INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

From the Desk of Ian Russell
President and CEO, Investment Industry Association of Canada (IIAC)

IIAC Fixed Income Market Regulatory Update – February 16, 2016

United States

International Monetary Fund (IMF) Highlights Vulnerabilities in U.S. and Global Debt Capital Markets

- In a speech delivered on February 10, IMF's José Viñals stated tensions in market liquidity could exacerbate pressure on credit markets.
- U.S. high yield securities are increasingly held by mutual funds—approximately 30% of the high yield market was owned by mutual funds in 2015, up from 15% in 2006. These funds promise daily liquidity to investors, but hold assets that are increasingly illiquid.
- High yield debt issuers have seen their leverage rise and are more likely to fall in distress, said Viñals. The share of distressed bonds in the U.S. high yield category has risen from 1% in 2013 to 7% year-end 2015.
- Highly indebted and fragile corporates could also suffer from funding stress if credit risks in the high yield bond market rise and liquidity wanes. Difficulties issuing new debt securities could lead to higher corporate defaults, amplifying bank charge-offs and leading to an increasing number of credit rating downgrades.
- Viñals also highlighted rising vulnerabilities in emerging markets in his speech. One-quarter of outstanding corporate debt in emerging markets is from oil and mining companies.
- You can read José Viñals' speech by clicking here.

IMF Highlights Risk in the Derivatives of Bond Mutual Funds

- IMF's Fabio Cortes noted a number of large bond mutual funds invest in derivative instruments—contracts that permit investors to bet on the future direction of interest rates. However, unlike bonds, most derivatives require a small deposit to make the investment, which amplifies their potential gains through leverage.
- Assets under management of large U.S. and European bond mutual funds that focus on derivative investments have increased significantly since the global financial crisis, exceeding an estimated $900 billion, or about 13% of the world's bond mutual funds.
- Investors in leveraged bond mutual funds, when faced with a rapid deterioration in the value of their investments, may rush to cash in, reinforcing a vicious cycle of fire sales, investor losses and redemptions.
- There is no requirement for disclosing leverage data in the U.S., and only on a selected basis in some European Union countries. This leaves investors and policymakers in the dark on a key issue for financial stability, said Cortes.
- The IMF recommends implementing detailed and globally consistent reporting standards across the asset management industry to provide regulators data to locate and measure the extent of leverage risks. The IMF said reporting standards should include leverage information (level of cash, assets,

and derivatives) to show mutual funds' sensitivity to large interest rate and credit market moves and to facilitate meaningful analysis of financial sector risks.

- Most of the funds showing high leverage levels are invested in a wide range of bonds, including U.S. Treasuries, emerging market bonds, junk bonds and asset backed securities. This is a further cause for concern because it could increase the risk of contagion.
- The U.S. Securities and Exchange Commission (SEC) is planning to require mutual funds to limit their use of derivatives and manage the associated risk by segregating enough collateral to cover all obligations, including "under stressed conditions".
- You can read more from the IMF's Fabio Cortes here.

Europe

MiFID II Delay

- MiFID II was slated to come into force January 3, 2017. The deadline has been pushed out one year to January 3. 2018.
- The totality of the MiFID text, comprising some 1,500 pages, reflects the vast scope of the rules and the complexity of implementing an ambitious legislative package, covering everything from derivatives trading to bond transparency.
- MiFID II broadens the pre- and post-trade transparency rules to include bonds. The European Securities and Markets Authority (ESMA) adopted an instrument-by-instrument approach to assess liquidity on individual bonds. Each borrowing instrument is assessed against the following three criteria:
    - Is the average daily notional amount traded at least €100,000;
    - Does the bond trade at least twice a day, on average; and
    - Does the bond trade in at least 80% of the trading sessions available?

  If the answer to all of these questions is yes, then the bond is deemed liquid. The calculation is undertaken every three months.
- Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, said MiFID II has been delayed due to "the complexity of the technical challenges"—the European regulators' IT systems are not ready, and market participants have not had enough time to design and build data reporting systems to comply with the measures.
- Information on MiFID II is available here.

Call for Evidence on EU Regulatory Framework for Financial Services

- Since the Global Financial Crisis there have been 48 pieces of European Union legislation in financial services and many more delegated and implementing acts. Some rules have yet to be fully implemented and much detail still to be finalised.
- The European Commission launched consultations and requested stakeholders submit evidence on: how rules affect the ability of the economy to finance itself and grow; unnecessary regulatory burdens; interactions, inconsistencies and gaps in the rules framework; and rules giving rise to unintended consequences. The European Commission's *Call for Evidence* consultation document is available here.
- In September 2015, Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union, requested feedback on the rule-making process since the 2008 financial crisis by the January 31, 2016 deadline. The financial industry responded overwhelmingly that the regulations had gone too far in achieving financial stability at the expense of an ever-expanding regulatory burden and inefficient markets. The interesting question is how the EU financial-services Commissioner will now respond.

