European Leveraged Finance Association

BRIEFINGS

LEGAL & REGULATORY

23 August 2021

Legal and Regulatory Updates

09/08/2021 – 13/08/2021

Key Highlights

- This Legal & Regulatory Update covers the week commencing **09/08/2021**.
- BoE publishes a staff working paper on corporate debt booms, financial constraints, and the investment nexus.
- ECB agrees on an ambitious roadmap on how to integrate climate change considerations into their work.
- AMF updates its policy on the pre-approval of changes to UCITS and AIFs during their lifetime.
- ICMA responds to IOSCO's consultation paper on Sustainability-Related Practices in Asset Management.
- IOSCO publishes its results on ETF behaviour during COVID-19 induced market stress.
- FSB publishes a summary of workshop on compensation practices 2021.
- FSB to host a virtual workshop to engage with external stakeholders on the preliminary lessons learnt form the COVID-19 experience.
- In this update, we also cover some of the most important news on leveraged finance published by the Financial Times during the week.

Bank of England (BoE)

13 August 2021: BoE publishes a staff working paper on corporate debt booms, financial constraints, and the investment nexus

The Bank of England (BoE) published a staff working paper on the Corporate debt booms, financial constraints, and the investment nexus. The Staff Working Paper found that:

- Debt overhang leads financially vulnerable firms to cut permanently back on investment.
- Vulnerable firms experience weaker intangible capital growth in the aftermath of debt booms, and
- General equilibrium effects dominate, stressing the risk that firm-specific debt booms in a subset of firms may spill over to the rest of the economy.

09 – 13 August 2021: Speeches, Letters & Other Publications

During the week, the BoE released the following speeches, announcements and publications that might be of interest to our readers:

- Minutes of the Working Group on Sterling Risk-Free Reference Rates - July 2021 – the Working Group on Sterling Risk-Free Reference Rates, which is comprised of a diverse set of market participants, is working to catalyse a broad-based transition to SONIA by end-2021
- Could price data from exchange-traded funds help open-ended fund managers calculate price adjustments? – Bank Overground

European Insurance and Occupational Pensions Authority (EIOPA)

09 – 13 August 2021: Speeches, Letters & Other Publications

During the week, the European Insurance and Occupational Pensions Authority (EIOPA) released the following speeches, announcements, letters, and publications that might be of interest to our readers:

- Follow-up report to peer review: Supervision of key functions has improved – the EIOPA published a follow-up report to the 2018 peer review on the supervisory practices for the application of proportionality principle in government requirements regarding key functions. The follow-up report assesses how national competent authorities (NCAs) have implemented the recommended actions from the original peer review.

European Central Bank (ECB)

9 August 2021: ECB agrees on an ambitious roadmap on how to integrate climate change considerations into their work

The European Central Bank (ECB) as part of their strategy review, agreed on an ambitious roadmap on how to integrate climate change considerations into their work. The three milestones agreed to be used to tackle climate change with their mandate are as follows:

The First Milestone: Paving the way with reliable data:

- Gathering needed for climate change risk analyses, and
- Adapting models and making them fit for climate change

The Second milestone: Knowledge is the driving force:

- The ECB will be checking their exposure to climate risks;
- Checking firm's and banks' exposure to climate risks;
- Making disclosure of climate risks a priority, and
- Reviewing how credit ratings reflect climate risks

The Third milestone: Action based on reliable data and best knowledge

- The ECB will be including climate risks into their collateral framework, and
- The ECB will make their asset purchases greener.

23 August 2021

09 – 13 August 2021: Speeches, Letters & Other Publications

During the week, the ECB released the following speeches, announcements, letters, and publications that might be of interest to our readers:

- The changing link between labour cost and price inflation in the United States – Working Paper Series - No. 2583
- Fifty shades of QE: comparing findings of central bankers and academics – Working Paper Series - No. 2584

Autorité des Marchés Financiers (AMF)

12 August 2021: AMF updates its policy on the pre-approval of changes to UCITS and AIFs during their lifetime

The Autorité des Marchés Financiers (AMF) has updated its policy on a number of instructions relating to authorised UCITS and AIFs funds. It has also clarified and simplified a number of rules relating to the approval of changes made during the life of these funds.

