AMIC
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AMIC Review

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ICMA Asset Management and Investors Council (AMIC) Conference

HOSTED BY BLACKROCK

7 November 2016, London

Agenda

10.30 **Registration**

11.00 **Welcome Remarks & Keynote address**

Dr Jean Boivin, Head of Economic and Markets Research, BlackRock Investment Institute

11.30 **Panel 1: Brexit – practical market impacts**

Moderator: Andreas Utermann, CEO and Global CIO, AllianzGI

Panellist: Jack Inglis, Chief Executive Officer, AIMA

Panellist: Simon Crown, Partner, Clifford Chance LLP

Panellist: Gina Miller, Founder, SCM Direct

12.20 **Presentation: Corporate Bond Market Liquidity – a buy-side perspective**

Andy Hill, Senior Director, ICMA

12.40 **Lunch**

13.20 **Panel 2: Liquidity in corporate bond markets**

Moderator: Andy Hill, Senior Director, ICMA

Panellist: Vasiliki Pachatouridi, Director, BlackRock Fixed Income Portfolio Management Group

Panellist: Pauli Mortensen, Head of Trading, Norges

Panellist: Robbie Boukhoufane, Global Head of Fixed Income / FX Trading, Schroders

14.00 **Panel 3: Coping in a negative interest rate environment**

Moderator: Robert Parker, Senior Advisor, Credit Suisse and Chairman of AMIC

Panellist: Jerome Jean Haegeli, Head Investment Strategy, Managing Director, Swiss Re Management Ltd

Panellist: Chris Hitchen, Chief Executive, RPMI

Panellist: Craig Turnbull, Investment Director, Insurance Solutions, Standard Life

14.50 **Investment challenges for the asset management industry in 2017**

Robert Parker, Senior Advisor, Credit Suisse and Chairman of AMIC

15.15 **Closing Remarks**

Martin Scheck, Chief Executive, ICMA

15.30 **Event Close**

Welcome

Martin Scheck,
Chief Executive, International Capital Market Association (ICMA)

ICMA is one of the few trade associations with a European focus that has both the buy-side and sell-side represented within its membership. From a total of over 500 members, currently around 160 have direct buy-side interests. Whilst the buy-side has always been present in its membership, for example private banks, in recent years ICMA has taken steps to consolidate buy-side participation as a key part of realising its mission to represent the full range of market users from issuers through to investors, via intermediaries and including infrastructure providers. Engagement with the buy-side is increasingly essential as boundaries between the activities of the sell-side and the buy-side continue to blur in areas that have traditionally been the preserve of the sell-side, such as repo and liquidity provision.

ICMA has grown its buy-side membership and expertise by providing dedicated resources to asset management and investment issues, and actively encouraging further involvement in the regulatory activities of ICMA. As a first step, the Asset Management and Investors Council (AMIC) was established as the independent voice for the buy-side within ICMA, followed in more recently by increasing the buy-side representation on the board of ICMA and in cross-industry working groups and committees.

As a move to incorporating the buy-side view, wherever possible new working groups are now built on the basis of a joint buy-side/sell-side membership from the start, e.g. the European Corporate Debt Private Placement Joint Committee, the AFME/ICMA joint Infrastructure Working Group, and more recently the Electronic Trading Working Group and the Green Bond Principles Executive Committee. These groups were all formed with the help of AMIC members.

Buy-side members – whether members of AMIC or not – have been encouraged to participate in ICMA committees and working groups that formerly only involved sell-side members. Examples include the Secondary Market Practices Committee and the European Repo and Collateral Council which have seen growing buy-side participation. A buy-side co-chair has been approved by the Secondary Market Practices Committee to represent a broader market view, and in the long-term attract more buy-side interest.

The buy-side is regularly consulted in other areas of ICMA's work. On the primary market side, a number of New Issue Process Roundtables in various countries have brought together investors and lead managers since 2010. Our issuer forums, representing public sector borrowers, corporate issuers and financial institutions have been keen to engage with buy-side speakers in meetings or discuss common topics. The Bail-in Working Group and the Financial Institution Issuer Forum have already held discussions on potential areas of convergence. We can see that there is scope for more cooperation between the AMIC and these forums in the future.

