Times they are a-changin':

the corporate bond market liquidity conundrum and the changing buy-side paradigm

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Liquidity: everything is broken

"There is still liquidity in euro IG credit. As a fund manager, you just have to accept that it is more challenging, that you need to create your own liquidity, and it comes at a price."

The debate about the state of liquidity across corporate bond markets continues to rage. ICMA's recently published second study into the state and evolution of the European investment grade corporate bond market,[1] based on market data, a buy-side survey, as well as extensive interviews with market participants, points to a market where it is becoming more challenging for the sell-side to provide liquidity and for the buy-side to source it. Meanwhile, a Consultation Report examining liquidity in corporate bond secondary markets published by IOSCO[2] concludes that it found no substantial evidence to suggest that liquidity has deteriorated markedly from historic norms for non-crisis periods. A 2015 study by the Autorité des marchés financiers (AMF)[3] goes a step further by suggesting that, for the French bond markets at least, liquidity has actually improved over the past five years.

While various market, authority, and academic studies and their conflicting conclusions continue to add more fuel to the fire of the liquidity debate, raising questions about the appropriate way to define and measure market liquidity,[4] what becomes clear is that regardless of who might be right, buy-side firms are having to rethink their business models as they adapt to a rapidly evolving market environment, with very 'different' liquidity conditions. This article draws on the ICMA study, particularly with respect to the interviews and survey of asset managers and institutional investors, to discuss this changing buy-side paradigm.

Immediacy: going, going, gone

"If you want to understand liquidity then there is no point in looking at what traded – it's what didn't trade that matters."

As noted by both the ICMA and IOSCO reports, the primary source of liquidity in the corporate debt markets has historically derived from market-makers: broker-dealers committed to showing bids and offers in a range of bonds, and acting as a principal counterparty, irrespective of whether they have a matching position or client order. While investors may not always like the prices they are shown, they could at least usually rely on immediacy of price and execution, as well as a degree of dealer completion. With the ever increasing cost of capital needed to support market-making, as well as related hedging and funding activities, banks are shrinking their balance sheets, and broker-dealers are transitioning their models from principal market-makers to principal brokers; working orders rather than providing immediate pricing. As the ICMA study highlights, immediacy in the corporate bond markets, particularly for larger transactions, is being lost. (See graphs in Figure 1).

Heading for the light: the changing buy-side paradigm

"The challenge for the buy-side is how to adjust their behaviour."

Since ICMA conducted its first study into the state and evolution of the European IG corporate bond market, it is notable that there is a very conscious shift in buy-side behaviour and an overwhelming acceptance that the traditional dealer-based model for market liquidity has not only become more challenged, but is likely to continue to do so. It becomes clear that even the larger, Tier 1 buy-side firms are having to change the way they think about market liquidity and the way they conduct their business. This is impacting both how they interact with their broker-dealers, as well as how they utilize technology. Essentially, as the market-making model breaks down, buy-side firms are not only being forced to find alternate sources of liquidity, but they are also learning how to create liquidity.

Handle with care: dealer relationships

"Picking up the phone and talking to your dealers is becoming more important than ever. You need to know who you can go to when the screens go blank."

1 ICMA, 2016, 'Remaking the corporate bond market: ICMA's 2nd study into the state and evolution of the European investment grade corporate bond secondary market'

2 IOSCO, 2016, 'Examination of Liquidity of the Secondary Corporate Bond Markets'

3 AMF, 2015, 'Study of liquidity in the French bond markets'

4 See ICMA response to the IOSCO Consultation Report

Despite the reducing capacity for dealers to provide liquidity, even to their favoured clients, a loud and clear message is that the buy-side is still very much dependent on their dealer relationships; in some cases, perhaps more than ever before. There is an understanding that banks are becoming more discerning in their liquidity provision, and a realization that liquidity comes at a cost. This is driving investors and asset managers to re-evaluate with whom they trade, the terms on which they trade, and how they interact. As one buy-side head of trading stated, it is becoming more important to leave something on the table for the dealer. Despite a shift to a greater use of platforms or electronic-based trading, buy-side firms are not only expanding the range of sell-side firms they trade with, but are also investing more time into talking to the salespeople and traders of these firms, in an attempt to establish stronger and deeper relationships. As one interviewee observed, at a time when everybody is talking about 'all-to-all' anonymous trading and open protocols, it is actually human relationships and people attributes, such as building trust and understanding, that is really adding value. (See Figure 2).

Every grain of sand: data and technology

"You need data to be able to add value. Data helps you to allocate resources efficiently and to modify your trading behaviour."

