Primary Markets

by Ruari Ewing

PRIIPs and MiFID II product governance: the initial experience

Since the beginning of the year, various ICMA members have reportedly been using the ICMA1 ("all bonds"/"professionals only") and ICMA2 ("simple listed bonds"/"general retail") approaches to the PRIIPs and MiFID II product governance (PG) regimes. These were outlined in, respectively, the 2017 Q4 and 2018 Q1 editions of this Quarterly Report.

Various ICMA working group deliberations continue, however, as: (i) the most directly affected market players (the more active "manufacturers" and "distributors") continue to deepen and widen their initial understanding of the regimes (including more marginal scenarios) and explore potential new compliance approaches; and (ii) other stakeholders (less active manufacturers/distributors, more geographically remote intermediaries, other borrowers, related advisors, investors and also regulators) familiarise themselves and react to "manufacturer"/"distributor" approaches. In this respect, ICMA staff presentations recapping on current dynamics have been published on ICMA's *MiFID II/R in primary markets* webpage.

There was significant press coverage in the major UK financial press at the start of the year concerning PRIIPs key information documents (KIDs) allegedly produced according the officially prescribed methodologies yet presenting results so extreme as to be misleading. The UK FCA subsequently acknowledged that, for some PRIIPs, "the 'performance scenario' information required in the KID may appear too optimistic and so has the potential to mislead consumers" and that reasons for this may include "the way the calculations in the RTSs must be carried out". The FCA noted in this respect being comfortable with manufacturers that produce KIDs "provide explanatory materials" to provide context and set out their concerns. But query then additional space sufficiency within the KID's strictly limited three pages and any "disclosure chain" considerations (the KID has to be a standalone document albeit with a strictly defined allowance for cross-references). ESMA's Chair, Steven Maijoor, has recently stated that ESMA is working on further guidance, on performance scenarios-related issues in particular. However, none of this seems likely to encourage, at least for now, benchmark borrowers who can access the institutional markets to produce KIDs (having set their likely focus on certainty of funding against liability considerations in the context of these large funding exposures running into the billions).

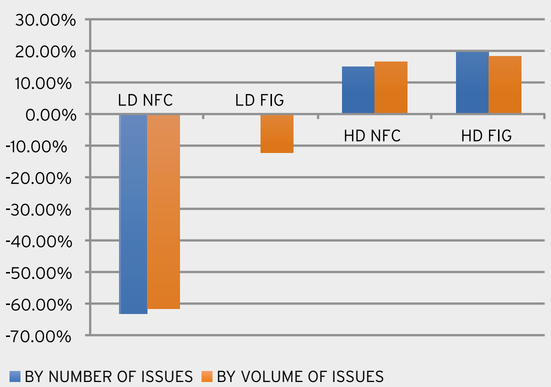
And it is distinctly worth remembering that prior PRIIPs coverage in this Quarterly Report noted potential liability concerns stemming from the PRIIPs KID concept itself (irrespective of the officially prescribed methodologies), starting with the KID's vague purpose – which a speech by ESMA's Chair, Steven Maijoor, interpreted as being *inter alia* to "contain sufficient information to allow consumers to make an informed investment decision". This seems close to the Prospectus Directive test for a full prospectus ("all information [...] necessary to enable investors to make an informed assessment"). It seems challenging, in a €500 million - €2 billion context, to reconcile discharging such a fulsome disclosure test in the KID's three pages, particularly set against the PRIIPs Regulation's absolute prohibition on the KID being "misleading." There is also the specific obligation that the KID include "key" information specified as such under the Regulation: the Regulation's civil liability exemption (for KIDs that are accurate, non-misleading and otherwise consistent with other specified documents such as a prospectus) would not apply to any consequential civil liability claim arising under non-EEA laws such as in the US (an important consideration given the international nature of the bond markets).

ICMA has conducted an initial analysis of Dealogic's new issue data for indications of any new regime impact on the availability of vanilla bonds to general retail investors. It did so by comparing the prevalence of low (€1,000 or less) and high (€100,000 or more) denominations in euro new issue data for 2018 Q1 (as of 21 March) against the equivalent 2017

Q1 data (the single currency scope limitation being to simplify the analysis). Given the many possible types of debt securities (involving different combinations of features) that have evolved to meet borrower and investor needs, there is no exhaustive and authoritative bond type nomenclature. ICMA's analysis consequentially focused on benchmark issuance (aggregate issue sizes of €500 million or more) as a rough proxy for vanilla bonds, since the only other bonds of that size are likely to be asset/mortgage-backed bonds that can be controlled for in Dealogic's nomenclature. Lastly, bonds have not traditionally had generic formal "retail" designations (having rather various retail-like characteristics stemming from regulatory, commercial or other drivers). ICMA's analysis consequentially focused on denomination as a rough proxy for potential retail status. Many bonds have €100,000 denominations, meaning that they can only be bought or sold in sizes of at least that order of magnitude (the trading value of vanilla bonds tends to oscillate around 100% of the denomination's face value – absent default or similar concerns). However general retail investors will only plausibly buy bonds with denominations of around €100, €1,000 or perhaps €10,000.

The analysis[1] by number and value of issuances, as shown in the chart below, reveals a marked decrease in low denomination issuances (over 60% in the case of non-financial corporate bonds), in contrast to 15%-20% increases in high denomination issuances.[2]

Percentage change in issuance 2018 Q1 over 2017 Q1



LD NFC = low-denomination, non-financial corporates; **LD FIG** = low denomination, financial institutions; **HD NFC** = high denomination, non-financial corporates; **HD FIG** = high denomination, financial institutions

Source: Dealogic

It remains to be confirmed whether this very significant reduction in vanilla low denomination bonds (i) indicates an ongoing trend, (ii) is caused by the PRIIPs and/or PG regimes and/or (iii) will be a concern for European authorities (eg in the context of the EU's CMU objectives). These initial results give food for thought in any case. A simpler statistic yet may be found in the number of KIDs known by ICMA to have been prepared among all benchmark bonds (not just the above EUR data set) since the PRIIPs regime took effect: none so far.

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1. This analysis involved a data set of 953 bond issues worth €882.7 billion, roughly equally split between the first quarters of 2018 (as of 21 March) and 2017. Around a quarter of the issues did not have denomination data and were discarded, leaving 698 issues worth €694.9 billion to analyse (again roughly equally split between the two first quarters). Aside from two issues only with €50,000 denominations, all issue denominations were relatively polarised between low denominations (€1,000 or less) and high denominations (€100,000 or more). 38 asset/mortgage-backed bonds were excluded (as non-vanilla), as were 160 sovereign, supranational and agency (SSA) bonds (as significantly less impacted or even exempt from the new regimes) – thus leaving 498 bonds worth €393 billion from financial institution and non-financial corporate borrowers most likely to be impacted (in a ratio of around 6/4).

2. The excluded SSA issuances decreased generally, though more markedly in high denominations.