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FINANCE AND MARKETS GLOBAL INSIGHT

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Contents

Foreword

This issue of Finance and Markets Global Insight reflects the ongoing evolution of global financial markets as financers and businesses continue to grapple with the two key themes of innovation and regulation.

There's discussion on the implantation of the revised regulatory framework for derivatives and securitization, as structurers deal with variation margin implantation, and debate around Article 17 of the Securitization Regulation concerning the exclusion of self-certified mortgages. We see how the Nordics are implanting PSD 2 and look at European Central Bank guidance to banks on dealing with non-performing loans.

We also weigh up the booming initial coin offerings market, and consider the European Commission's consultation on the impact of FinTech and its role in driving a more competitive and innovative European financial sector.

This issue also reports on a new set of framework principles for social bonds to encourage interest in environmental, social and ethically sound investments, the European Union's plan for retail financial services and the FX Global Code. It also brings a US perspective on the risks inherent in trade and commodity finance.

We hope that you enjoy this range of topics and views.

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Structurers consider the prospect of variation margin rules for ABS swaps

An analysis of the European Commission's proposal to introduce EMIR variation margin into ABS swaps

In brief…

In May 2017, the European Commission (the Commission) proposed to reform the European Market Infrastructure Regulation (EMIR) in a way which could, among other things, bring securitization special purpose entities (SSPEs) within scope for the EMIR variation margin regime.

Although there is a long way to go in the legislative process before any reforms are enacted and implemented, the impact could have a substantial (potentially negative) impact for the European securitization industry, affecting all participants including originators, arrangers, investors and swap providers.

This article provides a reminder of the current SSPE exemptions under EMIR on the proposed reforms, and an initial high-level look at some of the specific issues that might arise for market participants should SSPEs become subject to variation margin rules.

What is the background to the Commission's proposal?

EMIR was adopted by the EU in 2012 to reduce the systemic risks associated with the over-the-counter (OTC) derivatives market, and improve transparency for regulators of the European derivatives industry. Measures introduced by EMIR so far include:

- central clearing for standardized OTC derivatives contracts;
- reporting obligations;
- operational risk mitigation requires;
- variation margining for OTC derivatives contracts that are not centrally cleared – variation margin is collateral posted by a swap party that is 'out of the money' to mitigate the mark-to-market exposure of their counterparty; and
- initial margining for derivatives users with aggregate trades having an exceptionally large notional amount – initial margin is the posting of collateral by a swap party equivalent to an 'independent amount', as is used specifically to mitigate against the risk of default by the posting party.

Under Article 85(1)(b) of EMIR, the Commission was mandated to produce a report for the European Council and the European Parliament, which assesses the impact of EMIR on the use of OTC derivatives by non-financial firms, and the systemic importance of those firms. The same Article requires the Commission to coordinate with the European Securities and Markets Authority (ESMA) in producing this report[1]. This report was produced at the end of 2016, and incorporated into the Regulatory Fitness and Performance programme (REFIT), in which the Commission assesses whether steps taken in relation to the implementation of EMIR are enabling the objectives of EMIR to be met in a coherent, cost-effective and efficient manner.

Further to the findings of ESMA, the evaluation contained in the REFIT and the subsequent impact assessment, the Commission concluded that specified provisions of EMIR should be adjusted in order to, among other things, recalibrate the definitions of financial and non-financial counterparties (FCs and NFCs) – the definitions are important, as certain requirements under EMIR are only mandatory for FCs. As part of this recalibration, the Commission would look to include certain counterparties that are currently categorized as NFCs within the definition of FCs, to reflect the true nature of their activities.

What is the Commission proposing specifically?

In May this year, the Commission published a proposal for a new regulation, which would introduce amendments into the existing text of EMIR. Featured among those amendments are:

- the addition of 'securitization special purpose entities' to the definition of FC; and
- the introduction of new clearing thresholds, which a FC must exceed before it is required to centrally clear its OTC derivatives.

The definition of SSPEs is provided by the Capital Requirements Regulation[2], and captures the various special purpose, bankruptcy remote vehicles typically used for securitization transactions.

[1] EMIR Review Report No.1 Review on the use of OTC derivatives by non-financial counterparties

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

These amendments directly relate to three specific measures under EMIR:

- the requirement for central clearing;
- the initial margin requirements; and
- variation margining for un-cleared derivatives.

At present, EMIR is unlikely to require an SSPE to comply with the mandatory central clearing regime or either of the margining regimes, since they are categorized as NFCs – and NFCs are only subject to those regimes where their derivatives activity exceeds the applicable thresholds prescribed by EMIR (in which case they are an NFC+). Given the standalone nature of the securitization derivatives entered into by SSPEs, and the way in which derivatives activity is calculated for determining NFC+ status, they are unlikely to be so categorized. In addition, under Article 24 of the Commission Delegated Regulation 2016/2251 of October 2016 (the EMIR Variation Margin Rules), an FC that is trading with an NFC (other than an NFC+) is not required to post variation margin to the NFC (ie there is no posting of variation margin by either party).

However, by categorizing SSPEs as FCs, the Commission is apparently reconsidering the status of SSPEs for the purpose of determining whether they should be subject to the mandatory requirements for central clearing, and to the requirements for posting initial and variation margin.

The impact of the potential re-categorization of SSPEs for central clearing and posting initial margin may be less significant to the industry than the potential re-categorization in the context of posting variation margin. This is for two reasons:

- Firstly, the new clearing thresholds referenced above will need to be exceeded by the relevant FC before mandatory clearing would apply (the order of magnitude here is in the billions of Euros). An SSPE is unlikely to exceed these thresholds where it is independent of the originator group, although in the case of SSPE's on retained deals where the SSPE may be consolidated and where the notional amount of the securitization swap would be aggregated with the derivatives of the other FCs within the originator group, or within master trust structures, the applicable clearing threshold is more likely to be exceeded. A similar minimum threshold exists in relation to the requirement to post initial margin.
- Secondly, swaps for securitization transactions tend to be esoteric, and likely to fall outside of the scope for the central clearing requirements (a balance guaranteed swap would not be suitable for central clearing, for instance).

What are the potential implications of variation margin requirements applying to SSPEs?

We now look at the possible implications of the potential new variation margining requirement for both the SSPE and the entities which provide hedging to an SSPE within a securitization (Swap Providers).

It should be noted that certain high-quality securitizations would be exempt from these variation margin requirements. The relevant exemption can be found within Article 42 of the Securitization Regulation[3], and applies for SSPEs that issue simple, transparent and standardized (or STS) securitization under the Securitization Regulation. While this may have the beneficial impact of encouraging more STS securitizations, it should be remembered that many securitizations will not have the relevant assets class or structuring features in order to qualify for STS recognition, and therefore benefit from the variation margin exemption.

Members of the asset-backed securities (ABS) industry are wary about measures that (further) divide transactions that can be classified as STS, and those that cannot.

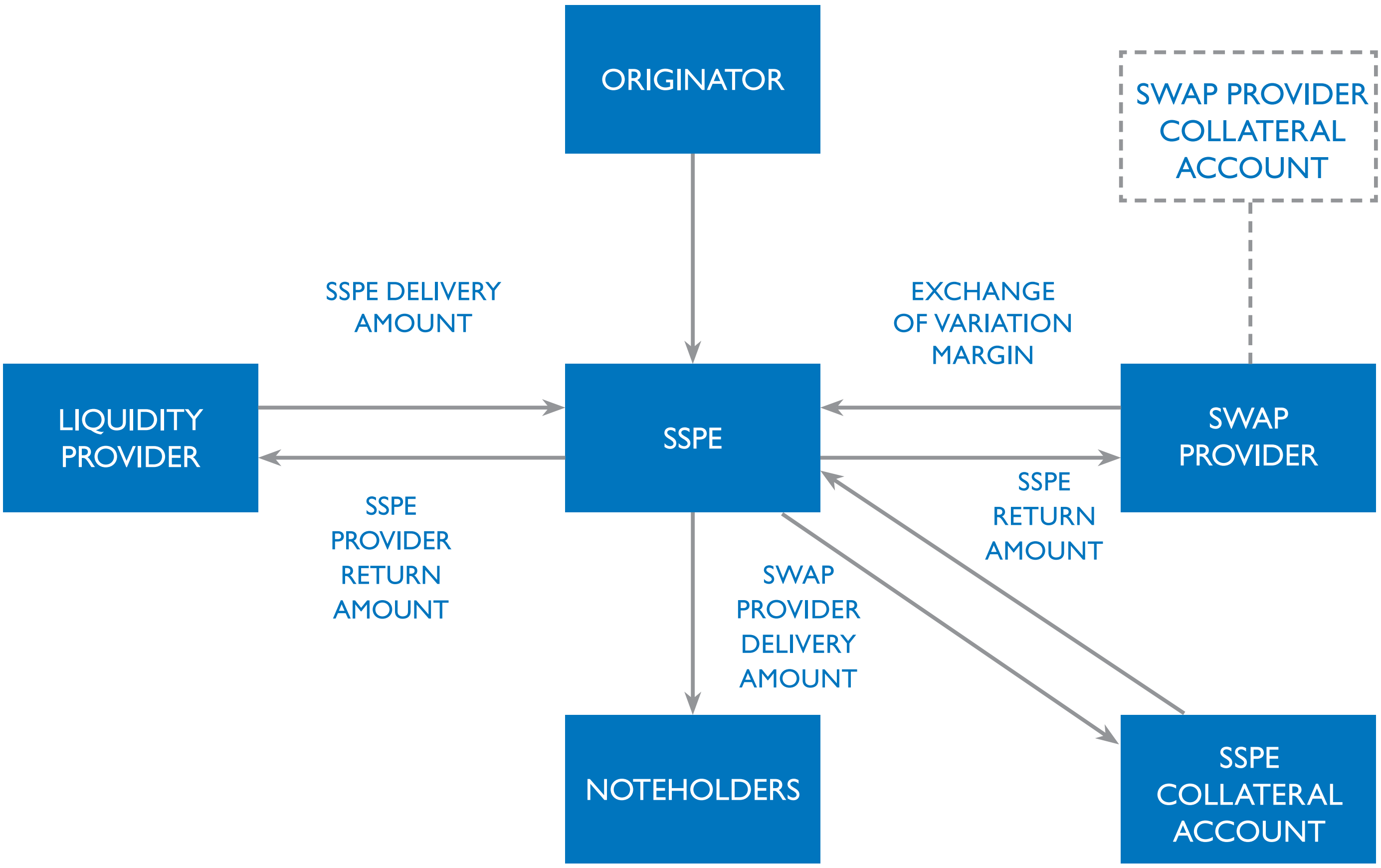
The big question for structurers of future securitization deals is how the SSPE might fund its requirement to post collateral to the Swap Provider in order to comply with the new rules. SSPEs for securitization transactions tend to have fixed liabilities, a fixed pool of assets from which to receive income to meet those liabilities, and little (if any) available cash which might be used in order to meet this new collateral requirement.

