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Euro Commercial Paper – Legal Background, Regulation and Development of ESG Programmes

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Today's topics

1. Overview and market development
2. Basics of ECP documentation
3. Comparison with the U.S. Commercial Paper
4. EU/UK regulatory considerations for Commercial Paper
5. Asset-backed Commercial Paper
6. ESG Commercial Paper

1. Overview and market development

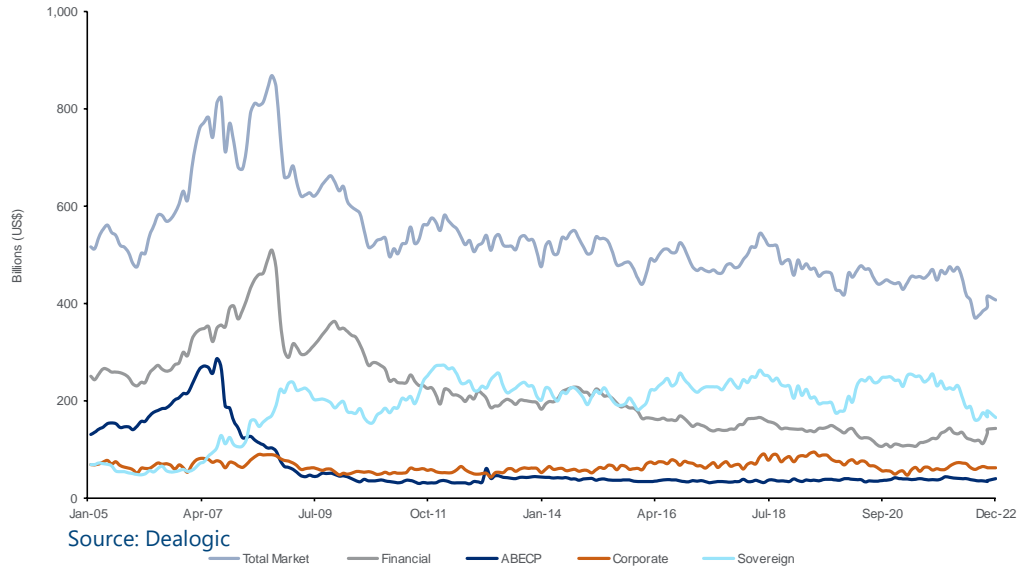
Overview

- The European Commercial Paper (ECP) programme is a **short-term, unsecured debt issuance programme** designed for large corporations and financial institutions to raise funds in the money market.
- It is an important market for **short-term and working capital requirements** of large corporations and financial institutions.
- ECP is a flexible funding tool, enabling issuers to tailor their issuance to meet specific funding needs and market conditions. It offers the ability to issue in **various currencies, maturities and sizes**.
- The ECP market is **one of the largest short-term debt markets globally** and provides an important source of funding for many large corporations and financial institutions.
- The European **Asset-Backed Commercial Paper (ABCP)** market is a subset of the ECP market and is backed by a pool of financial assets such as trade receivables, credit card receivables, and auto loans.

Market development

- The ECP market is part of the **wider European short-term credit market**, which is fragmented into a number of different markets with varying legal frameworks, practices, and participant types.
- Increasing participation from non-bank entities, with an higher demand for highly-rated issuers following the Covid-19 pandemic and a shift towards shorter maturities.
- **Covid-19** pandemic had a significant impact on market functioning and liquidity, highlighting potential areas for improvement. In particular, the fragmentation and the lack of harmonisation across markets presents challenges for issuers and investors, having an impact on the liquidity and efficiency of the system.
- In the UK, a number of new programmes were set up to take advantage of the UK HMT and Bank of England **Covid Corporate Financing Facility** (CCFF). This has now closed.
- ESG factors are becoming more important in investors' decision-making processes, leading to increased issuance of **sustainable commercial paper**.
- ICMA recommendations to develop the European CP/CD market focussed on **standardisation, transparency, secondary market liquidity** and **automation** to help develop the market (See: [ICMA-CPC-white-paper-The-European-Commercial-Paper-and-Certificates-of-Deposit-Market-September-2021-290921.pdf](#) (icmagroup.org)).