Just as the utilization of data and technology is becoming more important for intermediaries and platforms to help provide liquidity, so it is becoming critical for the buy-side for their ability to source it. The interviews suggest that asset managers are becoming more adept, and even systematic, in the ways in which they collate and process data related to their interactions with their broker-dealers, including axe lists, quotes provided in response to requests, hit rates, and 'slippage.' Utilizing these various data points allows the asset manager to see more readily where which dealers are more likely to provide a match, or at least a competitive quote, for their specific interest. As several interviewees explained, this is also becoming more important as market illiquidity is creating increased sensitivity to information leakage. If buy-side firms show their interest to too many dealers, particularly if one of them happens to be axed the same way, then they run the risk of the market moving

Figure 1: buy-side perspective of market liquidity over the past 12 months (Euro IG)[5]

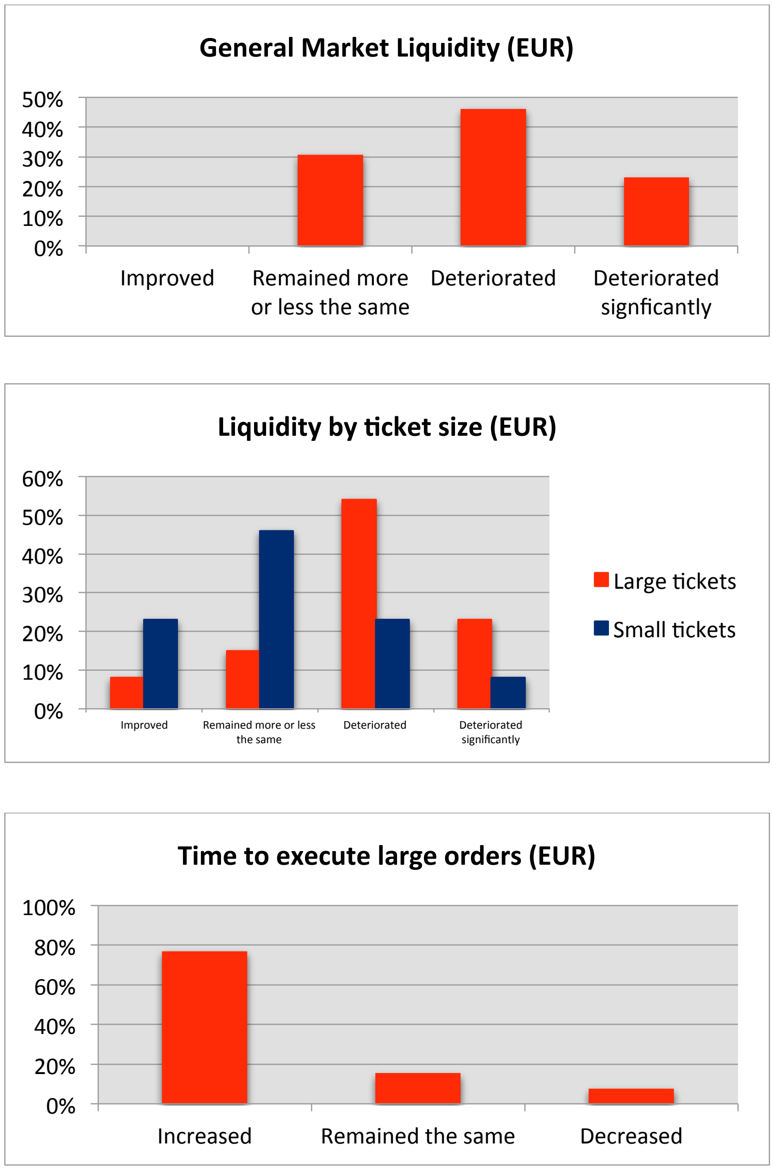
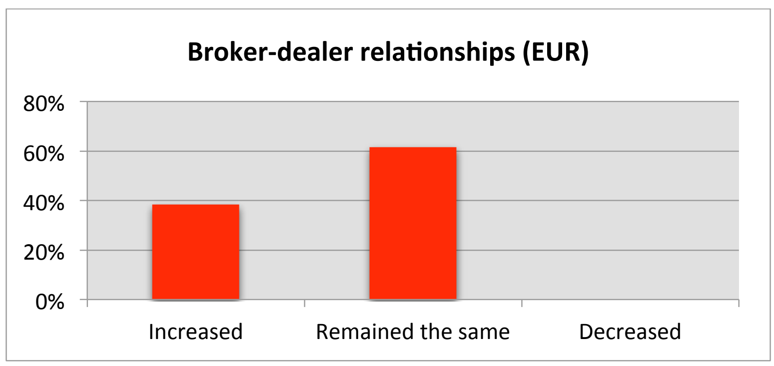
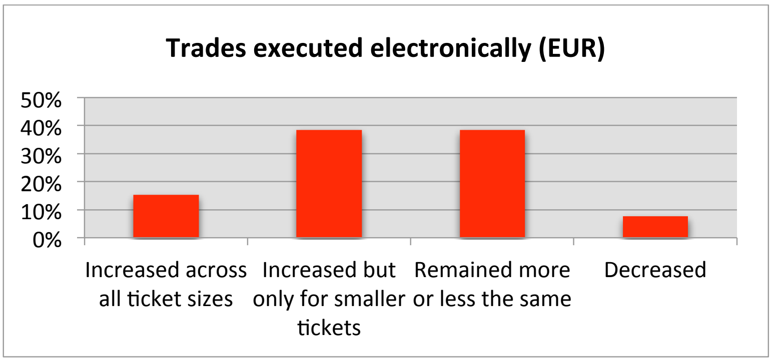