[3] Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitization and creating a European framework for simple, transparent and standardized securitization and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 dated 30 September 2015

The industry assumption is that such funding would be provided either through additional cash reserves or over-collateralization funded by the originator at the outset of the transaction, and topped-up during the replenishment period, or alternatively through a liquidity facility. Neither option is regarded as optimal, although the former seems particularly problematic as the mark-to-market (and therefore the collateral posting requirements) cannot be accurately predicted at the outset of the deal, and it is hard to imagine that an originator could (or would) provide sufficient cash upfront to cover the uncertain margin requirements arising over the life of the securitization. A creative use of caps and floors might provide a more acceptable degree of certainty for the originator, but may be inconsistent with the risk-mitigating purpose of hedging in securitization transactions, and require further pre-funding by the originator.

What might a liquidity facility solution look like?

The second option (use of a liquidity facility provider) is widely considered to be the more likely solution to the funding issue. The diagram (below) shows how this might look from a basic structural and cash-flow perspective. The concept is simple – to the extent that the SSPE is required to post variation margin, it may draw on the liquidity facility in order to fund the deliverable amount. If the Swap Provider's exposure is subsequently reduced, and a return amount of collateral is transferred to the SSPE, this amount may be used to repay the liquidity facility. We expect that all collateral movements in and out of the SSPE, and drawings and repayments under the liquidity facility, would remain outside of the cash-flow waterfall (ie not available to meet the claims of noteholders and other transaction creditors).



Variation margin is commonly transferred under a 'Credit Support Annex', which in short means that the collateral assets are transferred outright to the collateral taker, who may then use (or 'rehypothecate') the assets for its own purposes. An SSPE may be unable to assume additional credit risk against its Swap Provider for the return of any collateral it has posted, in which case the Swap Provider may be required to hold the collateral balance in a segregated collateral account.

There are many possible implications for the introduction of a new liquidity facility into securitization structures, but three particular disadvantages should be highlighted:

- The first is the additional cost to the originator (and, over the life of the deal, the SSPE through the cash-flow waterfall) of introducing the liquidity facility, including fees and interest payable to the facility provider.
- The second is that EMIR Variation Margin Rules require the calculation and posting of variation margin on a daily basis. This presents a problem for the SSPE in its own right, since it would almost certainly be necessary for it to outsource the operational requirements for complying with the daily margining demands. Furthermore, the extent to which a 'minimum transfer amount' mechanism could be used to remove the requirement to post de *minimis* collateral amounts is limited under the EMIR Variation Margin Rules. Using a liquidity facility to meet daily collateral demands brings further complications, as an SSPE could theoretically need to utilize the facility on a daily basis, in order to meet daily demands for collateral.
- The third is that the liquidity facility provider introduces a new counterparty credit risk into the structure.

This third point is particularly pertinent, and worthy of emphasis – although this may not be a significant hurdle where the facility provider is a highly-rated financial institution, the effective replacement of the counterparty risk of the Swap Provider, with the counterparty risk of a liquidity facility provider, goes right to the heart of what the EMIR variation margin regime is intended to address. The question must be asked: does shifting counterparty risk in this manner within securitization structures really move the needle for mitigating against systemic losses within the financial markets?

How are Swap Providers currently posting collateral to SSPEs?

In many cases, Swap Providers are already posting collateral to SSPEs in securitization transactions, or may be contractually required to post collateral to mitigate the credit risk inherent in a downgrade of the relevant Swap Provider's credit rating (such downgrade being the trigger event for the requirement to post collateral). The posting of collateral in this scenario is exclusively in order to maintain the credit rating of the securitization notes, which may be linked with the Swap Provider's own credit rating. The trigger for posting collateral, and determination of the collateral amount, is determined by reference to the criteria published by the rating agencies that are rating the notes.

As with variation margin, the collateral amount to be posted by the Swap Provider will reference the SSPE's exposure where the mark-to-market moves against the Swap Provider, with an additional 'volatility buffer' also applied in order to comply with the applicable rating agency criteria.

As an alternative to posting collateral, a Swap Provider that is subject to a rating downgrade is typically permitted to replace itself with an alternative swap counterparty, or procure a third-party guarantee in respect of its obligations under the trade. If its rating falls below a pre-set floor level, then it must take one of these remedial actions (but continue to post collateral in the interim period).

Collateral posted by the Swap Provider under these provisions is normally held in a separate swap collateral account, and is not included in the funds which are available to the SSPE in order for it to satisfy its payment obligations to noteholders and other secured creditors under the securitization. Instead, the collateral is expected to be used to fund the replacement of the Swap Provider in the event that the Swap Provider defaults upon its obligations under the trade.

Importantly, the posting of collateral in the normal course is unilateral – ie if the mark-to-market of the relevant trade moves against the SSPE (and taking into account the volatility buffer), there is no reciprocal obligation for the SSPE to post collateral to the Swap Provider – simply put, no collateral will be posted.

How will a new requirement for posting bilateral variation margin impact Swap Providers?

A new requirement for posting bilateral variation margin will potentially impact Swap Providers in two ways:

- Firstly, a Swap Provider that is 'in the money' would potentially be entitled to receive collateral from the SSPE in order to cover the Swap Provider's exposure. This benefit is unlikely to be material, since Swap Providers already manage their credit risk in securitizations through their senior (or 'super senior') ranking in the cash-flow waterfall, and therefore benefit from the security and credit enhancement made available to the transaction. It would be interesting to see whether receiving collateral would eventually result in Swap Providers agreeing to relinquish their super senior status (and whether this would offset any of the downside to the structure of having to fund such collateral).

- Secondly, a Swap Provider that is 'out of the money' would be required to post collateral to the SSPE, irrespective of their credit rating. This may be less problematic than one might initially expect. The financial institutions that provide hedging to securitizations are already FCs and substantial users of derivatives, and will have recently undergone (and will still be undergoing) a large-scale operation to update their derivatives arrangements with their international FC and NFC+ customers in order to bring those arrangements into line with the EMIR Variation Margin Rules – we would not expect the addition of securitization swaps to this process to be an overwhelming development for these financial institutions that have already had to embrace the new world of variation margin.

In addition, the existing rating agency-driven requirement for Swap Providers to post collateral into rated securitization transactions means that, for the most part, Swap Providers are already posting collateral to their SSPE counterparts, or holding treasury reserves against the contingency of having to post collateral in the event of a future ratings downgrade. The cost of funding for posting variation margin to SSPEs may already have been indirectly accounted for. The operational infrastructure for posting collateral into the SSPE will likely already exist as part of the rating agency requirements (or at least, the path is pretty well trodden) – for example, we expect that a segregated swap collateral account set up in the name of the SSPE for the purpose of receiving rating agency collateral from the Swap Provider, may also serve as a collateral account for the receipt of variation margin required under the EMIR rules.

Notwithstanding the points contained in the preceding paragraphs, the impact of the proposed EMIR amendments on the capabilities and incentives of Swap Providers to provide hedging to securitization SSPE's should not be taken lightly; and many structural, operational and funding complications are likely to need solving as we move closer to implementation of the proposed amendments.

How and to what extent might grandfathering apply to legacy transactions?

For legacy securitization transactions, the extent to which grandfathering may be applied is not yet clear. As noted above, SSPEs are unlikely to have the assets or income in order to meet any new requirement to post variation margin, and an orphan SSPE (or transaction in its amortization phase) will not have a sponsoring originator prepared to offer a funding solution. The Commission's draft regulation makes no specific reference to grandfathering; although the industry can reasonably expect that some modicum of grandfathering will apply, and we assume that grandfathering will ultimately apply to prevent the potentially absurd scenario described.

