Secondary Market Practices Committee

Meeting of the ICMA SMPC, January 25th 2017

The meeting was held at ICMA's London offices, and Chaired by Yann Couellan, Axa IM

Attendees

In the room:

Yann Couellan	Axa IM	(Co-chair)
Louise Drummond	Aberdeen Asset Management	
Fabio Del Gobbo	Banca IMI	
Philip Cramp	BGC Partners	
Dinos Daborn	AxeTrading	
Mark Watters	AxeTrading	
David Camara	Goldman Sachs	
Paul Glasgow	JP Morgan	
Mathieu Casadevall	SocGen	
Elizabeth Callaghan	ICMA	
Andy Hill	ICMA	(Secretary)
Paul Richards	ICMA	
Peter Eisenhardt	ICSA	

Special guest:

Omar Ghalloudi	Citi

On the line:

Sonali Theisen	Citi	(Co-chair)
Monica Cammarano	Banca IMI	
Umberto Menconi	Banca IMI	
Kamya Somasundaram	BlackRock	
Domingo Puerastrillio	BNP Paribas	
Dom Holland	BNY Mellon	
Goran Hoblaj	ERSTE Group	
Barbara Zittucro	Intesa San Paolo	
Michele Fassio	Intesa San Paolo	
Brett Chappell	Nordea AM	
Oliver Stahnke	PIMCO	
Johan Wijkstrom	Swedbank	
Leslie Woolaston	Unicredit	

Chair's welcome

Yann Couellan (Axa IM and Co-chair) thanked everybody in the room and on the call for their participation in the first meeting of the SMPC in 2017. He conveyed Sonali Theisen's (Citi and Co-chair) apologies for not being able to join in person for this meeting, but was pleased that she could dial-in. Yann noted that the meeting was structured into three sections which represented the most important themes impacting the European corporate bond markets.

Agenda items

Section I: Central Bank corporate purchase programmes

1) Impacts of the ECB's CSPP on market-maker liquidity provision: a sell-side perspective

Yann introduced and thanked Omar Ghalloudi (Head of IG European single-name credit trading at Citi) for joining the meeting and providing the forum with a sell-side perspective of the impacts of the ECB's Corporate Sector Purchase Programme on the European IG corporate bond secondary market. Omar talked the group through a presentation, entitled: '*Credit liquidity -here today, gone tomorrow?*'

Among the key points made in Omar's presentation were:

- Euro investment grade (IG) credit does not appear to react to political influences such as Brexit, the Trump election, or the Italian constitutional election; rather the main driver seems to be CSPP eligibility. This could make the market prone to non-linear reactions when market perceptions of the policy change.
- CSPP purchases account for more than 20% of eligible bond market turnover. Furthermore, expected purchases of €80-100bn in 2017 is more than 50% of the forecasted €148bn supply.
- Roughly one-third of € IG market is CSPP-eligible, and there is some evidence that this is impacting issuer decisions (such as changing the entity form which they issue). However, issuers need to weight up the benefits of what is expected to be a relatively short-term programme.
- Other than the volumes of purchases, there have been few surprises from the CSPP to date. However, primary market purchases, so far, have been lower than many expected, with the ECB able to execute most of its purchases in the secondary market. Also, eligibility criteria have typically been clear, but a published list of eligible securities (similar to the Bank of England's Corporate Bond Purchase Scheme) would help to avoid potential confusion.
- The CSPP can be viewed as part of a larger picture of central bank distortions on the € fixed income markets, where the investable universe of securities is shrinking.
- This is having an undeniable impact on spreads, which are closely correlated to central bank purchases. However, liquidity indicators suggest that the market remains healthy enough, although vulnerabilities remain, particularly the scope for the ECB to exit the programme.
- The CSPP has provided a boost for € IG trading volumes and a marginal decline in bid-offer spreads. It has also helped to increase trading volumes in beta products, such as CDS indices and bond ETFs, as the programme has made it difficult for investors to acquire diversified credit portfolios.
- It has become clear that the Public Sector Purchase Programme (PSPP) is increasingly subjecting the € sovereign repo market to distortions, suggesting a risk that that the CSPP could have a similar impact on the € credit repo market.

- Finally, it is difficult to agree on the impact of the CSPP on credit spreads due to gyration in government swap spreads, particularly at the end of 2016/early 2017.