ECP Outstandings – 2005- 2022



2. Basics of documentation

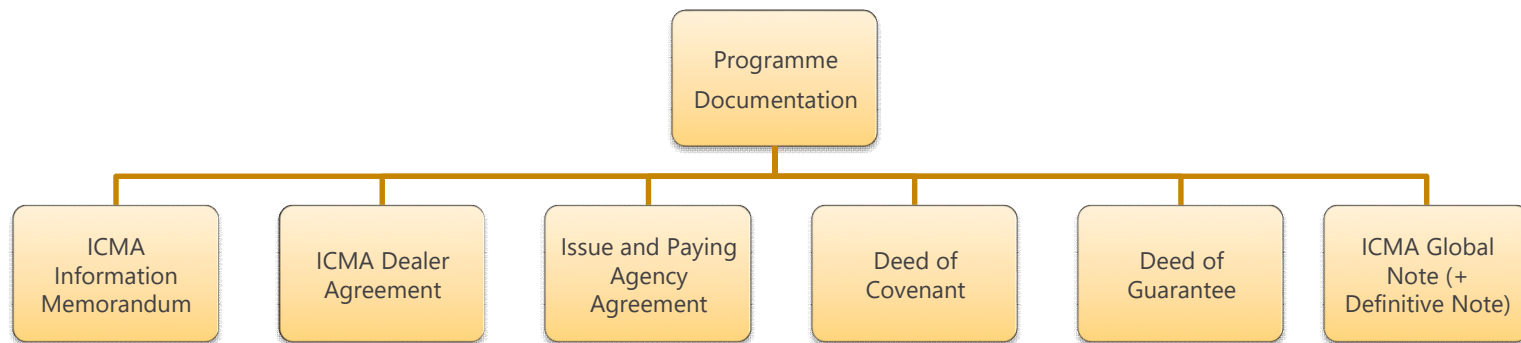
Basics of documentation

Main features of the CP programmes

- Issuers are usually investment grade/higher rated companies and banks, which are often frequent capital market issuers in other markets.
- CP programmes are characterised by short maturity (usually overnight to 364 days). Thus, there are no events of default and no negative pledge. ECP has simple terms - issued at discount, fixed and floating rates. Typically governed by English law.
- Bearer Notes (but not subject to TEFRA owing to short maturity).
- The set of documentation is much lighter compared to MTN programme and based on **International Capital Market Association (ICMA) standard forms**.
- ECP is not typically listed, therefore no need to prepare a full prospectus, instead a short-form information memorandum is sufficient. This will have limited disclosure and incorporate future financial information and filings.
- Unlike EMTN Programmes, ECP programmes are not subject to annual update requirements (save in relation to STEP which has a 3 year update cycle) and do not require supplements for new financial information.
- Some CP programmes apply for the STEP (Short-Term European Paper) Label. STEP aims to foster the integration of the European markets for short-term paper through the convergence of market standards and practices. A STEP label is also used where the programme is intended to be ECB eligible.

Basics of documentation

Documentation of English law CP programmes is heavily standardised and based on the **ICMA standard form** Information Memorandum, Dealer Agreement and Global Note. Note, for STEP programmes there is a **standard STEP form of Information Memorandum** that also needs to be taken into account



Basics of documentation

Other features of CP Programmes

- For UK companies, CP is UK withholding tax exempt on account of maturity of less than one year
- Institutional and not retail investor base
- Clearing in Euroclear and Clearstream is the norm
- Representations, undertaking and warranties in the Dealer Agreement follow ICMA form (albeit often with amendments to align with provisions of existing MTN programmes)
- No comfort letter or 10b-5 disclosure letter. No due diligence
- Investment grade rating is essential for market access
- ICMA documentation has been updated to include new RFR wording, based on ISDA calculation method, for floating rate notes
- ICMA documentation specifically caters for issuance in USD, EUR, GBP, Yen, CHF, CNY, AUD, CAD, NZD and HKD with the flexibility to issue in any other currency subject to legal and regulatory requirements
- Index linked ECP is no longer a feature of ECP programmes
- No outside counsel involvement in issuances

