BANKING AND FINANCE

Public consultation on Building a Capital Markets Union

Fields marked with * are mandatory.

Introduction

The purpose of the Green Paper is to consult all interested parties on the Commission's overall approach to putting in place the building blocks for CMU by 2019, the underlying economic rationale of CMU, and on possible measures which could be taken to achieve this objective.

The main areas that the Green Paper seeks to address are:

- Improving **access to financing** for all businesses across Europe and investment projects, in particular start-ups, SMEs and long-term projects;
- increasing and **diversifying the sources of funding** from investors in the EU and all over the world; and
- making the **markets work more effectively** so that the connections between investors and those who need funding are more efficient and effective, both within Member States and cross-border.

Please note: In order to ensure a fair and transparent consultation process **only responses received through our online questionnaire will be taken into account** and included in the report summarising the responses. Should you have a problem completing this questionnaire or if you require particular assistance, please contact fisma-cmu-surveyec.europa.eu.

More information:

- on this consultation
- on the green paper
- on the protection of personal data regime for this consultation

1. Information about you

*Are you replying as:

- ○ a private individual
- ◉ an organisation or a company
- ○ a public authority or an international organisation

*Name of your organisation:

International Securities Lending Association (ISLA)

Contact email address:

The information you provide here is for administrative purposes only and will not be published

admin@isla.co.uk

*Is your organisation included in the Transparency Register?
(If your organisation is not registered, we invite you to register here, although it is not compulsory to be registered to reply to this consultation. Why a transparency register?)

- ◉ Yes
- ○ No

*If so, please indicate your Register ID number:

575888466-70

*Type of organisation:

- ○ Academic institution
- ○ Company, SME, micro-enterprise, sole trader
- ○ Consultancy, law firm
- ○ Consumer organisation
- ◉ Industry association
- ○ Media
- ○ Non-governmental organisation
- ○ Think tank
- ○ Trade union
- ○ Other

*Where are you based and/or where do you carry out your activity?

United Kingdom

*Field of activity or sector (*if applicable*):

at least 1 choice(s)

- [x] Banking
- [ ] Insurance
- [ ] Pension provision
- [x] Investment management (e.g. hedge funds, private equity funds, venture capital funds, money market funds, securities)
- [ ] Market infrastructure operation (e.g. CCPs, CSDs, Stock exchanges)
- [ ] Other financial services (e.g. advice, brokerage)
- [ ] Non-financial sector
- [ ] Other
- [ ] Not applicable

Important notice on the publication of responses

*Contributions received are intended for publication on the Commission's website. Do you agree to your contribution being published?
(see specific privacy statement)

- (•) Yes, I agree to my response being published under the name I indicate (*name of your organisation/company/public authority or your name if your reply as an individual*)
- ( ) No, I do not want my response to be published

2. Your opinion

Respondents are invited to answer as many questions as they feel appropriate, but should not feel obliged to answer questions on which they have no opinion or expertise.

Even where yes/no questions are indicated, respondents are invited to also provide qualitative responses.

Respondents are also welcome to upload free text documents, position papers, reports which they consider relevant. A button for this purpose is provided at the end of the consultation.

Priorities for early action

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

1. Beyond the five priority areas identified for short term action, what other areas should be prioritised?

2. What further steps around the availability and standardisation of SME credit information could support a deeper market in SME and start-up finance and a wider investor base?

3. What support can be given to ELTIFs to encourage their take up?

4. Is any action by the EU needed to support the development of private placement markets other than supporting market-led efforts to agree common standards?

- Yes
- No

Comments on question 4:

Measures to develop and integrate capital markets - Improving access to finance

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

5. What further measures could help to increase access to funding and channelling of funds to those who need them?

6. Should measures be taken to promote greater liquidity in corporate bond markets, such as standardisation? If so, which measures are needed and can these be achieved by the market, or is regulatory action required?

7. Is any action by the EU needed to facilitate the development of standardised, transparent and accountable ESG (Environment, Social and Governance) investment, including green bonds, other than supporting the development of guidelines by the market?

- Yes
- No

Comments on question 7:

8. Is there value in developing a common EU level accounting standard for small and medium-sized companies listed on MTFs? Should such a standard become a feature of SME Growth Markets? If so, under which conditions?

