ICMA

International Capital Market Association

MiFID II/R and the bond markets: the first year

An analysis of the impacts and challenges of MiFID II/R implementation since January 2018

ICMA Webinar: MiFID II/R implications for Russia and other CIS countries

November 29 2018

Supported by MOEX and NFA

Agenda

Introduction

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II. Secondary markets

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Conclusion

Introduction

- The introduction of the second Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR) on 3 January 2018 is perhaps the most significant development to impact European bond markets in memory, with new requirements affecting everything from how new issues are marketed, to transaction reporting, trade transparency, secondary market structure, evidencing best execution, and even how fixed income research is distributed and consumed.

- This report, which largely draws on input from ICMA's diverse sell-side and buy-side members active in the European fixed income markets, is intended to provide an overview of the first year of MiFID II/R from the perspective of bond markets, covering primary market issuance, secondary market trading, and research distribution and consumption. It is hoped that this will prove useful to market participants and regulators alike as the MiFID II/R implementation 'process' continues into 2019 and beyond.

- This presentation also highlights some of the key extraterritorial impacts and considerations that may affect firms operating in the Russia and CIS region.

MiFID II/R and the bond markets: the first year

An analysis of the impacts and challenges of MiFID II/R implementation since January 2018

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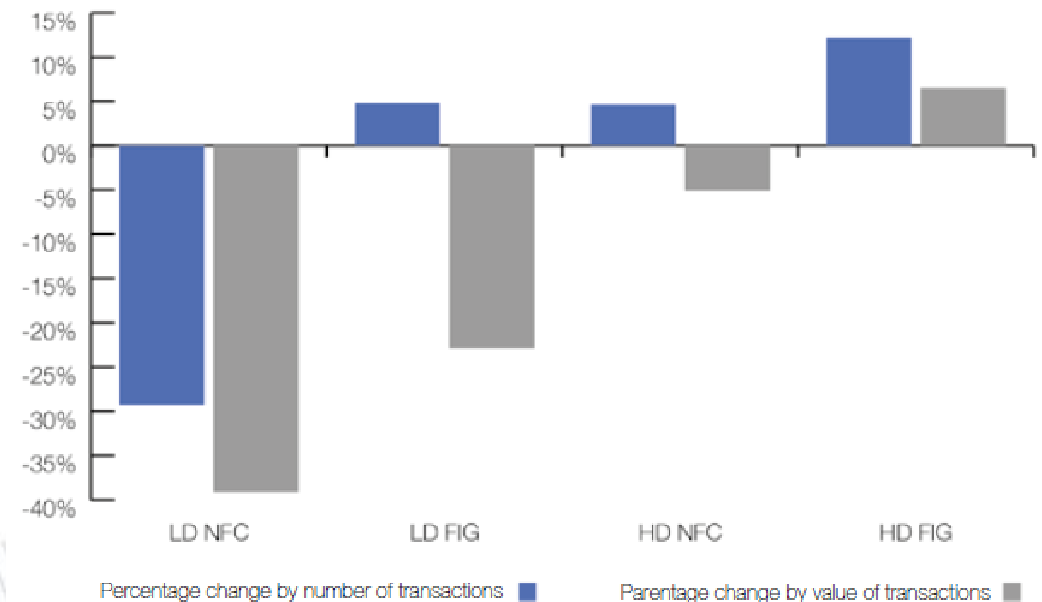
I. Primary markets

Primary markets

Overview

- The ICMA underwriting community has experienced certain primary market aspects of MiFID, as many underwriters participating in new issue syndicates are MiFID-authorised entities. These aspects include (i) allocation justification recording (in relation to underwriting & placing), (ii) the inducements and costs & charges regimes, (iii) trade and transaction reporting and (iv) product governance.
- The community has also experienced the Packaged Retail and Insurance-Based Investment Products (PRIIPs) regime, to the extent that certain bonds are potentially packaged and are being made available to retail in the EEA.



Conclusion

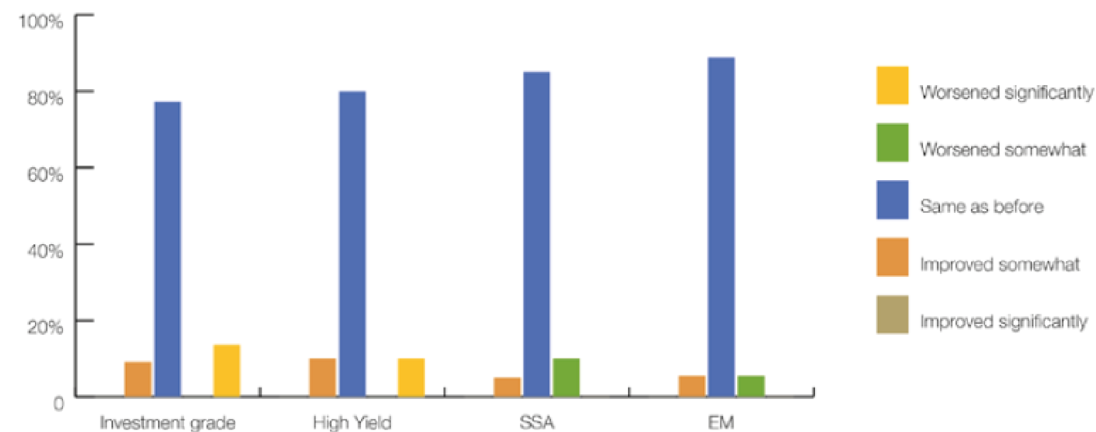
- Whilst the intention behind these primary market aspects of MiFID nominally relate to investor/consumer protection, it seems that the impact has mainly been an increase in administrative burdens and a reduction in retail access to the bond markets. ICMA will continue to engage EU authorities and national competent authorities to help minimize regulatory friction.

II. Secondary markets

37 member firms responded to the survey, of which 34 are MiFID regulated. 10 classify themselves as buy-side, 23 as sell-side (including 18 systematic internalisers for bonds), and 4 as regulated trading venues or 'platform providers'.

Market liquidity

- **Q: Since MiFID II/R took effect on 3rd January 2018, how would you describe liquidity in fixed income markets, taking into consideration bid-ask spreads, time to execute, ticket size, and depth, inter alia?**



Responses to the survey seem to suggest that liquidity has remained largely unaffected across all bond asset classes. Where responses suggest some improvement or worsening, one cannot necessarily draw conclusions with respect to causality (e.g. market sentiment, ECB Asset Purchase Programme, etc. will also have impacted liquidity).

Market liquidity

This would seem to be backed up by market data provided by Trax,[1] which shows that traded volumes (and trade count) in European IG credit, HY credit, and sovereign bond markets in 2018 are very much in line with 2017, with a small uptick in Q1 of 2018.

Source: ICMA analysis using Trax data (through November 13 2018)

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[1] Trax Data from MarketAxess offers unique, timely insight into the European fixed income market. It combines voice and electronic traded flow, including price and volume data as well as regulatory reported information.