3. Comparison with U.S. CP Market

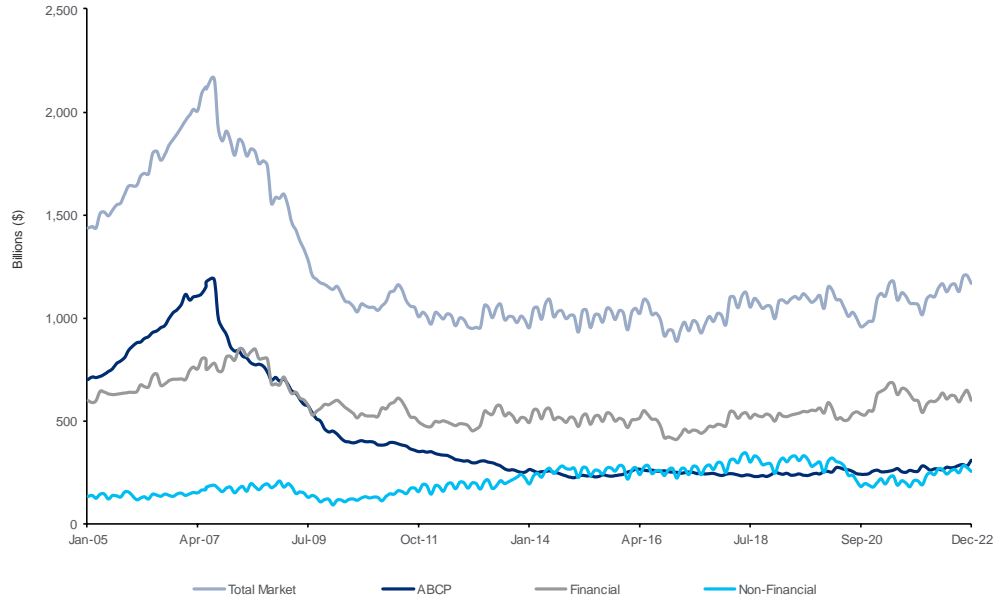
Comparison with the U.S. CP market

- It is important to highlight that there is no single pan-European market, and that the market consists of a number of different markets, each with their own legal frameworks, post-trade structures, participants and dynamics. This makes the European market distinct from the US CP market.
- The US CP market is more standardised, with most issuers following the same market conventions and credit rating agencies providing more detailed and standardised credit ratings. In contrast, the EU CP market is more fragmented and this can create some challenges for cross-border transactions and can make it more difficult for investors to compare the credit quality of different issuers.
- Compared to the single currency and unified regime of its US counterpart, the European market consists of multiple component parts, the largest of which is the ECP market, followed by the Negotiable European CP (NEU CP) market, as well as a range of other smaller domestic markets.
- There is no single European regulator overseeing the market, and issuers are not required to register their programs or provide ongoing disclosure. However, most CP issuers voluntarily adhere to the ICMA best practices for the CP market, which include transparency and reporting standards.

Comparison with the U.S. CP market

- In the US, the Federal Reserve has historically played a significant role in backstopping the CP market and providing liquidity during times of stress. Interventions by the Federal Reserve in US were critical in assisting the European CP market and helped to calm markets and restore confidence more globally. In the EU, the European Central Bank has a more limited role, although it has taken some steps to support the market during periods of market stress (especially during Covid-19 with the Pandemic Emergency Purchase Programme (PEPP)).
- US CP has been traditionally sold in reliance on the exemption from registration under the 1933 Act provided in Section 3(a)(3).
- Today, the US CP is sold in book-entry form through the Depository Trust Company. EU CP is settled and cleared through Euroclear and Clearstream
- A CP repo market is active in the US. EU is now considering developing a repo market for CP that would afford dealers greater flexibility in funding inventory, as well as provide a means for investors to raise liquidity against their CP holdings without having to liquidate them.
- Finally, the size of the US CP market is much larger than the EU/UK CP market.