We mentioned earlier the possibility that a Swap Provider might be able to replace itself within a securitization in order to cure a rating downgrade. Without more extensive (or nuanced) grandfathering, this replacement mechanism would be substantially fettered by the amended rules, since any replacement swap transaction is likely to be construed as a new transaction under EMIR, and therefore become subject to the variation margin rules applicable to the SSPE at the time of replacement (although most securitization swap documents do provide for alternative forms of remedial action, for example posting additional collateral, or appointing a third-party guarantor).

The recent trend for including negative consent provisions in securitization documents, which in many cases specifically permit transaction documents to be amended in order to comply with new requirements under EMIR, might be put to use in order to enable transactions to comply with the amended EMIR requirements, without going through the complication and uncertainty of a noteholder consent solicitation exercise.

To what extent is the Commission likely to introduce the proposed measures?

The first question that must be asked is whether the Commission fully understands, and intends to introduce, some of the measures described above. The ESMA report, which drives the Commission's thinking on this matter, is more equivocal around the need to amend the treatment of SSPE's and securitization swaps under EMIR, and seems to focus more on the investment funds and hedge funds that are heavy users of derivatives, often for non-hedging purposes, and yet currently fall within the NFC categorization. By contrast, SSPE's use derivatives exclusively for hedging purposes, in order to reduce certain structural risks for investors and rating agencies. Worryingly, it is not apparent from the REFIT and the ESMA report that the Commission and ESMA have fully appreciated this.

It could also be argued that the Commission's position is directly contrary to the direction of European legislation in the development of the Securitization Regulation, which focuses specifically on making high-quality securitization more attractive to investors through beneficial risk weighting, and drive liquidity and growth of ABS and its underlying markets and the goal of capital markets union in general. The proposed amendments to the EMIR rules appear to have the opposite effect, for the reasons outlined above, while making no apparent contribution to the primary aims of the Commission's report (ie furthering the objectives of EMIR in a coherent, cost-effective and efficient manner).

Nevertheless, the Commission's proposals must be taken seriously – the drafting of the relevant amendments to the EMIR rules is unambiguous, and ESMA has acknowledged that the legislative framework provides little scope to enable a more bespoke, securitization-specific framework, or grandfathering provisions which might address the replacement swap provider issue noted above.

One comparison frequently referenced is the covered bond exemption under the EMIR Variation Margin Rules, which exempts hedging in connection with covered bond issues from variation margin requirements (there remains a school of thought that this exemption only applies to the margin posting requirements of the covered bond issuer, and an 'out of the money' swap provider remains obligated to post variation margin to the covered bond issuer on a unilateral basis). A similar exemption from the EMIR Variation Margin Rules for hedging with SSPEs, irrespective of whether or not the exemption is extended to the obligation of the Swap Provider to post collateral to the SSPE, would generally be welcomed by the ABS industry. It remains to be seen whether the substantial amount of industry lobbying, led by the Association for Financial Markets in Europe, will persuade the Commission to pursue such an exemption.

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European securitization market debate surrounds Article 17

An opinion piece on the European Union's proposed Article 17 of the Securitization Regulation (Article 17) which would ban self-certified residential mortgages being part of existing STS and non-STS RMBS portfolios

In brief...

At the time of writing this article, the process of finalizing the European Union's (EU's) Securitization Regulation[1] is demonstrating 'the law of unintended consequences' as a result of what we understand was a *quid pro quo* at a 'trilogue', (ie the tripartite discussion process which has been taking place between the EU Commission, representatives of the European Parliament and the European Council) on 29 March 2017; in return for Paul Tang and his fellow Members of the European Parliament (MEPs) accepting something very close to the *status quo* regarding risk retention, the ban on self-certified residential mortgage loans forming part of the portfolio for any 'simple, transparent and standardised' (STS) residential mortgage-backed securitization (RMBS) issue (which had been included in the draft Securitization Regulation since the European Commission's first draft) was copied into Article 17 of the Securitization Regulation, and so was extended to non-STS securitizations too, without being trailed publicly and without the benefit of industry input beforehand. It became public when the revised post-trilogue text emerged on 15 June 2017, but even then it took until July 2017 for its significance to be appreciated.

This article was written as at 30 August 2017.

The potential impact of Article 17

As it stands, Article 17 would prevent existing deals containing self-certified mortgage loans from being refinanced in the securitization market. It would impact on the European Central Bank's unwinding of its ABS Asset Purchase Programme. Also, as many non-performing loan (NPL) portfolios may include some self-certified loans, it would be counterproductive regarding the resolution of the 'NPL overhang' that many southern European banks have.

Self-certified loans have been banned across the EU's 28 member states since the Mortgage Credit Directive[2] became effective in March 2016 – and in some countries since well before then – but many legacy loans are outstanding: the Association for Financial Markets in Europe (AFME) estimates that more than €35 billion of existing RMBS contain some self-certified loans.

Interpretation of Article 17

The wording of Article 17 is in any event poor: it talks of loans that are marketed and underwritten on the premise that the borrower was told that loan application information might not be verified – which could catch a wide variety of mortgage loans and conceivably not catch some that were indeed self-certified. A related question is whether buy-to-let mortgage loans are 'residential loans' within Article 17(2); the phrase is undefined, and the borrower's income would not need verification if the rental income cover was adequate.

Another problem with Article 17 stems from wording which had been included in the European Council text of the draft and remained in it despite industry comments about its unfeasibility. Article 17(1) (based on Article 408 of the Capital Requirements Regulation[3]) obliges original lenders, sponsors and originators to apply the same credit-granting criteria to securitized and non-securitized credits, and to have 'clearly established processes' for approving the granting of credit; and where assets are originated and then on-sold before being bought by the 'originator' for securitization, Article 17(3) obliges the originator to verify that the original lender met the Article 17(1) requirement. However, many NPL original lenders are not around anymore, and/or the assets may have been sold and on-sold so that there is no link between the originator and the original lender, making it difficult or impossible to do this verification (and in any event, for well-seasoned assets, the origination criteria are not anywhere near as relevant as the (non-)performance history). This hinders rather than helps a resolution of the 'NPL overhang' in countries such as Cyprus, Greece, Italy, Ireland, Portugal and Slovenia. European Banking Authority data emphasises the scale of the overhang: end-2016 statistics indicate 107 significant

1 Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitization and creating a European framework for simple, transparent and standardised securitization and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

2 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 Text with EEA relevance

3 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

institutions holding €866 billion of impaired assets, 6.4% of total loans, and in Cyprus, Greece, Italy, Ireland, Portugal and Slovenia, over 10% of the loan stock is NPL status.

A pragmatic solution

Bankers are understandably cautious that Article 17 could be a 'stick to beat them with' if there is another financial crisis and would prefer more certainty. The most pragmatic solution is to amend the text so that Article 17 only applies in respect of newly-originated assets, not seasoned legacy ones: it is not subject to any Regulatory Technical Standards and many participants may need more than non-binding European Securities and Markets Authority guidelines. Amending the text is not procedurally straightforward but anything else will be disappointing after all the effort made over several years to revive the European securitization market. Will a benefit of Brexit be to permit the adoption of more sensible UK regulations?

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Changes to the Italian securitization law let Italian SPVs grant loans to debtors

A summary of the amendments to the Italian securitization law which may help the sale of impaired receivables

In brief…

In June 2017, the Italian Parliament approved Law No. 96 of 21 June 2017 amending, *inter alia*, the Law No. 130 of 1999 (the Italian Securitization Law) – by adopting a new Article 7.1. This significantly expands the activities that can be carried out by special purpose vehicles (SPVs) in the context of an Italian securitization transaction, to facilitate, among others, the sale of impaired receivables (NPLs).

The current Italian NPLs market

Since the onset of the global financial crisis in 2008, the volume of NPLs on the balance sheets of European banks has risen substantially and Italy is one of the largest European distressed debt markets. After peaking in 2015, total NPL volume finally registered a reduction at the end of 2016 to €324 billion – but still remains high, adversely affecting Italian banks and as a consequence, the Italian economy. As the International Monetary Fund pointed out in its September 2015 paper, bank profitability suffers because high NPLs require banks to raise provisions, which lowers net income, while NPLs carried on banks' books do not usually generate income streams comparable to performing assets, and can tie up substantial amounts of capital due to higher-risk weights on impaired assets, which in turn raises a bank's funding costs because investors have heightened risk perceptions. The reduced lending capacity of bank's in turn undermines the growth prospects of viable firms, especially small-and medium-sized enterprises, which are more dependent on bank financing.

This has long been a focus of the European Commission's Capital Markets Union plan, including its desire to revive securitization in Europe (a topic covered elsewhere in this issue 13 of Finance and Markets Global Insight) and to reform sclerotic national insolvency laws. Nevertheless, at present the NPL phenomenon keeps on raising concerns about the soundness of the banking sector, triggering a vicious circle where the contraction in credit supply driven by the level of NPLs has led to lower growth, a slower recovery and hence a further deterioration in bank balance sheets.