9. Are there barriers to the development of appropriately regulated crowdfunding or peer to peer platforms including on a cross border basis? If so, how should they be addressed?

Measures to develop and integrate capital markets - Developing and diversifying the supply of funding - Boosting institutional investment

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

10. What policy measures could incentivise institutional investors to raise and invest larger amounts and in a broader range of assets, in particular long-term projects, SMEs and innovative and high growth start-ups?

11. What steps could be taken to reduce the costs to fund managers of setting up and marketing funds across the EU? What barriers are there to funds benefiting from economies of scale?

12. Should work on the tailored treatment of infrastructure investments target certain clearly identifiable sub-classes of assets?

- Yes
- No

Comments on question 12:

12.1 If so, which of these should the Commission prioritise in future reviews of the prudential rules such as CRDIV/CRR and Solvency II?

13. Would the introduction of a standardised product, or removing the existing obstacles to cross-border access, strengthen the single market in pension provision?

14. Would changes to the EuVECA and EuSEF Regulations make it easier for larger EU fund managers to run these types of funds?

14.1 What other changes if any should be made to increase the number of these types of fund?

15. How can the EU further develop private equity and venture capital as an alternative source of finance for the economy?

15.1 In particular, what measures could boost the scale of venture capital funds and enhance the exit opportunities for venture capital investors?

16. Are there impediments to increasing both bank and non-bank direct lending safely to companies that need finance?

Measures to develop and integrate capital markets - Developing and diversifying the supply of funding - Boosting retail investment

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

17. How can cross border retail participation in UCITS be increased?

18. How can the ESAs further contribute to ensuring consumer and investor protection?

19. What policy measures could increase retail investment?

19.1 What else could be done to empower and protect EU citizens accessing capital markets?

20. Are there national best practices in the development of simple and transparent investment products for consumers which can be shared?

Measures to develop and integrate capital markets - Attracting international investment

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

21. Are there additional actions in the field of financial services regulation that could be taken to ensure that the EU is internationally competitive and an attractive place in which to invest?

22. What measures can be taken to facilitate the access of EU firms to investors and capital markets in third countries?

Improving market effectiveness – intermediaries, infrastructures and the broader legal framework

Please refer to the corresponding section of the Green paper to read context information before answering the questions.

23. Are there mechanisms to improve the functioning and efficiency of markets not covered in this paper, particularly in the areas of equity and bond market functioning and liquidity?

- Yes
- No

Comments on question 23:

24. In your view, are there areas where the single rulebook remains insufficiently developed?

25. Do you think that the powers of the ESAs to ensure consistent supervision are sufficient? What additional measures relating to EU level supervision would materially contribute to developing a Capital Markets Union?

26. Taking into account past experience, are there targeted changes to securities ownership rules that could contribute to more integrated capital markets within the EU?

- Yes
- No

Comments on question 26:

27. What measures could be taken to improve the cross-border flow of collateral?

We welcome the acknowledgement in the Green paper that collateral is a vital part of the financial system. We fully agree with the Commission’s assessment that its fluidity is currently restricted, preventing markets from more operating efficiently. Collateral is fundamental to the development of safe, secure and well-functioning capital markets. It is an essential underpinning of a successful CMU.

The Securities lending market has played a critical role over the years in mobilising and deploying collateral. It developed in the first half of the 20th century as a tool for institutional investors such as pensions and insurers, to gain additional returns from their investments . The securities that are lent also enable the financial market to operate more efficiently, by facilitating core activities such as market making, investment hedging and settlement of bond and share transactions.

