ICMA

Secondary Market Practices Committee

Meeting of the ICMA SMPC, September 18th 2017

The meeting was held at ICMA's London offices, and Chaired by Sonali Das Theisen, Citigroup Global Markets

Attendees

In the room:

Sonali Theisen	Citi	(Co-chair)
Matthew Coupe	Barclays	
Kieron Local	BNP Paribas	
Andrei Serjantov	BNP Paribas	
Silas Findley	Citi	
Andy Beed	Credit Suisse	
Godfried De Vidts	Nex	(ERCC Chair)
Pedro Sousa	PIMCO	
Ricardo Goddard	Schroders	
Mathieu Casadevall	SocGen	
Danielle Sibony	SocGen	
Josh Masters	Westpac	
Elizabeth Callaghan	ICMA	
Gabriel Callsen	ICMA	
Andy Hill	ICMA	(Secretary)
Paul Richards	ICMA	
Bogdan Pop	ICMA	
Catherine Wade	ICMA	
Alexander Westphal	ICMA	

Special guests:

William Perraudin	Risk Control
Jozsef Kutas	Risk Control
Yixin Qui	Risk Control

On the line:

Umberto Menconi	Banca IMI
Andrew Wallhead	Barclays
Philip Cramp	BGC Partners
Dom Holland	BNY Mellon
Marco Ferrari	EFG Bank
Barbara Zittucro	Intesa San Paolo
Rutger Olthof	NN Investment Partners
Brett Chapel	Nordea IM
Sylvie Bonduelle	SocGen
Kai Seger	Unicredit

Agenda items

Co- Chairs' welcome

The meeting was opened with an introduction and welcome from Sonali Das Theisen.

The Secretary relayed Yann Couellan's (AXA IM and SMPC Co-chair) apologies for being unable to attend today's meeting.

Section I: Corporate bond market liquidity

1) **Liquidity Trends in the European Corporate Bond Market**
   Presentation and discussion

Risk Control provided an overview of the findings of a study on European Corporate Bond Market Liquidity undertaken for the European Commission. The final study will be published in November, but this was an opportunity for the SMPC to enjoy a specially authorized preview of the study's analysis and main conclusions.[1]

Research findings

Risk Control explained that this had been a major study, taking over a year to complete, and based on an enormous amount of data. The impetus for the study had been driven by conflicting conclusions of studies undertaken by various regulatory bodies (AMF, FCA, Federal Reserve) and anecdotal evidence from market practitioners with respect to market functioning and liquidity. The European Commission was looking to establish a group or market participants and stakeholders to provide thoughts and policy recommendations with respect to developing efficient and liquid pan-European corporate bond markets, but at the same time it was keen to understand better the current state of the market based on detailed quantitative analysis undertaken by a third party.

Risk Control further explained that the major challenge for the study had been in obtaining data. The researchers were eventually able to source data from 3 main sources: an MTF, Euroclear, and the FCA. These combined provided large volumes of data, across multiple currencies. Furthermore, the researchers decided to keep the analysis of the data as relatively vanilla as possible, rather than taking an abstract, academic approach.

One notable observation from the analysis relates to trends in turnover ratios. These have been negative, despite a marked increase in issuance. This downward trend is more pronounced with respect to non-financial corporates (NFCs). However, along with other indicators, this trend turns positive

[1] Note that the presentation slides used by Risk Control are not available to share, either in paper or electronic form.

following the launch of the ECB's Corporate Sector Purchase Programme (CSPP). Another, unexpected, observation is a general increase in the mean ticket size.

However, one of the key aspects of the analysis focused on holding variables constant, and running a series of regression models to view different indicators in isolation. For example, the analysis suggested that there is a direct relationship between the age of a bond and the probability of it trading, which supports the hypothesis that shortly after issuance, bonds are silo-ed by investors. However, the most interesting observation is adjusting for volatility. As volatility has dropped, bid-ask spreads (i.e. the imputed cost of trading) have widened. The last time the cost of trading was as high was during the 2007-08 financial crisis, which raises concerns about what would happen in the event of another crisis.

