatory criticism. The contrast between their importance in market practice and their negative image elsewhere also highlights how crucial it is to better educate those outside the markets as to how these instruments work, and why they are vital for markets to function optimally. They also highlight the nature of the fixed income markets where liquidity is provided by dealers willing to hold hedged positions.

The idea for the study sprang from the immense focus on the liquidity of bonds following the onset of the financial crisis. While econometric studies have their place, they also have many limits. Yet market liquidity is dominated by a very small number of liquidity providers, so why not ask them for their opinions? Furthermore, users of liquidity such as bank treasurers and dealers in investment firms are likely to have a good perspective on the issues, and probably have some influence on the behaviour of market makers.

The authors compiled a list of 47 factors which may influence the relative liquidity of

bonds and divided these into six categories: static data; market environment; valuation and transparency; market infrastructure; funding; and issuer behaviour. Within each factor subsidiary questions were included to define dealer preferences more closely. Thus, within the “static data” category, dealers were asked to rate the importance of “issue size” with a score from 0-10 and then to rate specific size ranges with a score of +5 to -5. To calibrate the results questions on current and expected liquidity conditions were included, as well as on dealers’ views on some liquidity proxies such as volatility. Data was obtained from fourteen dealers in face to face interviews in three European centres. After excluding statistical outliers the remaining 12 results were collated and average scores calculated for buy-side (three dealers), sell-side (nine dealers) and overall. The small sample means that results are not statistically robust; but since factors that contribute to liquidity are likely to change in time and different market conditions, the intention was that this first study should act as a pilot for further, regular and more extensive studies.

Yet this pilot study uncovered many interesting results, some of which have important implications for policy makers and for investor behaviour: we have already mentioned two above.

Other important results include the distinction between public and privately issued bonds (which was rated at the top of the 47 factors); and investor diversity.

Though the latter only ranked 18 in the list of factors, the answers to subsidiary questions were particularly telling since a predominantly retail investor base was considered a negative factor. Regulatory attempts to protect retail investors may steer them towards primarily retail issues and hence to relatively illiquid paper: retail investors rarely lend or trade stock, and market makers going short a retail issue may find it harder to cover their position. And while pre-trade transparency was considered 10th overall, post-trade transparency came in 40th place, which would hardly justify the regulatory focus on post-trade transparency.

Investor attitudes brought out some interesting results. Although the buy side sample rated “issuer behaviour” highly as a category, the specific factor “willingness to reward market makers with new issue mandates” ranked only 37th amongst buy-side dealers. Was this a case of investors giving lip service to a type of behaviour while failing to reward specific types of behaviour or a general lack of confidence in market making during a time of crisis?

There were many other results of interest which cannot be mentioned in a short article. Copies of the report can be obtained from [admin@belairadvisors.eu](mailto:admin@belairadvisors.eu). The study was sponsored by ICMA and EFFAS-EBC.

David Clark and Chris Golden

David Clark, a former head of funding at EIB, is Managing Director of Belair Advisors, and Chris Golden is Chairman of the EFFAS European Bond Commission.

## Managing client expectations

As the financial crisis continues to unfold, and investors in all markets suffer disappointing returns from their investments, AMIC has focused on the degree to which these returns are neither understood nor anticipated by clients. This can be very damaging to the asset management industry's credibility. Discussion at AMIC has recognised that clients' expectations are increasingly not met – either through over-promising because of the different cycles of the asset management industry, or due to the effects of the current market crisis. Furthermore, the extent of recent valuation mark-downs continues to cause surprise, even among experienced investors. In numerous instances, clients' portfolios have achieved results which differ markedly from what was expected, including significant financial losses on strategies originally marketed as low risk investments or with the principal objective of conserving capital.

As a result of this discussion, AMIC has issued a paper, *Managing client expectations*. The paper recognises and addresses the asset management industry's reputational issues, many of which predate the current market crisis. The root of much client disappointment is traced right back to the initial process of selecting and hiring a new manager, a process which the paper considers carries a significant risk of being asymmetrically biased towards optimistic, as opposed to realistic, estimations of performance. The paper identifies the causes of this cycle of over-promising and client disappointment, and concludes that although many of the industry's current problems are related to current market conditions, others are longer term in nature and are inherent in the current structure of the industry.