ICMA sees the need to represent the views of the whole market in its dialogue with the authorities, leveraging its dual buy-side/sell-side membership is key to this. We are looking at further practical steps to bring in more content and expertise from our buy-side members and provide them with additional value from their ICMA membership. ■

"ICMA has taken steps to consolidate buy-side participation as a key part of realising its mission to represent the full range of market users from issuers through to investors".

The AMIC

The independent voice of the buy-side within ICMA

Robert Parker,
Chair of the ICMA Asset Management and Investor Council (AMIC) and Senior Advisor, Credit Suisse

To reflect the growing importance of the buy-side in the marketplace in general and the value public authorities give to the buy-side voice, ICMA decided in 2008 to set up an Asset Management and Investors Council (AMIC) which I have chaired since then. The AMIC was established to represent the views of the buy-side members of ICMA and to add value by discussing investment issues of common interest, with the aim of reaching a consensus and recommending any action that ICMA should take. It has grown from 15 people (recruited through personal contacts) to a fully structured Council within ICMA encompassing more than 200 contacts and now organises biannual conferences, quarterly Executive Committee meetings and several working groups. Only buy-side members are invited to join the AMIC's sub-committees and working groups.

The AMIC's main tasks include:

- discussing macro level industry and regulatory issues;
- identifying and suggesting solutions to practical issues for members at a technical level;
- coordinating market-led initiatives in response to the challenges it has identified;
- preparing responses to the authorities, representing the views of AMIC's cross-border membership from the international asset management and wealth management industry;
- engaging with regulatory authorities, as AMIC or as part of a cross-industry group, at national, European and international level in a world where the regulatory authorities are increasingly moving from a national to an international remit;
- working to ensure that authorities fully understand the consequences of any regulatory proposals for the asset management and wealth management industry; and
- promoting buy-side members within other ICMA committees and working groups, to ensure that buy-side concerns are better reflected in ICMA's output.

How does the AMIC work?

Since its first meeting in March 2008 in Zurich, the AMIC has broadened its composition to represent not only asset managers but also end investors. It also addresses a wider range of market issues, beyond the fixed income space. To reflect this evolution, an Executive Committee was formed in 2012 to give direction to the underlying working groups. Andreas Utermann was recently appointed Vice Chairman of the AMIC Executive Committee.

The Asset Management and Investors Council

All AMIC members are equally represented on the AMIC Council which meets regularly to discuss broad industry issues and to guide the AMIC Executive Committee on the choice of projects and working groups. The AMIC Council holds two plenary sessions annually, both to advise the Executive Committee of AMIC on priorities and to discuss current issues at biannual conferences – organised in the spring in a continental European city and in the autumn in London.

The AMIC Executive Committee

The Executive Committee is effectively the executive arm of the Council and comprises a subset of Council members. The Executive Committee is composed of individuals representing institutions which are full ICMA members. The Executive Committee takes account of the views of the Council and is responsible for the "public output" of the AMIC, such as opinions on regulatory and market practice developments, responses to consultation papers, etc. The Executive Committee also calls upon experts on specific topics.

The Executive Committee meets four times a year allowing members to discuss the most topical buy-side issues of the day.

The AMIC working groups

The working groups are the core of the AMIC. The AMIC has already set up a number of temporary and permanent working groups and Councils. Some are asset class-focused (covered bonds, securitisation) and some look at industry issues (market finance, private banking). External experts are also invited to join the the working groups when relevant.

The AMIC Secretariat sends a weekly update to contacts, outlining its current activities and a specific regulatory update. Sign up by contacting **amic@icmagroup.org**

The AMIC Secretariat is in constant contact with AMIC members. To ensure that the AMIC brand is maintained in the wider investor community and to step up awareness of ICMA's buy-side activities, the AMIC Secretariat also sends out a weekly regulatory update, with information about key AMIC developments, to a broad list of recipients.