For all of these reasons, for roughly two years, the Italian government has been looking for legislative solutions to facilitate the disposal of NPLs. It introduced the so-called Guarantee on Securitization of Bank Non Performing Loans (GACS), a state-guarantee scheme for NPL-backed securities, but this has not reached its potential in terms of attracting investor interest for the junior tranches of NPL securitizations and has been used only a few times since its launch in February 2016. Other measures such as the private bank-rescue fund, called the Atlante fund, are still being improved.

By contrast, the provisions of the new Article 7.1, as outlined below, embrace more effective recent market practice and seem to be business oriented.

Granting loans to facilitate credit recovery

Italian securitization vehicles (Italian Securitization Law SPVs) are now permitted to grant loans to debtors made with the explicit aim of improving the recoverability of the securitized receivables and helping the debtors' financial positions. The granting of loans to entities (other than physical persons and micro-companies) remains subject to the previous conditions of the Italian Securitization Law:

- the debtors shall be identified by a bank or by a regulated financial intermediary;
- the notes issued to finance the granting of loans shall be subscribed by qualified investors only; and
- the bank or the regulated financial intermediary must retain a 5% risk retention.

This amendment helpfully clarifies a previously uncertain position.

Participating in debt/equity swaps

In the context of restructuring agreements or recovery procedures (under Articles 124, 160, 182-bis e 186-bis of the Italian Bankruptcy Law or other analogous procedures), Article 7.1 now permits Italian Securitization Law 130 SPVs to purchase or subscribe for equity or quasi-equity instruments issued by the debtor as part of a debt-to-equity swap.

Moreover, Article 7.1 disapplies provisions of Italian bankruptcy law (in particular Articles 2467 and 2497-*quinquies* of the Italian Civil Code) that provide for the subordination of shareholders' loans to other creditors, thus encouraging SPVs to subscribe for debtors' equity instruments.

The amount deriving from the purchase or subscription of equity or quasi-equity instruments must be considered as payments made by the debtors, and therefore remain segregated and directed to satisfy noteholders' rights and securitization transaction costs.

SPVs to have specialized management

The amendments to the Italian Securitization Law aim to improve the SPVs' role in the management of NPLs and in their relevant recovery functions. To this purpose, Italian Securitization Law SPVs must appoint specialized entities, which meet the necessary competence requirements and authorizations provided for by the law. Such specialized entities, which shall be identified in the securitization prospectus, will carry out all those management functions that are not usually provided by servicers.

When Italian Securitization Law 130 SPV purchases credits and grants loans, the specialized entity must be either a bank or a regulated financial intermediary. When the Italian Securitization Law SPV purchases/subscribes equity or quasi-equity instruments, the specialized entity may also be an investment company (*società di intermediazione mobiliare*) or an asset management company.

In addition, the specialized entity shall also verify the compliance of the activities carried out, and of the whole securitization transaction, with the law and with the securitization prospectus.

Real estate and receivables arising out of leasing agreements

Pursuant to Article 7.1, it may be possible to set up SPVs – in the form of public companies – having the exclusive scope of purchasing, managing and increasing the value of real estate assets, registered movable assets and any collateral of receivables, including assets arising out of leasing agreements. The amounts generated by the managing of such assets should be exclusively segregated for the benefit of noteholders and for the payment of the securitization transaction costs.

This kind of 'specialized' SPV was possible before the amendments to the Italian Securitization Law, but the new provisions should particularly facilitate the transferring of non-performing receivables arising out of leasing agreements. In fact, such amendments make it clear that the SPV may both purchase the underlying asset of or succeed to all the contractual rights and obligations relating to, such leasing agreements. On the other hand, in order for the SPV to purchase both the underlying asset of the leasing agreement and succeed to the contractual rights and obligations relating to such agreement, it must be:

- fully consolidated in the balance sheet of a bank;
- set up solely for the purposes of concluding this type of securitization transaction; and
- liquidated upon termination of the securitization transaction.

In this case, the SPVs are subject to the Italian taxation provisions that apply to financial leasing companies and the real estate transfers concluded by such SPVs are subject to the relevant tax benefits.

Publication regime

Finally, the new provisions also simplify the publication regime for the purpose of the enforceability of the transfer of receivables, disapplying many reporting obligations provided by the Italian Civil Code in relation to the notification obligations to debtors. In particular, the receivables purchased by a Italian Securitization Law SPV, when not identified by block criteria, shall be published on the Companies Register and the transfer notice shall be published in the Italian Official Journal, derogating from the debtor's notification obligations under the Italian Civil Code.

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ECB publishes guidance on tackling NPLs

An overview of the ECB's final guidance on NPL strategies, forbearance solutions and impairment data requests

In brief…

On 20 March 2017, the European Central Bank (ECB) published its final guidance (Guidance) to banks on non-performing loans (NPLs). The Guidance provides measures, processes and best practices for banks in respect of NPLs. It invites banks to implement realistic and ambitious strategies for NPL reduction and seeks to facilitate the day-to-day supervisory dialogue with banks on various issues. The final guidance follows the ECB's consultation on the draft guidance that ran from September 2016 to November 2016.

Application

The Guidance is applicable to all significant institutions supervised under the Single Supervisory Mechanism (SSM), although it is acknowledged that it should be considered in the light of the principles of materiality and proportionality, with some parts of more relevance to banks with higher levels of NPLs.

Despite the Guidance currently being non-binding, it is stated that banks should be able to explain any areas where the Guidance has substantially not been followed, and the Guidance will be considered as part of a bank's Supervisory Review and Evaluation Process. The Guidance also notes that non-compliance may result in supervisory measures being adopted.

Implications

The Guidance emphasizes the importance for banks with high NPL exposures to develop an NPL strategy, which should establish strategic objectives for the reduction of NPLs over a realistic but ambitious period of time. The ECB identifies that an NPL strategy should cover mechanics for assessing the operating environment, developing the NPL strategy and implementing and fully embedding this strategy. The Guidance also stresses the importance of ensuring there is appropriate governance and operational set-up to oversee the implementation of the NPL strategy in the short and longer term. The Guidance emphasizes the importance of management's role in approving and monitoring the NPL strategy and recommends particular operating model procedures, including the creation of 'NPL workout units', dedicated to addressing NPLs, which operate separately and independently from other functions of the bank.

Forbearance measures can be both preventative and remedial, and should seek to ensure borrowers are able to perform their repayment obligations under the agreement. In order to avoid the misrepresentation of asset quality on the balance sheet, the ECB distinguishes between viable forbearance solutions (ie those that truly contribute to reducing the borrower's balance of credit facilities) and non-viable ones. The ultimate outcome of the forbearance measures should be the repayment of the owed amount and not the extension of the grace period.

The ECB encourages the adoption of the European Bank Authority's (EBA's) definition of non-performing exposures (NPE) based on the 'past-due' and 'unlikely-to-pay' criteria. The definition and identification of NPE should be consistent at the entity and banking-group level, as well as in all subsidiaries and branches.

The Guidance seeks to address three principal objectives in respect of impairment:

- adequate measurement of impairment provisions across all loan portfolios through sound and robust provisioning methodologies;
- timely recognition of loan losses within the context of relevant and applicable accounting standards and timely write-offs; and
- enhanced procedures including significant improvement to the number and granularity of asset quality and credit risk controls.

Under the Guidance, banks should be able, on request, to provide supervisors with data regarding the models they use to calculate impairment allowances for NPLs on a collective basis. Banks are also expected to disclose publically a detailed set of quantitative and qualitative disclosures in their financial statements regarding loan quality and credit risk control.

The ECB also provides guidance on ensuring the completeness and accuracy of immovable property valuation, including recommending that the valuations are performed by independent qualified appraisers, with an appropriate level of professional indemnity insurance. The Guidance states that the frequency of valuations should be at least every year for commercial immovable property and every three years for residential immovable property, but more frequent when there are significant negative changes or signs of a decline in the value of individual collateral. The Guidance also provides further detail on the methodology for valuations and the valuation of foreclosed assets.

Conclusion

The ECB identifies the next steps as sending letters to banks with high levels of NPLs as part of their normal supervisory activities, to ensure that banks are managing and addressing NPLs in accordance with supervisory expectations.

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ICOs are more than a token gesture

An assessment of some of the key considerations for issuers of and investors in ICOs

In brief…

With total amounts raised in initial coin offerings (ICOs) this year exceeding US$2 billion and a number of sales coming forward each month there is an understandable interest in the operation of this new phenomenon.

In addition to private investors, the funds world is taking interest with a number of hedge funds already investing in portfolios and building strategies based on cryptocurrencies and token offerings. This interest in the technology is only likely to increase.

Against this background there is a huge divergence in opinion as to attitudes regulators should take to the product. At one end of the spectrum is the view that this will revolutionize the finance market with cheaper more-efficient access to direct holdings of assets and closer and better links between companies and their customers, supplier and investors. At the other end of the spectrum is the belief that these offerings will be used mainly for abusive or fraudulent purposes. The reality is likely to be somewhere in between. Properly advised and supported by an open regulatory framework, ICOs could provide a new and valuable range of business and stimulate innovation and enterprise as a truly global product.

What are ICOs?