Figure 2: trends in dealer relationships over past 12 months (EUR IG)



5 *All the charts in this article are taken from the buy-side survey results published in the ICMA report. In total ICMA received 18 individual responses, from 15 firms, representing some €2 trillion AUM.*

Figure 3: trends in e-trading over past 12 months (EUR IG)



against them before they are able to transact. In the case of less liquid bonds, the ability to show their interest to the least number of dealers (and in some cases, ideally just the one who is optimally axed) improves their execution efficiency, in terms of both price and time.

The use of these data also allow buy-side firms to track the relative performance of their dealers in order to understand better which are the best sources of liquidity across different asset classes, sectors, or credits. This not only helps them to know where to go for pricing for specific interests, but it enables them to asses which dealer relationships are the most valuable (and so where to reward with more flow) and which ones require either more work or re-evaluating.

It's not dark yet: e-trading and the buy-side

"Many think that e-trading is the solution. But it's not true. E-trading does not create liquidity. It is only a venue to facilitate trading."

Perhaps not surprisingly, a good part of every single interview focused on the ongoing electronification of the European corporate bond markets, and how this is helping to shape and evolve market structure. Both sell-side and buy-side firms reported that they were not only executing a greater proportion of their trades electronically, but that they were becoming more interested in the potential for technology to support and enhance their business models. Underlying this evolution seem to be a number of factors, including the opportunity to achieve greater efficiencies, advances in available technology, and improved capacity to comply with upcoming regulatory reporting requirements, in particular those under MiFID II/R. However, what also becomes clear is that many market participants are also looking to technology to help support the sourcing or provision of market liquidity, as this becomes ever more challenging.

Most of the developments in fixed income e-trading, at least until very recently, have been based around RFQ (request for quote) protocols, which is simply the automation of the traditional market-maker model. New products such as request-for-stream (continuous RFQ) and all-to-all, anonymized RFQ, seem to have found some traction among market participants. However, where much interest seems to be developing is in platforms that focus more on identifying and matching axes rather than quotes, that connect all market participants (including buy-side to buy-side), and that try to identify pools of liquidity, rather than try to create liquidity. This new generation of platforms places less importance on facilitating trade execution (in fact, some do not even do this), rather their key function is to 'scrape' the axe sheets and order books of participants in order to connect potential sellers and buyers. Discussions around size and price come later, either anonymously (so called 'dark pools' that are executed through a principal intermediary) or directly. Effectively, these platforms are not so much e-trading platforms in the traditional sense, but rather they are 'matching engines' or 'information networks.' (See Figure 3).

Tangled up in blue: e-fragmentation

"There is no perfect technology model, so connectivity is key. There needs to be a standardized infrastructure for the different platforms that lets you plug-in wherever you want."

Despite the rapid growth in these new initiatives to support e-trading and liquidity sourcing, the interviews suggest a high degree of concern, and even frustration, as a result of the number and diversity of the products available. A common complaint is that so many different platforms and variations on protocols are only serving to fragment the market, spreading liquidity thinly across a range of locations, rather than concentrating it into one easily accessible place. This makes selecting which platforms to use increasingly challenging, particularly since connecting to each platform requires significant investment and time in terms of harmonizing different connectivity and messaging standards between firms' internal order and execution management systems and those of the respective platforms, as well as legal and data security considerations. Furthermore, as a number of interviews pointed out, even if one could connect to all the platforms on the market, you can only physically look at a few at a time.

While eventual consolidation in the e-trading and platform space is considered inevitable, there seems to be a strong desire, particularly from the buy-side, for this to happen sooner, or at least to find some way of pooling the liquidity provided by the various products into one centralized venue.

However, as many interviewees were keen to point out, the full automation of the credit markets is an unlikely and undesirable eventuality. A message repeated through numerous interviews is that corporate bond markets are distinct from equities, commodities, or financial futures, and even from sovereign bond markets. While technology has an important role to play, a significant part of the market will always need to be 'people based' and negotiated by voice.