The paper highlights that for any industry, particularly one of a fiduciary nature, this combination of unmet expectations and client disappointment carries a number of risks. To counter this, and to assist in rebuilding client confidence in the wake

of the current market trauma, the paper proposes a set of General Principles for the asset management and consultant industry. These are grouped under the broad headings: "Understanding the client's profile"; "Setting appropriate objectives"; "Ensuring transparency"; and "Reviewing investment guidelines". The essence of the General Principles is that there should be "no surprises": while the paper accepts that asset managers cannot entirely shield their clients from a general reduction in market valuations, it strongly urges them to be pro-active in sharing with their clients any adverse news on their portfolios at the earliest opportunity. In this way, while bad news for clients may not be wholly avoided, it will hopefully be less of a shock and less of a source of dissatisfaction with the manager.

To read the full AMIC paper [Managing client expectations](#) see the ICMA website.



John Nugée

*John Nugée is a Managing Director of State Street Global Advisors (SSgA), and a member of the Asset Management and Investors Council. The views expressed are in a personal capacity and do not necessarily reflect those of SSgA.*

### Asset Management and Investors Council

ICMA's Asset Management and Investors Council (AMIC) is a newly formed special interest group that brings together buy-side members of ICMA in a confidential discussion forum. AMIC is comprised of both asset managers and end investors, and offers a forum for them to discuss issues of common interest. AMIC also allows members to highlight areas where ICMA may wish to become formally involved, and present a consensus view on any recommended action. Such action may include inviting ICMA to propose market-led initiatives and market practice guidelines, where these are appropriate, and responding to consultation papers from regulators.



## The AMIC principles

In the light of its Report, the AMIC recommends the following principles:

### ***Understanding clients' profile***

Prior to running an asset management programme for a client, it is critical for the asset manager to fully understand the risk profile of the client, and to explain to clients, in conjunction with their consultants, the projected market risks of the programme and therefore test whether the client is comfortable with the suggested risk profile.

Asset managers should fully understand the return expectations of clients and test whether these expectations are realistic, particularly to align return expectations with projected market returns.

Asset managers should ensure that their clients fully understand the products and strategies they are offered. Clients should be informed in order to make a considered decision about the financial products presented.

### ***Setting appropriate objectives***

Asset managers should clearly establish with clients whether they have absolute return requirements or relative return objectives based on a market benchmark.

Marketing meetings with clients and their consultants should focus on investment processes, resources and risk

management and in presenting performance, while historical performance is a guide, asset managers should emphasise risk adjusted projected performance.

Asset managers should explain clearly their administrative and reporting capabilities and test whether these are consistent with client requirements.

### ***Ensuring transparency***

Asset managers should be transparent over their investment processes, the sources of performance and their risk management systems.

Asset management fees should be transparent and any other revenues accruing to the asset manager, whether directly or indirectly, should be disclosed to clients. Performance fees should be designed so that clients only pay fees where performance has been added over a minimum of a market cycle.

### ***Reviewing investment guidelines***

Investment return objectives and risk limits should specify a time horizon over which the asset manager's work will be assessed.

Asset managers should review investment guidelines with clients to ensure that guidelines are consistent with market conditions.

## Second money market funds report

At the publication in December 2008 of its first report on money market funds (MMFs), the AMIC considered that more statistical analysis was needed to pin down the issues with these financial products. A [second report](#), prepared by Christiane Haberl of Research Intelligence and ICMA, was presented to the AMIC at its March meeting.

The aim of this second report on MMFs is to offer data on this type of financial instruments in Europe as a continuation of and supplement to [the first report](#).

The first report gave an overview of MMFs in Europe. Moreover, the paper discussed regulatory developments, notably steps forward to an integrated market. Possible introduction of standardisation and, more importantly, clarification in the definition of MMFs were considered. Recent events have highlighted that investors should be made aware of the quality of their investments and should not worry about differences between rating agencies. The first report called for a pan-European regulatory framework, specific to money market funds, which would have paralleled the US approach, to ensure a high degree of transparency and consistency. This second report provides data to help assess these issues.