ICOs are a form of digital currency or token using blockchain technology. Typically an issuer accepts a cryptocurrency such as bitcoin or ether in exchange for a new digital coin or token that carries rights in respect of assets associated with a business or project. ICOs are being structured in a wide variety of forms and may be used for various purposes. Some ICOs are directed at customers or suppliers as a form of loyalty program or to provide a form of access or purchasing power (preferential or otherwise) in respect of assets of the issuer's business. Other ICOs are similar to venture capital, more focused on raising initial funding; and they have proved popular for funding new blockchain or cryptocurrency ventures. Some of these offers will be highly speculative and involve substantial levels of risk for example into new and untested technology products which put the whole of the upfront investment at risk. It is essential to examine the legal and regulatory basis for any ICO as an unauthorized offering of securities is illegal and may result in criminal sanctions in a number of jurisdictions. Legal analysis of the underlying token will determine if it should be treated as a specified investment or form of regulated security or is more appropriately a form of digital asset that is not itself subject to the regulatory regime.

How are the regulators treating ICOs so far?

While a few jurisdictions and most notably China, have banned ICOs outright, most jurisdictions are applying a more thoughtful approach to the new technology. ICOs are not generally regulated as a specific product under most financial regulatory regimes. The financial regulator will typically apply the existing regulatory regime to the underlying product and business (eg is it a security, a commodity, electronic money or does the business of the offeror constitute a peer-to-peer platform or exchange). Based on this analysis the offering or platform may fall outside the regulatory perimeter or may be subject to regulatory permissions or authorization.

What are key considerations and some of the typical aspects of ICOs?

The nature of the token product will vary based on the underlying venture and the style of offering. However typical attributes provided by tokens will include:

- access to the assets or features of a particular project;
- the ability to earn rewards for various forms of participation on the platform; and
- prospective return on the investment.

The nature of the business and the purpose and structure of the token offering will typically be set out in a white paper available to potential purchasers. As the white paper is not required to comply with any regulatory disclosure standard (unlike a prospectus) the quality and information covered can be varied. While the best white papers can provide a clear and detailed analysis of the underlying business and technology involved and highlight relevant risks and concerns, some provide scant details and a poor understanding of the business uses and risks involved and should be avoided.

Key aspects to consider will include the:

- availability and limitations on the total amount of the tokens;
- decision-making process in relation to the rules or ability to change the rules of the scheme;
- nature of project to which the tokens relate;
- technical milestones applicable to the project;
- basis and security of underlying technology;
- amount of coin or token that is reserved or available to issuer and its sponsors and the basis of existing rights;

- quality and experience of management; and
- compliance with law and all regulatory requirements.

If ICOs are to succeed the standard of risk management and disclosure will need to improve. Those that are securities should be regulated as such, while those that are in effect of a sale of a digital asset continue to be sold outside the regulatory framework. In either case it is likely that a large number of token offerings will fail to deliver the perceived benefits much like any high-risk investment pool. Investors should not be misled by the marketing papers or market hype. Different types of token offerings carry different levels of risk and it is hoped that over time the market will identify and properly categorize the appropriate level of risk and disclosure associated with a token offering.

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Commodities merit creditors' caution

Risk mitigation strategies for lenders in trade finance deals secured either directly or indirectly by commodities

In brief…

Wild fluctuations in commodity prices can pose challenges but also provide opportunities for intrepid financiers. Loans, letters of credit, factoring, credit insurance, pre-export financing and prepayment arrangements are common trade finance products. While a broad array of credit products exist to facilitate trade finance transactions, lenders should be aware of the unique risks inherent in these deals. Although each structure carries risks, these issues can be amplified if the transaction is secured either directly or indirectly by commodities. From diligence to documentation, however, there are tools that creditors can use to minimize losses and write-offs.

Addressing legal and compliance risks

Offshore legal risks in trade financing arise from the creation and perfection of foreign security, compliance with local rules and regulations, export license requirements, tax matters and the ability to enforce an international judgment in a borrower's country. Compliance risks include breaching anti-money laundering (AML) laws, customs and related regulations. Violating these laws can result in monetary penalties and reputational losses and prevent a lender from collecting on a transaction.

Diligence is of paramount importance as creditors underwrite a trade finance transaction. If commodities are grossly overvalued or undervalued, this can be indicative of an AML or customs issues. Where the commodity is being exported, lenders should require the export contract be executed on satisfactory terms prior to the initial funding. If the borrower uses key input suppliers to produce the commodity, lenders should ascertain the reputability and historical performance of such suppliers.

For more complicated transactions, lenders can structure a letter of credit or other trade-finance offering to involve an intermediary or correspondent bank as a means of reducing legal and compliance risks. A correspondent bank that has an established relationship with the lender, is situated in the same foreign jurisdiction as the borrower and is familiar with local laws and regulations of that foreign jurisdiction would be an ideal intermediary. In exchange for its services, correspondent banks would assess fees, which would factor in the risk profile of the underlying commodity.

Containing production and economic risks

In financing the production of a commodity, lenders should also confirm that the borrower has a consistent track record for producing a quality product. Lenders can further mitigate this risk by monitoring the commodity's production levels and the borrower's cash flows during the term of the financing. They can use a lockbox or other collection mechanism pursuant to which the commodity purchaser would deposit the sale proceeds directly into an account under the lender's control. Additionally, a lender can add leverage and debt service coverage ratio covenants into documentation to monitor the financial performance of a borrower. Finally, in instances where the sale of the commodity provides the primary source of repayment for the financing, as part of their diligence, lenders should confirm that the price of the commodity has been established with buyers for a certain length of time to protect against adverse market fluctuations.

Managing country and political risks

Lenders also need to assess the political climate and the significance of the commodity in the local economy. Lenders will not generally require political risk insurance as a condition precedent to the financing. However, in some jurisdictions, if there is a conceivable threat that political instability would halt production of the commodity or otherwise impair its sale, lenders may require this insurance to mitigate potential losses even though it can be costly.

In commodities finance scenarios, lenders can reduce losses by performing thorough due diligence, engaging intermediaries in foreign jurisdictions, adding structural controls such as lockboxes and requiring enhanced insurance protections. They can also include financial covenants to monitor a borrower's economic performance. While there is always a certain level of risk in a financing, a more mindful approach in structuring the transaction upfront will reduce write-offs after funding.

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The Nordics implement PSD 2

An analysis of the implementation of the European Union's Payment Services Directive II in Denmark, Finland, Norway and Sweden

In brief…

The Payment Services Directive II (Directive 2015/2366/EU of 25 November 2015 on payment services in the internal market) (PSD 2) must be transposed into local legislation by 13 January 2018. PSD 2 enables bank customers, both consumers and businesses, to use third-party providers (Payment Initiation Service Providers (PISPs) and Account Information Service Providers (AISPs)) to manage their finances. The scope of regulation will also include the issuing of card-based payment instruments connected to an account provided by another payment service provider (Third Party Payment Instrument Issuers). Once their customers have provided consent, banks are obliged to provide these third-party providers with access to such customers' accounts through machine-to-machine communication. Banks can, however, also act as PISPs and AISPs themselves.

As well as creating a framework to allow new competitors to enter the market, PSD 2 also creates a single set of rules for payments and payment services across the European Union. PSD 2 also requires the payment service providers to exercise robust customer authentication when a customer initiates an electronic payment transaction and accesses its payment account online.

PSD 2 is relevant to payment service providers, such as credit institutions, payment institutions, e-money firms and their agents, many FinTech firms, social media networks and telecommunications firms among others.

PSD 2 is a maximum harmonization directive, so the member states may not introduce provisions other than those laid down in the directive. However, PSD 2 provides for a number of options, meaning that each individual member state can decide whether or not to exercise such optionality.

PSD 2 will have a major impact on payment and account services delivered in Europe. Together, the Nordic countries (Denmark, Finland, Norway and Sweden) represent a significant and strategic market in Europe. This article describes the implementation of PSD 2 in the Nordic countries, highlights the applied member state options and points out where the local implementation goes further than the minimum obligations in the directive.

Denmark

On 2 June 2017, the Danish parliament passed legislation which implements PSD 2. The legislation comes into force on 1 January 2018. Generally, the Danish legislation does not differ substantially from PSD 2. However, in certain areas the Danish implementation law goes further than the minimum obligations in PSD 2 in relation to having sufficient consumer protection and keeping existing Danish payment solutions in tact, especially regarding the national debit card 'Dankortet'.

In short, the areas concerned are:

- data-protection;
- rules concerning payment institutions and e-payment institutions management and organization of such institutions, especially the obligation to have an arrangement for their employees to be able to report any possible breach of the law committed by the institution;
- rules on good business practice; and
- the obligation to provide information of any surcharges prior to the execution of a transaction.

Furthermore, some of the optionality provided for in PSD 2 has been used in the Danish implementation law. This is the case for:

- **Article 32** – exemption for smaller payment service providers from part of the procedure and conditions;
- **Article 42 and Article 63** – doubling the amounts set out in the PSD 2 for the value of individual payment transactions, spending limit and store funds according to the framework contract for low-value payment instruments and electronic money; and
- **Article 74** – reducing liability for unauthorized payment transactions in favor of the consumer.

Finland

In Finland, PSD 2 will be transposed in two parts. Titles III and IV are implemented by changes to the Finnish Payment Services Act and titles II, IV and VI by changes to the Finnish Payment Institutions Act.