As the Commission rightly identifies, the demand for collateral in recent years has increased significantly driven by both Basel III/CRR and EMIR reforms (requiring financial market participants to use collateral to reduce risk in their activities), as well as more cautious and risk adverse market behaviour. Recent studies show that the demand for collateral will rise further as those reforms are fully implemented, and whilst there is likely to be sufficient supply available, it is important that safe and effective mechanisms (such as securities

lending) are available so that it can be mobilised. Through the use of market standard master documentation the securities lending markets provide a tried and tested and legally robust infrastructure for the mobilisation of collateral.
Although there is considerable debate as to the timing and quantum of any collateral shortfall within the system our view, as least initially, is that the issue is predominantly one of mobilisation rather than actual scarcity with broadly enough collateral within the system, but much of it in the wrong place. Through our analysis we estimated that as at 31st December 2014 there was Euro 1.9 trillion of government bonds in lending programmes of which Euro 688bn was on loan. Normal operational and risk parameters will naturally limit the level of securities on loan at any one time but certain lending clients and institutions face regulatory restrictions that bring this ceiling down still further. For example UCIT's funds are unable to enter into term transactions. This will make their lendable assets less attractive to borrowers who are now driven by the Liquidity Coverage Ratio (LCR) which pushes borrowers to spread the term of their liabilities.

The recent decision by the European Central Bank and other Euro central banks to make securities purchased under the Public Sector Purchase Programme (PSPP) available for securities lending further underlines the strategic importance of securities lending in the context of managing liquidity in the public and private debt markets.

Furthermore, as the CMU seeks to develop broader and deeper capital markets that support growth and jobs, it is important to ensure that secondary market liquidity exists to support this objective. Whilst many investments are purchased by investors as part of a long term investment portfolio, changing circumstances may dictate that investors have to sell or liquidate investments. For instance an insurance company may have to liquidate investment to meet claims or other liability obligations. Also over time pension funds may want to rebalance a fund to reflect the changing demographics of its beneficiaries. Without the ability to both value or price an asset and sell it quickly and efficiently, long tern investors may shy away from such investments or markets altogether. Without access to a liquid pool of securities to borrow, market makers will either increase their bid-offer spreads to compensate for the risk of not being able to deliver a security or decline to make markets in a particular security or market. Without market derived mark-to-market valuations investors may have to resort to model based valuations that may be subject to model risk and underlying price volatility.

Finally, it should be noted that securities lending is a discretionary and low margin activity for most investor lenders. As such, any regulatory or other frictions that makes their participation increasingly complex or costly is likely to mean some lenders will simply withdraw from the market thereby undermining available supply and market liquidity.

With the above in mind, we set out below what we believe to be the necessary policy measures to take or review in order to improve cross-border flow of collateral. They revolve around two essential principles: increasing collateral fluidity and providing legal certainty.

Increasing collateral fluidity

Barriers to collateral flow can be avoided/reduced by ensuring all of the following:

1. Banks' funding desks can effectively intermediate between users and takers of collateral.

The Basel framework is making it increasingly harder for banks to act as intermediaries between the demand for financing or funding and the supply of institutional investment flows. We support the CMU's broad objectives of transitioning Europe towards a more markets-based funding model but we also feel that it is important that banks are still able to actively match some of these investment flows and that regulation is appropriately calibrated to facilitate this transition. New capital rules, particularly the Leverage Ratio (LR), liquidity rules including Liquidity Coverage (LCR) and Net Stable Funding (NSFR) ratios are examples of current regulation that may need recalibration in the context of their ability to support securities financing activities if banks are to be able to fully participate in the development of the CMU. For example, the LR was conceived as a simple gross balance sheet ratio that looks at total assets verses capital. However by effectively ignoring collateral received within securities financing transactions higher volume lower margin collateralised business tends to be unduly penalised by this regime. This means that the banks' ability to support the movement of government bond collateral within the system through securities financing and repo is potentially marginalised by adherence to the LR. The NSFR although designed to ensure adequate term funding for riskier assets such as equities fails to address certain short term businesses such as securities lending where an equity asset may only be on balance sheet for a very short period, but still requires a minimum of 50% of the exposure to be funded for at least 12 months.

Securities lending can provide a key platform for collateral mobilisation in support of the CMU objective of facilitating the flow of capital in the system, and channelling assets to where they are most needed - but this requires incentives for banks to continue to be willing to intermediate between supply and demand for collateral.