USCP Outstandings



Source: Federal Reserve

4. EU/UK regulatory considerations

EU/UK regulatory considerations for commercial paper

Main features of EU/UK regulation applicable to CP programme:

- **Prospectus regulation:** CP is exempt from the requirements of the EU and UK Prospectus Regulations (but it is classified as a 'financial instrument' for the purposes of EU MiFID II, UK MiFIR and the FCA Handbook). CP is exempt because it is classified as a money market instrument with a maturity less than 12 months and therefore not a "transferable security". The minimum denomination of CP is always higher than €100,000 which also means there is no obligation to publish a prospectus pursuant to EU and UK Prospectus Regulations.
- **PRIIPS/Selling restrictions:** Market consensus is that CP does not constitute a PRIIP and therefore it is not necessary to include the PRIIPS legend in the CP documentation. Investor base is not retail.
- **Product Governance:** Depending on whether the ECP issuer is a MiFID II firm or a FCA authorised firm (and therefore a "manufacturer") or the relevant dealer considers itself to be a "distributor" and not a "manufacturer", particular disclosure language will need to be inserted in the Information Memorandum and Dealer Agreement. Generally, underwriters do not consider themselves manufacturers.
- **FSMA Deposit Taking:** Where commercial paper is issued by issuers who are not authorised or exempt, the standard ICMA selling restrictions requires that the managers represent and agree that the commercial paper is only offered to investors whose ordinary activities involve them acquiring, holding, managing or disposing of investments. To fall within this exemption, it is also customary for commercial paper to have a minimum denomination of at least GBP100,000 (or equivalent in another currency).

5. Asset-Backed Commercial Paper

What is Asset-Backed Commercial Paper (ABCP)?

- ABCP is commercial paper collateralised by asset-backed securities or loans which fund underlying receivables. ABCP is issued and the collateral is held by a bankruptcy remote special purpose company known as a *conduit*.
- The conduit is typically:
 - sponsored by a bank.
 - 'fully supported' – the sponsor bank essentially guarantees timely payment of ABCP if the conduit has insufficient cash to pay maturing ABCP.
 - 'multi-seller' – it purchases receivables from several sellers rather than from a single originator.
- ABCP is a dual-recourse instrument – it is rated by rating agencies on the basis of the credit quality of the collateral and the credit rating of the sponsor.
- The conduit grants security over the underlying assets to a trustee in favour of ABCP holders and other secured creditors.
- Investors are typically money market funds or corporate treasury departments.
- ABCP conduits typically fund 'real economy' assets such as trade receivables, auto loans / leases credit cards, equipment loans / leases and personal loans.
- ABCP financing allows the borrower to diversify funding sources beyond full recourse lending (e.g. on-balance sheet bond or loan financings) and potentially to access lower funding costs in the CP market.
- Conduit financing is often in the form of a 1-3 year committed facility, under which the conduit commits to purchase assets originated by a borrower up to a commitment limit.

ABCP in the Financial Crisis – and since

- At its peak July 2007 total ABCP outstanding stood at \$1.2tn; by 2017 ABCP outstanding had declined 81% to \$231 billion.
- Proliferation of ABCP structures made it difficult for ABCP buyers to analyse risk among various programmes.
- Structured investment vehicles (SIVs), which funded long-term assets with ABCP), shared structural similarities with ABCP programmes.
- Several SIVs were caught up in the subprime crisis and became insolvent, leading to a rapid fall in the popularity of ABCP in general.
- Traditional multi-seller ABCP conduits were able to continue issuing ABCP during the crisis.
- Decline of ABCP was the result of investors' ongoing aversion, banks' reduced need for off-balance sheet funding and increased regulation.
- General effect of post-crisis regulatory changes was to require 100% credit and liquidity support and so effectively to transfer the conduit's liabilities to the sponsor's balance sheet.
- Liquidity coverage ratio requirement (LCR) requires a bank sponsor to hold high quality liquid assets equal to 100% of ABCP maturing within 30 days.
- LCR led some banks to exit the ABCP market because of the liquidity impact on their balance sheet.