The Secretariat of the AMIC is small and therefore quite capable to flexibly respond to the needs of its membership. The overall working group structure allows for permanent as well as temporary working groups. I would encourage any AMIC Council member to get engaged with the working groups, or at the very least get the weekly update to keep abreast of our current activities and priorities.

Contact: **amic@icmagroup.org** ■

Key AMIC achievements and current initiatives

- In the European covered bond sector, the **Covered Bond Investor Council (CBIC)** has published a template of the key information required by investors in covered bonds to make better informed investment decisions and sought the buy-in of issuers, which was the impetus for the issuers' market led initiative on transparency and their Harmonised Transparency Template – frequently reviewed by the CBIC.
- The **Securitisation Working Group**, through coordination with other industry representative bodies, has argued for a requirement for third-party attestation of simple, transparent and standardised (STS) status in the European Commission's proposal for STS securitisation.
- The AMIC has been key in the establishment of **European Corporate Debt Private Placement Joint Committee**, which has developed the common standards and best practices essential for the development of a Pan-European private placement market for corporate debt, namely the Pan-European Corporate Private Placement Market Guide.
- On **Market Finance**, the AMIC is actively engaged with regulators in the current debate over systemic risk in asset management, responding to international and European consultations on shadow banking and sharing its concerns on the broad definition suggested by the consultations. The AMIC has recently published, alongside the European Fund and Asset Management Association (EFAMA), a report on fund liquidity risk management, with a view to contribute to the debate in light of future consultations to come on this topic.
- On **Bail-in**, an AMIC investor group has been heavily involved in the debate about the level of transparency that issuing banks have to provide investors in bail-inable securities. The Bail-in Working Group sent several letters to the European Central Bank (ECB) recently and will continue to engage with authorities on this important topic.
- The **Wealth Management Charter of Quality**, which draws together the standards adopted by the private banking industry in a single document, has been signed by the Luxembourg Bankers' Association and is now sponsored by the CSSF in Luxembourg as a minimum standard.

Market Outlook

Andreas Utermann,
CEO and Global CIO, AllianzGI

Global economic growth will remain lackluster, while central banks suppress yields and politics create uncertainty. In this environment, investors' returns will be driven by their ability to take risk and stay active.

The state of the global economy

Economic growth and inflation have remained weak this year. Slow recoveries after financial crises are, in fact, rather the rule than the exception. Nevertheless, global growth has been surprisingly sluggish in a historical context, particularly in view of the huge monetary stimulus globally. Real bond yields have continued to fall, significantly influenced by negative interest-rate policies (NIRP) in Europe and Japan. As expected, we have also seen increasing volatility in many asset classes, such as global equities, oil and bonds.

With global growth relatively slow and the wiggle room of the major central banks dwindling, calls for fiscal stimulus and growth-enhancing structural reforms are becoming louder within the G20. The latter in particular would be welcomed, as the disappointing growth momentum in the advanced economies appears to be less the effect of a prolonged phase of cyclical weakness and more the result of subsiding long-term growth drivers, such as weak demographics and labour productivity growth (see chart below).

On the bright side, India and Indonesia have offered resilient growth this year, with improving signs of policy traction from their new governments, and with more upside still to come. In addition, China's renminbi has remained quite stable despite fears of a major depreciation, while oil has remained within a distinct trading range.

Political risks go global

Politics has grown into an increasingly important risk factor for investors – especially given the Brexit result, the mounting political troubles seen in Spain and Italy, and the upcoming US elections. This is giving rise to a greater sense of political uncertainty that may have contributed to the sideways movement of many markets.