The draft Finnish implementation acts and the draft explanatory notes were published in March 2017 (Payment Services Act) and July 2017 (Payment Institutions Act). Both drafts are subject to consultation. Thereafter, the Finnish legislator will present its final proposal for the changes to the respective acts and the parliament of Finland will decide on the proposal before the acts are final. It is intended that the legislation will be in force by the PSD 2 deadline of 13 January 2018.

Generally, the Finnish implementation does not go further than the directive and the existing legislation is amended only to the extent required by the implementation of PSD 2.

Some of the optionality provided for in PSD 2 has been used in the Finnish implementation, corresponding with the member state options applied initially in the implementation of the original Payment Services Directive (PSD) in Finland. The optionality has thus been exercised to the same extent as exercised in the implementation of PSD and PSD 2.

In short, the member state options include:

- **Article 2** – exempting Finnvera Plc and Finnish Fund for Industrial Cooperation Ltd. (Finnfund) from the scope of PSD 2;
- **Article 3** – exempting services based on specific payment instruments valid only in Finland provided at the request of an undertaking or a public sector entity and regulated by a national or regional public authority for specific social or tax purposes to acquire specific goods or services from suppliers having a commercial agreement with the issuer of such specific payment instrument;
- **Article 8** – disapplying own funds requirement in relation to payment institutions which are included in the consolidated supervision of the parent credit institution;
- **Article 29** – requiring payment institutions having agents or branches in Finland to report to the Finnish Financial Supervision Authority on the activities carried out in Finland;
- **Article 32** – exempting smaller payment service providers from part of the procedure and conditions; and
- **Article 109** – automatically granting authorizations and registry entries.

Options included in Articles 29(4), 32(1) (national threshold) and 32(4) PSD 2 will not be exercised.

Norway

In Norway, PSD 2 will also be transposed in two parts. Titles III and IV are implemented by changes to the Norwegian Finance Contract Act and titles II, IV and V by changes to the Norwegian Financial Undertakings Act of 2015 and the Payment System Act of 1999. Norway is still in the early stages of the legislative process of implementing PSD 2. The draft implementation acts and draft explanatory notes in respect of the institutional rules in titles II, IV and VI were published in May 2017, subject to consultation and with a deadline to comment by mid-October 2017 and the other consultation paper in respect of titles III and IV on 7 September 2017 and with a deadline to comments by mid-December 2017.

The reason for this division is that the regulations come under two different ministries. According to market participants, it is difficult to respond properly to the draft implementation acts in respect of the institutional rules without seeing the other part of the draft proposal however, which is now recently published. PSD 2 must also be incorporated into the European Economic Area (EEA)-agreement as Norway is an EEA country. It does not seem likely that the deadline set by European Union for implementation of PSD 2 legislation will be met by Norway.

In short, the member state options dealt with in the draft implementation acts in respect of the governing business rules included:

- **Article 2** – entities exempted from the scope – as the Capital Requirements Directive IV (CRD IV) is currently not incorporated into the EEA-agreement, the discretion to exempt certain entities from the scope in accordance with the CRD IV is not a relevant option for Norway;
- **Article 8** – disapplying the own funds requirement in relation to payment institutions which are included in the consolidated supervision of the parent credit institution (the Norwegian legislator has decided not to take advantages of this option);
- **Article 32** – exempting smaller payment service providers from part of the procedure and conditions – the Norwegian legislator has proposed to continue the current regime for a limited payment service license and operating with the same threshold in respect of transactional volume; and
- **Article 62** – the option to prohibit or limit surcharges at a later date – Under Norwegian law an empowering provision has been included which states that the legislator may, at a later stage, adopt a regulation to prohibit or limit surcharging. According to the explanatory notes of the draft implementation acts of Article 62, the legislator refers to the empowering provision set out in the current legislation and states that an introduction of a prohibition of surcharging will require a more comprehensive review. The draft implementation acts regarding the payment services, which has not yet been seen, will address the implementation of PSD 2, Article 62, paragraph 4.

Sweden

The Swedish government has not yet published any draft government bill. Until now, the government has only published an official report (SOU 2016:53, published on 31 August 2016). Generally, the official report's proposition for new legislation does not go further than the directive and the existing legislation is proposed to be amended only to the extent required by the implementation of PSD 2. The report, however, proposes an implementation of the exclusion in Article 3(b) of PSD 2 that appears to be contrary to the wording and intention of PSD 2.

The official report proposes that some of the optionality provided for in PSD 2 should be used in the Swedish implementation, corresponding almost to the member state options exercised in the implementation of PSD in Sweden. The optionality is thus proposed to be exercised to a similar extent in the implementation of PSD and PSD 2. A notable difference is that cash-in-transit companies' 'counting services' are proposed not to be exempted from the scope of the Payment Services Act (which is currently the case). Also, the report proposes that an exemption should be made from the scope of the Payment Services Act for payment transactions completed using mobile telephones or other technological devices, for example when purchasing an electronic ticket for a journey. One condition for such transactions being exempted is that the cost of the transaction is not to exceed an amount corresponding to €50.

Additional optionality which Sweden proposed to exercise includes:

- **Article 29** – the report proposes that foreign payment institutions operating in Sweden through agents or branches be required to submit information on their activities in Sweden at the request of Finansinspektionen or the Riksbank and that payment institutions headquartered in another member state and operating in Sweden through agents be required to appoint a central contact point in Sweden if Finansinspektionen deems this necessary.

As mentioned, the proposed implementation of the exclusion in Article 3(b) of PSD 2 appears to be contrary to the wording and intention of PSD 2. According to Article 3(b) of PSD 2, the directive does not apply to payment transactions from the payer to the payee through a commercial agent authorized via an agreement to negotiate or conclude the sale or purchase of goods or services on behalf of only the payer or only the payee, whereas according to the Swedish Official report's proposal to Chapter 1, Section 7, the Payment Services Act does not apply to payment transactions from the payer to the payee through a 'handelskommissionär' ie a legal figure that in Swedish law refers to a person who buys or sells movable property in ie its own name, but on behalf of someone else, in the course of a business.

Otherwise, there have not been any other noted deviations in the official reports proposal for new legislation.

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Social bonds get the green light

Guidelines and market trends for ethical bond investing

In brief…

Investors are starting to notice that there is the potential opportunity to create space to make an impact beyond the green bond market to create a positive impact on society; and the market for social bond issuance has quickly expanded over the past two years. Social bonds are any types of bond instruments the proceeds of which are used exclusively for financing social projects. Alongside an updated set of Green Bond Principles (the GBPs), the International Capital Markets Association (ICMA) recently published The Social Bond Principles 2017 (the SBPs) to replace the Guidance for Issuers of Social Bonds it issued in 2016 (the SB Guidelines), having consulted various members and working groups within the association.

Ethical investment growth

Ethical and responsible investing has become increasingly important to participants in the international capital markets. Investors pay attention to the environmental, social and governance values created by the money they invest.

The appetite for ethical and responsible investing may have been further encouraged by the United Nations when it rolled out the Sustainable Development Goals (SDGs) in 2016 with the mission of bringing the world together to improve and tackle 17 major problems relating to, among other things, poverty, education, inequality and climate change.

Other than green bonds, the popularity of which has created a market value of about US$200 billion (as of September 2017, in terms of principal amounts outstanding), ethical bond investors now have another investment option to consider. A market for social bonds aimed at financing projects with social impact has emerged, with an increasing number of supporting investors who have begun to include environmental, social and governance (ESG) standards in their investment decisions.

The social bond market is still at an early stage – in 2016, about US$2 billion of social bonds were issued. However, the social bond market is growing rapidly. The first half of 2017 has seen more than US$4.5 billion of social bonds issued globally.

Trend setters

The trend that institutional investors, such as pension funds and insurance companies, are putting more emphasis on ESG values has driven the continued growth of the green bond market and the emergence of the social bond market.

In the first half of 2017, Apple raised US$1 billion through the issuance of a green bond to fund environmentally focused initiatives: to reduce its impact on climate change, to use materials which are more environmentally friendly in its production and to conserve resources. This follows Apple's largest green bond issuance in 2016 at US$12 billion.

Swiss Re has recently caught up with the trend. Since the beginning of 2017, Swiss Re has begun integrating ESG considerations into its investment process. Its whole investment portfolio, with a value of approximately US$130 billion will be based on ethical principles. It is understood that Swiss Re's portfolio managers will have to use the ESG indices of MSCI (Morgan Stanley Capital International) as benchmarks, and there will be very limited room for deviation from such ESG benchmarks. According to research conducted by Swiss Re, the difference between the total return offered by the ESG indices and that offered by traditional indices is small, with that of ESG benchmarks being very slightly lower. However, Swiss Re's view is that ESG indices provide better risk-adjusted returns, as they are usually less volatile.

In relation to social bonds in particular, NWB Bank (a Dutch state-owned bank), entered the social bond market by issuing the largest social bond to date in June 2017, raising €2 billion for on-lending to social housing associations in the Netherlands. According to NWB Bank, the 'social bond label' attracted a new group of socially-conscious investors who had not previously backed any of its bonds. In addition, the label is believed to have helped the bank raise more cash at a good price.

