Deutsches Aktieninstitut

Corporate bonds are not in the scope of PRIIPs

Clarifiation is urgently needed

Comment on the ESA's Joint Consultation Paper concerning amendments to the PRIIPs KID (JC 2018 60), 6 December 2018

Leave corporate bonds out of the PRIIPs-scope

As association of German companies using capital markets for financing purposes we deeply regret that an issue of utmost importance for our member companies, i.e. corporate issuers, is not in the scope of the consultation paper: The treatment of corporate bonds under PRIIPs. This holds especially true in the light of the letter submitted by the ESAs "Implications of the uncertainty as to the scope of the PRIIPs Regulation (1286/2014) and request for Commission guidance" from 19 July 2018. In this letter the ESAs urge the Commission to provide guidance on which products fall in the scope of PRIIPs and which do not. In the annex of the letter they provide helpful examples.

Corporate bonds are assets that are held directly by investors either through primary market access or through the secondary market and rightfully do not fall in the Key Investor Document (KID) scope under PRIIPs.

Unfortunately, significant uncertainty among corporate issuers remains whether regulators would regard certain corporate bonds as a PRIIP due to commonly used standard terms and conditions included in corporate bonds.

As a result, issuers would have to condense a 100 pages (often more) prospectus into a 3 pager KID that will always be contestable and leaves the issuer with unbearable liability risk. This has already lead corporate issuers to exclude retail investors of those bonds that are likely to be considered a PRIIP, thus avoiding the question whether it is necessary to prepare a KID or not. As the EBAs state in their letter mentioned above analysis indicate a 60 per cent reduction in the number and overall volume of low domination issuances in the first quarter of 2018 compared to the first quarter of 2017.

This limits not only the opportunities and investment scope of retail investors to invest directly and in a transparent, cost efficient way in investment grade corporate bonds. In addition, this deprives corporate bond issuers of a simple access to an important, diversified investor base for their funding needs that is considered "buy and hold", i.e. adds to market stability.

Overall, the inclusion of certain corporate bonds as PRIIPs thwarts the efforts of the European Commission as expressed in the Capital Markets Union initiative. To avoid these unintended side effects, we urge the regulator to clarify the scope of the PRIIP in the context of corporate bonds. In particular, the regulator should confirm that certain well-established standard terms and conditions do not turn corporate bonds into PRIIPs. The annex provided by ESAs in their letter should be taken as starting point.

Given that the definition of PRIIPs in Art. 4 relates to investments where the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor, the following features of a corporate bond should be considered for exemption from the PRIIPs-regulation:

- Caps and floors on the interest rate, as these features relate to the regular interest payments and not to the amount repayable at maturity, which for corporate bonds is in general the nominal value. Uncertainty relates also to “implicit” floors, which are required by certain national legislations for different reasons, and which does not relate to a structuring purpose. According to German law, e.g., an interest payment below a rate of zero is not allowed. This is an issue especially in the low-interest environment. Consequently, market participants are discussing whether this requirement, which is often not explicitly stated in the bond documentation, could be regarded as a structuring topic under PRIIPs.

- The same holds true for redemption rights of the issuer (e.g. customarily used “make whole clauses”, “par call clauses 3 months ahead of final maturity”, “clean up calls” or “M&A clauses”), because such redemption rights simply provide legal certainty for the investor in case the issuer wishes to buy back an existing bond before maturity. As all of the applicable redemption rights ensure that bonds are redeemed at least at the principal amount and, e.g., in case of “make whole clauses” offer an economic benefit to the investor, we also do not see any potential risk from an investor protection perspective in such a case. Nevertheless, this uncertainty lead banks to refuse issuances of bonds including “make whole clauses” without a KID since PRIIPs is in place. Furthermore, it should be noted that the investor has redemption rights as well, e.g. change of control clauses. Regarding these instruments, we would very much welcome the clarification that these clauses are not in the scope of PRIIPs, given that the mechanism to calculate the redemption amount is known to the retail investor in advance, as indicated by ESAs in their letter.

- Clarification is also needed regarding floating rate notes, which of course relate by their very nature to a reference value. As these are plain instruments commonly used for financing purposes in the real economy it seems odd, that they should not be covered by the bond exemption under PRIIPs. Furthermore, compared to bonds with fixed coupons no additional risks are arising for the end investor: The bond price fluctuation risk, which is always zero for floating rate notes, is substituted by the risk of a variable interest payment.

Clarification of the above would avoid further harming of the integrity of the European capital markets and would be in line with the objective of the Capital Markets Union as well as the PRIIPS regulation.

In addition, it is utterly important and good legislative practice to apply any rule only for those bond issuances after the implementation of such rule. An application of such rule to all bonds irrespective of time of issuance creates significant burdens and risks for all issuers, especially smaller issuers who do not have the ability to update their bond prospectuses issued in the past. It creates also a burden for retail investors, as also mentioned in the EBA-letter, and their ability to trade their bonds issued before the date of the entry into force of the regulation.

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