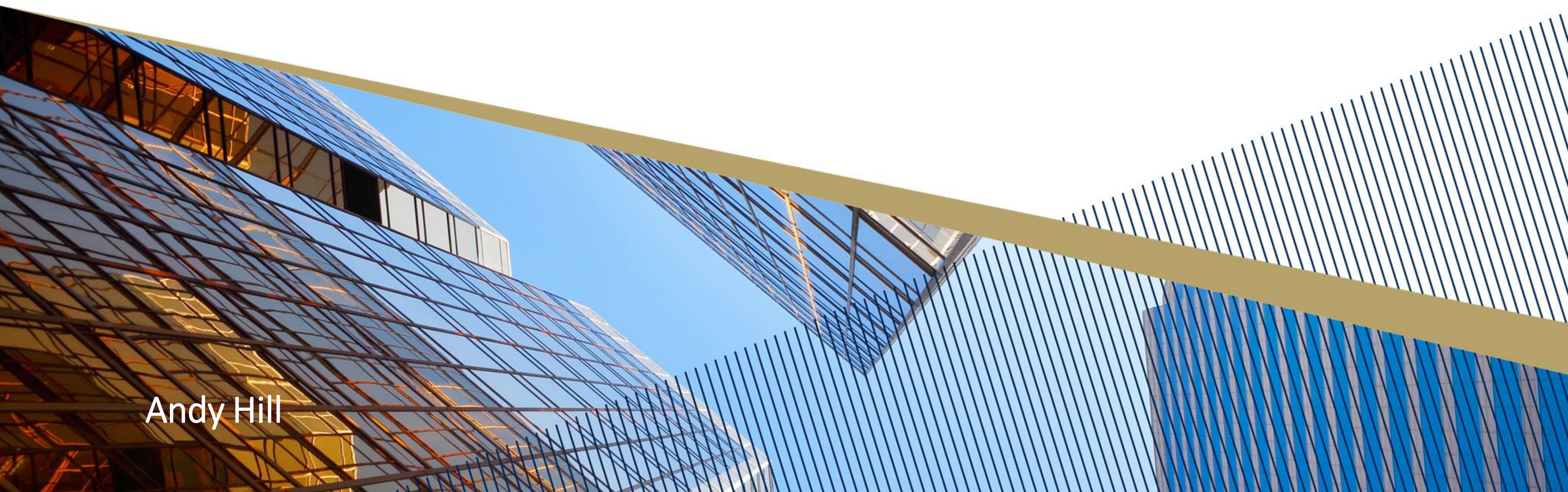
Remaking the corporate bond market

ICMA's 2nd study into the state and evolution of the European investment grade corporate bond secondary market (2016)