To determine whether a change in investment strategy that influences a fund's risk and reward profile is a change, subject to pre-approval by the AMF or just a simple change, asset management companies have to closely examine the risk level linked to changes in exposure to one or more types of risk resulting from these transactions. The change is subject to pre-approval by the AMF, if this change is strictly greater than 20% of net assets.

The new rule has been introduced to determine whether or not a change requires pre-approval by the AMF and to refocus the AMF's work on the most high-stakes transactions. Two criteria have been considered:

- Changes in the synthetic risk indicator (SRRI) and
- Changes in exposure to one or more types of risk.

It is important to note that the rules on informing investors (individually or by any other means) and the rules on exiting the fund free of charge, remain unchanged. Only the rules for determining whether pre-approval by the AMF is required have changed.

Authorised collective investment management companies will have to comply with the provisions of the new instructions for requests received on or after 1 September 2021.

International Capital Market Association (ICMA)

13 August 2021: ICMA AMIC responds to IOSCO's consultation paper on Sustainability-Related Practices in Asset Management

International Capital Market's Association's (ICMA) has submitted its response on IOSCO's consultation on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management. The Asset Management and Investors Council (AMIC), ICMA's buy side voice, was the key group in preparing the draft for this response. AMIC expressed its support for IOSCO's recommendations and highlighted three key priority areas in needing to address:

- The Risk of market fragmentation: The creation of local labels, taxonomies and rules have certainly helped structure the uptake of ESG and sustainable investment solutions; this was viable when these strategies were still relatively niche. But given that these strategies are becoming more mainstream and are witnessing new expectations from both asset owners and global regulators, it is now reaching a stage where ensuring international coordination is crucially needed. Adding further mandatory frameworks, definitions and interpretations related to sustainable finance and on a unilateral basis could hinder cross-border distribution of funds and limit options available to investors.
- Ensuring global alignment across jurisdictions: Global alignment is thus critical to minimise some of the cross-border issues and ensure consistent transparency across the entity and product level disclosures across jurisdictions. The TCFD framework is the globally recognised standard where the EU has also put in place voluntary climate-related guidelines largely inspired by TCFD. When it comes to other environmental and social/governance aspects, standards and practices are understandably more fragmented but anticipate that it will be addressed in the future sustainability reporting standard developed by the newly established ISSB. Until this work is finalised ICMA recommends focusing on climate related disclosures and, to cover social and governance aspects, referring to the SASB and the GRI frameworks, which have served as credible references for both issuers and asset managers in the recent years.
- Recognise and Mitigate data gap challenges: The recent regulatory developments are for the most part strictly focusing on the buy-side and their products and rarely involves similar disclosure requirements for issuers. This leaves investors in a vulnerable position, as they need to report against mandatory sustainability KPIs at either product or entity level but cannot rely on audited data published by issuers. This heterogeneity of information already forces asset managers to work with several ESG data providers in order to work out the credible average performance of an issuer against the KPIs recommended by supervisors, and new mandatory reporting requirements will accentuate this problem. ICMA welcome the fact the IFRS is already working toward a global sustainability reporting standard, but until this work is finalised and adopted locally, ICMA suggests for supervisors to acknowledge the data challenges that asset managers are currently facing, to limit mandatory reporting requirements and allow them to perform these new disclosures on a voluntary basis or at least on a reasonable efforts basis.

After highlighting these key priorities, ICMA further provided high level responses to the Consultation paper's questions. The Consultation Paper was issued by IOSCO in June 2021 and can be accessed here.