Discussion

David Camara (Goldman Sachs) commented on the relative disparity between primary market and secondary market purchases, noting that many had expected more purchases in the primary market and wondering why this has not happened. Omar felt that this was driven by the ECB's wish to stabilize the market, which it could do more effectively by operating in the secondary market.

Paul Richards (ICMA) asked Omar what advice would he give to the ECB, based on his assessment of the CSPP, other than providing a list of eligible securities. Omar suggested that they should take extreme care when it comes to tapering, noting that when the Covered Bond Purchase Programme (CBPP3) came to an end, spreads blew out significantly in a very short time.

Section II: Corporate bond market liquidity

2) AXA bond market liquidity study

Yann Couellan provided a brief overview of the recently published AXA study, *'Fixed Income Liquidity: a lookback at our historical trading data'*. The AXA study, based on a retrospective analysis of their own trading data for fixed income, suggests that despite changing market structure, along with lower capacity of banks to warehouse bonds due to new regulatory framework and more stringent risk constraints, their statistics challenge the general perception of a major breakdown in corporate bond secondary market.

Yann made a number of observations related to the study:

- While the study uses bid-ask spreads as a proxy to gauge liquidity conditions in the EUR and GBP sovereign and credit markets, tighter bid-ask spreads do not in themselves imply improved liquidity, and it is broadly recognized that conditions in the EUR and GBP IG and High Yield (HY) markets have become more challenging.
- The AXA analysis introduces a new proprietary metric, the 'Full Execution Ratio', which tracks the percentage of orders executed on the same day as it was received in AXA's Order Management System – the closer to 100%, the better liquidity was. From 2012 onward, this is very much in a 95% to 100% range for both sovereigns and IG corporates. The notable exception is the first quarter of 2016, when the ratio drops for IG credit. However, this recovered to trend in Q2, following the announcement of the ECB's CSPP.
- Another dimension to this analytic is average order size, which has shown a steady decline since 2012 for both sovereigns and corporates, but has trended higher for credit since 2015.
- Complementary to the Full Execution Ratio, AXA also monitored the number of trades not executed in one day and the average number of days necessary to execute the remaining size. For government bonds, virtually all trades are executed in one day. This is higher for credit,

reaching a peak of more than three days on average in early 2016, but has subsequently improved close to an average of one day.

- Another metric is the ratio of split orders, which expresses the number of transactions required to execute an order fully within a single day. This is analyzed for orders less than €10mm and greater than €10mm. The analysis highlights more difficult trading conditions for credit, where orders greater than 10mm are, on average, split into two or three shapes. However, this also reflects how buy-side firms are adapting their trading strategies. Also, both the average split and average transaction size have improved during 2016.
- In terms of secondary market turnover, volumes in € credit were up 57% in 2016 compared to 2015.
- AXA are currently undertaking a follow-up study which aims to be more granular, analyzing liquidity based on different factors, such as bond type, issue sizes, bond age/maturities, and whether buying or selling.

Discussion

Liz Callaghan (ICMA) asked whether the underlying investment strategy of buy-side firms made a difference to liquidity, and whether passive funds, for instance, enjoyed better liquidity since they were potentially less price sensitive. Yann responded that the data related to both active and passive funds, and that liquidity was the same for both. However, he did note that some funds may have to give up more of the bid-ask spread than others in order to get the bonds they needed.

Omar Ghalloudi noted that the study showed an increase in volumes of more than two-fold since 2007, and asked how this trend looked if adjusted for changes in assets under management (AUM). Yann responded that volumes had increased independently of AUM.

Andy Hill (ICMA) noted that the AXA study made a point of refencing the recent IOSCO study on corporate bond market liquidity, and largely corroborated its findings. However, the IOSCO study had been criticized by many commentators, who pointed to potential flaws and inconsistencies in its methodology and analysis. While the conclusions of both the AXA and IOSCO study may be consistent, Andy asked whether it was wise to cite the IOSCO study as the reasons underlying the conclusions are very different. Yann answered that the what the AXA stud was really trying to communicate was not that liquidity was fantastic, but it is not the end of the world. Rather this a story of adaptation, and a recognition that liquidity has changed: accordingly buy-side firms have had to change their behaviour, working smaller ticket sizes, utilizing different e-protocols, and becoming more proactive. The reference to regulatory studies is intended to help regulators recognize the need that there needs to be more collaboration with market participants in assessing liquidity. It is also important to remember that liquidity is not equal for all firms, and that Tier 2 and Tier 3 buy-side firms experience very different liquidity conditions to Tier 1 firms.