ERCC General Meeting, London, September 27 2016

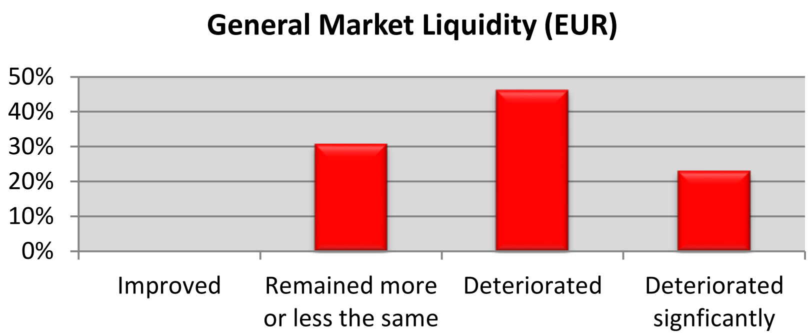


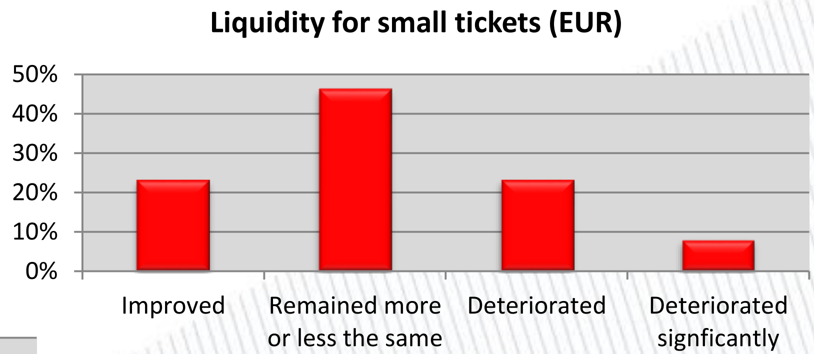
Andy Hill

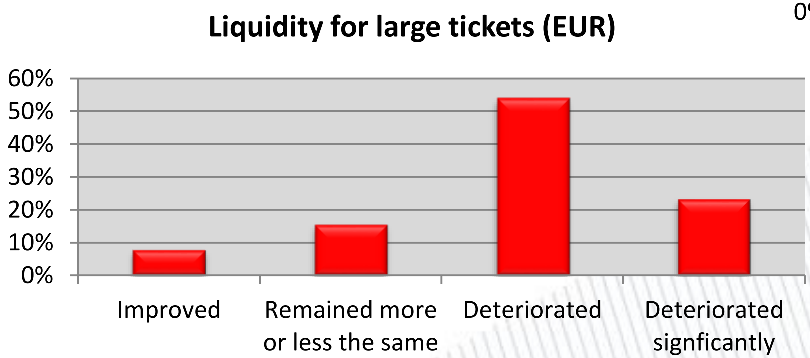
Key findings of the study?

- The general perception is that market liquidity is declining – but it is more nuanced than simply things are getting worse
- Over all, liquidity is becoming more challenging to provide and source
- Causes for this are attributed to the confluence of monetary policy and regulation
- Market participants are responding the challenge, including sell-side, buy-side, intermediaries, and infrastructure providers: changing business models and behaviour
- More interest in new trading protocols and e-solutions, as well as alternative products
- Looking ahead, major risks seen as the ECB's CSPP, MiFID II/R pre-trade transparency, and CSDR mandatory buy-ins [pre-Brexit]
- Corporate issuers more focused than ever: concerned about a growing disconnect between secondary market liquidity and primary market efficiency