International Organisation of Securities Commission (IOSCO)

12 August 2021: IOSCO publishes its results on Exchange Traded Fund behaviour during COVID-19 induced market stress

The International Organisation of Securities Commission (IOSCO) published its Report reviewing the impact of COVID-19 stresses on the operation and activity of the primary and secondary markets of ETFs. In particular, it explored the impact of the stress on the ETF structure and functioning, the causes of the pricing differences between some fixed income ETFs' secondary market prices and their net asset values (NAVs). It also outlined some challenging circumstances concerning some derivatives-based ETFs.

The analysis grouped ETFs based on their underlying asset classes (i.e., equities, government bonds, investment-grade (IG) bonds and high-yield (HY) bonds) and geographical regions / listing venues (i.e., US, Europe, and Asia Pacific) to provide a more granular view of how each category of ETFs fared in different regions during the period.

Overall, the report highlights that the data analysed, including the feedback received from participants, has not indicated any significant risks or fragilities in the ETF structure, although a subset of ETFs temporarily experienced unusual trading behaviours. The analysis could prove instructive when IOSCO considers future enhancements to ETF regulation and guidance.

The report further goes on to show how the COVID-19 volatility has shed light on the resilience of most ETFs across various market segments during stressed markets. There is an emerging consensus that fixed income ETFs could provide useful pricing information to the wider market. However, a fixed income ETF's value as a price discovery tool for the individual bonds in the underlying portfolio remains subject to debate and ongoing research. In addition, the stress episode helped alleviate concerns about possible financial stability risks relating to the ETF structure. Nevertheless, this note could also prove instructive in the consideration of future enhancements in ETF regulation and guidance.

In accordance with its 2021-2022 Work Program, IOSCO is continuing its broader analysis of the ETF market in 2021. As part of this, it will consult on ETF policy proposals in late 2021/H1 2022.

Financial Stability Board (FSB)

09 August 2021: FSB publishes a summary of workshop on compensation practices 2021

The Financial Stability Board (FSB) published a summary of discussions on an industry virtual workshop that took place in May 2021. It hosted the workshop as a part of its regular assessment of the effectiveness of the implementation of the FSB's Principles for sound compensation Practices and their Implementation Standards.

The workshop was an opportunity to exchange information on key compensation issues and challenges for the effective alignment of risk and compensation, with an additional focus on the impact of the pandemic on firms' compensation practices. The workshop covered:

- Non-financial criteria and measures, behaviours, and firm culture – Participants identified trends in the use of non-financial criteria, potential differences across sectors and how these criteria affect and are affected by firm culture.
- Effective alignment of risk and compensation – Participants identified effective practices for alignment between risk and compensation and how practices may vary across sectors.
- Legal and regulatory issues – The discussion focused on the most significant legal and regulatory impediments to the use of compensation tools, such as malus and clawback and possible steps to address these. The session also explored firms' use of severance pay.
- COVID-19 and compensation – Participants discussed compensation-related actions firms and supervisors have taken in relation to COVID-19.

The discussions from the workshop will provide an input into the FSB's ongoing work on identifying effective practices and enhancements to compensation frameworks.

13 August 2021: FSB to host a virtual workshop to engage with external stakeholders on the preliminary lessons learnt form the COVID-19 experience

The Financial Stability Board (FSB) aims to host a workshop to provide an informal forum for stakeholders to exchange views on the issues discussed in its interim report. The Report published in July identified preliminary lessons learnt from the COVID-19 experience and aspects of the functioning of the G20 financial reforms that may warrant attention at the international level. As per the report, the pandemic reinforced the importance of completing the remaining elements of the G20 reform agenda, as those parts of the global financial system where implementation of the reforms were more advanced, displayed resilience. The functioning of capital and liquidity buffers warrants further consideration, while some concerns about excessive financial system procyclicality remain.

The report further went on to explain how the March 2020 market turmoil underscored the need to strengthen the resilience in non-bank financial intermediation. While the pandemic highlighted the importance of effective operational risk management arrangements, the need to enhance further crisis management preparedness, and the importance of promoting financial resilience amidst rapid technological change more generally.