Transparency

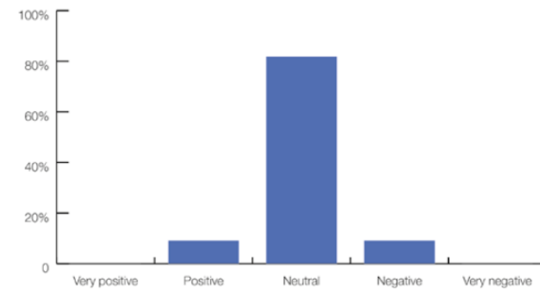
While greater transparency is a key objective of the regulation, this very much seems to be work in progress as far as bond markets are concerned. Respondents suggest that, to date, post-trade transparency has not improved as a result of the regulation. This can partly be attributed to the challenge of accessing trade data (86% of respondents find it ‘difficult’ or ‘very difficult’) as well as to the quality of the data itself (73% of respondents believe that less than 10% of the available data is ‘usable’). However, there seems to be a degree of optimism that in time the pre- and post-trade data will become more reliable; although, even by 2022, the expectations for the extent of usability seem to be mixed at best. It is perhaps no surprise that most respondents feel that price discovery is either the same or worse (90% of respondents) than pre-MiFID II/R.

Consistent with previous ICMA member feedback, the majority of respondents (86%) feel that a consolidated tape, provided as a utility (similar to TRACE in the US), would help to provide the level playing field that the regulation is intended to deliver.

Transparency

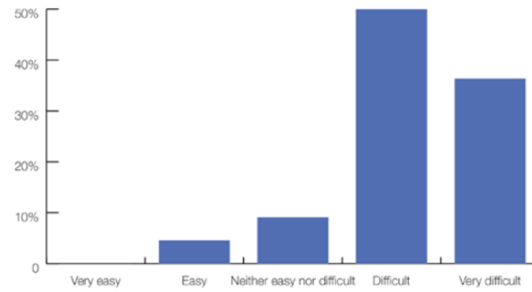
Q: How would you describe post-trade transparency in fixed income markets in comparison to a pre-MiFID II/R environment?

Post-trade transparency post MiFID II/R



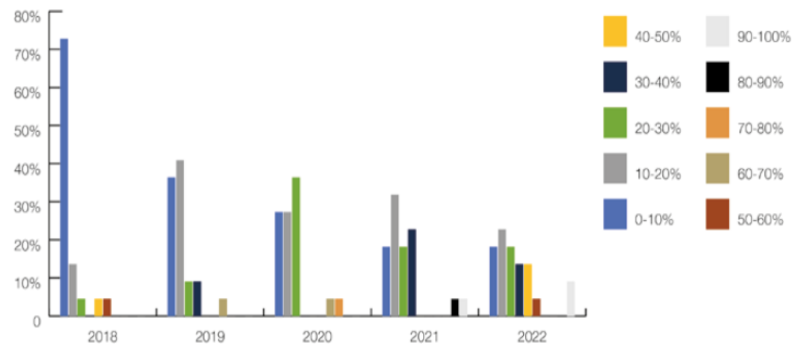
Q: How would you describe access to publicly available APA data (both data published in near-real time and after a deferral period)?

Access to APA data



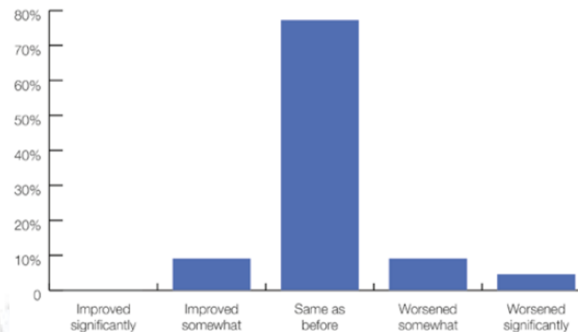
Q: What percentage of the publicly available transparency data under MiFID II/R (pre- and post-trade) would you consider to be usable, currently and in the future?

% usable trade data

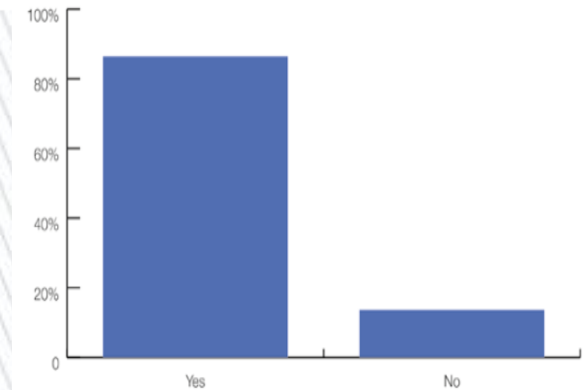


Q: How would you describe price discovery in fixed income markets in comparison to a pre-MiFID II/R environment?

Price discovery post MiFID II/R



Would a utility CTP help to 'even the field'?



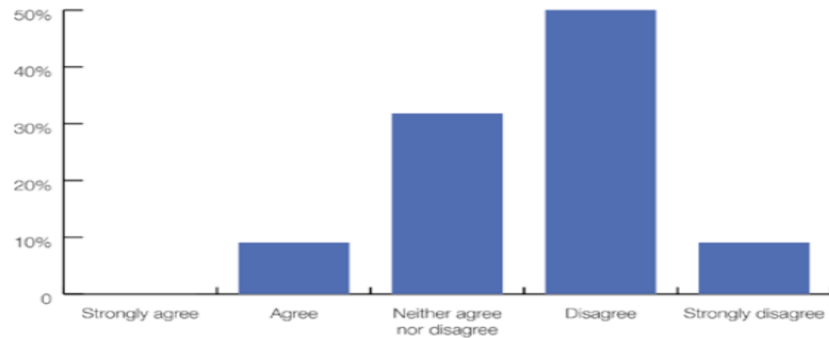
Transparency

Introducing the systematic internaliser (SI) regime to fixed income is hoped to improve transparency in what has traditionally been an OTC market and so create a level playing field between on- and off-venue liquidity provision. Many firms opted-in to the regime from January 2018, and 18 of the 23 sell-side respondents to the survey identify themselves as SIs for bonds.

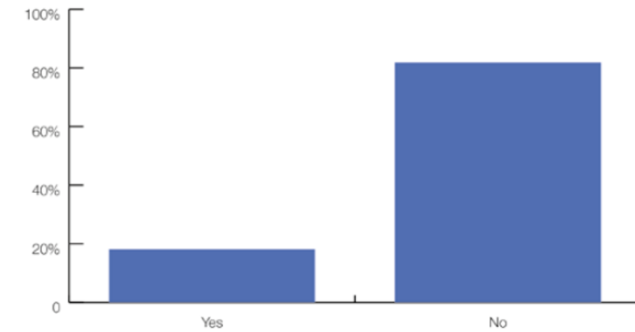
The feedback would seem to confirm that, so far at least, the SI regime has neither created a level playing field nor improved transparency. Comments further suggest that it has merely forced more trades that would otherwise be OTC onto venues, while creating an unlevel playing field with respect to transacting OTC in the EU versus non-EU. To the extent that trading with an SI is preferable, identifying which counterparties are SIs also appears to be challenging.