ICMA Buy-side Liquidity Survey



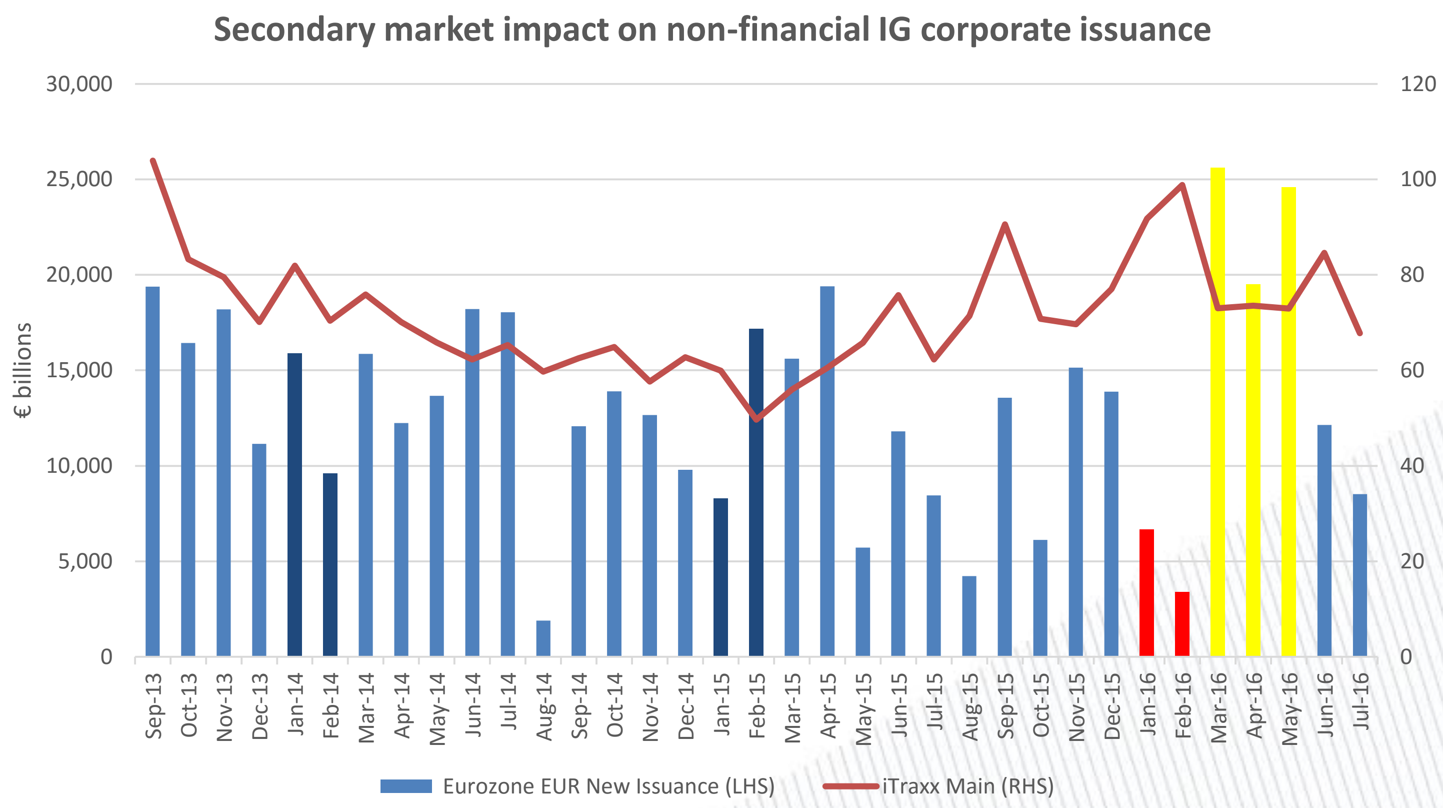




What do we mean by liquidity?

- “The ability to get a price in the size you require, when you need it”?
- The ability to trade without major market impact?
- Can liquidity be measured?
  - MiFID II/R liquidity measures
  - Interactive Data’s Liquidity Indicators
  - Bloomberg’s LQA
- What are the appropriate determinants?
  - Bid-ask spread? Market depth? Expected time to execute? Market impact? Historical volume and prints? Characteristics of instrument? Distribution of holders?
- Should liquidity measures be based on trade data, or on what failed to trade?
- Is liquidity dynamic?
- Should liquidity have a cost?