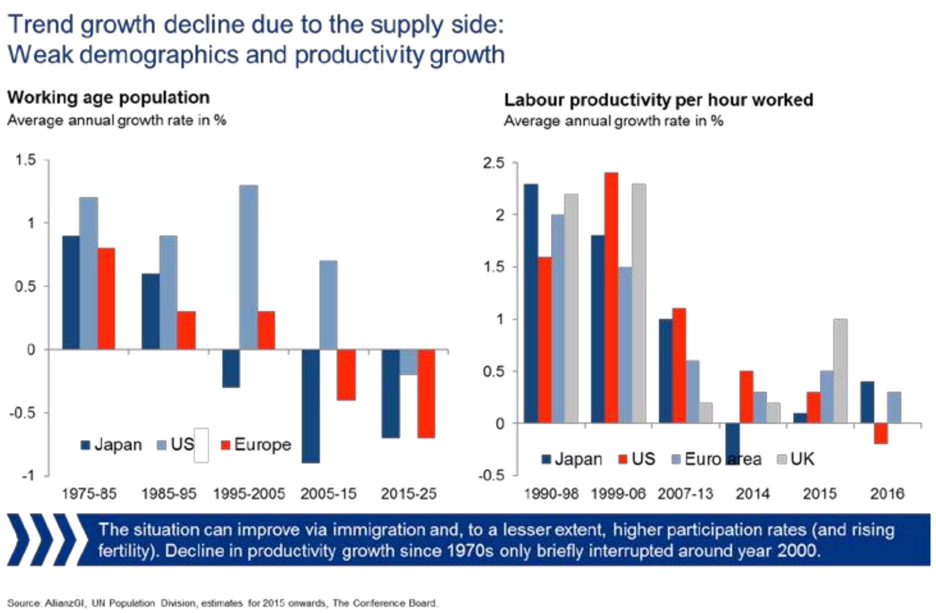
The growing number of geopolitical conflicts is adding to the rising populist and nationalist movements seen in the US and Europe, which could roll back the growth-friendly globalization, free trade and de-regulation policies that have been in place since the 1980s.

Will Europe fall into the same trap as Japan?

In recent years, it has become clear that many of the promises that politicians have made to their electorates – think healthcare and welfare – may prove to be unaffordable unless their governments enact significant structural reforms.

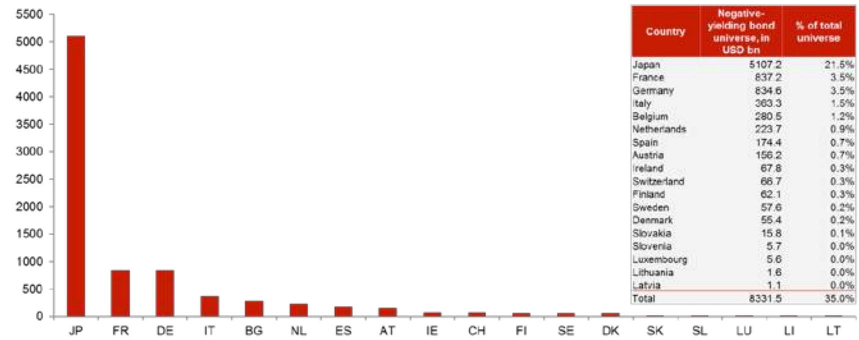
Key Takeaways

- Uncertainty remains high globally as financial repression accumulates, and as policy cycles and geo-political events accelerate.
- Brexit and other major political questions keep plaguing Europe, which is already sensitive to the dull global growth environment.
- A flight to safety from NIRP economies makes equities attractive in Asia and EM; risk-adjusted returns from alternatives can help investors take measured risk.



Negative yields are a global phenomenon

Amount outstanding of public debt of industrialized countries* with negative yields (in USD bn)



Country	Negative-yielding bond universe, in USD bn	% of total universe
Japan	5107.2	21.5%
France	837.2	3.5%
Germany	834.6	3.5%
Italy	363.3	1.5%
Belgium	280.5	1.2%
Netherlands	223.7	0.9%
Spain	174.4	0.7%
Austria	156.2	0.7%
Ireland	67.8	0.3%
Switzerland	66.7	0.3%
Finland	62.1	0.3%
Sweden	57.6	0.2%
Denmark	55.4	0.2%
Slovakia	15.8	0.1%
Slovenia	5.7	0.0%
Luxembourg	5.6	0.0%
Lithuania	1.6	0.0%
Latvia	1.1	0.0%
Total	8331.5	35.0%

Negative yields are now a global phenomenon in the government bond market. Globally, and with Japan standing out from the crowd, there are now more than USD 8.3 trillion worth of government bonds with negative yields. This corresponds to nearly 35 % of the industrialized countries' sovereign bond universe.