Louise Drummond (Aberdeen AM) concurred that buy-side firms have had to change the way they trade in response to changing market liquidity dynamics, noting that only a few years ago, as a Tier 1 fund, dealers were far more willing to provide liquidity, but this could no longer be relied upon. Furthermore, what many of the reports being produced fail to illustrate is what does not trade. Liquidity is not ‘fine’, and the ability for Tier 1 firms to still get ‘done’ is not fully representative of overall market conditions.

Omar Ghalloudi suggested that the definition of ‘best execution’ has changed, and that dealer relationships have become more important than ever for buy-side firms. In many cases, it is not possible to work blocks on platforms, as this will move the market. Similarly, firms do not want to show these interests to dealers who are not able to show a quote. Yann Couellan concurred that this is why these axes cannot be shown through an 'RFQ-to-all', and why it is necessary to rely on proprietary market data to identify where the liquidity is and where to go to get a quote.

Brett Chappell (Nordea AM) added that there are two elements a buy-side firm needs to consider: sensitivity and immediacy. For example, if you need to sell out of a 100mm position by the end of the day, this should be possible, and there will be a price. However, if you are sensitive to the price, then this could be difficult. In other words, there is usually liquidity, but you have to pay for it. If you have the luxury of time, then it is different.

David Camara commented that as credit spreads narrowed, so investors were looking to pay less to trade, but they are not yet seeing the cost of implementing regulations reflected in dealer bid-ask spreads. Meanwhile, buy-side firms themselves are having to spend as much, if not more, to implement and comply with regulation. Omar agreed that the costs of regulation were a barrier to entry for the buy-side, especially for smaller firms. Liz Callaghan added this was one of the drivers of outsourced trading by smaller buy-side firms. Fabio Del Gobbo (Banca IMI) felt that this is also where agency models could help, combining technology with the delegation of interests to reliable intermediaries.

Yann Couellan commented that there are costs involved in connecting to many different platforms, but it was necessary to increase access to liquidity. However, trading platforms also fragmented liquidity, particularly across different venues and by reducing ticket sizes. But the natural consequence of regulation was to force more trades onto platforms. In AXA's case, 70-80% of fixed income transactions were on venue, but this accounted for 40% of overall volumes. Fabio Del Gobbo asked to what extent AXA relied on technology for TCA (transaction cost analysis) and how much to facilitate execution? In other words, what was more important: connectivity or data? Yann responded that data to support analysis was, for him, the most important factor, as this helped identify sell-side liquidity.

Andy Hill raised the question often posed by regulators that if the costs of providing liquidity, such as capital, financing, and hedging, increase, why is this simply not reflected in a wider bid-ask spread and so passed on to investors. Peter Eisenhardt (ICSA) suggested that this was mainly due to a lack of supply. Omar Ghalloudi added that bid-ask spreads did tend to gap wider around events, such as Brexit, but supply seems to be the driving force. Furthermore, it was not certain what would happen once the CSPP ceases, and whether bids would disappear. A further factor, pointed out by Louise Drummond, was that as many trades are now worked as orders, it was quite normal that they should be executed inside the bid-ask spread. Accordingly, we are observing more turnover and less spread. Omar concurred that since 2008 dealers were taking less risk, and were acting more as principal brokers. Furthermore, there are many more participants than ten years ago. If these intermediaries are not applying balance sheet, then this should be reflected in tighter bid-ask spreads. Yann Couellan added that an understanding of best execution is also important when considering bid-ask spreads. In most cases, it is possible to trade within the spread, even for large sizes. However, if one requires immediacy, then you have to be prepared to transact outside of the spread. Louise agreed that liquidity was now very much driven by matching axes, and this was reflected in tighter bid-ask spreads.

3) The European Commission's Expert Group on Corporate Bond Market Liquidity

Andy Hill provided a briefing on the objectives and progress of the recently formed European Commission Expert Group on Corporate Bond Market Liquidity (the 'Group'). Andy reminded the SMPC that the Group is made up of 17 individuals representing a broad cross-section of corporate bond market interests and participants, and the task of the Group is to assist the Commission in the preparation of analysis of market developments, policy evaluation, and definition related to European corporate bond markets. The eventual output of the Group would be a report with policy recommendations to help support and maintain liquid and efficient pan-European corporate bond markets. ICMA, represented by Andy Hill, was pleased to be a member of the Group.