The researches also analyzed dealer profitability. Without access to dealer data, Risk Control modeled for this by firstly estimating capital costs, based on simulating a large banks internal risk model and a stylized trading portfolio. They then used the FCA data to filter the trading activity of the 10 largest banks. They next calculated profitability, based on trade entry and exit levels, immunizing for interest rate risk, applying estimated repo costs, and adjusting for assumptions for book-level hedging of credit risk. The results show a clear downward trend in profitability. Meanwhile, the average time to trade out of a position has increased (to approximately 30 days), while the average number of transactions to trade out of a position have decreased. The analysis notes that dealers are consumers of liquidity, as much as providers, and so are equally finding it difficult to generate returns or to get out of positions.

Discussion

A number of questions and observations were raised by the SMPC participants.

Firstly, it was noted that the impact of the CSPP was constantly changing, which adds another level of complexity when analyzing the market liquidity landscape.

Another question related to a slide summarizing the regression analysis, suggesting that the 'R-squared' (correlation determination) values appeared low. It was explained that this was due to such a large pool of underlying data.

Members picked up on a statistic on the analysis which suggested that the volume of electronically traded corporate bonds in the European market was less than 10%. Members felt that this was more likely in a 30% to 45% range. The difference seemed to lie in the exclusion of transactions executed via Bloomberg, and the specific definition of what constituted an electronic trading platform.

It was suggested that one of the most revealing measures of liquidity was to analyze what could not be traded, rather than what actually has traded. Risk Control responded that they had investigated this possibility, but it was difficult to obtain this data, and eventually they ran out of bandwidth. However, they noted that the FCA had looked at data on unfilled trades when it updated its analysis of UK corporate bond markets earlier in 2017, and that this had led it change its perspective on market liquidity.

Members asked Risk Control whether they had a sense of how the European Commission might respond to the report. The researchers pointed out that there were two components to the Commission's work: the output of the industry Expert Group, and the Risk Control study. It was hoped that the conclusions of

the study would complement, and reinforce, the conclusions and recommendations of the Expert Group.

As a final point, the SMPC suggested that disaggregating turnover data between new issues and seasoned issued would be very helpful, as well as looking at investor concentration as issues aged. But overall the analysis was very thorough, the SMPC welcomed the report, and looked forward to its eventual publication.

2) IOSCO and corporate bond markets

The secretariat provided an overview of two ongoing IOSCO initiatives related to corporate bond markets in which ICMA and the SMPC are invited to provide input.

(i) Liquidity in Corporate Bond Markets under stressed conditions

It was explained that IOSCO's Committee for Emerging Risks (CER) intended to follow-up on IOSCO's 2016 study into secondary corporate bond market liquidity by conducting a study into corporate bond market liquidity under stressed conditions. The approach is to undertake a mapping exercise of corporate bond markets, to understand better the different participants and stakeholders, how they interacted, and the drivers of behaviour, particularly under different market scenarios. The intention was to use this mapping exercise to support work being undertaken by other bodies, such as the Bank of England and the FSB, to help in the design of their models and to replicate better real-world scenarios.

The CER research team had approached the ICMA SMPC to assist. Accordingly, ICMA planned to set up a series of group calls with the CER researchers: one for sell-side members (engaging the SMPC), one for buy-side members (engaging the SMPC and the ICMA Asset Management and Investors Council), and one for corporate issuers (engaging the ICMA Corporate Issuer Forum). Details would be sent out soon, and SMPC members were encouraged to participate. Alternatively, if any members were interested in bilateral discussions with IOSCO to support this work, ICMA would be happy to facilitate.

(ii) Regulatory Reporting and Public Transparency in the Secondary Corporate Bond Markets (Consultation)

In August, IOSCO's Committee on Regulation of the Secondary Markets (C2) published a consultation report on Regulatory Reporting and Public Transparency in the Secondary Corporate Bond Markets. Building on its previous work on transparency, published in 2004, this updated report makes 7 recommendations related to regulatory reporting and the public dissemination of pre- and post-trade market data. IOSCO invited responses from market stakeholders up until October 6th 2017.

