The move towards a border-free European bond issuance market

EURONEXT SECURITIES

Introduction

The Eurobond market has often been described as conservative. Participants rely on established, proven ways of doing business, and change often comes slowly and out of necessity rather than the desire for innovation or reinvention. Thus, when Autostrade made history by issuing the very first euro bond on 17 July 1963, it wasn't about challenging the status quo. Autostrade needed to procure financing outside of its local market, and so the company worked with a UK-based law firm and issued its bond on the Luxembourg stock exchange. The move was without precedent, so it needed to create a new market practice. In time, that new practice became the industry standard.

In the decades that followed, issuance basically followed one of two approaches: local or global. If an issuer wanted to address the local market and investors, they issued in the local currency, under local law and through the local CSD. On the other hand, if that issuer wanted to address an international market, they used the global note scheme. They issued under UK law, listed the bond on the Luxembourg or Dublin stock exchange, and went through the ICSDs with cash settlement in commercial bank money. Almost 60 years later, the process is well established and, on the surface, there is no strong impetus for change. However, developments over the past 20 years indicate that a shift in market practice could be imminent.

The quest to create a European capital markets union

The desire to create a capital markets union in Europe is not new. The Treaty of Rome, signed in 1957, included as one of its objectives the desire for free capital movement. When the euro was introduced in 1999, focus on EU-wide financial activity increased. Then in 2001, the Giovannini Group published a report identifying 15 barriers to the efficient functioning and development of cross-border clearing and settlement. The conclusion was that there were significant technical, tax and legal barriers to creating a capital markets union. The desire, however, remains, and many European financial policy makers believe the formation of this union is a necessity to compete in the global marketplace. And thus, over the past 20 years, authorities have passed several regulations in the effort to create a level playing field, and ensure cross-border competition and harmonisation.

Laying the regulatory groundwork

Challenging the traditional concept of local vs global issuance.

While the regulations leading the European markets towards harmonisation are many, there are a few that are particularly significant to the discussion at hand, challenging the traditional concept of local vs global issuance.

2004

- In 2004, the first **Markets in Financial Instrument Directive (MiFID)** was introduced to improve EU financial markets' competitiveness by creating a single market for investment services and activities, as well as ensure harmonised investor protection[1]. This triggered the establishment of new marketplaces such as multilateral trading facilities (MTFs) and resulted in a consolidation of trading venues over the next decade.

2012

- In 2012, the **European market infrastructure regulation (EMIR)** created a framework for the operation of central counterparties and also promoted their cross-border activities. It was now possible for trading members who did not know the local counterparties to trade through the central counterparties, which reduced risk and gave brokers the appetite to offer trading in more locations.

2015

- In 2015, the **Regulation on central securities depositories (CSDR)** enabled competition between depos itories and supported their activities across borders as well. The aim of this regulation was to make markets more stable, transparent and efficient by regulating securities settlement and settlement infrastructures in a harmonised manner across the European Union and the European Economic Area (EEA).

These regulations helped establish a common set of rules of engagement that makes it more feasible for local CSDs to operate outside of their country's borders, issuing securities that reach a global, or at least European, investor pool. However, rules and policies are not all that is required to achieve a seamless securities market. To truly facilitate cross-border issuance, you need a common infrastructure.

[1] https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

Creating a pan-European infrastructure

In 2015, the European Central Bank (ECB) introduced the TARGET2-Securities (T2S) platform, a single European securities settlement platform. This platform, coupled with the possibility of cross-border competition created by CSDR, created the market environment necessary to challenge the status quo regarding cross-border issuance. Now there are frameworks in place to facilitate cross-border activities; the European Central Bank has become an infrastructure provider, building the target platform for payments and securities and paving the way for process unification. The stark lines of demarcation between global and local markets are fading. The market environment is shifting; will this shift lead to a corresponding change in behaviour?

Fact: Cross-border investing is a growing trend

CONSIDER THESE FIGURES FROM DENMARK[2] :

47%	Of debt instruments issued in Denmark are owned by international investors.
64%	Of equity instruments issued in Denmark are owned by international investors.
36bn	The market value of EUR-denominated issuances through Euronext Securities Copenhagen is EUR 36 billion.

[2] As of Jan 2022

Five advantages

Despite these developments, we still see extensive fragmentation. European CSDs remain deeply entrenched in their local markets and competing across borders has been challenging for them. Issuers continue to take the established paths: the local CSD to reach local investors and the global note scheme to reach European investors. The process works, they reason, so why change it? Consider five benefits issuers can realise by issuing international bonds through their local CSD.