2. Coherent and consistent implementation of market infrastructure requirements around collateral securities settlement, that do not inadvertently discourage the provision of liquidity

Whilst we fully support the objective of better settlement disciplines that settlement fail fines will encourage in CSDR, we are concerned that the proposed levels of fines will potentially discourage lenders from

making their securities available for lending as a single settlement fine is likely to equate to several days of trading revenues, especially in lower value transactions.
Further, CSDR contemplates that any failing settlement in cash securities would automatically trigger a buy-in after four days in most instances and after seven days for least liquid securities. The Regulation would apply to securities lending transactions which by their very nature are loans and not outright purchases or sales and as such any buy-in would effectively turn a loan exposure into an outright long cash market position which would fundamentally change the economic and market risk exposure within the transaction.
An International Capital Market Association (ICMA)'s survey published in February 2015 indicated that in a post CSDR environment liquidity across secondary European bond and securities financing markets would reduce significantly, whilst bid-offer spreads would widen dramatically. The survey further suggested that for many less liquid corporate bonds the secondary market could effectively close.

Failing any successful adjustments at Level 2, we believe that CSDR will need to be revisited as a matter of priority; both for the overall benefit of enhancing the fixed income and equity markets but also to better balance the needs of settlement disciplines with the provision of market liquidity.

The phased implementation of T2S (TARGET2-Securities) the new European securities settlement infrastructure which aims to offer centralised delivery-versus-payment (DvP) settlement in central bank funds across all European securities markets is another important step to improve settlement disciplines and reduce risk within the system across Europe provided it is implemented consistently by member states. In our view it would make sense to review the requirements and scope of a revised CSDR in a post T2S world when the market and regulators would have the benefit of better upstanding how T2S has worked.

The market in Europe has developed a non-cash collateral business model within the securities financing world. For example from our own analysis we estimate that 90% all European government bonds are lent on a non -cash basis i.e. against receipt of other securities as collateral. Most of the non-cash collateral that is received by lenders is held and managed predominantly by specialist tri party collateral managers who maintain the value of the collateral including any agreed haircut and the quality and performance of the collateral over the life of the loan. New Alternative Investment Fund Managers Directive (AIFMD) rules require clear segregation between client and proprietary assets within custody and sub account structures. Whilst we fully support the objective of clear and transparent segregation certain elements of the AIFMD rules may require individual sub accounts to be created for every underlying client. In turn any securities lending non -cash collateral received would have to be allocated down to all legal sub accounts. This raises a number of operational and risk management issues for securities lending especially in respect of non-cash collateral which is normally managed on a pool basis for those clients participating in a given lending programme. Whilst the proposed AIFMD rules would currently only apply to a relatively small section of the lending market any move to apply these rules to a broader investment community such UCIT’s would have a significant impact on the operational and cost structure of this business and effectively undermine the natural efficiencies of tri-party collateral management .

3. UCITs can use collateralised markets to satisfy new regulatory requirements. UCITs’ regulation focuses on maintaining liquidity and managing risk within UCITs. One consequence of this approach has meant that UCITs and other similar funds are currently restricted in the context of securities lending. UCITs have to source High Quality Liquid Assets (HQLA) to comply with EMIR and similar regulation but are, for instance, unable to use either cash collateral or HQLA received to pledge against OTC derivative exposure. Also, they cannot currently contemplate transactions that match the requirements of borrowers especially around term and ESMA collateral guidelines have made securities lending supply from this important source of both securities and collateral progressively less attractive. Although we fully appreciate and understand the reasons behind the current UCITs regulations we would suggest that any further review of UCIT guidelines should take in to account not just internal risk and fund liquidity requirements but also address the wider questions of how the UCIT community better fulfil their objectives to source collateral for their own OTC requirements.

4. Coherent regulatory framework that incentivises collateral fluidity

The EU proposal for the Regulation on Reporting and Transparency of Securities Financing Transactions (SFTR) provides the framework for better and more consistent reporting of securities financing transactions across Europe. The FSB in its August 2013 publication A Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repo cited the lack of transparency into these markets as a material factor in not allowing regulators to see the build-up of leverage and exposures in these markets ahead of the crisis. The SFTR will address all of the key issues highlighted by the FSB and we continue to support that the general aims and objectives of that initiative.

However we remain cautious about dialogue associated with potential restrictions on collateral reuse and ‘hard’ minimum haircut levels in these markets.