Furthermore, the report highlighted that the COVID-19 crisis may yet test the resilience of the global financial system. As, Banks and non-bank lenders could face additional losses as support measures are unwound. Addressing debt overhang, including by facilitating the market exit of unviable companies and by promoting the efficient reallocation of resources to viable firms, may be a key task for policymakers going forward.

The feedback received during the workshop will help inform the FSB's final report, which will be published ahead of the G20 Summit in October 2021. Participation in the workshop is open to all and all participants are encouraged to contribute to the ensuing discussion. The workshop will be held on Wednesday 1 September at 13:00 (CEST) and will cover market and institutional resilience, operational and cyber resilience, and crisis management preparedness.

23 August 2021

In the News

During the week, the Financial Times published the following news that might be of interest to our readers.

- Distressed debt fund SVP bets Europe will have long 'hangover' from Covid
  "The average yield of US junk bonds — debt issued by companies rated below investment grade — has tumbled from a peak of more than 11 per cent in March 2020 to under 4 per cent earlier this summer. That drop, the flip side of rising prices, takes yields to their lowest since at least 1996, according to ICE data. Junk bond yields are even lower in Europe, due to the European Central Bank's aggressive quantitative easing programme and below-zero interest rates. The effective yield of ICE's euro-denominated "high yield" index is just 2.3 per cent."
- A hedge fund revival? Industry hopes a dismal decade is over
  "Fixed income has historically been a mainstay of most investors' portfolios, thanks to their subdued but steady returns and ability to rally when stock markets are rocky. But with bond yields hitting record lows, the return outlook is dismal and their historical ability to buffer stock market losses is severely impaired, many investors fret. Moreover, if inflation does ignite then supposedly safe fixed income markets might even start losing money. That means many investors are desperately looking for a "fixed income substitute" — something that could at least plausibly do well even if stock markets wobble."
- Private capital groups soar on boom in unlisted assets
  "Although the market rebound since the depths of the coronavirus crisis has lifted the value of assets they hold, the outlook for further gains now looks limited in almost all leading bond and equity markets, given record or near-record valuations. As a result, many are turning to private equity, venture capital, infrastructure, real estate, and direct lending — strategies often grouped together as "private capital", as they invest in opaque assets that do not trade on public exchange — to amplify their returns. "People are quite worried about the long-term prospects of listed equities and fixed income, and therefore need to look at alternatives to generate their target returns," said Garvan McCarthy, a partner at investment consultancy Mercer."
- Back from brink Chesapeake buys shale rival Vine
  "Chesapeake Energy, the US shale pioneer that collapsed during last year's oil-price crash only to emerge from bankruptcy in February, has agreed to buy rival natural gas producer Vine Energy for $2.2bn in equity and cash…US shale operators are trying to reduce their operations' greenhouse gas emissions ahead of new anti-methane measures expected from the EU, an important market for American exports, and in response to pressure from ESG-focused investors"
- Treacherous markets fuel boom in outsourcing investment teams
  "The trend towards outsourcing will only continue to accelerate," Larry Fink, BlackRock chief executive, said on the asset manager's recent earnings call. "More clients are looking to outsource their entire portfolio as regulations intensify, operating costs rise and investing grows more complex." BlackRock recently won a $30bn OCIO mandate to manage British Airways' pension plan — the biggest such deal on record in the UK, according to the asset manager — and Fink predicted that this would become "a catalyst for more transformational change in the industry."
- Venture debt: start-up borrowing fails pandemic test
  "Silver Lake and Sixth Street Partners made a near 100 per cent return lending to Airbnb last year before the home rental company went public. Low interest rates in the US, where the 10-year Treasury yield is 1.43 per cent, have increased demand for high-yield debt."
- Lenders offer cheap deals to Silicon Valley to compete with flood of venture capital
  "Banks and other lenders have cut prices and loosened their terms to make debt more attractive to Silicon Valley start-ups, as they try to compete with flush venture capitalists."
- Evergrande shares jump as indebted developer confirms asset sale talks
  "But last week, S&P Global Ratings downgraded Evergrande deeper into speculative grade and said the company's liquidity position was "eroding more quickly and by more than we previously expected". The company's offshore bonds are being closely tracked by investors and rating agencies amid a surge in short selling bets against them."
- Tobacco group PMI wins support of Vectura's board for £1bn takeover
  "Many of our investors want us to be able to show we're putting ESG up there" alongside financial returns, he said ahead of the board's announcement. "It's a very difficult one." He said he feared that selling to the tobacco group might enable it to use Vectura as "window dressing" or for "greenwashing". However, a PMI spokesman hit back at "critics of the transformation of the tobacco industry". The company "has been very clear about its strategy to leave cigarettes behind". Smoke-free products now accounted for 28 per cent of PMI's revenues, up from "almost zero" in 2015, he said.
- Banks close to business as usual in US and Europe despite pandemic effects
  "US and European banks have begun to move on from the worst effects of the coronavirus pandemic as they attempt to return to business as usual. Second-quarter results showed investment banking revenues surging past pre-pandemic levels, while US and British banks have taken back much of the capital, they set aside a year ago in preparation for a wave of defaults. Recent European bank stress test results also showed that, even in the worst-case scenarios devised by regulators, most large lenders have enough capital in reserve to survive the pandemic's long-term economic consequences"