Transparency

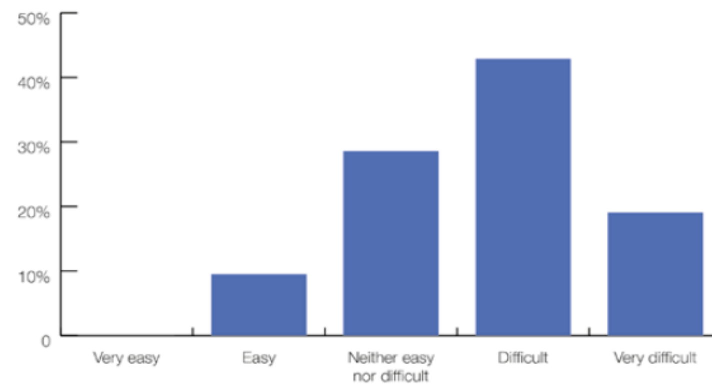
Q: One of the main objectives of MiFID II/R is to create a more 'level playing field' between trading venues on the one hand and market makers and other liquidity providers on the other. Do you agree that it is achieving this objective?



Q: In your view, has the SI regime improved transparency in fixed income markets?



Q: How would you describe the ease of identifying whether your counterparty is a Systematic Internaliser (SI)?



Electronic trading

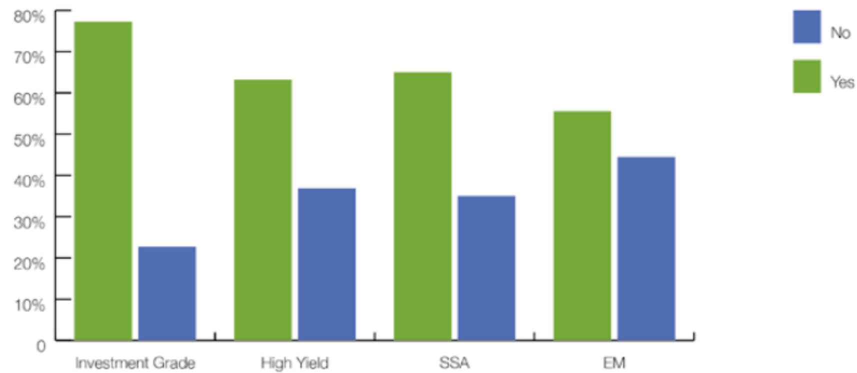
One of the objectives of MiFID II/R is to move trading in more traditional OTC asset classes (such as fixed income) onto regulated markets and trading venues. While European bond markets have been 'electronified' for more than two decades, with a growing propensity for both sell-side and buy-side to utilize the exponentially expanding choice of new trading venues and electronic protocols, the introduction of MiFID II/R seems to have provided this already well established trend with a slight but discernible nudge.

The survey responses suggest that while the increase in electronic trading is not significant, it is prevalent (77% to 56% across bond asset classes) and perhaps more noticeable in the relatively more commoditized SSA and IG credit markets. What the comments (and the survey results, to an extent) do point to, however, is evidence of some firms opting to move most, if not all, of their trading onto venue (even in more traditionally OTC based markets, such as HY and EM).

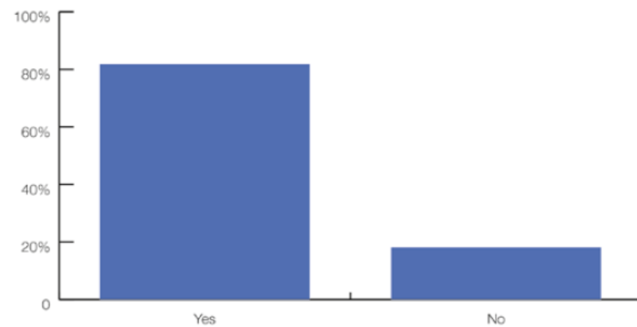
It would further seem as if much of this incremental shift to more electronic trading is through the use of 'move to venue' protocols (sometimes referred to as 'processed trades'), whereby the original pre-trade negotiations take place off-venue (via messaging, 'chat', or over the phone), but the final execution takes place on-venue. Respondent comments suggest that 'move to venue' transactions are vey much client driven, but also are by no means anything new.

Electronic trading

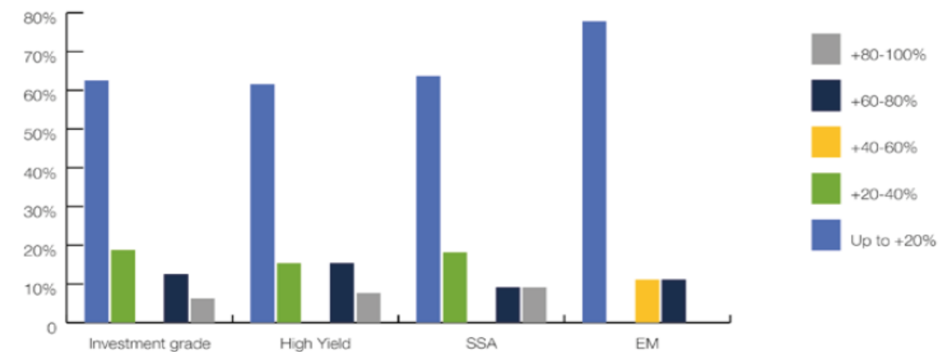
Q: Do you execute a larger share of your tradeflow electronically since MiFID II/R entered into force?



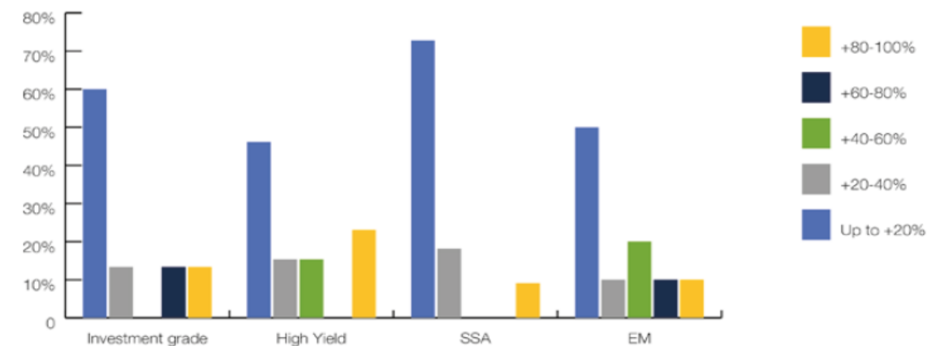
Q: 'Move-to-venue' (or 'processed') trades enable market participants to initiate a trade bilaterally, and formalise the transaction on-venue subject to the trading venue's rule book. Do you make use of this protocol?



Q: If yes, how would you quantify the increase of electronic trading in comparison to OTC trading (year-on-year)?



Q: If you answered 'Yes' in the previous question: How would you quantify the increased use of the 'move-to-venue' protocol in comparison to pre-MiFID II?