I shall be released: the buy-side as price-makers

"We are all learning how to work in this new environment. First you need to rely more on the human element, and network better; second you need to become the price decider."

Another popular theme in the buy-side interviews is the capacity and willingness for asset managers to become more pro-active in terms of how they interact with the market, even those managing more passive, index-based funds. This already seems to be happening in a number of different ways. Firstly, they are becoming more flexible in terms of portfolio construction. For instance: if the portfolio manager sends the execution desk an order to purchase BMW 2020s, and the buy-side trader struggles to find a fair value offer, but also sees that one of his dealers is axed in BMW 2021s (and so can offer at a much better spread than the best market offer in the '20s'), she will recommend that the portfolio manager take the slightly longer duration. This flexibility might not only apply to duration, but could also extend to substituting with different, albeit similar, credits.

Another key change is in the way the buy-side are becoming 'price-makers,' rather than purely 'price-takers.' Whereas traditionally asset managers would rely on their dealers to provide quotes for a specific interest before trading on the best one, now they are beginning to decide what the appropriate price for their buy or sell interest should be, and providing the dealer not only with their axe, but also their target price. A number of interviewees were keen to stress that this in no way means that buy-side firms are becoming market-makers, and so risk-takers, which is unlikely to happen due to a number of constraints, not least fiduciary responsibility to their investors; rather it is a subtler cultural shift toward playing a more active role in market price formation.

Gotta serve somebody: other buy-side initiatives

"There is no single solution to the liquidity challenge."

A further key way in which asset managers are becoming more active liquidity creators, and discussed in some of the interviews, is in terms of facilitating trading (or 'crossing') between their various funds. Rather than funds individually work their separate buy and sell orders in the market, buy-side execution desks intermediate between the various funds, so creating 'internalized liquidity.' At least for the larger buys-side firms, this seems to present an opportunity to become less reliant on dealer-driven liquidity.

Another interesting initiative highlighted by one interviewee is the outsourcing of trading by smaller, Tier 2 or Tier 3, buy-side firms, to the larger asset managers. As broker-dealers become more discerning and concentrated in terms of their liquidity provision to favoured clients, usually at the expense of smaller asset managers, the only way smaller clients can access liquidity could be through passing their orders to the larger buys-side firms who effectively act as their brokers. In turn, this would also provide these so-called 'super desks' more crossing opportunities between both their own and external funds, and so a further source of buy-side liquidity generation.

Conclusion: you ain't goin' nowhere

"We all need to adjust to a market that does not trade on the same basis as before."

ICMA's ongoing work on the state and evolution of the European corporate bond markets reveals a rapidly changing landscape. While authorities and market participants argue over the definitions of liquidity, and what is the right amount, the reality is that when it comes to executing orders, asset managers can no longer rely on the levels of immediacy from broker-dealers as previously, and this is unlikely to improve. As banks become less able or willing to provide true market-making services, moving more to an agency model rather than a true principal model of liquidity provision, as well as becoming more discerning in the markets in which they operate and the clients that they serve, so the buy-side is having to rethink its own business model, and how it sources or generates the market liquidity it requires.

Innovations in technology and data management are increasingly playing a part; although perhaps not in the way many observers would necessarily expect. While e-trading can deliver pre and post-trade efficiencies, and new platform types and protocols can facilitate broader connectivity of buyers and sellers, this in itself does not create liquidity. What becomes clear from interviews with the buy-side is that the dealer-centric model may be changing, but it is not going away anytime soon, at least not for corporate bond markets. What is becoming more important is the role of the buy-side within this model, and how it evolves its relationships and interactions both with dealers and other market participants, leveraging data and technology to support this. Times may be a-changin', but the longstanding market foundations of human interaction and knowing your counterpart remain as important as ever. ■

Most likely you go your way and I'll go mine: the challenges of trying to measure market liquidity

- There is no single, agreed definition of liquidity.
- Data is often difficult to source, and some measures may rely on incomplete or inconsistent data sources.
- Some studies merge data relating to different asset types, currencies, and markets, so diluting the analysis.
- Some data are unreliable, for example screen quotes, which in the European corporate bond markets are indications at best, and 'stale' prices at worst.
- How data is interpreted in the analysis can also be contentious. For example, it is noted that bid-ask spreads in the IG European corporate bond markets have narrowed over the past few years; however, relative to the yields of the underlying bonds they have widened significantly.
- Often pointed out is that data based on what has traded does not reflect illiquidity; what is more important is what could not be traded.
- Some often used academic metrics (such as the Amihud measure) use questionable methodology and may not necessarily reflect what they are intended to capture.
- Many composite measures often rely on arbitrary constituent metrics and are difficult to compare with other measures.
- Many studies often fail to attempt to reconcile their data driven results with anecdotal evidence, thus underlying assumptions and conclusions are left unchallenged.