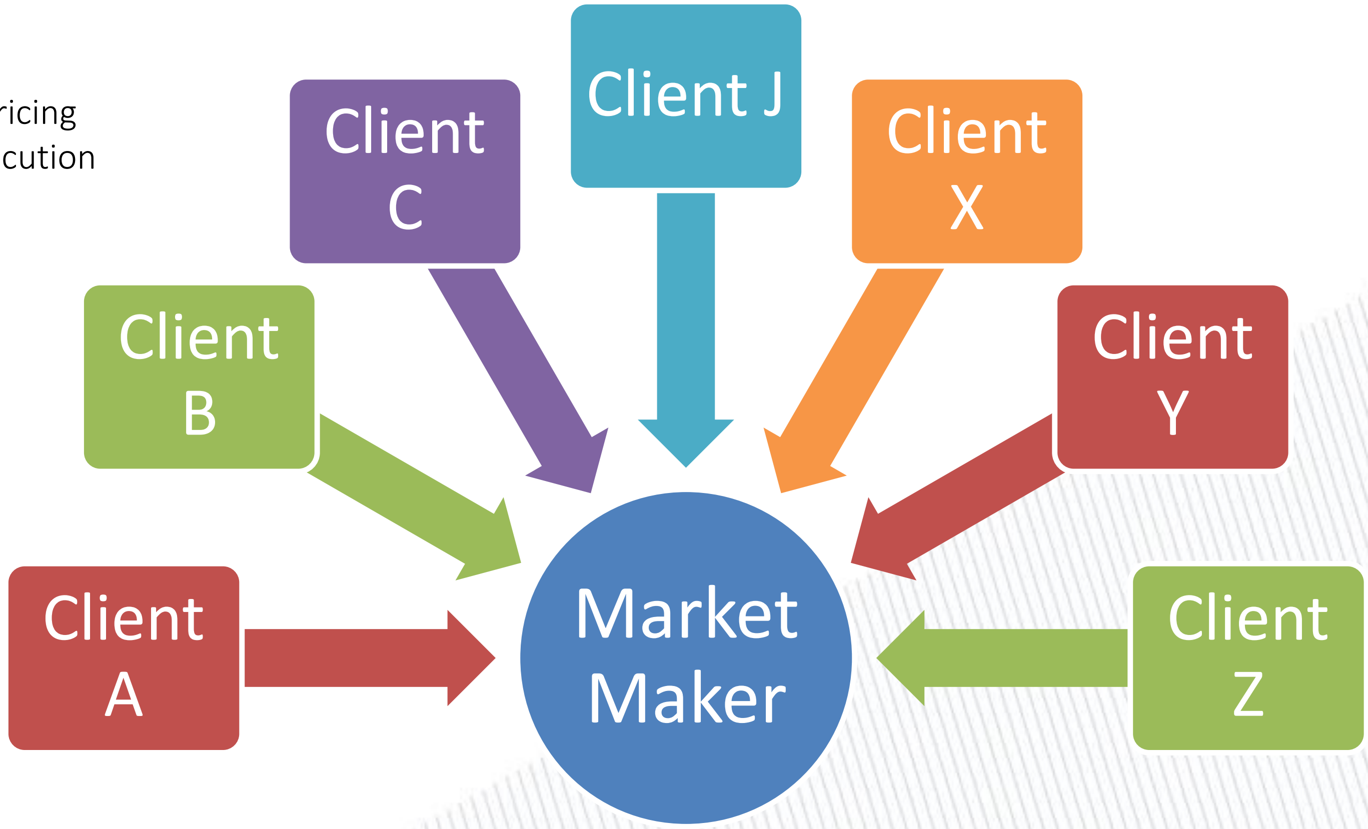
Issuer concerns



The traditional fixed income liquidity model

Provides for:

- Ready two-way pricing
- Immediacy of execution



The principal dealer (or market-maker) model

Essential ingredients for the model:

- ❑ Availability of capital (balance sheet) to hold long and short-positions and warehouse risk
- ❑ Availability of an efficient and liquid derivatives market (such as single-name CDS) to hedge dealer positions
- ❑ Availability of an efficient and liquid repo market to fund dealer positions
- ❑ Skills and experience of the trader

The principal dealer (or market-maker) model

Undermining the model:

- Availability of capital (balance sheet) to hold long and short-positions and warehouse risk
  - Increased cost of capital (Basel III & IV)
  - Volker Rule and restrictions on bank proprietary trading

- Availability of an efficient and liquid derivatives market (such as single-name CDS) to hedge dealer positions
  - CRD IV/R, EMIR, NSFR
- Availability of an efficient and liquid repo market to fund dealer positions
  - Leverage Ratio, NSFR,....
  - QE: negative rates and excess reserves

- Skills and experience of the trader
  - Ongoing attrition of experienced staff and ‘juniorization’ of trading desks

The evolving dealer model

Principal trader → Principal broker → Agency broker

Changes in dealer behaviour:

- Smaller inventories and faster turnover
- More considered allocation of balance sheet
- Deeper client engagement and awareness of needs
- More specialization and focus on competitive advantage
- More streamlined trading and sales desks

What we lose is:

- Ready two-way pricing
- Immediacy of execution

How is the market responding?

- Electronification: new initiatives, platforms, tools, and protocols
  - Connectivity
  - Data
- Changes in buy-side behaviour
  - Primary vs secondary
  - Buy-to-hold
  - Dealer relationships
  - Price ‘makers’
  - Fund crossing
  - Outsourcing (‘super desks’)
- Use of alternative products, such as bond ETFs, CDS indices, Bond Index TRS
- Discussions on changes in issuance practice (‘benchmarking’)
- CMU Call for Evidence and the ‘better regulation’ initiative

Future potential challenges to bond market efficiency and liquidity

- ❑ MiFID II/R pre- and post-trade transparency requirements (for bonds and single name CDS)
- ❑ MiFID II/R best-execution requirements
- ❑ CSDR mandatory buy-ins
- ❑ Even higher capital and funding costs (FRTB, NSFR)
- ❑ Other miscellaneous regulatory challenges (e.g. MAR disclosure requirements)
- ❑ ECB’s Corporate Sector Purchase Programme
- ❑ Brexit