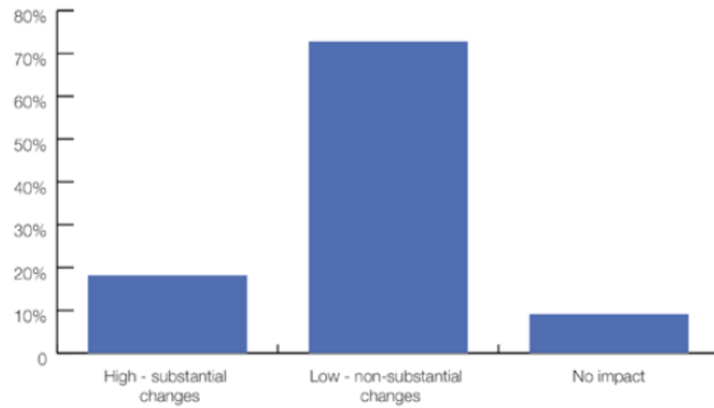


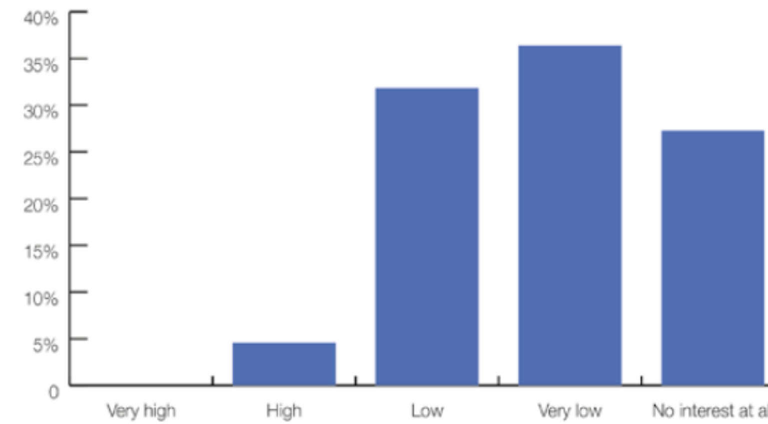
Best execution

The regulation requires investment firms to establish and implement an order execution policy, which must be disclosed to, and consented on by, the firm's clients. Trading venues, systematic internalisers, market makers, and other liquidity providers, are required to make data available to the public, on a regular basis, at no cost, on the quality of transaction execution. Best execution policies (including for fixed income) have existed long before MiFID II/R, while the extensive best execution related data public reporting obligations are not only a new requirement but would also seem to be of questionable value.

Survey responses confirm that firms already had in place robust best execution policies, communicated to clients, and that the regulation has not had any material impact on these (90%). The data (and comments) further confirm that the best execution data reporting requirements (under RTS 27 and 28) are challenging, time and resource draining, and of little or no value (95%). It would further seem that the most interest in the best execution data comes form competitors and journalists – not from clients, for whom it is intended.

Best execution



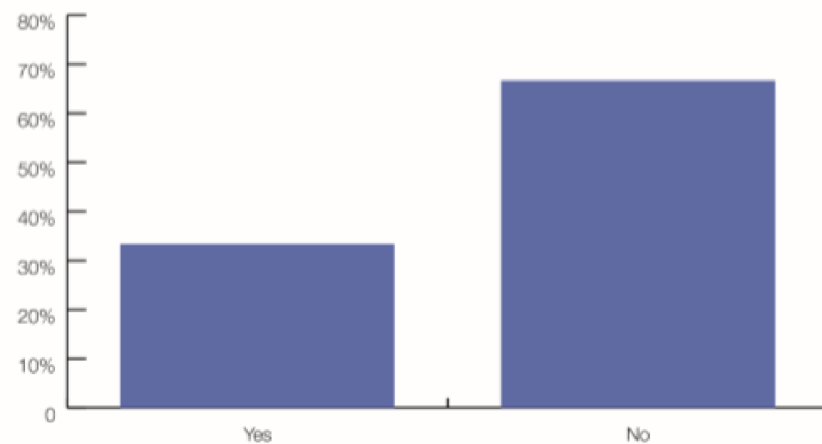


Extraterritorial impacts

In the lead-up to January 2018, ICMA, as well as other global associations, had relayed a number of concerns related to the extraterritorial implications of MiFID II/R, in particular the requirement for entities (issuers and trading parties) to provide legal entity identifiers (LEIs), detailed (even personal) information necessary to meet transaction obligations, as well as confusion over reporting and transparency responsibilities.

The survey suggests that many of these fears have been allayed, and that mostly (67%) business with non-EU/EEA firms has not been negatively impacted. However, the comments highlight issues with non-equivalent reporting regimes, as well as the fact that where market liquidity is available outside of the EU, this will be preferable for non-EU clients.

Extraterritorial impacts



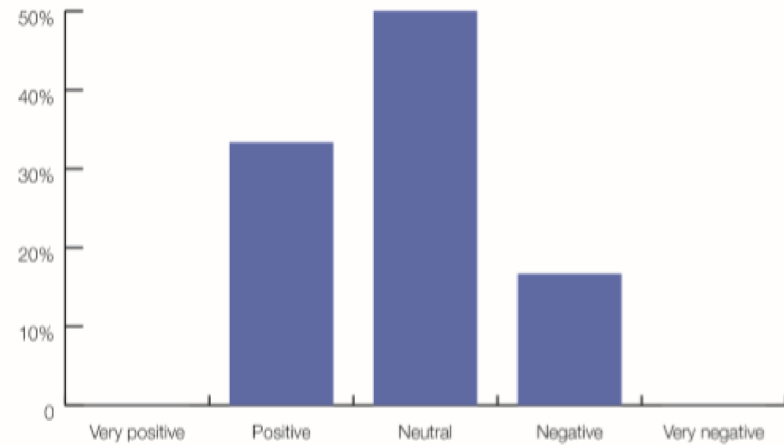
Regulatory guidance

Given the complexities and ambiguities involved in complying with such a regulatory juggernaut as MiFID II/R, firms (and their representative bodies) naturally looked to their local regulatory bodies, as well as to ESMA, for guidance in the lead-up to January 2018. While it is impossible to extrapolate form the survey the degree to which firms actively engaged regulators (whether directly or through their various representative bodies), the overriding perception on regulatory guidance is that it has been marginally positive for some, (33% for NCAs[2] and 17% for ESMA), but mostly neutral (50% NCAs, 58% ESMA) to negative (17% NCAs, 25% ESMA).

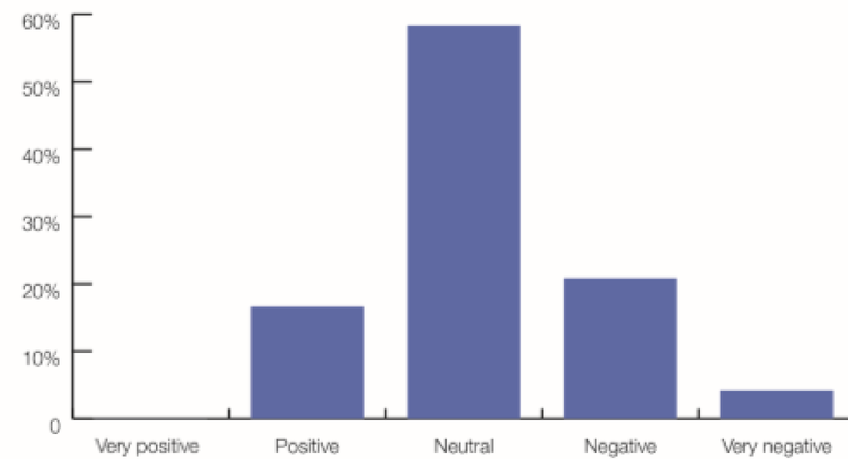
[2] The respondents to this survey are regulated across 9 different EU jurisdictions and 2 non-EU. In many cases firms have more than one jurisdictional regulator.

