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Government Borrowers Forum

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Ladies and gentlemen,

As ESMA is for the first time formally represented at a Government Borrowers Forum I feel obliged to briefly introduce my organisation. ESMA's mission is to enhance the protection of investors and promote stable and well-functioning financial markets in the European Union (EU). As an independent institution, ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active coordination of national supervisory activity.

To briefly illustrate some of our activities, we have already made technical standards for Credit Rating Agencies (CRAs) and short-selling, and now we are drafting technical standards for OTC derivatives. In addition, CRAs are under our direct supervision and we will participate in the supervisory colleges of CCPs.

Let me now move on to the topic of this panel. Secondary markets for government bonds have gone through a lot of changes in recent years. The financial crisis has shown that bond markets can be as volatile as equity markets, and what once was a relatively quiet part of financial markets has turned into the centre of the storm. There are a number of relevant processes taking place, such as a deepening linkage between banking and sovereign markets and increased participation in these markets through both cash instruments and credit derivatives.

It is no coincidence that securities markets regulators are paying increasing attention to this market, to adjust its characteristics and ensure that it has adequate standards of transparency and rules of conduct. ESMA is also looking into this market with a view to ensuring transparent and orderly trading and price formation. I will discuss some of the relevant issues that this market is facing from a European perspective.

Transparency

A first regulatory topic in relation to government bond secondary markets is the issue of how transparent these markets should be. By transparency we refer to the availability of price and volume information on secondary markets, both prior to the transaction (pre-trade transparency) and after it has taken place (post-trade transparency). U.S. and EU authorities have been looking at the topic of transparency in the bond market for some time.

In the U.S., the TRACE (Trade Reporting and Compliance Engine) captures and disseminates consolidated information, such as real-time pricing and trade volume, on transactions relating to eligible fixed-income securities. Introduced in 2002, this system has been refined and expanded since then. In the EU, as you are aware, one of the key elements of the European Commission's proposal for the review of MiFID is the extension of the MiFID transparency framework (applied now to equities only) to bonds and other non-equity products, like derivatives.

In the proposed Regulation, on the pre-trade side, trading venues should make public prices, and the depth of trading interests at those prices, for orders or quotes advertised through their systems for bonds admitted to trading on a regulated market, or for which a prospectus has been published. As regards OTC trading, systematic internalisers (firms that trade frequently on their own account on a financial instrument) should provide binding quotes in those bonds when quoting at the request of a client.

On post-trade transparency, publication of the price, volume and time of the transactions would be required, even though there is room for deferred publication, particularly for large trades.

ESMA has identified in the past a need for enhancing transparency in the non-equity space. As indicated by the European Commission, currently prices in several non-equity OTC markets are a function of the willingness of dealers to provide investors with quotes on request without a public interaction of supply and demand. That level of transparency is not always sufficient.

Any enhancement of the trade transparency for non-equities should be carefully calibrated to meet the specific needs of the EU environment. In particular, the calibration of transparency regimes beyond equities has to be carefully assessed, undertaken per asset class and in many cases per type of instrument within each asset class so as to avoid transparency harming liquidity. It is expected that ESMA will advise the European Commission in the design of these transparency regimes. The main issues in that work will be that such calibration may suffer from a lack of available data and the wide array of instruments to be covered.

In any case, I believe that more transparency, if adequately calibrated, will bring better price formation and this will ultimately benefit primary markets, the ones you tackle as borrowers, since liquid and fair secondary markets have always been important for well-functioning primary markets.

On price sensitive information

With the sovereign debt crisis in Europe, much attention has been focused on the information that relates to government policies and their decisions in the field of public debt. While, for many years price-sensitive inside information was associated with listed companies, the crisis shows that information on government finances, public debt restructuring or rating actions by CRAs on governments can be as relevant and price-sensitive.

You all know that, at least under the EU regime for market abuse, there is this general rule that an issuer of financial instruments that are traded on a regulated market needs to publish inside information as soon as possible. Indeed, any person who is in possession of such inside information is prohibited from using it to trade, to disclose it to another person or recommend or induce someone to trade on it. The proposal recently issued by the European Commission to review this regime expands and clarifies the scope of the market abuse regime, extending it to financial instruments traded on MTFs as well as to Credit Default Swaps.

It is true that the EU market abuse regime sets out exemptions from the prohibitions for transactions carried out in pursuit of monetary policy, exchange-rate or public debt management policy by a Member State, a national central bank, any officially designated entity (for example debt management office) or the ECB as well as by any person acting on their behalf. Similarly, the prohibitions on market manipulation, like price manipulation, do not apply to these transactions.