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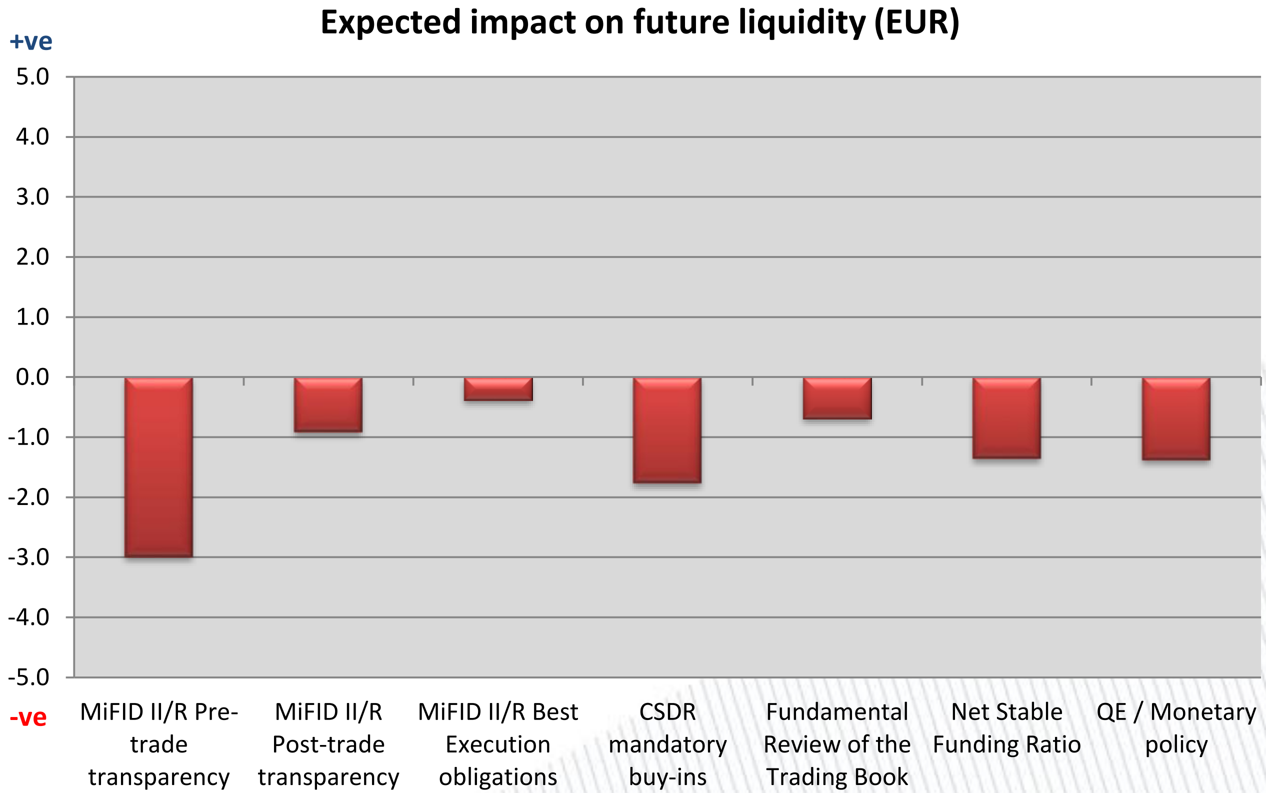

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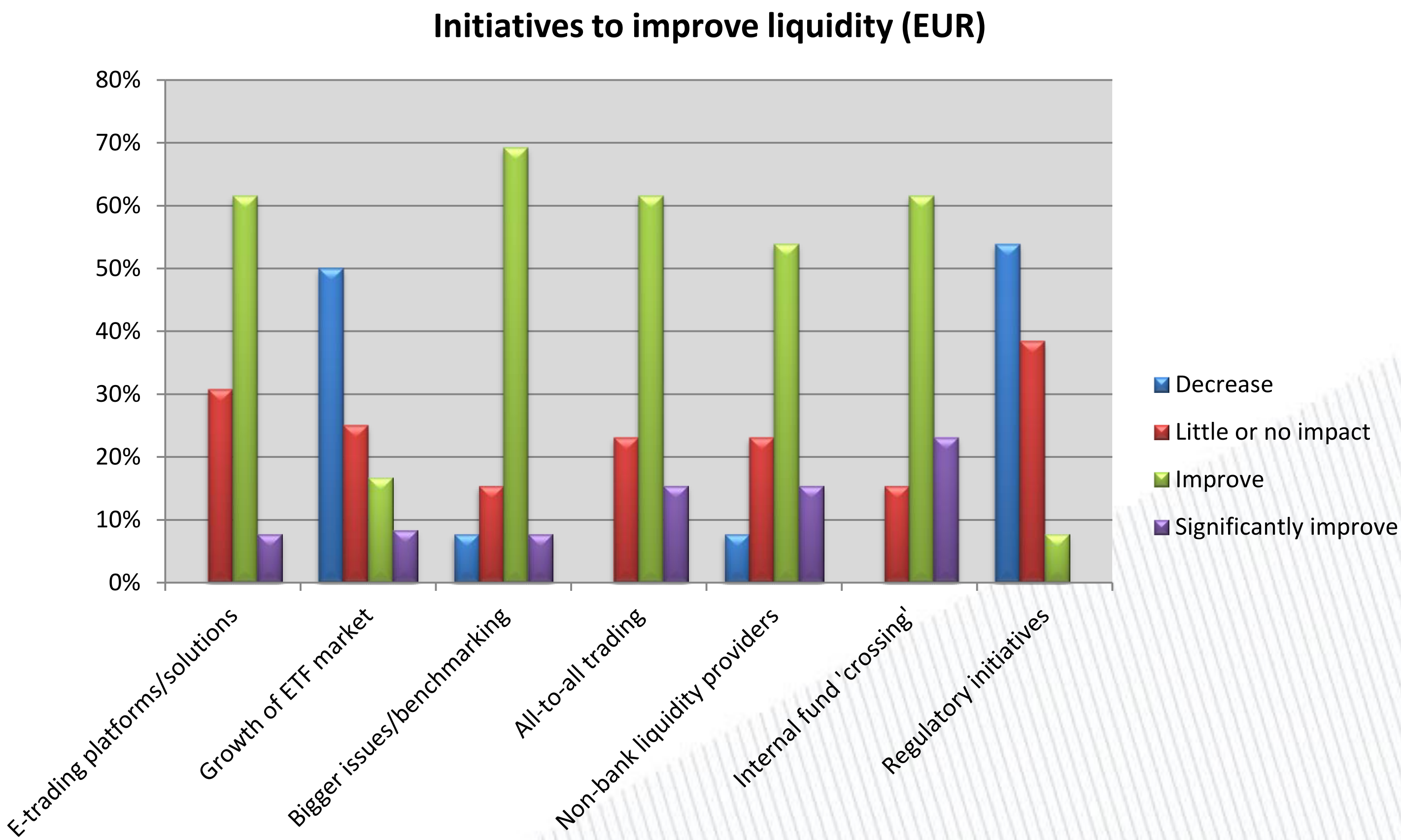