Regulatory guidance

Q: From your perspective, how would you describe the guidance you received from your national regulator with respect to MiFID II/R?



Q: From your perspective, how would you describe the guidance you received from ESMA with respect to MiFID II/R?



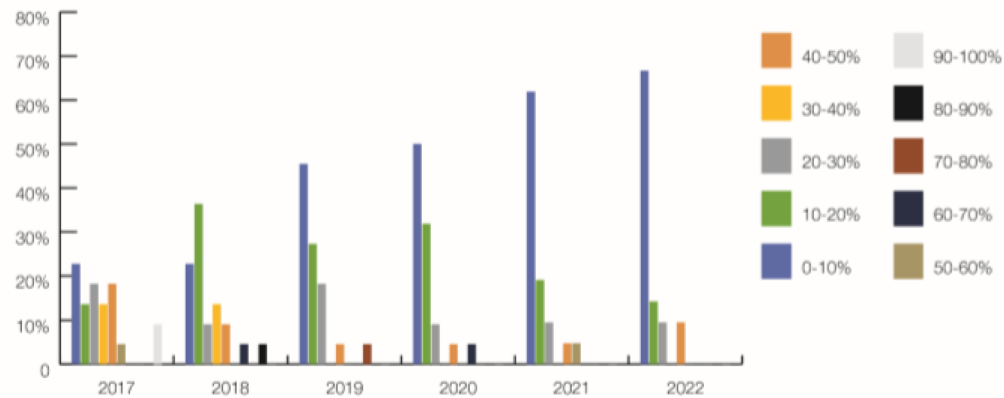
Cost

Respondents confirm that implementing MiFID II/R has been an expensive exercise. While comments suggest that trying to disentangle specific implementation costs from firms' overall IT budget is difficult, estimates indicate that for 2017 and 2018, in most cases, it was a significant proportion. Again, acknowledging the challenge of isolating specific cost allocation, the bulk of the spend appears to be related to complying with the various transparency obligations. While these costs appear likely to continue, the expectation seems to be that in the near term they will reduce as a share of firms' overall IT budget.

Cost

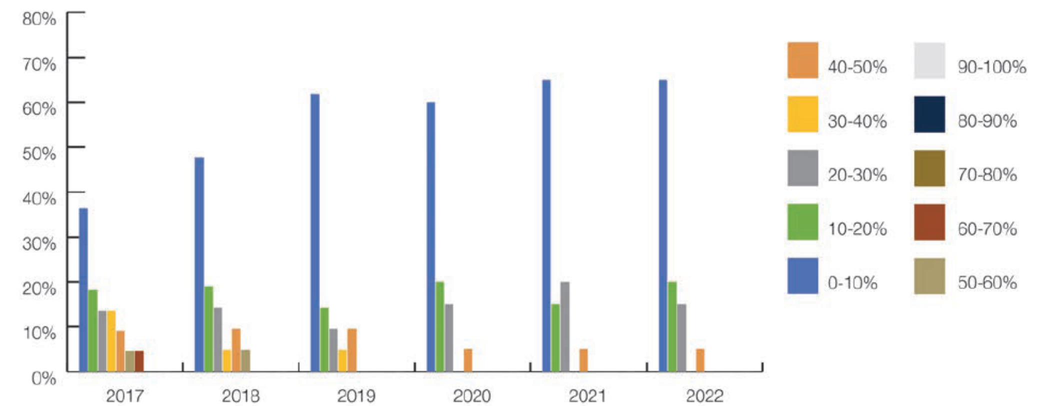
Q: What percentage of your firm's overall IT budget has been / will be allocated to MiFID II/R?

% of IT budget allocated to MiFID II/R



Q: What percentage of your firm's MiFID II/R budget was allocated to MiFID II/R transparency reporting purposes?

% of budget allocated to MiFID II/R transparency reporting



III. Research unbundling

Introduction

In October 2018, the Asset Management and Investors Council (AMIC), ICMA's buy-side committee, issued its second FICC Research Unbundling Survey.

The purpose of the survey is to help improve market clarity on this topic, identify remaining challenges, difficulties and outstanding issues in the implementation of the new MiFID II research rules and to establish progress compared to the first survey issued in 2017.

This survey is aimed at buy-side firms and focused on FICC research only.

27 firms responded to this survey.

In respect of types of firms, respondents classify as:

- 93% asset managers or investment funds; and
- 7% private banks.

In terms of AUM (expressed in USD) respondents are:

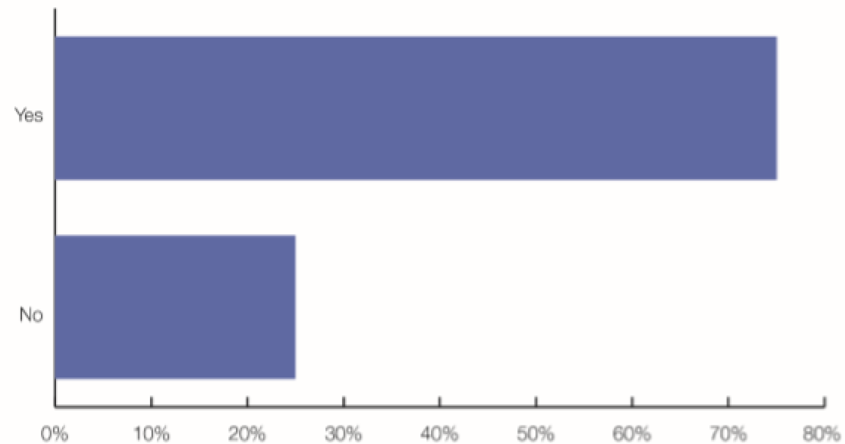
- 64% above $100bn;
- 21% between $10bn and $100bn;
- 11% between $1bn and $10bn; and
- 4% below $1bn.