ICMA, led by the SMPC, intended to respond to the Consultation Report. ICMA had already sent a SurveyMonkey link to its relevant constituents, including the SMPC, asking for qualitative input with respect to the IOSCO Paper and the various recommendations. The ICMA secretariat would use this as the basis of a draft response, which would be circulated to members for further comments and edits. The final response would be submitted on October 6th.

3) ICMA market studies

The secretariat reminded the SMPC that it was currently working on two studies related to credit markets. One was a joint study with ISDA into the state and evolution of the European Single Name CDS market. The approach was both qualitative and quantitative, with ICMA undertaking a series of interviews with market participants, both sell-side and buy-side, while ISDA was focusing on data analysis. The plan was to publish the final report later in Q4. The secretariat encouraged members active in the SN-CDS market who had not already participated to make themselves available to be interviewed in the coming weeks.

The second study was focused on the state and evolution of the Asian cross-border corporate bond secondary markets. Similar to the previous ICMA studies on the European corporate bond markets, the core of the analysis is expected to be based on stakeholder interviews. ICMA had already met with a number of market participants in the region, including sell-side, buy-side, trading platforms, and regulators. Again, the secretariat encouraged SMPC members to put their regional colleagues in touch with ICMA in order to participate in and to inform this study.

Section II: Market matters

4) Bail-in and Certificates of Entitlement

Paul Glasgow (JP Morgan) led a discussion on a proposal, supported by the Bank of England, for the SMPC to develop an industry position on the creation of Certificates of Entitlement to replace bailed-in bonds.

It was explained that the catalyst for this initiative had been the recent Banco Popular bail-in. After the subordinated bonds had been written down to zero, the ICSDs canceled the ISINs two days later. This caused disruptions in the secondary market as trades executed prior to resolution could not be settled once the ISINs had been canceled. Furthermore, holders of the bonds were effectively left with no transferable instrument that represented their rights to any potential future compensation. Furthermore, the absence of any transferable security post bail-in made it difficult to determine the termination value of related CDS.

ICMA and a small SMPC delegation had met with the Bank of England in July to discuss an initiative originally mooted by the Bank to replace the ISINs of bailed-in bonds with ‘Certificates of Entitlement’ (CEs). Whether these eventually get paid-out is not really the point, rather they represent a prior holding with respect to debt holders. Replacing bonds with CEs would also allow ongoing settlement of trades executed prior to resolution. A further upside of this is that following the settlement issues created by the Banco Popular bail-in, this is likely to harm secondary market liquidity the next time the market senses a risk of a potential bail-in. Knowing that settlement of trades will not be disrupted would help to avoid liquidity drying up.

The Bank of England suggested that ICMA, ideally working jointly with ISDA, produce an industry position paper highlighting the advantages of replacing written down bonds with CEs in the event of a bail-in. This position paper could then be used as an educational or advocacy tool to help raise awareness among various national resolution authorities.

Discussion

An SMPC member suggested that it was important that ICMA work very closely on ISDA on this initiative, ad that the approach be very pragmatic, outlining the various scenarios and how CEs could add value.

Another member asked whether it was likely that various regulators would take the recommendation on board. It was noted that while the Bank of England was broadly supportive, and had originally floated the idea, other resolution authorities were less enthusiastic. Trying to get 27 separate regulatory bodies on board was always going to be a big ask, but as an initial step ICMA and ISDA could at least raise awareness of the issues and put the suggestion out there. This should hopefully pave the way for further discussion with and among the various authorities.

As a final point, it was also suggested that ICMA review its Secondary Market Rules and Recommendations with respect to written down bonds, as there may be scope here for the Rules to facilitate orderly settlement of trades once the ISIN has been canceled.

5) Benchmark reform and the future of LIBOR

Catherine Wade of ICMA provided a brief update on the implications of benchmark reform for corporate bond markets.

The key takeaway from Andrew Bailey's statement is that the FCA, as regulator of LIBOR, will not use its influence or legal powers to persuade or compel the panel banks that submit contributions to the benchmark to make submissions after 2021. The speech made it clear that market participants will need to (i) develop alternative benchmark rates, and (ii) ensure that there are sufficiently robust fall-back arrangements for contracts entered into now that extend beyond 2021 - when it may well be that LIBOR will cease to exist in its current form.