After presenting in brief the data sources and methodology, the second report illustrates the development in the volume of liquidity funds over time followed by the movement of the net assets of enhanced cash funds over time and then compares them. The paper also considers the trend in liquidity fund portfolio composition over the past 19 months and portfolio composition data on enhanced cash funds.

On the basis of the data provided, this second report reiterates the need for standardising definitions of money market funds and for considering a clearer identification of different types of MMFs. Moreover a pan-European regulatory framework, specific to MMFs, which would have paralleled the US approach, should be considered to ensure a high degree of transparency and consistency.

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### Covered Bond Investor Council

The [Covered Bond Investor Council](#) (CBIC) has now been launched under the Chairmanship of Claus Tofte Nielsen of Norges Bank in Oslo and Andreas Denger, Vice Chairman from MEAG in Munich. Bob Parker, the Chairman of the AMIC, has agreed to act as President of the CBIC, thereby forging an important link between the specialist focused CBIC and the “bigger picture” strategic AMIC. It often takes a crisis to bring about change. The specific catalyst for the creation of the CBIC came about in the autumn of 2008 when there occurred two well publicised failures of Anglo-Saxon covered bond issuing banks: Washington Mutual in the US, and Bradford & Bingley in the UK. Both threatened the ordered and supposedly super-safe covered bond market with some hard practical examples of what would happen if a covered bond bank fails. In each case the regulatory authorities provided comfort to the investors, but a number of key holders of the bonds realised that there was the need for a better channel of communications between themselves and the regulators. What was available was somewhat haphazard, and therefore a decision was taken to move ahead and explore the idea of creating the Council.

Naturally setting up organisations takes time, but the experience of the ICMA with the AMIC already provided a sound model, allowing relatively fast progress to be made. Bob Parker was highly supportive, particularly as he is also familiar with the covered bond asset class and its peculiarities. The support and encouragement also subsequently voiced by officials at several central banks further validated the concept. The case for creating the CBIC became compelling. The prime objective will be for the organisation to help rebuild confidence in the asset class.

Nevertheless, much work will have to be done to reach out across the investor community to persuade organisations that have not naturally been members of trade associations to sign up. Beyond that the technical working groups will be a priority so that the Council is in a position to deliver value to the members on a range of topical issues centred on ensuring that covered bonds are once more considered a premium product. Specific topics might include looking at standards for transparency and reporting and other measures designed to restore covered bonds' status and trust in the market.

Understandably there will be people who will be concerned about a change in the market dynamics, as investors work together more closely to coordinate their views. Some might see this as a threat to the *status quo*. Yet, the dislocation of the markets and breakdown in traditional approaches is precisely why new ideas and a fresh approach are part of the recovery phase of the capital markets. Most observers will embrace the CBIC and find ways of constructively engaging with it in pursuit of a common aim – greater market confidence and a return to some basic liquidity that will combine to significantly improve the market and improve access. The creation of the CBIC is a timely measure designed to rebuild market liquidity. Though the financial press and the European public may still think of the banking industry in unflattering terms, much is being done to restore confidence and come up with solutions.

For further information, please contact CBIC at: [cbic@icmagroup.org](mailto:cbic@icmagroup.org)

Tim Skeet

*Tim Skeet is Head of Covered Bonds at Bank of America Merrill Lynch, Chair of the ICMA UK and Ireland Region, member of the Steering Committee of the US Covered Bond Council and special advisor to CBIC.*

## Proposed EU central counterparty for credit default swaps

As previously reported in our [Newsletter of January 2009](#), one of the initiatives being progressed in response to the financial crisis relates to the development of central counterparty (CCP) capabilities for the handling of credit default swaps (CDS) and certain other over-the-counter (OTC) instruments. Whilst significant progress has already been made on this in the US, for regulatory, supervisory and monetary reasons, the political decision is that there also has to be a truly EU CCP.

In late 2008, the European Commission sought to obtain commitments from the industry to establish such an EU CCP and to migrate business accordingly. Progress was made through a number of meetings and discussions but efforts finally stalled, with the Commission unhappy at the level of commitment which was being offered. In consequence the Commission threatened to legislate to force a solution.