Benefit #1

Same investor reach at a lower cost

There is a common misconception that reaching an international investor pool requires going through one of the ICSDs. However, experience has demonstrated this is not the case. One of the main benefits of using the T2S settlement platform is that local CSDs can achieve the same investor reach as the ICSDs. And the added advantage for investors is that they benefit from lower costs by safekeeping their bonds in local CSDs. Investors and intermediaries can also use a known operational setup where they can receive the bonds on their preferred securities accounts thanks to a competitive network of direct CSD links.

For example, when Euronext chose to finance the purchase of Borsa Italiana Group by issuing a corporate bond via Euronext Securities Copenhagen, the bond performance and pricing actually exceeded expectations. The final order book reached an amount of c. €5 billion and was more than 2.7 times oversubscribed. The issuance attracted a wide range of international investors from France, Germany, Austria, the Nordics, the UK, Ireland and the Benelux.

Jyske Realkredit, a mortgage institution located in Denmark, had a similar experience when issuing a euro covered bond (CBD) through Euronext Securities Copenhagen. "When I look in my order book, there's no difference between this issuance and our previous ones," Anders Lund Hansen, Head of Mortgage ALM at Jyske Bank, observed. "We have the same investors, both large and small, as we would expect to see."

Fact:

T2S connects local CSDs to an international investor pool

There are currently **21 Central Securities Depositories (CSDs)** on the T2S platform and a total of **1,490 banks**. Euronext Securities also maintain eligible links to the biggest investor hubs, e.g. Euroclear bank with **1,600 banks** and Clearstream Bank Luxembourg with **1,300 banks**. Issuers also reach Tier 2 and 3 investors by issuing via T2S.

Benefit #2

Reduced legal fees by issuing under local law

Issuing via the local CSD means issuers can choose to issue under their local legislation, as opposed to having to engage external counsel to issue under UK law. This often means that issuers can have fewer advisors and external counsel involved. Issuers frequently experience a legal process that is within their control, as they are the ones drafting the prospectus and leading the discussions with the regulators who have to approve it. Issuers can also capitalise on their existing expertise of issuing under their local legislation, which makes the entire issuance process smoother and cheaper.

Euronext Securities customers have also found that by issuing bonds under local law, they can reduce the cost base for legal documentation by three to five times. "Our primary advantage was the cost savings," states Jimmy Bak, Head of Legal, Funding at Nykredit, who issued euro-based mortgage bonds under a Danish law prospectus through Euronext Securities Copenhagen back in 2017. "There was a significant cost savings for us to have a Danish law prospectus instead of one based on English law. Even though you could use Danish law for some of the security-related aspects of the prospectus, you would still have to go with an Ireland- or Luxembourg-based regulator. You would also need to engage external counsel to maintain the programme. So, handling everything under Danish law saves money."

Customers have also experienced that the documentation process, including paying agent agreements, is easier when issuing under local law and with a dematerialised bond. For example, Dan Lauder, Counsel at Allen & Overy, who was Euronext's counsel on the Borsa Italian Group acquisition, observed, "The issuing and paying agency process and the relationships were much lighter than the actual heavy English documents, which are stuffed with references to physical bonds."

Benefit #3

Reduced settlement risk with central bank money issuance

Minimising risk is another key advantage when issuing through the local CSD. Local CSDs settle using central bank funds, as opposed to the commercial ICSDs that settle using commercial bank funds. Thus, by issuing via their local CSD, issuers access the same price structure as they would on the international market, yet with considerably lower risk.

Benefit #4

Increased operational efficiency through process harmonisation

Using the same CSD for all issuances also means that issuers can use the same business process irrespective of the target currency or market. By streamlining the process and centralising on one CSD, issuers can significantly reduce their operational costs. Centralisation also paves the way for process improvement, as back-office staff spend less time learning various settlement processes and systems, and can instead focus on honing one process, making it faster and more effective. The end result is a settlement process with fewer errors.

Benefit #5 Issuing locally supports local capital markets

Issuing capital through the local CSD strengthens the local capital market as a whole, benefitting issuers and investment banks alike. Issuers gain access to the same international pool of investors. Custodian banks will then use the local CSD for safe-keeping and other post-trade services, such as corporate actions and clearing and settlement services. These custodians can then service international customers, thus generating more business for local banks.

What about dematerialisation?

Perhaps the greatest difference between issuing locally and internationally is the matter of dematerialisation vs global notes. While it's true that issuing global notes is a part of the established market practice, the precedent for issuing dematerialised bonds does exist. For example, bonds have been dematerialised in France since the 1980s. There it is a fairly tried and tested approach. This provides a model of how dematerialisation could work in other financial jurisdictions with similar clearing systems. Dematerialisation has also been used under English law, where banks have used a dematerialised structure for debt programmes for small level transactions. There are also indications that dematerialisation is the way forward. For example, the CSDR states that all issuances have to be dematerialised from 2023. Issuers that gain experience with dematerialisation now will have the added benefit of creating a future-proof process.