- In response to the call for evidence, the Her Majesty's Treasury (HM Treasury) noted the following:
    - Fixed income market participants, including national debt managers, are observing declining market liquidity across all major bond markets. The Basel III leverage ratio framework has been commonly cited as a cause of poor liquidity in fixed income instruments.
    - The proposed MiFID II regulatory technical standards on bond market transparency (see section above) could damage the efficient functioning of Europe's bond markets through the calibration of the thresholds and requirements to provide firm quotes on market liquidity. Poorly calibrated transparency requirements in secondary markets may have a significant impact on the costs of financing in the wider economy. Issuers could face higher funding costs to attract investors.
    - Under MiFID II, a bond that is traded on average at least twice a day, on 80% of trading sessions, at a notional amount of at least €100,000, is defined as liquid. This threshold is contrary to the typical definition of liquidity—where there are ready and willing buyers on a continuous basis.
    - The IMF and the Bank of International Settlements have indicated that as depth in fixed income markets has been declining, execution strategies have increasingly been carried out using more trades with smaller ticket sizes. This is a sign of deteriorating liquidity, but the liquidity criteria in MiFID capture this as increased liquidity. These market conditions have not been properly considered in setting the two trades a day threshold.
    - Supporting the industry-led development of robust standards and processes for green bonds will be particularly important to mobilise the capital managed by long-term institutional investors, such as pension funds and life insurers. At present, European legislative intervention could be misguided and potentially counterproductive—it would act as a disincentive to issuers of green securities by creating prohibitive legal costs, or stifle the market in other unforeseen ways.

European Covered Bond Market

- A Europe-wide rule book for covered bonds looks less likely, according to Jonathan Hill, European Commissioner for Financial Stability, Financial Services and Capital Markets Union. His remarks came at the conclusion of European Commission consultations on the structure and treatment of covered bonds.
- The European Commission consultation paper outlined two options for harmonising covered bond issuance across the EU: 1) convergence of countries' covered bond laws through voluntary, non-legislative co-ordination measures; and 2) direct legislation at EU level.
- The majority of respondents to the Commission's consultation largely rejected full-blown EU-wide standardisation. They warned bringing together different countries' markets will be difficult and should be done carefully to avoid damaging individual markets.
- The European Commission wants a "more integrated market" rather than "one harmonised framework".
- Submissions noted there are a number of local factors—including, type of mortgage, interest rate, and extent of recourse—that impact the quality of assets. They will continue to impact covered bond markets, even if there is EU market uniform legislation.
- Despite concerns about EU-wide standardisation, most respondents agree a more integrated covered bond framework could deliver benefits—i.e. enhanced transparency, greater liquidity and more cross-border investment.
- Additional information on the Commission's consultation, including submissions, is available here.

Asia

China releases Code on the Content and Format of Information Disclosure by Corporate Bond Issuers

- The China Securities Regulatory Commission said it will improve the regulatory system of corporate bond information disclosure, intensify interim and post-supervision to push for standardization, and protect the investors' legal rights and interests.
- Additional information is available from the National Association of Financial Market Institutional Investors (NAFMII) here.

Korean Government Expanding the Scope of Collateral of Corporate Bonds

- According to news reports, Korean companies that have trouble raising funds due to a low credit rating may be able to issue corporate bonds with favorable conditions by combining tangible and intangible assets as collateral of secured corporate bonds.
- The current *Secured Corporate Bond Trust Act* stipulates that collaterals are chattels, real estate, bonds and stocks. The government is considering expanding collaterals to include patents, lease rights, brand value, goodwill and other intangible assets.
- Investor protection will be further strengthened.
- The Korean government is considering change-of-control investor put options used in the U.S. They provide bondholders with the right to require the issuer to redeem the bonds at a cash price usually equal to 101% of the principal amount of the bond, if a change of control event takes place.

The Investment Industry Association of Canada (IIAC)
Representing Canada's Investment Dealer Firms

The Investment Industry Association of Canada (IIAC) is the national association representing the position of 144 IIROC-regulated Dealer Member firms on securities regulation, public policy and industry issues. The IIAC has successfully argued for positive change in securities regulation and public policy that has improved market efficiency and lowered costs for dealers and market participants without jeopardizing investor protection. Click here to read the Highlights of Our 2015 Achievements.

The IIAC's efforts have assisted Member firms address:

- CRM rule-making and managing industry CRM compliance efforts
- Cyber threats
- Tax reporting requirements (e.g. FATCA, OECD Common Reporting Standard, and Specified Foreign Property Tax Reporting)

The IIAC has also taken a leading role among trade associations in laying out the rationale for a cooperative securities regulator, pension reform and OTC derivatives reform with positive results.

For the latest IIAC news, events, commentary and more, connect with the IIAC on social media.

LinkedIn

Twitter @IIACACCVM

Google+

Facebook

flickr

http://iiac.ca