The second meeting of the Group had taken place in Brussels earlier that week (January 23), where it was decided that the members would break-out into four sub-groups to focus on specific areas of the corporate bond market that best represented the expertise and knowledge of the respective members. The four sub-groups would focus on: (i) supply ('issuers and issuance'); (ii) demand ('investors and asset managers'); (iii) intermediation and market-making; and (iv) ecosystem and framing conditions. ICMA was part of the intermediation sub-group, but all members were able to interact with the other sub-groups, and ultimately the final report would be approved by all members of the Group.

Andy stated that he looked forward to keeping SMPC members informed of the work of the Expert Group as it developed, and, as much as possible, to engage SMPC members in providing valuable input into the Group's output.

Section III: regulation and market practice

4) Upcoming ICMA MiFID II workshops

Liz Callaghan briefed the SMPC on the projected ICMA MiFID II/R workshops for member focused on (i) the implementation of the systematic internaliser regime; and (ii) the implementation of best execution obligations.

Systematic internaliser workshop

The Systematic Internaliser (SI) Workshop would take place at ICMA on February 3 2017. It was clear that there was a fair amount of confusion about the implications of the SI regime, and the main objective of the workshop would be to facilitate discussion between sell-side and buy-side members to help clarify what are the key issues, and the main 'unknowns'. The agenda was being finalized ahead of circulation, but there would be a presentation on the role of Approved Publication Arrangements (APAs), and both sell-side and buy-side panel discussions, led by Andrew Bowley (Nomura), Ashlin Kholer (Citi), and Louise Drummond (Aberdeen). The intention was not to drive any future advocacy, although where areas for further clarity were identified, it may be necessary to follow-up with ESMA through the Level 3 process, in which case this would be done in close cooperation with other associations, such as AFME and the IA.

Best execution workshop

The Best Execution ('Best Ex') Workshop was provisionally scheduled for February, but the timing would be contingent on the follow-up work-load coming out of the SI Workshop. The focus would very much be on RTS 27 and RTS 28 of MiFID II, and was intended to look at the practicalities of implementation, particularly with respect to supporting the various reporting requirements, and where, again, there seems to be a degree of confusion.

Brett Chappell suggested that the issue of 'research unbundling' might also be a consideration for the Best Ex Workshop, particularly from the perspective of impacts to the buy-side. Liz responded that this was an area of focus of ICMA and other associations, and that it should be possible to discuss the various options open to sell-side firms in the provision of research, but not the commercial elements of this. She suggested a follow-up discussion involving the AMIC, who had been focusing on this specific issue.

5) ESMA's consultation on a consolidated tape

Liz Callaghan provide an update on the ICMA response to ESMA's consultation paper on its draft regulatory technical standards for non-equity instruments (under MiFID II) that was submitted in December 2016.

Liz had initiated a working group to produce the response, primarily constituted of SMPC/MiFID II Working Group buy-side members, who were most interested in the development of a consolidate tape for non-equities. The main issue was that ESMA seemed content with the development of multiple consolidated tapes, and that these did not have to be exhaustive as they could exclude reported trades that were relatively infrequent on some venues.

Liz informed the SMPC that the final response, which was available on the ICMA website, proposed a single source of post-trade data in the form of a truly consolidated tape, owned and maintained by ESMA. The response also suggested how the solution could be self-funded. The response also provided an alternative solution for a single-source consolidated tape. What becomes clear is that buy-side firms are happy to pay for enriched data (i.e. including advanced analysis), but less so to receive raw trade data, particularly from multiple sources.

David Camara commented that the main problem with the European post-trade transparency mechanism was not like TRACE in the US, and the risk with multiple, disperse APAs would be fragmented and reduced post-trade visibility. Liz agreed, adding that the only workable way to replicate the TRACE model would require ESMA consolidating the various data.

Paul Richards asked when we could expect ESMA to respond to the consultation. Liz responded that there was no formal response expected from ESMA, nor any timing, and the consultation process had mainly been for their information. However, she thought that a visit to discuss this in person with ESMA might be warranted, possibly in the spring.