23 August 2021

- Quitting QE may be harder than the Bank of England believes
  “After more than a decade of quantitative easing, the Bank of England will soon have almost £900bn of government bonds on its hands. The central bank last week offered the first detailed plan of how it aims to get rid of them, as it gradually tightens monetary policy following the Covid-19 pandemic.”
- The whistleblower who calls ESG a deadly distraction
  “the UN-backed Principles for Responsible Investment had delayed until 2023 the date by which signatories must report how they measure up to its sustainable reporting standards. The tougher reporting standards PRI piloted last year were aimed at making it “much harder to get the top mark”, she said. But technical issues bedevilled the pilot, with the world’s biggest pension funds and asset managers finding PRI’s reporting system difficult to use. After the system broke, gaps in the reported data emerged, making consistent measurement impossible.”
- Letter: UK can lead by example on green recovery funds
  “Chancellor Rishi Sunak has promised to launch a “green bond” this summer and, were savers to be adequately incentivised, it has been shown how this could finance the Green New Deal.”
- ESG must learn from the tech bubble — returns matter
  “History is not preordained to repeat itself, but ESG investors should pay attention to prospective financial returns as well as other potential gains to society. If they are not aligned, someone will be paying over the odds. Morningstar reports that a net $51.1bn flowed into US sustainable funds alone in 2020. In early April 2021, BlackRock, the investment group, achieved the largest ETF launch to date, raising $1.25bn for its new US Carbon Transition Readiness Fund. Existing funds are rebranding as ESG-focused. Many companies are rushing to align with the trend. New sustainability benchmarks have been developed. Green bonds are being issued at a premium to their conventional equivalents from the same issuers.”
- Climate change: companies must see past trees to blazing forests
  “But, plainly, a business cannot legitimately tell ESG investors that a project is carbon neutral if offsets have been literally carbonised. The onus is on businesses to account as transparently for carbon reduction as they do for profits. Fund management groups must hold them to account.”

Regulators and Associations Monitored

1. FCA
2. BoE
3. The Pensions Regulator
4. FRC
5. ESMA
6. EBA
7. EIOPA
8. ESRB
9. ECB
10. European Commission
11. BCBS
12. Autorité des Marchés Financiers (AMF) of France
13. CSSF
14. FINMA
15. CBI
16. ICMA
17. IOSCO
18. FSB

Important Information:

European Leveraged Finance Association
35 Ballards Lane, London N3 1XW
T +44 (0)7921 384457
E support@elfainvestors.com