Historically where non cash collateral securities lending models have developed, documentation associated with those markets, which are predominantly in Europe and Asia, has evolved to allow for full title transfer of collateral from the borrower to the lender. This allows for legal certainty particularity where a lender may have to take control of the collateral in a bankruptcy situation. However full title transfer of

collateral also infers that the lender has full and unencumbered rights over that collateral including the right to re-use it if they so desire. Notwithstanding this, market convention today is such that very little collateral received by institutional lenders is actively re-used with most being held within tri-party collateral arrangements.
Where banks using securities lending techniques receive collateral it is normally held in a central pool and managed as part of the banks overall liquidity process. Consequently and unlike the institutional lending sector collateral received here is likely to be reused. Large financial entities will have multiple sources and uses of securities, including from investment, securities market making and trading, asset and liability management, securities financing transactions and margining (e.g. initial and variation margins). As a result of all these sources and uses securities will be flowing in and out, with multiple transactions in any given line of securities (ISIN) occurring on a daily basis.

5. No unnecessary fiscal disincentives on markets that are crucial to the mobilisation of collateral.

Please see our response to Question 30.

Creating legal certainty.

One overarching prerequisite to participants who conduct business on a collateralised basis is legal surety that in the event that a counterparty fails, for whatever reason, to redeliver either the securities they borrowed or collateral it received in a securities lending transaction, the other counterparty has full and immediate rights to either the securities it borrowed or collateral it received to close out its exposure on a net rather than gross basis. ISLA currently sponsors the Global Master Securities Lending Agreement (GMSLA). To provide the necessary legal certainty to market participants we also gather annual legal opinions from over 60 jurisdictions globally on the enforceability of the GMSLA in the event of a default by a party subject to their respective local bankruptcy/insolvency laws and regulations. To retain confidence in this market and ensure the continuation of this robust legal framework we would urge caution around the adoption of other measures or regulations that may undermine this legal certainty - and thereby become another barrier to cross-border collateral flows. This can be avoided/reduced by ensuring the appropriate regulatory framework that respects the different legal basis between Title Transfer Collateral Arrangements and Security interest based agreements.
The EU proposal for the Regulation on Reporting and Transparency of Securities Financing Transactions (“SFTR”) has made a number of proposals in this area that we believe, if implemented as currently drafted, could undermine this certainty and push participants away from the market.

Our aim is to ensure that the SFTR transparency objectives are achieved in an effective and efficient way that also takes account of existing market practice. In particular;

1. Article 15 – Transparency of Collateral Reuse

The Commission proposal requires certain disclosure and consent requirements before collateral may be rehypothecated. Broadening the scope from “rehypothecation” to “reuse” has introduced significant legal risks that would undermine the use of title transfer collateral arrangements (TTCAs) on which SFT and other collateral markets heavily rely upon at present in Europe.

Under a TTCA, the collateral giver passes full title (i.e. full ownership rights) in the collateral to the collateral receiver; these ownership rights naturally include the right to reuse, or to sell, the collateral. This mechanism gives the parties a high degree of legal certainty and protection should one of them default on its obligations .

Requiring that a party only has the right to reuse collateral where the collateral provider is informed of the risks (of reuse) and has granted express consent (to the reuse) would jeopardise the legal effectiveness of TTCAs: by imposing conditions on that party’s ability to dispose of the collateral it is possible that a court would find that title to the collateral did not in fact pass and put at risk a party’s ability to rely upon it in a default situation.

The consequences of introducing legal uncertainty regarding the effectiveness of TTCAs are severe:

- Collateral is used to support SFTs but also to reduce risk in derivatives transactions, and CCPs accept collateral as part of their (systemically important) risk management process. Any undermining of the legal certainty associated with TTCA would be deemed to increase uncertainty and risk for investors, banks and market infrastructure providers across a wide variety of transaction types.
- Institutional investors would question whether they would wish to lend securities; banks would find it harder to borrow or lend money on a secured basis, and more expensive and risky to finance the issuance of government debt in their role as primary dealers.
- This would all have major implications for primary and secondary markets functioning, deprive investors of low risk securities lending revenues, increase risk exposure levels, and substantially reduce the supply of collateral within the financial system.