6) ICMA Buy-in Rules

Andy Hill drew the Committee's attention to the recent publication of the proposed changes to the buy-in and sell-out processes under the ICMA Secondary Market Rules and Recommendations, which were also circulated with supporting documents for the meeting. He highlighted, again, the key proposals:

- The counterparty initiating the buy-in can specify a notification period of between 4 and 10 business days (which will remain consistent in any pass-on situation)
- There is no longer a requirement to appoint a buy-in agent. The non-defaulting party can execute the buy-in themselves (so long as they do not purchase securities form their own account or from an affiliated entity).
- The Rules will provide for the possibility of a reverse auction process to execute the buy-in.
- Partial deliveries should not render the balance of securities to be bought in untradeable.
- Where relevant, the sell-out rules should be consistent with the buy-in rules.
- The Rules should explicitly provide for parties to negotiate a cash compensation remedy (although outlining an approach for this is beyond the scope of the Rules).

Andy asked the SMPC whether they had any objections to the proposed changes, which were developed following an extensive consultation process with the members. Given no objections from those present or on the call, it was agreed that the proposals would go to the ICMA Executive Committee for final approval.

7) Key SMPC priorities for 2017

Andy Hill and Liz Callaghan briefly outlined the identified key priorities of the SMPC and its subsidiary Working Groups for 2017. These could be grouped under three main headings:

Regulation: primarily MiFID II (through the MiFID II Working Group), with particular focus on Best Execution, the SI regime, Consolidate Tape, Regulatory divergence and third country equivalence, and overlap with repo and securities financing transactions; but also CSDR-Settlement Discipline, in particular mandatory buy-ins (through the CSDR/Buy-in Working Group).

FinTech, Electronic Trading, and Market Structure: mainly through the Electronic Trading and Platform Working Groups, looking to extend the Electronic Trading Platform (ETP) mapping database to include APAs, and Best Ex providers, undertaking an ETP mapping exercise for fixed income markets in Asia, producing a white paper on trends in European electronic trading and e-solutions, and undertaking a mapping of post-trade solutions.

Market Liquidity: guided primarily by the SMPC, undertaking a number of studies including a Credit Repo Market study, an Asian Corporate Bond Market study, and a second Buy-side Liquidity Survey; providing relevant market data via the ICMA-SMPC website; and continuing to engage with various regulators and policy makers on the issue of market liquidity, including the European Commission (primarily through the Expert Group), IOSCO, the ECB, Bank of England, FCA, and the FSB.

The SMPC was asked whether they felt that the priorities were relevant and appropriate, and whether there were other areas where the SMPC and related Working Groups should be dedicating more focus.

Discussion

Yann Couellan noted that there were already many different areas of focus for the SMPC, and that it was important that topics such as MiFID II, developments in electronic trading, and market liquidity remained key themes. However, one possible area for ongoing monitoring might be the impacts of Brexit on European credit markets.

David Camara raised the issue of potential regulatory divergence between different national authorities, noting that this could be a key area of focus. Mathieu Casadevall (SocGen) suggested that it may be helpful for the SMPC to engage with the FCA on this topic. Liz Callaghan added that maybe the way forward was to bring together all the various NCAs (National Competent Authorities) to talk through the implications. David Camara responded that supervisory convergence was a key aim of ESMA for 2017, and he expected them to remain very focused on this; a view corroborated by Mathieu Casadevall.

Paul Richards asked whether the central bank purchase programmes would remain a key focus for the SMPC in 2017. Andy Hill responded that they were, and that ICMA and the SMPC would continue to seek active engagement and dialogue with both the ECB and Bank of England as their respective corporate bond purchase programmes progressed.

David Camara added that overall he was very happy with the work being undertaken by the SMPC and its Working Groups, and what made ICMA's secondary market work unique was that it involved both sell-side and buy-side market participants.

8) Any other business

Andy Hill suggested May 2nd as a date for the next meeting of the SMPC, which the Co-chairs had proposed holding in London just ahead of the ICMA AGM and Conference in Luxembourg on May 4th-5th.

Chair's final comments

Yann Couellan thanked all those in the room and on the call for their participation and active engagement, and looked forward to seeing and hearing them all again at the next meeting in May.

Andy Hill, January 2017