The International Finance Corporation (widely known as the IFC) has two active themed product lines:

- the Green Bond Program, which is aligned with the GBPs; and
- the Social Bond Program, which was aligned with the SB Guidelines prior to the publication of the SBPs.

On an annual basis, the IFC publishes impact reports for projects financed through its green bonds and its social bonds. In relation to social bonds, in particular, eligible projects funded generally involved investments in companies sourcing directly from smallholder farmers, in utilities that provide low-income households with better access to services, in provision of health or education services to low-income populations or in loans for on-lending to women-owned enterprises.

Sustainability bonds

It is worth noting that a particular project to be funded may bring about both environmental and social impacts. Bonds issued to fund such projects could be designated as sustainability bonds. According to The Sustainability Bond Guidelines 2017 published by ICMA in June 2017, sustainability bonds are bonds for which the proceeds 'will be exclusively applied to finance or re-finance a combination of both Green and Social Projects'. Sustainability bonds shall comply with the four core components of both the GBPs and the SBPs.

The SBPs

ICMA first published the SB Guidelines in 2016, acknowledging that, alongside the development of the green bond market, a related market aimed at funding projects with social objectives, or with a combination of social and environmentally sustainable objectives had emerged. In June 2017, ICMA published the first edition of the SBPs, the framework of which is similar to its GBPs. The purpose of the SBPs is to encourage entry into the market by providing guidance on key features in launching a social bond, standardizing the approach in the market and moving the market towards expected disclosures that will facilitate social bond transactions.

The SBPs are voluntary process guidelines which according to ICMA emphasize the transparency, accuracy and integrity of information that will be disclosed and reported by issuers to the stakeholders involved.

The SBPs consist of four core components, as follows.

- **Use of proceeds** – The social projects funded should seek to achieve socio-economic benefits for targeted populations (eg persons living below the poverty line, excluded/marginalized communities and disabled persons). The SBPs provided a number of categories under which objectives of the projects funded by social bonds may align. These include, without limitation, affordable housing, access to essential services such as healthcare and education and job creation. It is important to provide a clear description of the social projects to be funded, which is a key feature for social bonds. Ideally, the social benefits of the projects should be indicated, assessed, and where practicable, quantified.
- **Process for project evaluation and selection** – Issuers of social bonds are encouraged to be transparent about the process by which they determine how the objective(s) of the social project(s) fit within which categories of social outcome to be achieved, and to have this explained within the context of the issuers' social strategy and objectives. If there are social economic risks which may be potentially material, there should also be discussions as to how they could be managed.
- **Management of proceeds** – The SBPs provide recommendations as to how the net proceeds of the bond issuance could be managed, eg by moving into a sub-account tracked by the issuer. Issuers are encouraged to engage auditors or independent third parties for the purpose of tracking the allocation and the use of funds raised.
- **Reporting** – Issuers of social bonds are recommended to keep and make available information relating to the allocation and use of proceeds of the social bonds issued. Issuers should consider using both qualitative as well as quantitative indicators to measure performance.

Social bonds versus social impact bonds

For the sake of clarity, social bonds should not be confused with social impact bonds. While both set out to be financial products, the proceeds of which are to be used to finance projects with a positive social objective, social impact bonds do not normally share characteristics of a typical bond instrument – instead, it is a payment-by-result type of financial instrument whereby the cash flows under the social impact bonds are dependent on the achievement of certain pre-defined social objectives.

Therefore, while it is possible that an investor in social impact bonds may not recover 100% of its investment if the intended results are not achieved, social bond investors' recovery of investments is not dependent upon the successful achievement of the social project it funds. Certain types of investors may not be in the position to invest in financial products which by nature (other than counterparty risks) do not provide for 100% return of principal.

What's next?

While the market for social bonds is currently a fraction of the size of the green bond market, it is expected that the social bond market will continue to grow quickly – with an increasing number of institutional investors looking to have a stronger focus on ethical and responsible investments, the market may also expect an increase in the demand for ethical investment opportunities.

The introduction of the SBPs is a milestone in the development of this market, and should acceptance be gained from market participants, ie the issuers, the arrangers and the investors, the SBPs could play a significant role in standardizing the requirements for transparency, disclosure and reporting in connection with the issuance of social bonds. It will also be interesting to see more sustainability bonds being issued to finance projects with a wider range of environmental and social impacts.

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New law brings opportunities for secured financing in Belgium

An illustration of the key features of the new Belgium law on security over movable assets and how lenders can look to enhance the workability, flexibility and legal certainty of their existing security packages

In brief…

A new Belgian law on security over movable assets is expected to enter into force before 1 January 2018. This will bring to an end sometimes overly complex, legally uncertain and costly structures currently existing in the finance markets when taking (floating) security over moveable assets, especially in trade finance transactions. Clients may want to reconsider existing security packages in view of the new system, depending on the specifics of the securities currently in place as well as the secured assets.

The Belgian law of 11 July 2013 is set to amend the Belgian Civil Code with respect to securities over moveable assets (the Security Law). This new framework will finally provide a modern legal framework, among others by creating an efficient means for taking security over moveable assets which will be easier, safer, more flexible and less expensive than before.

No dispossession required

The Security Law will allow for a pledge without dispossession over:

- any movable asset, tangible or intangible (except ships and financial collateral, which remain subject to other rules), including assets represented by warehouse certificates;
- any group of assets, such as machinery or inventory; and
- business assets as a whole, whether those assets are actual or future.

To create a valid and enforceable right of pledge over any relevant movable asset, the sole registration of the pledge in the National Pledge Register (yet to be set up) will be sufficient. Although dispossession of the goods will remain a possible alternative to such registration, it is no longer required to develop overly cumbersome structures to satisfy the requirement for the pledgee/lender to enter into possession of the pledged movable assets, for instance through a third-party pledge holder (such as a warehouse or storage tank manager in which liquids of gasses are stored ie an oil tank). The ranking and priority of such right of pledge will be determined on the basis of the date of registration or the date of dispossession, depending on the perfection method chosen.

Substitution and co-mingling of pledged assets

When a pledge is taken over a group of assets, such as the inventory of the pledgor located at a specific warehouse (or, given that dispossession is no longer legally required, the pledgor's own premises), it will be possible for the pledgor to substitute any of the pledged assets without potentially restarting any hardening period. The pledgor will no longer have to maintain a minimum amount or value of the pledged assets at the premises for the pledge to remain valid and enforceable. Pursuant to the Security Law, a pledge over (a group of) assets will no longer be affected by the co-mingling or transformation of any of the pledged assets. After the co-mingling, the pledgee will have a proportionate right over the co-mingled assets. However, to avoid potential conflicts with the owners or other rights holders of the other parts of the co-mingled assets, under certain circumstances it may remain advisable to prohibit co-mingling of the pledged assets by the pledgor.

No limitations in respect of inventory value

The Security Law does not provide for any limitation of the scope of the pledge. Contrary to the current legal regime of the floating business pledge (*pand op handelszaak/gage sur fonds de commerce*), it will be possible to pledge up to 100% (and no longer a maximum of 50%) of the value of a pledgor's inventory under a pledge over business assets. On the other hand, it will also be possible to exclude any asset from the scope of the pledge over business assets.

Limited registration fees

The fee for registering a pledge in the National Pledge Register is expected to be a fixed fee, based on the secured amount of the pledge, but capped at an amount which will be significantly lower than the current uncapped fees for registering pledges over business assets (up to 0.60% of the secured amount of the pledge). As a result, it is expected that the current practice (guided by cost limitation requirements of borrowers) of taking a pledge over business assets for a limited secured amount, together with a mandate to pledge the same assets for a larger secured amount, will disappear.

Simplified enforcement procedures

Enforcement of a pledge will no longer require prior judicial approval. Provided that ten days' notice is given to the pledgor, a pledge can be enforced by way of a sale, appropriation or lease of the pledged assets. An ongoing enforcement may be suspended following a challenge in court, but post enforcement judicial review will in principle only be possible within one year after the notification of the completion of the enforcement.

Actions for existing security interests

Although every existing security package should always be examined on a case-by-case basis, the Security Law may provide an opportunity to enhance the workability, flexibility and legal certainty of the security packages lenders may currently have in place.

Clients who currently have any security interest in Belgium, may benefit from reconsidering that interest in light of this new framework. In brief, the following points may be of interest:

Pledge over business assets	■ Existing pledges over business assets need to be registered in the National Pledge Register within 12 months following the entry into force of the Security Law to maintain their current rank. This can be done free of charge, but the registration will only be valid for the remainder of the initial ten-year validity period. ■ It should be analyzed whether an amendment to the pledge agreement would be useful, to implement certain novel nuances of the Security Law, such as an increase of the secured amount (without significant additional costs) or the possibility of enforcement of the pledge without prior court approval by way of sale or appropriation.
Pledge over business assets mandate	■ As the registration of a pledge will no longer be subject to substantive registration fees, it may be advisable to make use of the mandate by taking an actual pledge, rather than to continue the existence of the mandate to create the same, which does not constitute an *in rem* security.
Pledge over movable assets (such as inventory)	■ It may be advisable to amend an existing pledge agreement to certain impracticalities and legal uncertainties that currently exist in relation to such pledges, such as the dispossession requirement (which require a minimum value or amount of pledged assets to be maintained) or the possibility of enforcement of the pledge without prior court approval by way of sale or appropriation.
Other security interests	■ Although the nuances of the Security Law for pledges over other assets are more limited, for existing pledges over shares, receivables, bank accounts or intellectual property rights, it should always be analyzed on a case-by-case basis whether amendments to the agreement may be useful. ■ Other security interests, such as guarantees, sureties, mortgages or mortgage mandates remain unaffected by the Security Law.