Nevertheless efforts to find a way to progress have continued on a number of fronts, with ISDA particularly active in coordinating efforts with its member firms. Now for a variety of reasons, including a significantly higher degree of confidence in its technical feasibility, firms have agreed to

move ahead with a commitment to clearing CDS in Europe, by 31 July 2009. A letter to this effect was sent on 17 February to the Commission by a group of nine firms who are key players in the CDS market. This letter has been [welcomed by the Commission](#), though the threat of legislation still remains.

Besides committing the firms to engage to use EU-based central clearing for eligible EU CDS contracts by the end of July 2009, the letter also commits the signatories to work closely with infrastructure providers, regulators and the Commission in resolving outstanding technical, regulatory, legal and practical issues. Each firm will make an individual choice on which central clearing house or houses might best meet its risk management objectives, subject to regulatory approval of any such clearing house in Europe. Progress will be regularly examined in meetings with the Commission.

Additionally on 19 February there was an [announcement of a global framework for cooperation among CDS CCP regulators](#). This followed from discussions amongst US, EU, UK and German regulatory representatives. The primary objectives include:

- mutually supporting each regulator in carrying out its respective authorities and responsibilities with respect to CDS CCPs; and
- applying consistent standards and promoting consistent public policy objectives and oversight approaches for all CDS CCPs.

Other recent public announcements are indicative of tangible progress. Examples include:

- 13 February: [LCH.Clearnet plans to launch clearing services for CDS](#) in the euro area by December 2009, subject to regulatory approval;
- 19 February: [IntercontinentalExchange \(ICE\) will create a new service](#) to serve as a European-regulated central counterparty clearing house for European CDS; and
- 3 March: [ICE Clear Europe to meet key European CDS clearing requirements](#) during first half of 2009.

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## Other financial infrastructure developments in Europe

- On 3 February, the [Monitoring Group \(MOG\)](#) reassessed the implementation of the Code of Conduct and considered recent developments in the European clearing and settlement infrastructure. Of particular importance were different market developments, such as [the Memorandum of Understanding signed between European Multilateral Clearing Facility \(EMCF\) and SIS x clear](#) outlining commitment to offer any of the exchanges or platforms they work with competitive clearing services under the dual CCP model, and also [the announcement of a CCP for Nordic markets by NASDAQ OMX and EMCF](#). The next MOG is scheduled for 7 July.
- The Clearing and Settlement Advisory and Monitoring Expert (CESAME) 2 group was given [an update on progress on Barriers 4&7, and 2&10](#). Two sub groups of the expert group are currently working on these two issues, preparing a report for the June CESAME 2 meeting. The European Repo Council (ERC) Operations and European Primary Dealers Association (EPDA) working group specifically looks at Barriers 2&10 and the impact on Barriers 4&7. The ERC Operations and EPDA group is carrying on its work and aims to present its final report at the June CESAME 2 meeting.
- At the last [Target2 Securities \(T2S\) meeting held in February](#), the T2S team made a presentation on the current

status of T2S. A major step this year has been the publication of [the General Functional Specifications \(GFS\)](#) on 22 January. In order to facilitate the validation process, workshops with central securities depositories (CSDs) were organised by the ECB and four central banks during the first quarter. During its meeting in January 2009, [the T2S Advisory Group \(AG\)](#) primarily focused on technical issues, in particular on the outcome of the work by the different sub-groups of the AG. It was decided that a dedicated workshop on pricing would occur in February. Another important step for the first quarter of 2009 is the invitation to non euro area CSDs to notify their commitment to the ECB. Denmark and Lithuania have already committed for euro and their national currency. The [March T2S AG meeting](#) received an update on technical issues, including pricing, and ensured coordination with CESAME 2 group work.

- CESR also published its [Draft technical advice on access and interoperability arrangements](#). The Commission mandated CESR to map the current regulatory arrangements for post trading infrastructures and advise on possible solutions to bridge any potential differences in these arrangements.

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### GMRA: update of legal opinions

We are pleased to inform you that ICMA will shortly complete the Global Master Repurchase Agreement (GMRA) legal opinion update exercise for 2009. ICMA has obtained update opinions on the GMRA for 68 jurisdictions and a new opinion on the GMRA for Oman.