*) Based on Merrill Lynch's Global High Grade Sovereign Index (W0G1 Index). Past performance is not a reliable indicator of future results. Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research. Data as of 29 August 2016.

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In Japan and much of Europe, these reform initiatives are seriously lacking, which could cause economies that are already suffering from systemic demographic challenges to stagnate further.

Indeed, there are signs that Europe's shrinking economic growth could push it into the same economic blind alley that Japan entered in the 1990s. On a more positive note, Europe's GDP per capita is much stronger than Japan's, and Europe is substantially less leveraged and thus requires less balance-sheet restructuring. Importantly, Europe does not have an overvalued property sector to deal with, even if its banking sector and credit multipliers look eerily similar to Japan's at this time.

NIRP's implications for financial stability and economic growth

Negative yields are now a global phenomenon in the government bond market (see chart above). Globally, and with Japan standing out from the crowd, there are now more than USD 8.3 trillion worth of government bonds with negative yields. This corresponds to nearly 35% of the industrialized countries' sovereign bond universe. Of course, the euro-zone's banks are echoing the traumas that are affecting Japan's banks. Indeed, a close analysis of Europe's monetary policy suggests that the ECB may have overstepped with NIRP.

For the moment, fundamental factors have largely been brushed aside on government bond markets. After 19 months of sovereign bond purchases by the Eurosystem, along with negative deposit rates, roughly half of the euro-zone government bond universe is currently carrying a negative nominal yield. In light of the deepened pool of negative yielding bonds, "scarcity scares" related to the ECB's self-imposed constraints, namely the deposit rate restriction, are back on the agenda. One thing seems to be clear: Given current market conditions, the ECB will hardly be able to avoid adjusting its QE parameters over the months ahead.

Financial Repression – how long will it take ?

10 year Government Bond Yields : Japan, Germany, US

If we follow Japan, we may be " here " for 20 more years ...

Meanwhile, a look at the transmission channels of QE to the real economy shows a mixed picture. The large-scale measures by the ECB appear to have boosted growth and consumer price inflation only to a limited extent. This modest success has forestalled any incentive to deepen structural reforms – particularly given that the ECB has no ability to punish under-reformers. In Japan, meanwhile, sustained zero and negative interest-rate policies have affected the returns and solvency of all banks and insurers. This may be the future that beckons in Europe.

The central banks' journey into NIRP has been a long one. Unlike how monetary policy was employed before the GFC, it is now being used to sustain economic growth. Meanwhile, ZIRP/NIRP have not only driven investors into ever-riskier assets in search of return but also blurred the lines between monetary and fiscal policy, which will make today's monetary policies that much harder to exit from. The Eurosystem has become the largest creditor of the euro area countries already.

Action points for investors

We expect the "lower for longer" environment to continue; in fact, financial repression may persist for longer than originally anticipated (see chart left). As such, and without growth-enhancing structural reforms, global economic growth will remain slow and low in historical comparison, and investors' returns will be driven by their appetite for accepting volatility and risk.

With the stage set for volatility stemming from so many political, economic and monetary uncertainties, investors must be active, disciplined and tenacious in harnessing returns. Attractive opportunities can be found in equities, and good income potential can be found in fixed-income securities in emerging markets, Asia and the US. Of course, it is especially important to actively pursue alpha in these areas, since beta returns are set to be low and volatile, which could undermine cheap index investments. Investors should take a particularly close look at the risk-mitigation and diversification benefits that alternative asset classes provide, but above all, investors need to realize that they must take some risk to achieve their return targets. ■

Liquidity: the investor perspective

An interview with Joanna Cound of BlackRock

Investors today face a number of challenges in Europe's corporate bond market. Low interest rates mean that issuers are looking into lock in the financing today and primary market issuance remains highly fragmenting. Banks are reducing inventory and are less able to make markets in bonds which presents a challenge to access liquidity in the secondary market. These factors in combination have resulted in significant change to the dynamics of today's corporate bond market.