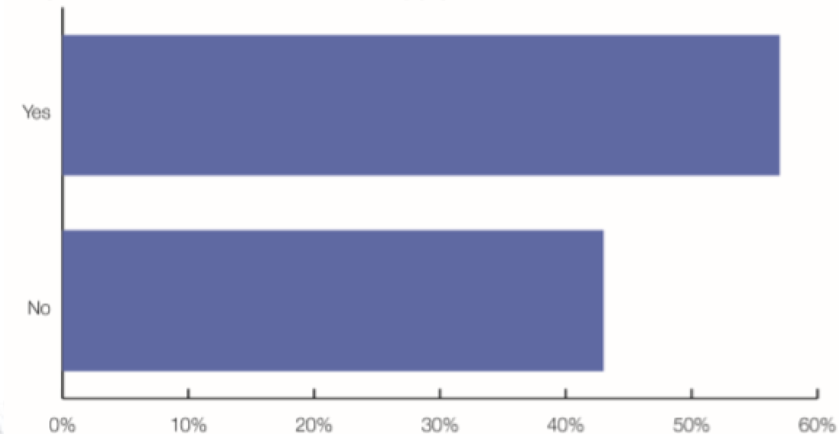
Geographically, the majority of respondents were based in the UK (39%) and Germany (21%). The remainder were from France, Switzerland, the Netherlands and other countries within the EU.

Deciding what is research

The majority of firms (75%) said that they have found it difficult to decide what research needs to be paid for and what can be classified as minor-non monetary benefits (MNMB) for which payment is not required.

43% of the firms surveyed said that they have not received enough guidance from their national regulator or ESMA about the implementation of research unbundling for FICC research. This is down from 52% in November last year.

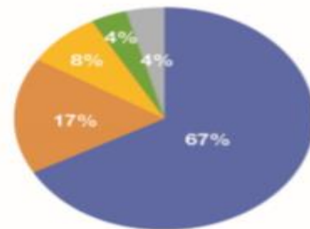


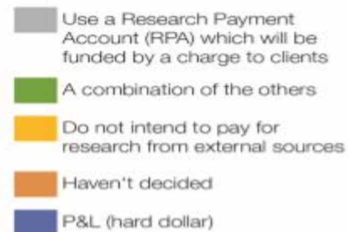


Payment for research

In line with recent market developments, the majority of asset managers intend to pay for research themselves. 79% of firms pay for FICC Research using their P&L, up from 67% last year. 7% intend to use an RPA funded by charge to clients, up from 4% last year and 14% intend to use a combination of the above, which is up from 4% last year.

November 2017





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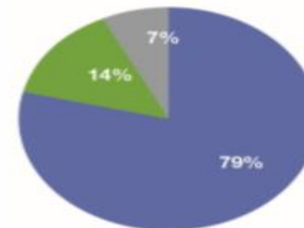
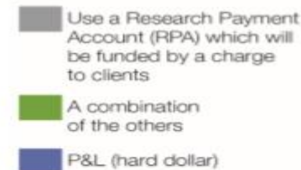


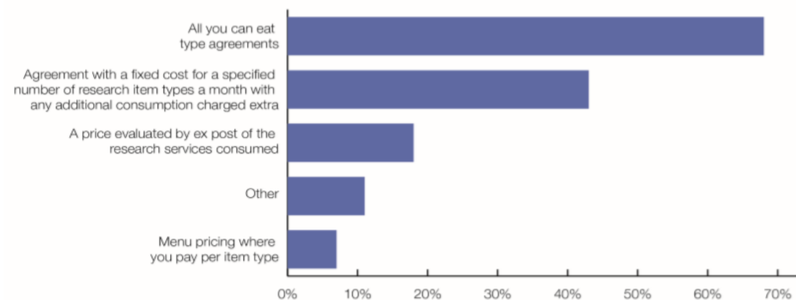


Preferred type of research consumption

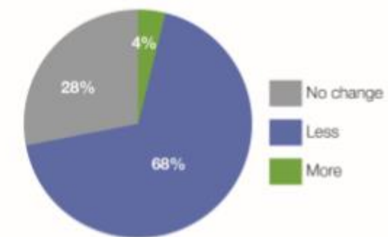
Firm preferences for type of research show most preferring “all you can eat” type research agreements (68%) closely followed by agreements with a fixed cost but where additional consumption is charged (43%).

Overall independent research providers do seem to get a larger slice out of the shrinking pie, which is in line with our survey results from 2017.

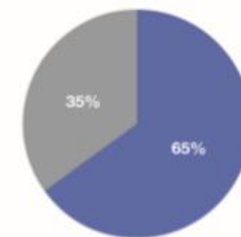
What kind of research consumption has your firm signed up for:



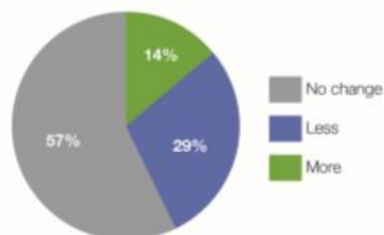
All research providers



2017

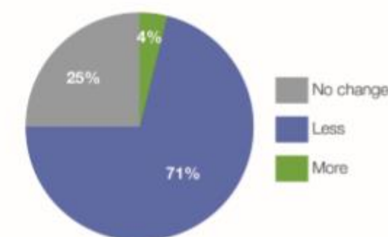


Independent research providers

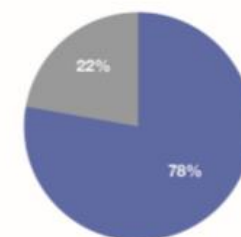


2017

Banks/brokers

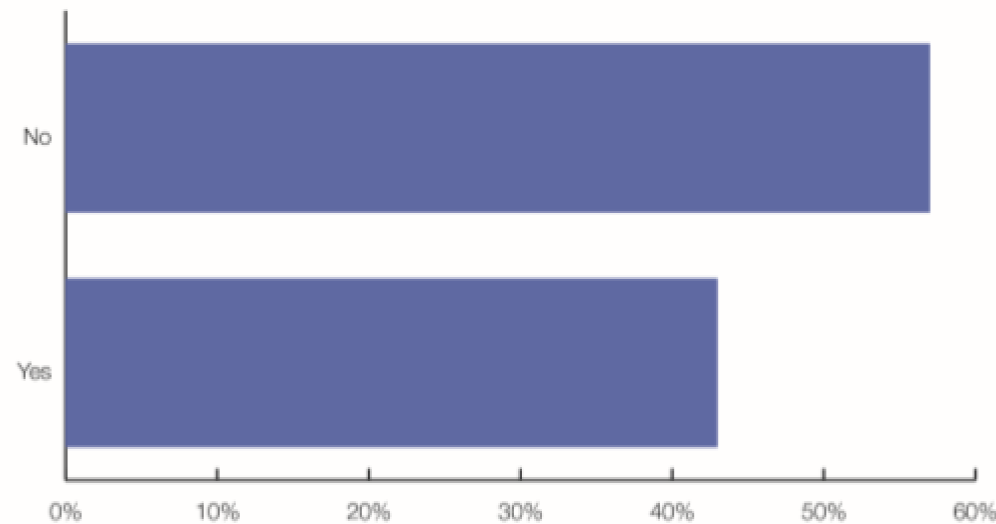


2017



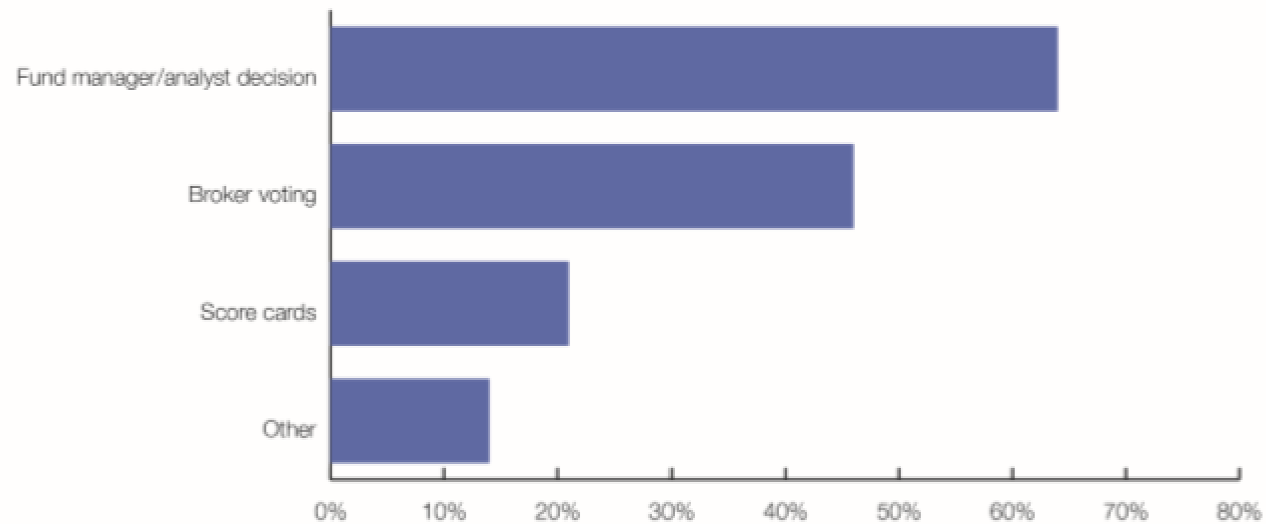
Availability and breadth of SME FICC research

While a majority of the respondents who answered this question (57%) said that they have not noticed a decrease in the availability of SME FICC research, it is interesting that less than a year after implementation 43% said they have noticed a decrease. We expect this trend to continue as the reforms bed down.



Establishing the value of research

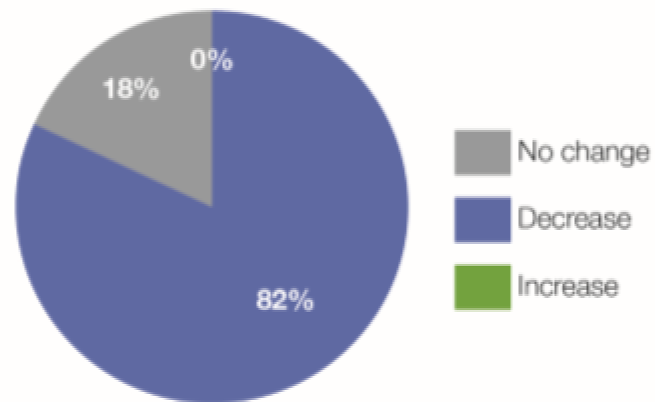
The majority of respondents (64%) said that the fund managers and analysts have a big say in deciding the value of research, with broker voting also being used by 46% of respondents.



Changes in the number of FICC research providers

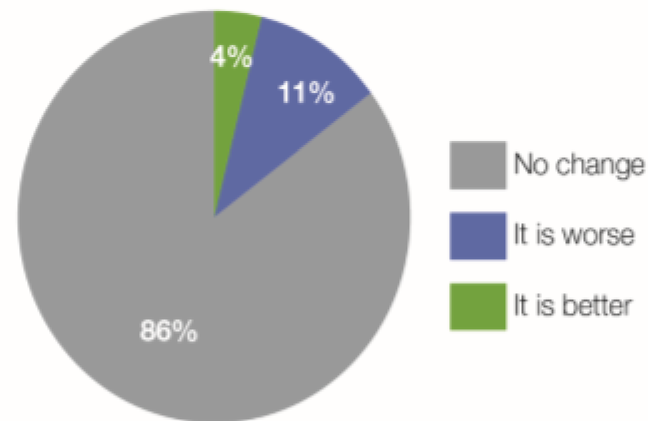
As expected, the majority of respondents (82%) said that they are using a smaller number of research providers, with the remainder (18%) noting no change. This is very much in line with last year's survey where 83% of respondents expected to use a smaller number of providers and 13% expected no change.

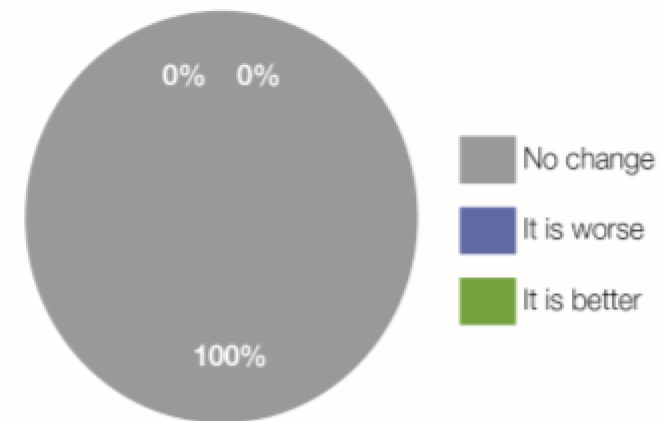
How has the number of providers whose FICC research you consume changed?



Quality of FICC research

The vast majority of respondents said that the quality of FICC research has not changed, with 86% in respect of research from banks/brokers and 100% for independent research providers. Only a few believe the quality of FICC research from banks improved (4%). This shows a significant shift from last year's expectations, where 32% participants said they believe research will get worse, while 14% said they believe it will get better.

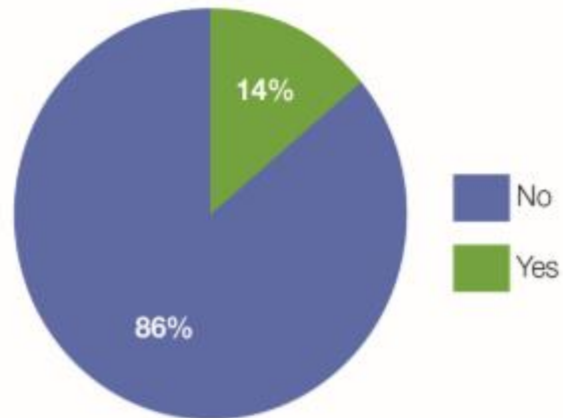




Impact on fund performance

The majority of asset managers are confident that the reduction in the number of FICC research providers does not have a negative impact on their funds' performance. 86% of respondents said they are not concerned about this scenario, showing a potential oversupply of research.

Are you concerned that the reduction in the number of FICC research providers used has had or will have a negative impact on fund performance?