What about ECB eligibility?

Another common concern related to issuing through the local CSD is whether or not bonds issued locally can be eligible for the ECB's collateral programmes. For a bond to be eligible, it must meet three criteria:

1. **The issuance must be done through a CSD in the European Economic Area;**
2. **When using the collateral, it must be held in an eligible Securities Settlement System (SSS)[3];**
3. **The transfer from the issuer CSD to the eligible SSS must be done via an eligible link[4].**

If these criteria are fulfilled, then eligibility is not an issue. Bonds issued through Euronext Securities' network of CSDs are eligible for the ECB's two collateral programmes: the Correspondent Central Banking Model (CCBM) and the Corporate Sector Purchase Programme (CSPP).

What about the number of laws in the prospectus?

Some might wonder about the implications of a company being incorporated in one country and issuing under the law of another country. Yet, it is actually quite common for a prospectus to reference two to three different law codes. Over time, as investor interest across Europe has increased, it has become more frequent that a prospectus features multiple laws for dematerialisation or tax purposes.

[3] https://www.ecb.europa.eu/ paym/coll/coll/html/SSS_links_ en.html

[4] https://www.ecb.europa.eu/paym/coll/coll/ssslinks/html/index.en.html

What about the ISIN?

Euronext Securities' customers have found that international investors are not concerned by the lack of an XS ISIN. For example, during the book building process for Euronext's own bond, the lead managers did not receive a single question about or objection to the DK ISIN. Jyske Realkredit had a similar experience. "We have 83 active investors in our issuance, and we haven't received a single question about the DK ISIN. This shows that this is a fully accepted solution seen from the European markets' standpoint," stated Anders Lund Hansen.

How issuers are benefitting from leveraging their local CSD

One issuer that has successfully reached international investors through its local CSD is Tryg Forsikring. In March 2021, Tryg issued SEK 1bn in Restricted Tier 1 Capital Notes via Euronext Securities Copenhagen with a listing on the Oslo Stock Exchange (Oslo Børs). The combination of capital notes issued in Swedish krona and listed on the Norwegian stock exchange is one that Tryg has had success with in the past, and suits the company's Scandinavia based investor pool. The vast majority of the company's investors, 87%, are Swedish, and the remaining 13% are located in Denmark and Norway. That investors have no clear preference for which market the company issues in can be seen in the bond's performance. It was 2.5 times oversubscribed, with pricing that met the company's expectations and a solid order book comprising asset managers and pension funds. The issuance was the second of its kind in three years, and Tryg clearly benefited from being able to centralise everything on the same exchange and using an established process.

Market developments leading to a change in market practice

Shifts in market practice have occurred before; they simply require the necessary impetus. For example, France moved from issuing covered bonds under UK and US law to French law in the early 2000s. This move was prompted by the switch to using the French clearing system and the need to have dematerialised notes. Since that time, virtually every French corporate issues under French law. This demonstrates that change can happen. The foundation for change is there. The regulatory framework and technical infrastructure are in place to support a federal issuance model. Statistics reveal that the pronounced lines of demarcation between local and global markets are disappearing. And recent issuances demonstrate that investors are increasingly market-agnostic. What will it take for the industry to reach the tipping point?

The need for a 'green Capital Markets Union'

The ECB has stated that EU countries need to invest around €330 billion each year by 2030 to achieve the union's climate and energy targets. As a recent Reuters article[5] pointed out, "the massive investments needed to tackle climate change have added a sense of urgency" to the need to establish a capital markets union. In fact, Christine Lagarde, President of the ECB, has drawn attention to the current market fragmentation as a barrier to the necessary investments in a sustainable economy. For example, in a May 2021[6] speech, Ms. Lagarde stated, "I believe that the green transition offers us a unique opportunity to build a truly European capital market that transcends national borders – or what I would call green capital markets union." According to Ms. Lagarde, there are three main reasons why green finance could provide the necessary catalyst for creating the long sought-after capital markets union.

1st **First, Europe is already leading the way in green bond issuance. In 2020 alone, around 60% of all green senior unsecured bonds issued globally originated in Europe. And the market is growing rapidly – the outstanding volume of green bonds issued in the EU has grown almost eight-fold since 2015.**

2nd **Second, environmental, social and corporate governance (ESG) investment is also concentrated in Europe. The assets under management of investment funds with ESG mandates have almost tripled since 2015, and over half of bond funds are domiciled in the euro area.**

3rd **And third, the euro has taken the lead as the global currency of green finance. Last year, around half of the green bonds issued worldwide were in euro.**

In a separate paper[7], the ECB has also highlighted how the green bond market has already achieved greater pan-European scale. The authors state, "The green bond market currently displays a higher degree of integration across the euro area than the aggregate bond market, with euro area issued green bonds being roughly twice as likely to be held cross-border by euro area investors than euro area-issued bonds overall."