Faced with these market challenges, in the midst of regulatory changes and monetary intervention, we caught up with Joanna Cound, Head of EMEA Government Relations and Public Policy at BlackRock, and a newly appointed ICMA Board member, to get her impressions on how the buy-side is adapting to this changing market environment for corporate bonds.

Why does liquidity matter to end-investors?

Market liquidity refers to the market's ability to facilitate the purchase and or sale of an asset without causing a change in the asset's price, a market impact. Market liquidity matters greatly to asset managers and end-investors such as Europe's savers and pensioners. A rather large imbalance is being created between the daily liquidity in the asset management world and the broker dealer liquidity available to that world and the absence of long-term fundamental investors who will buy bonds when everyone else is selling.

The current lack of consistent trading volume data in Europe results in an incomplete picture of liquidity in Europe, while it also poses several other challenges for market participants when it comes to risk or transaction cost analysis, reporting and best execution.

But many of the discussions relating to market liquidity in fact reflect an ongoing evolution of global bond markets, as market participants adapt to structural changes, due to an impaired bank lending channel and a push to grow the public debt markets by regulators.

Can you tell us more about the structural changes, and specifically the European Commission's drive to stimulate market finance through the Capital Markets Union (CMU) initiative?

Euro denominated corporate bond issuance data, vis-à-vis bank loan flows to non-financial corporates, point to a more structural shift in favour of public debt markets in Europe. Between 2012 and Q1 2016, EUR 344 billion net issuance by non-financial companies appears largely to have compensated for a reduction of EUR 471 billion in bank loans. This is fairly reasonable considering the ongoing balance sheet restructuring in the banking sector, and therefore the reduced capacity of banks to provide financing to the rest of the economy.

The increased role of market finance is beneficial for non-financial corporations and banks alike, as corporates can diversify their funding structure, and banks can act as underwriters earning revenue without adding pressure to their balance sheets or taking on more risks. That said, firms must be large enough to afford the fixed costs of issuing debt. In other words, firms that have trouble accessing bank credit (i.e. traditional SMEs) are not necessarily those that can borrow on the bond market.

How could the CMU best work for end-investors?

Enhancing the efficiency of public markets offers the greatest potential return in terms of funding opportunities for European companies. Ensuring that markets are structured in a way that provides liquidity – especially in fixed income – needs to be critically assessed to provide a firm foundation for a CMU creating greater funding opportunities and maintaining the confidence of a broader range of investors in capital markets.

Insurance corporations and pension funds (ICPFs) are the biggest owners of debt in Europe, and their holdings have increased significantly since 2008 from EUR 2.3 trillion to EUR 3.9 trillion at the end of Q1 2016. ICPFs are more in need of predictable and long-term cash flows which largely explains their bias towards bonds and in particular Eurozone sovereigns. This is also due to the tight restrictions on credit ratings, which assign a greater role to sovereign bonds within the fixed income landscape.

"Market liquidity matters greatly to asset managers and end-investors such as Europe's savers and pensioners."

"While considerable reform has been agreed for equity markets, fixed income markets are in need of greater scrutiny."

In terms of asset allocation, corporate bonds make up only a small portion of most investors' asset allocation, while ownership of euro area debt is well diversified at an aggregate level. For example, non-financial euro corporates make up less than 3% of ICPFs' assets, while even bond funds invest only around 7%. This is clearly potential for this segment to grow further.

While considerable reform has been agreed for equity markets, fixed income markets are in need of greater scrutiny. We welcome the European Commission's forthcoming assessment in Q4 2016 of the corporate bond markets in the EU as part of the CMU framework, in parallel with the ongoing assessment of the cumulative impact of regulation. The aggregate impact of shifts in regulation impacting banks and market structure with temporary macro-economic factors has been attributed to reduced secondary market liquidity in global corporate bond markets in recent years.