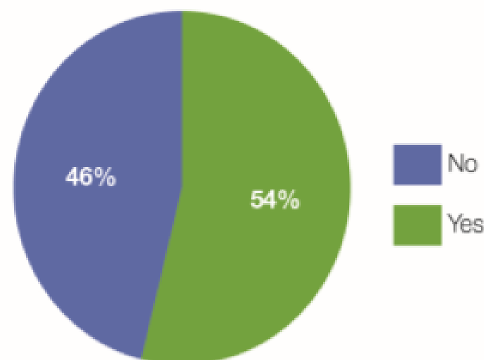


Attitude to investor roadshows

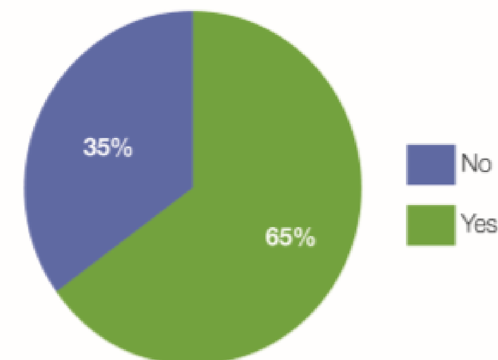
The majority of respondents (54%) said they have changed their attitude to and participation in investor roadshows as a result of the new rules, while 46% said they have not.

The majority of respondents who answered yes above, also said that the reason for the change relates to difficulties in deciding which type of roadshows can be considered minor non-monetary benefits and which should be paid for (65%), while 35% said their change in attitude is due to other reasons.

Since the MiFID II rules came into effect, has your attitude to/participation in investor roadshows changed?



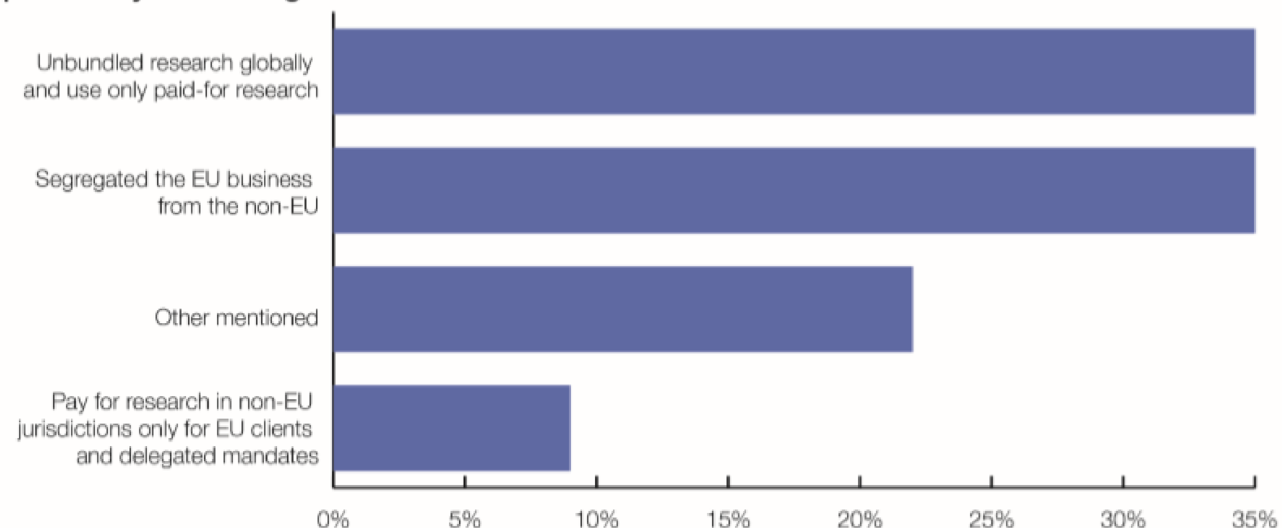
Does this change relate to difficulties in deciding which type of roadshows are MNMB and which should be paid for?



Approach to conflicting rules on non-EU FICC research

Respondents' approach to tackling the conflicting rules around FICC research globally seems to be equally split between unbundling research fees globally (35%) and segregating the EU and non-EU businesses (35%).

Our 2017 survey showed that the majority, 64% of firms, were planning to unbundle globally and only 7% of firms were planning to segregate EU and non-EU businesses. The significant change in firm attitude to the business segregation model may reflect that the costs and complexities of segregating their businesses geographically outweigh the costs and complexities that come from unbundling globally.



Conclusion

Conclusion

- The feedback confirms that the first year of MiFID II/R implementation has not been without challenges for the bond markets and, in many cases, it has fallen short of its objectives.
- From a primary market perspective, the obligations regarding allocation justification recording, disclosures of cost and charges, and transaction and trade reporting have had little substantive impact other than additional administrative burden. The product governance (and PRIIPs) regime, however, have caused significant concern and debate around the practicability of compliance in the Eurobond context. The introduction of these regimes has been followed by a marked drop in low-denomination bond issuance.
- In terms of secondary market impacts, the headline is that liquidity and functioning appear to have remained mostly unscathed in the wake of the regulation, and that for the most part it is business as usual. However, there have been a number of disappointments, particularly with respect to the transparency regime and the accessibility and quality of pre- and post-trade data. While there is some optimism that this will improve over time, the regulation seems to have missed a golden opportunity to provide a utility-based consolidated tape for fixed income.
- Other disappointments include the systematic internaliser regime, which thus far has failed either to improve transparency or create a level playing field, and public best execution reporting, which is challenging and expensive to produce, but ultimately not used by anybody. Meanwhile, the regulation does seem to have helped push a little more trading onto venues, which is one of its main objectives.
- The implications for FICC research also seem to be evolving. Many firms are finding it difficult to decide what research needs to be paid for, and there still seems to be a need for further regulatory guidance in this respect. While the number of research providers used by firms has decreased, most feel that the overall quality of research has remained unchanged, although views on the availability and breadth of SME focused research is more mixed. So far, firms have been able to cope with the reduction in accessible research and have not noticed a negative impact on fund performance.
- In summary, it would seem as if MiFID II/R has not derailed the European bond markets, but, at least so far, nor has it brought about significant tangible change with respect to its objectives of improved investor protection, greater transparency, and a more competitive landscape. In some case it has produced unintended consequences in terms of market structure. While for many it has mostly been an expensive and time-consuming exercise in regulatory compliance.
- But MiFID II/R is as much as a journey as a destination, and it is broadly understood that it will take time (perhaps years) for the many challenges to be addressed and for any benefits to become manifest. Reports such as this will hopefully help to guide market participants and regulators alike as they continue that shared journey.

ICMA would like to thank the participants and their firms who provided valuable data and input for this report, whether through the secondary market and research unbundling surveys, or informally through conversations or relevant committee and working group meetings. This report would not be possible without the engagement of ICMA member firms and market stakeholders.

ICMA would further like to extend its gratitude to Trax (a subsidiary of MarketAxess) and ICE Data Services for providing market data used in this report.

Contributors to this report:

Primary

Ruari Ewing — ruari.ewing@icmagroup.org

Secondary

Gabriel Callsen — gabriel.callsen@icmagroup.org

Elizabeth Callaghan — liz.callaghan@icmagroup.org

Andy Hill — andy.hill@icmagroup.org

Research unbundling

Bogdan Pop — bogdan.pop@icmagroup.org

Edited by Andy Hill

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