[5] https://www.reuters.com/markets/stocks/eu-adds-more-pieces-its-elusive-capital-market-jigsaw-2021-11-25/

[6] Speech by Christine Lagarde, President of the European Central Bank, at the European Commission's high-level conference on the proposal for a Corporate Sustainability Reporting Directive, Frankfurt am Main, 6 May 2021. Source: bis.org

[7] Towards a green capital markets union: developing sustainable, integrated and resilient European capital markets / Prepared by Alexandra Born, Margherita Giuzio, Claudia Lambert, Dilyara Salakhova, Hanni Schölermann, Fabio Tamburrini [Source: European Central Bank website]

Enabling cross-border sustainable investing

Euronext's own experience within the area of green bonds testifies to the pan-European nature of these investments. Euronext ESG Bonds is an online platform that combines all eligible and consenting ESG bonds and securities in all Euronext markets in one location. This list now contains over 850 ESG bonds from more than 280 issuers across the globe. This platform connects investors and issuers, creating an international financial community for those actively involved in sustainable investments. Issuers on this platform have raised in excess of €600 billion, representing approximately 44% of total global sustainable issuance.

The introduction of a shared EU Taxonomy for green bonds, as a part of the European Green Bond Standard (EUGBS) will hopefully make it even easier for investors to identify sustainable investments across Europe and pave the way for increased cross-border investment. Christine Lagarde's hope is that this will benefit all European economies. "With their pan-European reach, green markets could also help all countries to access the capital they need to finance economic transformation – not only those with the most sophisticated financial markets. That would support convergence within Europe, enabling capital to flow to regions that are currently lagging behind in the transition to a more sustainable economy."

Euronext also sees signs that the green investment trend is accelerating. In 2021, Euronext added over 250 ESG bonds. Euronext has also contributed to the UNGC Blue Bond Reference Paper, with the scope of identifying opportunities to use the ESG bond market to secure capital for ocean-related projects and companies that have made, or are planning to make, a significant contribution to the UN Sustainable Development Goals (SDG), particularly SDG 14 "Life Below Water". By mid-2021, 162 companies were listed in sectors related to the Blue Economy, in all Euronext countries. These companies had a market capitalisation of over 675 billion euros, with total revenues of over 840 billion euros, and employed over 1.4 million people.

Conclusion

In summary, regulations have paved the way for cross-border competition. With the implementation of the T2S platform, we have the infrastructure in place to issue locally and reach an international pool of investors across Europe. Recent issuances demonstrate that issuers can reach the same investors by issuing through their local CSD, and at the same time, benefit from a more efficient and cost-effective issuance process. And perhaps the need to fund the transition to the blue and green economy will prove to be the final catalyst to creating a borderless capital market union in Europe.

Pierre Davoust, Head of Euronext Securities, believes the post-trade industry will see a further blurring of the lines between the local and international markets. "It has been possible to compete across Europe since 2014. Despite the regulatory framework being in place, we still see the same number of CSDs, each remaining in their own market, and the level of competition between them is relatively low. Which means issuers have yet to benefit from the promise of harmonisation and increased competition. This is where we hope to make an impact as a large-scale CSD network. By pan-Europeanising our CSDs, we aim to help our issuers benefit from the framework that is already in place and give them access to the global capital markets from their local market. We offer efficient and robust issuance, custody and settlement services across European markets in multiple currencies. And for those interested in ESG-related issuances, we offer a tailored programme to help them build their ESG ambition, connect with the right investors and promote their sustainability strategy across markets."

About Euronext

Euronext is the leading pan-European market infrastructure, connecting European economies to global capital markets, to accelerate innovation and sustainable growth. It operates regulated exchanges in Belgium, France, Ireland, Italy, the Netherlands, Norway and Portugal. With close to 2,000 listed equity issuers and around €6.6 trillion in market capitalisation as of end March 2022, it has an unmatched blue chip franchise and a strong diverse domestic and international client base. Euronext operates regulated and transparent equity and derivatives markets, one of Europe's leading electronic fixed income trading markets and is the largest centre for debt and funds listings in the world. Its total product offering includes Equities, FX, Exchange Traded Funds, Warrants & Certificates, Bonds, Derivatives, Commodities and Indices. The Group provides a multi-asset clearing house through Euronext Clearing, and custody and settlement services through Euronext Securities central securities depositories in Denmark, Italy, Norway and Portugal. Euronext also leverages its expertise in running markets by providing technology and managed services to third parties. In addition to its main regulated market, it also operates a number of junior markets, simplifying access to listing for SMEs.

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