Remaking the corporate bond market

ICMA’s 2\textsuperscript{nd} study into the state and evolution of the European investment grade corporate bond secondary market (2016)

ERCC General Meeting, London, September 27 2016
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.

- Overall, 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

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General Market Liquidity (EUR)

Liquidity for small tickets (EUR)

Liquidity for large tickets (EUR)
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?


Should liquidity measures be based on trade data, or on what failed to trade?

Is liquidity dynamic?

Should liquidity have a cost?
Issuer concerns

Secondary market impact on non-financial IG corporate issuance

Eurozone EUR New Issuance (LHS)  
iTraxx Main (RHS)
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

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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Expected impact on future liquidity (EUR)

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MiFID II/R Pre-trade transparency
MiFID II/R Post-trade transparency
MiFID II/R Best Execution obligations
CSDR mandatory buy-ins
Fundamental Review of the Trading Book
Net Stable Funding Ratio
QE / Monetary policy

+ve
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Initiatives to improve liquidity (EUR)

- E-trading platforms/solutions
- Growth of ETF market
- Bigger issues/benchmarking
- All-to-all trading
- Non-bank liquidity providers
- Internal fund crossing
- Regulatory initiatives

- Decrease
- Little or no impact
- Improve
- Significantly improve
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**Liquidity: next 12 months (EUR)**

- Improve: 20%
- Remain more or less the same: 10%
- Deteriorate: 80%
- Deteriorate significantly: 0%

**Liquidity: next 12 months (GBP)**

- Improve: 0%
- Remain more or less the same: 40%
- Deteriorate: 80%
- Deteriorate significantly: 0%
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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.”