The 2009 GMRA Opinions have been obtained for the benefit of ICMA, its members and associate members and cover the 1995 and 2000 versions of the GMRA as well as the GMRA 1995 as amended by the Amendment Agreement to the GMRA 1995.

The 2009 GMRA Opinions cover both the enforceability of the netting provisions of the GMRA as well as the validity of the GMRA as a whole. Furthermore, the 2009 GMRA Opinions address the issue of recharacterisation risk (in respect of both the transfer of securities and the transfer of margin).

The 2009 GMRA Opinions (including, in the case of each 2009 update opinion, a clean version and a blacklined version that tracks the amendments made to the 2008 opinion) will shortly be made available to ICMA members and associate members on [ICMA's website](#).

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## Collaboration with Asian trade associations

In recent weeks ICMA has entered into two separate cooperative arrangements with trade associations in the Asian market, signing Memoranda of Understanding with the [Singapore Investment Banking Association \(SIBA\)](#) and the [Hong Kong Treasury Market Association \(TMA\)](#).

These important strategic relationships with national associations are designed to allow knowledge transfer across borders and asset classes and so assist in the development of internationally recognised global standards for transacting business.

ICMA will work with both SIBA and TMA on a variety of issues, including: law and regulation, including self regulation, clearing and settlement procedures and accreditation and training for market professionals.

## Professional repo and collateral management course March 2009

Last month, despite continuing gloom in the financial markets, over 250 delegates working in the international repo market gathered in Brussels for the latest in a long and successful series of ICMA-ACI repo courses. Over two days they heard a range of speakers, including market professionals, academics and central bank officials give practical insights on the working of the repo market, trading and settling repo, its documentation, triparty repo and collateral management. This unique event also provided an update on the impact of the crisis on the repo market in Europe. For the first time course delegates had the option to attend a pre-conference workshop on securities lending produced in cooperation with ISLA, providing an overview of equity and fixed income lending markets from both a lender and borrower perspective.

For more information about the next Professional repo market course please contact the ICMA events team.

Contact: [events@icmagroup.org](mailto:events@icmagroup.org)

## ICMA AGM and Conference 2009

ICMA's 41st AGM and Conference will take place in Montreux from 3-5 June this year. As in previous years the two day Conference is open to non-members as well as members of the Association.

The Conference this year will feature debates on what the future holds for the global finance industry in the light of the continuing financial crisis, including sessions on the regulatory response to the crisis, prospects for issuers, opportunities for investors, changing market practice, clearing and settlement and private banking.

There will be contributions from leading industry figures, central bankers and regulators including:

**Mark Cutis**, Chief Investment Officer – Global Special Situation Group, Abu Dhabi Investment Council;

**Philipp Hildebrand**, Vice Chairman of the Governing Board, Swiss National Bank;

**Bertrand de Mazières**, Director General, Finance, European Investment Bank;

**Yoshio Okubo**, Senior Managing Director, Japan Securities Dealers Association;

**Francesco Papadia**, Director General, Market Operations, European Central Bank;

**Robert Parker**, Vice Chairman, Credit Suisse Asset Management;

**Michel Prada**, Former Chairman, Autorité des Marchés Financiers;

**Hans-Joerg Rudloff**, Chairman, Barclays Capital, and Chairman, ICMA;

**Greg Tanzer**, Secretary General, IOSCO;

**Gillian Tett**, Assistant Editor, FT;

**Daniel Zuberbühler**, Director, Financial Market Supervisory Authority.

For a detailed conference programme and to register your attendance at the event please go to the [ICMA website](#).

## Educational Courses

[International Fixed Income and Derivatives Certificate Programme \(IFID\)](#)

26 April-2 May 2009  
Sitges, Barcelona

[Primary Market Certificate Programme \(PMC\)](#)

18-22 May 2009  
London

[Financial Markets Foundation Course \(FMFC\)](#)

14-16 September 2009  
London

[Financial Markets Foundation Course \(FMFC\)](#)

21-23 September 2009  
Luxembourg

[Primary Market Certificate Programme \(PMC\) Bahrain](#)

25-29 October 2009  
Bahrain

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