However, I would like to stress that this does not fully exonerate these entities and persons from the European market abuse regime. A Member State, or a national debt management agency, that issues sovereign bonds admitted to trading on a regulated market is an issuer in the meaning of the Market Abuse Directive, and therefore, any relevant inside information should then be made public. Of course, like any other issuer Member States are allowed to delay the disclosure of inside information under certain circumstance: if it has legitimate reasons, if the public is not misled by the omission and if the confidentiality of the information can be ensured.

Therefore, it is very important that inside information relating to governments is properly managed by them and all through the chain of parties involved with them. As for any other issuer, leaks should be avoided, not only for their potentially significant impact on sovereign bond markets and financial stability, but because they introduce informational asymmetry and this damages market integrity and fairness.

We have witnessed several leaks on very relevant price-sensitive information in the last few years. Therefore, I think it is in the interest of market integrity and cleanliness that issuers, including governments, regulators and firms work together to ensure fair and transparent markets.

The 12-Hour rule for rating actions and the market abuse regime

One example of possible leaks is information on rating actions. The Credit Rating Agencies Regulation provides that a CRA shall inform the rated entity at least 12 hours before publication of the credit rating, in order to give the entity the opportunity to request the correction of any factual errors. Such exchanges are covered by confidentiality obligations.

The CRA Regulation requires CRAs to respect strict confidentiality requirements as regards the information disclosed under the 12-hour rule. In the first place, our Regulation requires CRAs to disclose any credit rating on a non-selective basis and in a timely manner, which means that the preliminary communication of a forthcoming rating action under the 12-hour rule must be strictly limited to the rated entity. Moreover, the Regulation stipulates that rating analysts, other employees of the CRA and any other natural person working for the CRA do not disclose any information about credit ratings except to the rated entity or its related party.

On the other hand, the CRA Regulation does not cover the confidentiality requirements of the issuers and their related parties. In this respect, as explained before, the Market Abuse Directive provides that price-sensitive information should remain confidential until it is publicly disclosed to the market as a whole, and the EU market abuse regime does not exempt governments from respecting the confidentiality of information received from CRAs under the 12-hour rule.

ESMA and CRA supervision

As you probably already know, since 1 July 2011 ESMA is the exclusive supervisor for credit rating agencies (CRAs) in the EU. The legal basis for our supervisory competences is provided for in the CRA Regulation currently in force, and in the implementation measures already adopted and under adoption by the European Commission.

As regards our day-to-day supervisory duties, following the registration of the major CRAs last year, ESMA took immediate supervisory steps with a first round of on-site inspections of the three main CRAs in December 2011. This was done in order to get a better understanding of the rating process and to assess the regulatory compliance by CRAs in this area. A report with the main findings of these initial examinations has been published by ESMA on 22 March 2012. ESMA identified several shortcomings and areas for improvement that apply, to a varying extent, to all three CRAs relating to such topics as transparency and disclosure of rating methodologies and ratings, controls over IT systems, the recording of core internal processes, and the resources devoted to internal control functions and analytical business lines. ESMA is now following-up on the observations through risk mitigation plans for each individual CRA.

In its on-going supervision, ESMA is required to ensure that methodologies are rigorous, systematic, continuous, and subject to validation based on historical experience, including back testing. However, the CRA Regulation prevents ESMA from interfering with the content of credit ratings or methodologies. This also applies to the European Commission and any public authority of a Member State.

The regulatory framework for CRAs will probably be soon amended by the CRA 3 Regulation, which is currently being negotiated at the European Parliament and at the Council. While waiting for the final political agreement, the proposal adopted by the European Commission last November gives a general idea of the new regulatory requirements that might be introduced. I will highlight a few elements of the proposed legislation.

CRA 3 includes a proposal for a new disclosure platform to be run by ESMA to improve the level of transparency of the credit rating market. As regards the prevention of conflicts of interest, the proposal states that CRAs shall not issue credit ratings when their major shareholders have interests in the rated entity, or when the rated entities are major CRA shareholders themselves. The CRA 3 proposal also introduces several provisions on mandatory rotation for rating analysts and CRAs with the aim of achieving greater competition in the CRA sector. Finally, I would like to highlight the proposal that Member States shall ensure civil liability for the infringements of the CRA Regulation made with intent or through gross negligence.

Conclusion

As you can see, there are many contact points between sovereign borrowing in capital markets and securities markets regulation. ESMA is looking forward to strengthening the regulatory focus on bond markets and helping to develop the implementing European legislation on market structures and conduct rules. This development is consistent with the increasing role of sovereign debt and sovereign issuers in financial markets. I think it needs no further explanation that we all benefit from stable and well-functioning debt markets.

Thank you for your attention.