ISLA strongly believes that the best outcome is to exempt TTCA from both disclosure and consent requirements in order to fully remove the legal risk described above.

2. Enforceability of close-out netting. We are concerned that implementation of the Bank Recovery and Resolution Directive (BRRD) across Europe, by allowing the resolution authorities to temporarily suspend termination rights and impose stays, will override certain key

provisions of the market standard GMSLA which may impact the efficacy of close out netting.

Set against this legislative backdrop of stays being a matter of law these arrangements do not necessarily deal with situations where there is an element of extraterritoriality involved in the transaction. Consequently a contractual solution has been requested by regulators to plug this legislative gap with stay provisions being inserted into our standard agreements by the end of 2015. Whilst we understand the objectives of policy makers in this regard it is important that any solution here does not create legal uncertainties, especially in respect of close out netting which if challenged could lead to higher capital charges associated with such business or a lead to various market participants standing away from this market.

Conclusion
The aspiration described in the CMU Green paper to create a more diverse, deeper and integrated capital market across Europe will require well-functioning securities financing markets. Investors and those seeking finance will need to be assured that the right legal, operational and regulatory environment underpins this new direction in Europe.

If Europe is to attract investment flows from outside of Europe then it will also be important that we can demonstrate superior execution effectively linking liquidity between buyers and sellers. This will include both primary and secondary market liquidity as well as recognition that a freer flow of collateral will be integral to this process.

Securities lending sits in the middle of this process providing both the fuel to allow market makers to operate efficiently and effectively, and as an increasing source of HQLA for collateral purposes. The specific points we have made on collateral mobility and market liquidity would, if acted upon, allow securities lending to play an active and prominent role in the ongoing development of the CMU. As the CMU develops pace it will be important that regulators have the political will to revisit certain elements of regulation and market infrastructure to keep pace with these developments.

27.1 Should work be undertaken to improve the legal enforceability of collateral and close-out netting arrangements cross-border?

- (x) Yes
- ( ) No

Comments on question 27.1:

```
Please see our above comments on Question 27.
```

28. What are the main obstacles to integrated capital markets arising from company law, including corporate governance? Are there targeted measures which could contribute to overcoming them?

29. What specific aspects of insolvency laws would need to be harmonised in order to support the emergence of a pan-European capital market?

30. What barriers are there around taxation that should be looked at as a matter of priority to contribute to more integrated capital markets within the EU and a more robust funding structure at company level and through which instruments?

There are two specific areas are of concern to ISLA in the context of current and future tax plans across the EU.

Financial Transaction Tax (FTT); we note the continued debate around the form and substance of any final FTT. Notwithstanding the final outcome of these deliberations it is clear that any FTT will fall short of its original objectives. Furthermore numerous studies have demonstrated that any final FTT will increase funding costs and in all likelihood push participants away from the market and those that do remain will simply pass this additional cost down to end investors. This would appear to be completely out of step with the objectives of the CMU and would in our view take focus away from the important agenda of job and wealth creation.

Base Erosion Profit Sharing (BEPS); through the Organisation for Economic Cooperation and Development (OECD) the BEPS initiative is global problem that requires global solutions and refers broadly to issues associated with tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low tax jurisdictions where these is little or no real economic activities by the company concerned.

ISLA supports the overall BEPS project; the details of its implementation and scope however may lead to unintended consequences and we continue to work with relevant tax and regulatory authorities to outline the details of our concerns.

31. How can the EU best support the development by the market of new technologies and business models, to the benefit of integrated and efficient capital markets?

32. Are there other issues, not identified in this Green Paper, which in your view require action to achieve a Capital Markets Union? If so, what are they and what form could such action take?

3. Additional information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) here:

Useful links

Consultation details (http://ec.europa.eu/finance/consultations/2015/capital-markets-union/index_en.htm)

Text of the green paper (http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf)

Specific privacy statement (http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/privacy-statement_en.pdf)

More on the Transparency register (http://ec.europa.eu/transparencyregister/public/homePage.do?locale=en)

Contact

✉ fisma-cmu-survey@ec.europa.eu