Going, going, gone—ICMA launches new auction initiative for fixed income market

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Banking & Finance analysis: The 'aged-fails auction' is a market driven initiative by the International Capital Markets Association (ICMA) to improve settlement efficiency in the European fixed income markets. Andy Hill, senior director, market practice and regulatory policy and secretary to the ICMA Secondary Market Practices Committee, explains the ICMA's hopes for the auction process to drive up market liquidity and prepare the market for 2018's mandatory buy-in regime.

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The ICMA's 'aged-fails auction' is intended to provide an alternative source of liquidity for market-makers who are looking to cover short positions that are failing as a result of a lack of liquidity in the secondary bond or repo markets. It aims to help dealers to manage their risk more effectively, and to avoid the inherent costs of failing a short-sale transaction, including the risk of being bought-in.

What is the initiative?

The concept is a voluntary auction process, known as the aged-fails auction initiative, which is held on a regulated trading platform and allows market-makers that have short illiquid or hard-to-source bonds to bid for them directly from holders of those bonds. The concept was originally devised for European corporate bonds (investment grade (IG) and high yield (HY)), but it can also be extended to other fixed income asset classes, such as sovereigns, emerging markets, and covered bonds.

Why was it deemed necessary?

Liquidity in bond markets is becoming seriously impaired, primarily as a result of regulatory initiatives that are impacting the cost of capital, as well as liquidity in derivatives and funding (repo) markets. All foundations of the provision of liquidity in bond markets, whether intentionally or otherwise, are being challenged. We have a functionality problem—our bond markets don't work the way they used to, and the situation is getting worse. The new regulatory landscape makes it much more difficult for market-makers to take and maintain long and short bond positions, as well as to trade out of those positions. The auction is intended to provide a means by which market-makers can potentially cover short positions, particularly where they are failing and in danger of being bought-in. It therefore has the dual objectives of enhancing market liquidity and improving settlement efficiency.

The ICMA is very engaged in trying to find market-led solutions beyond influencing regulators that improve the functionality and the liquidity in bond markets. The aged-fails auction initiative is just one of many initiatives we are currently involved in.

How will the auction process work?

Dealers that are looking to bid for certain bonds will communicate their interests to the relevant trading platform that will host the auction. In turn, the platform will communicate the details of upcoming auctions to central securities depositories (where the securities are likely to be held) who, via their corporate actions messaging networks, will inform the owners of the relevant securities of the auction details. Holders will then have the opportunity to tender their bonds into the auction. It is expected that there will be a premium to the cleared price, which will be the inducement for owners to tender their bonds.

It might be that individual banks go into the auction maybe two to four times a month, but if that is aggregated across the market, we may even see weekly auctions where there could be upwards of 10 to 20 different issues being bid on, and which will gain traction as people become more comfortable with the process. The next stage for ICMA is to develop this into a buy-in auction mechanism, to dovetail with the Central Securities Depositories Regulation (CSDR) settlement discipline likely to be introduced in early 2018, which will include mandatory buy-ins. When this happens, there will be a huge need for that functionality (see next answer).

What is the CSDR settlement mechanism and why will it encourage participants to join the auction process?

The CSDR provides for a mandatory buy-in mechanism. Buy-ins already exist as a discretionary remedy for failing trades in the non-centrally cleared bond markets, however, the CSDR (expected to be implemented in 2018) will turn this into a mandatory process. All the evidence and research ICMA has collated would suggest that the most significant likely impact of this is a further drop in market liquidity, particularly for less liquid markets such as corporate bonds, and ICMA has published an impact study which illustrates this. Another impact will be a proliferation of buy-ins in the number of buy-ins, which will increase the importance of market-makers being able to cover their shorts quickly.

We would like to think that the aged-fails auction initiative and, in the longer term, buy-in auction mechanism will help ameliorate some of that negative impact and limit the damage to bond markets.

What are the next steps?

ICMA is hoping that interested bond trading platforms will trial the auction initiative in the coming months. Interested parties will need to establish an efficient price formation process for the auction and determine how it will work best, how frequent, etc. We don't want to give too much guidance on that, rather that the market works out between platforms and users how they want that price formation to work. It is also critical that participants have connectivity with the international central securities depositories (ICSDs), because the auction mechanism relies on real money-holders of the bonds to enter them and utilise their corporate action notification mechanisms to notify holders of the securities of the auction.

ICMA will help facilitate discussions between the interested platforms and its market-makers and buy-side member firms, as well as the relevant CSDs.

As I have already mentioned, in the longer-term, it is hoped that the auction process can be adapted to become a buy-in auction. ICMA plans on revising its buy-in rules over the coming months to facilitate buy-in auctions as a more efficient and transparent alternative to the current buy-in agent model. ICMA is waiting for the European Commission, Parliament and Council to finalise the CSDR settlement discipline, including mandatory buy-in rules, within the next few months so we can ensure our over-the-counter (OTC) buy-in rules are consistent with those before we can be in a position to amend them.

It is anticipated that a buy-in auction process would be welcomed by the market in the near-term, but is likely to see significant demand in the post-CSDR world.

Interviewed by Duncan Wood.

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