EU / UK regulatory considerations for ABCP

EU/ UK Securitisation Regulation

- An ABCP transaction will typically use the proceeds from the issuance of ABCP to obtain an interest in transactions that have tranching credit exposure and qualify as securitisations for EU/UK regulatory purposes.
- ABCP (and liquidity or asset purchase facilities) will therefore also typically be securitisation positions for the purpose of the EU/UK Securitisation Regulation.
- EU/UK Securitisation Regulation requires:
 - initial and ongoing due diligence by EU/UK institutional investors in relation to a securitisation position
 - risk retention of at least a 5% of net economic interest in the securitisation transaction
 - but fully supported ABCP programs do not require risk retention at transaction level
 - disclosure to investors, competent authorities and, on request, potential investors
 - transaction summary
 - monthly asset-level report and investor report (Annexes 11 & 13 of ESMA templates)
 - 'significant event' disclosure

EU / UK regulatory considerations for ABCP

EU/ UK Securitisation Regulation

- STS - ABCP transactions or programmes which qualify as STS (simple, transparent and standardised) may result in reduced regulatory capital requirements or other regulatory benefits for bank holders of an exposure to the transaction/programme
 - STS criteria for ABCP transactions include requirements relating to:
 - simplicity, including true sale and underwriting standards, homogeneity
 - standardisation, including risk retention
 - transparency, including provision of information to potential investors
 - sponsor and sponsor support for the ABCP programme
 - criteria for ABCP programmes to be STS require:
 - all underlying transactions to be STS (except that a maximum of 5 % of the aggregate amount of the exposures may temporarily be non-compliant a period of no more than six months)
 - programme to be fully supported by the sponsor
 - remaining weighted average life of the underlying exposures to not be more than two years
 - ABCP may not include call options, extension clauses or other clauses that have an effect on final maturity, where such options or clauses may be exercised at the discretion of the seller, sponsor or the conduit
- No resecuritisation at ABCP Transaction level - securitised exposures transferred by the seller to the conduit may not be resecuritisations.

EU / UK regulatory considerations for ABCP

Money Markets Fund Regulation

- Money market funds may invest
 - up to 20% of their assets in ABCP which is STS
 - up to 15% of their assets in non- STS ABCP

6. ESG Commercial Paper

ESG Commercial Paper

There is an increasing focus on ESG considerations in the short-term credit markets, in particular on the development of ESG programs and the potential for green CP and CD.

- The ESG CP market is predominantly driven by organisations that already have ESG-labelled term debt: 95% of issuers have already issued green or sustainability-linked public bonds and they are looking to extend ESG features across their capital structure.
- There isn't clear guidance for market participants. Note, in the French market, the Paris marketplace launched a ESG NEU CP – NEU MTN Working Group and IM Template for ESG issuances on the [Banque de France's website](#).
- Issuers are now issuing sustainable use of proceeds CP through the adoption of a specific ESG framework and the obtainment of a second-party opinion in order to have an external firm performing specific procedures to provide assurance to investors.
- In an economic environment characterised by capital market volatility, access to short-term markets with ESG features has grown in importance and money market funds are attracting meaningful inflows. Due to this increasing appeal, ICMA has set-up a Sustainable CP taskforce to develop official guidance on sustainable CP market.

ESG Commercial Paper

Sustainable CP programmes can be structured in different ways:

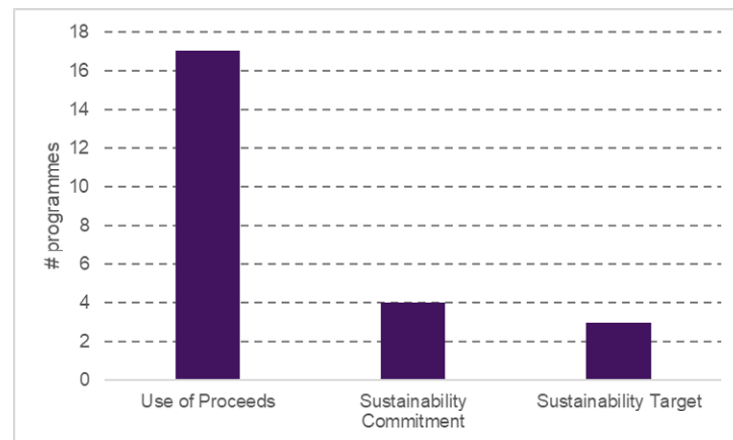
- “Use of proceeds” sustainable CP
- Sustainability target-linked CP
- Sustainability commitment CP

These programmes do not always comply with the ICMA Green, Social or Sustainability Bonds principles (because the use of proceeds for ECP is working capital) or the ICMA Sustainability-Linked Bond principles (as the ECP is too short-term to have testing on sustainability KPIs).

In general, there are no events of default, penalties or other consequences for the issuer that ceases to meet the sustainability or the ESG target/condition. The risk is primarily reputational and the issuer will not be able to issue further sustainable CP under the relevant programme.

Important to ensure that Programmes are correctly structured, explained and disclaimed as there is significant and increasing public, investor and regulatory scrutiny around ESG financial products.

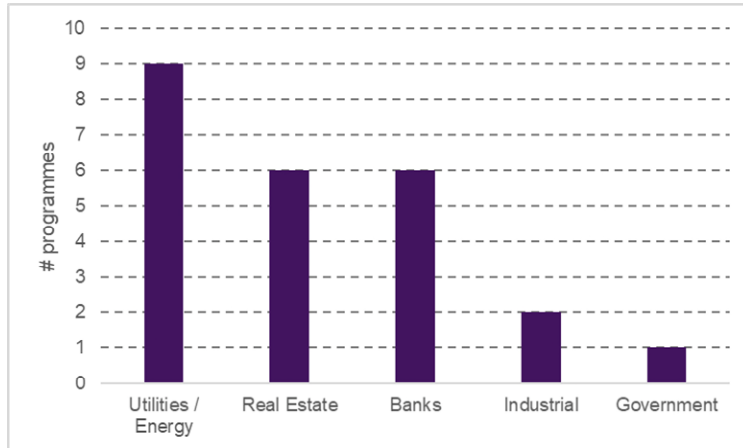
Sustainable CP programmes by sustainability structure



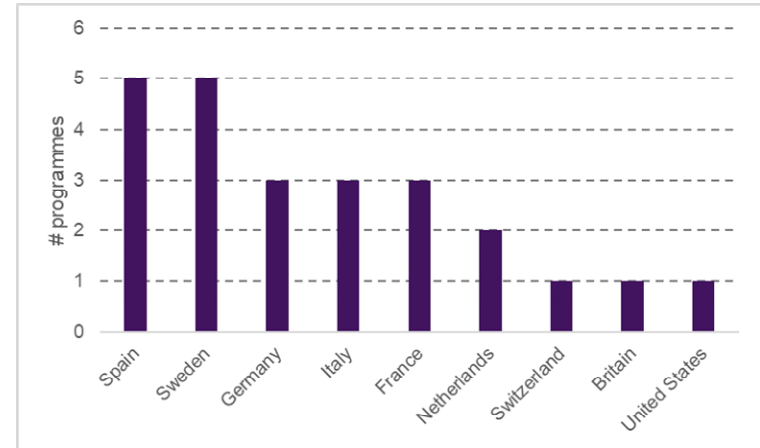
Source: NatWest Markets

ESG Commercial Paper

Sustainable CP programmes by sector



Sustainable CP programmes by country



Source: NatWest Markets

Additional Resources

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Neil Hamilton, a partner in the London Banking & Finance practice, acts for arrangers, originators, servicers and investors and has extensive experience in a variety of asset classes, including ABCP, RMBS, CLOs, CMBS, auto loans and leases trade, receivables and consumer loans. Neil frequently advises clients in relation to the EU and UK Securitization Regulations and other legal and regulatory aspects of securitization and structured finance transactions.

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