ICMA is looking at possible long-term solutions, but is also focused on what the market may need to think about in the short-term. For example, what will happen to existing FNRs with maturities beyond 2021?

In the plain vanilla bond market, long-term floating rate notes are not hugely prevalent, with many having a maturity of less than three years. However, long-term securities referencing IBORs are more common in the context of regulatory capital for banks, with for example reset provisions from fixed to floating rate, corporate hybrid issuance, insurance regulatory capital and in the securitization market.

There is no standard master form of terms and conditions for the international bond market. This is in contrast to the derivatives market which uses the various ISDA definitions. There is, however, a great deal of communality in the drafting of the relevant provisions in bond terms and conditions, with the

outcomes being broadly consistent. Currently the most common provisions found in bond terms and conditions are known as 'ISDA determination' or 'screen rate determination'. Depending upon which option is selected by the bond issuer, the relevant fall backs which would apply in the event of a failure or termination of a chosen benchmark are set out in the contractual documentation as a waterfall of options. If the reference rate cannot be determined by application of the first specified fall back, the following applicable fall back applies and so on until the final fall back is reached. There may also be variations on these alternatives described, as well as different historic provisions in documentation in relation to legacy floating rate notes.

ICMA is participating in data gathering on the volume of long term outstanding floating rate notes to quantify the challenges in relation to legacy trades. However, any such high-level data will not give granular information on the specific bond terms and conditions that apply to those legacy bonds.

Discussion

An SMPC member suggested that this impact a significant segment of the market, particularly with respect to TLAC elated issuance, although it was also noted that most regulatory capital issuance is callable, so the underlying assumption is that this could be called. It was pointed out that there is a lot of outstanding FRN issuance with long calls, and that this should impact valuations; although so far there had not been a noticeable market reaction to the FCA's statement.

A further point was raised with regard to selecting the appropriate replacement for the IBORs, and the risks inherent in selecting reference rates that extrapolate a relatively illiquid overnight unsecured rate, as opposed to an actively traded secured reference rate.

6) ICMA Rules and failed trades

Members were asked for their views on the application and efficiency of the recent amendments to the ICMA Rules with respect to (i) negative interest rate claims for fails [Rule 407] and (ii) buy-ins, in particular the elimination of the need to appoint a buy-in agent [Rule 450].

An SMPC member raised a concern with respect to the application of Rule 407, stating that some sell-side firms were flatly refusing to pay claims, despite being an ICMA Rule and therefore a term of their contractual agreement. They requested that the application of Rule 407 be discussed with the broader membership to establish whether this was a broader problem, and whether market practice was not to honour claims made under the Rule. The secretariat agreed to follow-up.

Section III: Regulation

7) MiFIR Treatment of Index Options

Sonali Theisen update the SMPC on the proposed ICMA position paper on the MiFIR treatment of CDS index options.

ICMA had previously drafted a paper, which had been circulated among the SMPC for comments. However, since then there had been two developments. Firstly, the updated ESMA interim transparency calculations for derivatives listed indices on the list of liquid credit derivatives, but not options on these. Secondly, ISDA was in the process of drafting a letter to ESMA regarding outstanding uncertainties in the MiFIR transparency framework, which also addressed the interim transparency calculations, as well as suggesting that index options should not be treated as liquid instruments. In light of this, there did not seem any value in finalizing the ICMA position paper at this stage.

Discussion

An SMPC member asked whether it would be helpful to have an ICMA position that reinforced the ISDA paper. Members agreed that the ISDA approach, to include the issue in a broader note with respect to reporting derivatives under MiFIR, was, on balance, better than flagging the issue in a headline report.

8) ICMA MiFID II/R Workshops

Liz Callaghan and Andy Hill updated SMPC members on the recent and ongoing ICMA MiFID II/R implementation workshops being rolled out across Europe and Asia.