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GFXC launches a new FX global code

A synopsis of the background, content and applicability of the GFXC's FX Global Code as well as industry reactions to it in Europe

In brief…

On 25 May 2017, the Global Financial Exchange Committee (GFXC) launched a new FX Global Code (Code). The Code includes a set of 55 global principles of good practice and replaces the existing codes. It was developed to promote the integrity and effective functioning of the wholesale foreign exchange market (FX market).

Background and content of the Code

The Code was developed by a partnership between central banks and market participants from 16 jurisdictions. The first phase of the Code was published by the Bank for International Settlements (BIS) in May 2016 covering areas such as ethics, information sharing, aspects of execution and confirmation and settlement. The second phase further covers aspects of execution including e-trading and platforms, prime brokerage, governance, risk management and compliance. Annex I of the Code provides examples for each of the key principles. These examples aim to illustrate situations where the principles could be applicable, but they do not constitute prescriptive or comprehensive guidance.

Applicability

The Code applies to all FX market participants engaging in the FX market, including both sell-side and buy-side entities, non-bank liquidity providers, operators of e-trading platforms and other entities providing brokerage, execution and settlement services. It does not impose any legal or regulatory obligations on market participants, but its works as a voluntary supplement to applicable rules by identifying global good practices and processes. Market participants must still ensure that internal policies and procedures are in place and they must also comply with the laws, rules and regulations applicable to them. The relevance of the principles depends on the nature, size, complexity and type of the engagement with the FX market. Annex III of the Code includes a sample 'statement of commitment', which is voluntary and which market participants may use to support the objectives of the Code, enhancing transparency, efficiency and functioning in the FX market.

BoE, FCA and EBA's reaction

The Bank of England (BoE) issued a press release stating that the Code 'supersedes and substantively updates existing guidance for participants in FX markets provided by the Non-investment Products (NIPs) Code'.

In its statement, the Financial Conduct Authority (FCA) welcomed the Code and stated that standards can be 'a useful way for the industry to police itself in support of their regulatory work and can help firms to communicate expectations of individuals when linked to the Senior Managers and Certification Regime'. The FCA statement also mentions that firms have begun work to ensure their FX businesses satisfy the principles of the Code. The FCA also noted that firms can help promote the wide adoption of the Code by expecting that their FX counterparties also take steps to adhere to it.

In a press release, the European Banking Authority (EBA) also welcomed the launch of the complete Code and confirmed that its 'guidelines for responsible participation in the FX market are in line with the EBA's work aimed at fostering financial institutions' effective governance and enhanced consumer protection in all areas of financial products and services'.

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European commission publishes consultation paper on FinTech

A summary of the broad policy objectives of the European Commission's consultation on the impact of FinTech for a more competitive and innovate European financial sector

In brief…

On 23 March 2017, the European Commission published a consultation document, 'FinTech: a more competitive and innovative European financial sector'. The European Commission sought input from both providers of financial services and consumers in order to further shape its policy towards technological innovation in financial services and make the single market for financial services more competitive, inclusive and efficient. Interested parties could submit their responses online by 15 June 2017.

The consultation identifies the creation of a connected digital single market as one of the political priorities of the European Commission in order for the European Union economy, industry and citizens to take full advantage of an increasingly digital world. The European Commission's approach with regard to FinTech relies on three core principles: technological neutrality, proportionality and market integrity.

The European Commission has received more than 220 responses to the consultation, which are published on its website. A summary of responses is expected in due course.

The consultation is structured along four broad policy objectives, which this article summarizes below.

Fostering access to financial services for consumers and businesses

The European Commission explores the benefits and assesses the potential risks and challenges faced by consumers, investors and firms as a result of FinTech. Among other benefits, the European Commission considers how innovative technologies can help individuals and small and medium-sized enterprises access alternative funding sources. The European Commission invites comments specifically on artificial intelligence and big data analytics, social media and automated matching platforms and sensor data analytics in the insurance industry.

Bringing down operational costs and increasing efficiency for the industry

The European Commission enquires about how FinTech, by means of streamlining processes in the provision of services, can lead to better, more efficient and more innovative services at lower operational costs. The European Commission also examines the potential challenges for financial stability and financial sector employment. In this area, the European Commission specifically addresses questions relating to the development of RegTech, cloud computing, distributed ledger technology and outsourcing.

Making the single market more competitive by lowering barriers to entry

The European Commission describes how FinTech may be of benefit to the competitiveness of the single market by facilitating the entry of newcomers, but also preserving fair competition. The European Commission also looks into the role that the regulators, supervisors and industry can play in supporting innovation in the financial sector. The European Commission looks at both the role FinTech can play in reducing barriers to entry, but also the barriers that remain, the role of market participants and regulators and the challenges faced with respect to the safety and soundness of incumbent firms.

Balancing greater data sharing and transparency with data security and protection needs

The European Commission focuses on the protection of privacy and personal data. Considering the access to large amounts of data that traditional channels have offered, the European Commission explores how FinTech can impact the estimation and monitoring of risk in the financial sector. The European Commission notes that although FinTech can lower information barriers and strengthen supervisors' monitoring ability, the new environment will need to rely on greater transparency and data sharing.

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The European Commission sets out a roadmap for retail financial services

A note on the European Commission's Action Plan to increase consumer choice, competition and cross-border supply of retail financial products, as part of its work towards an EU Capital Markets Union

In brief…

On 23 March 2017, the European Commission published its consumer finance Action Plan (Action Plan) to set out steps to increase consumer choice, competition and cross-border supply of retail financial products in the European Union (EU).

The Action Plan sets out the European Commission's plans to ensure that consumers can choose from retail financial products across the single market and get value for money, while being reassured they are properly protected.

The European Commission also published an annex, which summarized the European Commission's action points and provided an indicative timetable, a press release, FAQs, a fact sheet, a speech by European Commission Vice-President Valdis Dombrovskis and a new webpage.

Background

The Action Plan follows the European Commission's green paper on retail financial services, published in December 2015, and forms parts of the European Commission's work towards establishing a Capital Markets Union.

Key actions identified

The Action Plan identifies some of the measures that have already been taken to overcome obstacles to closer integration, but highlights that there are areas where the market in consumer financial services remains fragmented.

The European Commission considered a number of supply-and-demand-side factors which were holding back closer integration, and identified three main areas for focus, as summarized below.

Increase consumer trust and empower consumers

Some of the European Commission's key observations in this area included the following.

- Although firms can decide where to offer their services, there remained instances of unjustified discrimination against customers based on their residence, particularly where firms provided different products in different jurisdictions. The European Commission said it would consider appropriate measures to resolve this, without seeking to impose undue regulatory burdens on firms.
- The European Commission noted it will propose widening the scope of currencies covered by the regulation on cross-border payments (No. 924/2009) to reduce cross-border transaction fees for all currencies.
- Currency conversion rates, in some areas, remain insufficiently transparent and the European Commission proposed a review of good and bad practices in this area.
- With the exception of accounts covered by the Payment Accounts Directive 2014/92/EU) (PAD), switching providers for financial services can sometimes be difficult. The European Commission will review this area building on the lessons from implementation of the PAD, and will also look at enhancing the quality and reliability of price comparison websites in financial services.

The European Commission noted that the evolution of new types of consumer credit lending (for example online and peer-to-peer) has resulted in some EU legislation failing to adequately cover developments in some areas, and stated that the increased availability of consumer credit could result in risks of irresponsible lending and borrowing causing over indebtedness. The European Commission stated that it would explore ways of facilitating cross-border lending while maintaining high standards of consumer protection.

Reduce legal and regulatory obstacles affecting businesses

The European Commission identified that differences in consumer protection and conduct rules between member states may create unjustified barriers for the cross-border provision of financial services, and stated it would examine this area further.

The European Commission also noted that the cross-border creditworthiness assessments could be facilitated and carried out in a more harmonized way, and will seek to introduce common creditworthiness assessment standards and principles for consumer lending, and look to develop a minimum set of creditworthiness information to be shared between credit registers.

Support the development of an innovative digital world

The European Commission stated its aim to create an environment where technology and innovation can be used for the benefit of the consumers. To this end, it encouraged new regulatory and supervisory approaches and cross-border co-operation when dealing with innovative firms, so long as customers remain well protected. The European Commission stated it would decide on its approach in this area building on the work of its newly launched internal FinTech Task Force, and the responses to its public consultation on financial technology.

The European Commission also stated it would seek to enable cross-border digital identification of customers through e-identification methods and 'know your customer' (KYC) transferability, as well as looking for potential optimizations in the distance selling regulations, including pre-contract disclosure requirements.

Next steps

The European Commission identified various 'action points' to support its Action Plan. It stated the initiatives would be facilitated through various public consultations and impact assessments.

The Action Plan sets out a roadmap for further work until 2019, with the first actions expected in Q4 2017.

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