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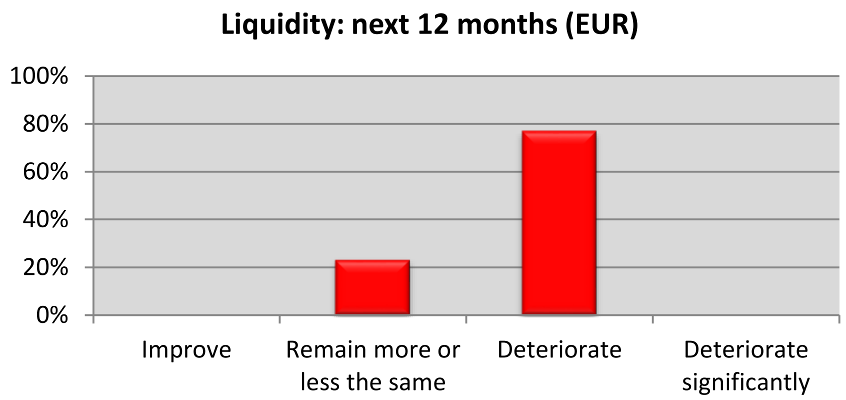

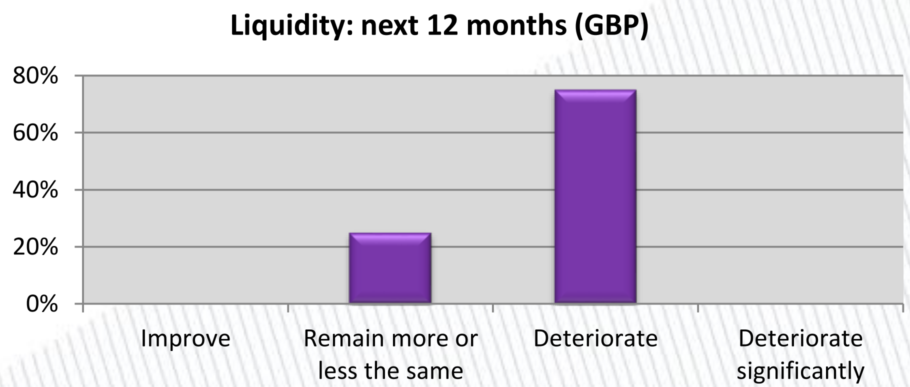

Recommendations

- ❑ Provide capital relief for market-making
- ❑ Revitalize the single-name CDS market
- ❑ Review and re-assess harmful regulation
- ❑ Bring all market stakeholders together to review the market structure

"Only through a greater understanding and appreciation of different stakeholder needs and perspectives can the market community achieve consensus and develop private and public initiatives to maintain and grow a healthy and vibrant pan-European corporate bond market."

Contact: RegulatoryPolicy@icmagroup.org