The SMPC was informed that two events had been held in the Asia region (one in Hong Kong and one in Singapore), which provided an overview of the key requirements of the regulation from a fixed income perspective, as well as the pertinent extra-territorial considerations for regional investment firms. Perhaps not surprisingly, both events well attended (the Singapore event was over-subscribed) which indicated the high level of interest, and concern, among Asian firms.

Meanwhile, ICMA had held the first of a series of workshops across Europe, aimed specifically at the Nordic region and hosted jointly with the Swedish Securities Dealers Association in Stockholm on September 6th. This highlighted a number of regional differences and nuances in the interpretation of the regulation, particularly with respect to transparency, with regulators seemingly concerned that MiFIR will result in less transparency.

Further workshops were scheduled over the coming weeks for Brussels, Luxembourg, Paris, Madrid, Frankfurt, and Milan.

FCA discussions

Liz Callaghan flagged a recent note she had circulated with the MiFID II Working Group (MWG) on September 13th, and which provided an update on responses from the FCA to some key questions.

Hybrid model for SIs

Firstly, the FCA had clarified that a firm can act as both a systematic internaliser (SI) and a principle broker, and so could execute part of a client order against its SI quote, while working the remainder of the order in a riskless capacity. However, with respect to the appropriate pre-trade transparency waivers, it cannot treat the order as 'Large in Scale' (LIS) if the size of the trade transacted against the SI quote is below the LIS threshold.

SMPC members confirmed that this was not a surprise, and that they would expect the LIS or SSTI ('Size Specific to The Instrument') thresholds to apply to each individual transaction, not the overall order. The ICMA secretariat suggested that other EU regimes took a different view. The SMPC were interested to know which national regulators this related to.

One member felt that from their discussion with the regulator the critical consideration was whether the order was being traded at risk (on the SI's balance sheet) or was being 'matched' (riskless principle). In the case of at-risk fills, the SI can aggregate these into a single 'end of day' fill, with the appropriate thresholds applying to this. Where a trade is matched (riskless), this should be considered as a separate trade. The latter could also be executed on an OTF, which would have a separate reporting obligation.

This prompted the question of when an order is executed as a single end of day fill, what should be the appropriate time stamp? The view was that when a trade is executed that is the appropriate time stamp, and so this could be a change going forward with respect to end of day fills.

One buy-side member stated that they would be reluctant to leave orders with dealers if they are giving multiple fills below the deferral thresholds, and that they would prefer to incentivize true market-making.

Another member suggested that post-trade was the real problem, and that liquidity would be directed in terms of the deferral regimes. A common approach to the post-trade deferrals was essential. A member suggested that if a firm was uncertain about different deferrals, the safest approach was to execute on a London based platform.

RFQ-for-1

Secondly, the FCA was supportive of the continued practice of agreeing a trade OTC and then executing it on a platform. Alternatively, it was also possible to agree a trade subject to execution on a platform. However, this would only apply to large trades that were above the pre-trade transparency thresholds.

Some SMPC members confirmed that this was also their understanding, and that, subject to the SSTI and LIS thresholds, this existing workflow was still permissible under the regulation. One member raised a concern, however, that the use of terminology to describe this workflow, such as 'processed trades' or 'negotiated trades' was unhelpful, as it seemed to suggest that this was a new protocol or some form of

regulatory workaround, and so could attract unwarranted regulatory scrutiny. A number of members emphatically agreed with this point.

The secretariat suggested that the one change that would need to be introduced would be a flag on the platform execution to indicate that this was a non-competitive request for quote for one ('RFQ-for-1'). A number of members challenged this assertion, noting that this may be an individual firm requirement, but not a regulatory obligation. Furthermore, there were other means of flagging trades for internal compliance requirements that did not require a market standard protocol.

It was suggested by one SMPC member that ahead of the projected ICMA event the following month, when the three main fixed income platforms were scheduled to present their post-MiFIR functionality to support the continuation of this established workflow, some of the more vocal MWG and SMPC members meet to discuss some of these issues more fully among themselves, before discussing further with the platforms. There was broad agreement for this suggestion.

9) Any other business

There were no other points of business

10) Approval of the minutes of the last meeting

In the absence of any comments, the minutes form the meeting of May 2nd 2017 were approved.

Prepared by: Andy

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