Reforms have indeed reduced dealer inventories, and low interest rates have given rise to record issuance, which has resulted in vast numbers of bonds, and this combined effect has further fragmented liquidity. As banks curtail their market making activities, execution risk is shifting from banks (where they no longer act as principal) and is increasingly borne by end-investors. These end-investors are the same pensioners and savers who are being asked to commit more capital to markets through the CMU initiative – making the efficient functioning of fixed income markets of paramount importance.

What sort of practical steps could help stimulate capital market development more broadly?

Arguably, today there isn't such a thing as a single European corporate bond market. Fragmented and typically bilateral trading presents material barriers to integration, and the inevitable complexity and inefficiency arising from this could manifest itself as a cost to European companies and investors. Companies have tended to issue bonds whenever financing needs arise or opportunities present themselves. As a result, trading and liquidity remains sub-optimally fragmented across thousands of bonds of varying maturities. Delivering MiFID II and MiFIR and ensuring that the provisions relating to post-trade infrastructure connectivity are fully implemented – and where necessary enforced – will go some way to address this situation. But further work will be necessary from both industry and policy-makers to ensure that European bond markets can play the role needed in helping to provide finance.

To preserve these dynamics, the CMU should in addition consider introducing measures to increase gradually institutional allocations into corporate bonds, and help institutional investors widen their corporate bond portfolios by allowing more flexible measures. Finally, by increasing investor demand, these measures should lower the cost of issuing bonds in the long run and would make bond issuance a more robust alternative to bank lending.

"Corporate bond ETFs are the biggest driver of growth and increasing trading volumes, despite sluggish growth in OTC bond liquidity."

How do you see the trading ecosystem in Europe evolving and will this evolution help end-investors?

The combined impact of regulatory change and technology is changing the practices and behaviour of European bond market trading and the toolkit to operate within it. This is just the beginning of the process as we foresee a staged approach to how protocols and platforms evolve in the coming years. Equally, we do not expect a single model or platform to be suited to all types of trades. Something that is clear, however, is that a flexible and scalable model is emerging; one that allows participants to choose a strategy and venue based on the characteristics of the trade.

BlackRock is the world leader in Exchange Traded Funds (ETFs). What is the role of ETFs in capital markets going forward?

The rise of bond ETFs in Europe as a source of bond market liquidity, and the scope for future development of this market segment is significant.

ETFs can help enhance price discovery, provide investors with low execution costs to establish a diversified portfolio, and increase bond market liquidity and transparency. ETF liquidity is incremental to the underlying bond market liquidity because buyers and sellers can offset each other's transactions without necessarily having to trade in the underlying market. Even during periods of market stress, ETF shares are at least as liquid as the underlying portfolio securities.

Corporate bond ETFs are the biggest driver of growth and increasing trading volumes, despite sluggish growth in OTC bond liquidity. European domiciled ETFs hold roughly EUR 38 billion in EUR corporate bonds both from euro area and international issuers, split between EUR 31 billion of investment grade and EUR 6.4 billion of high-yield focused ETFs. To put that in context, this is less than direct household investments in euro non-financial corporate bonds coming from countries with high savings rates, such as Germany and Italy, and those with a culture of holding securities, such as Belgium, Italy and Spain.

As the ETF market ecosystem continues to develop alongside the bond trading ecosystem in Europe, the future scope for these products will see a more diversified client base and further utilisation of bond ETFs as financial instruments. Trade reporting and post trade transparency under MiFID II is one obvious development that will enhance the perception of liquidity in European domiciled ETFs as more OTC trades will be visible. Other key drivers of growth for this market will likely include standardised risk and trading metrics, larger lending pools of ETFs, the development of derivatives in ETFs, as well as increased acceptance as collateral in OTC transactions.

You were elected to sit on the ICMA Board last May, what will be your contribution to help ICMA to promote efficient capital markets?

ICMA has a long-standing experience of critically analysing the efficiency of corporate bond markets. The appointment of more buy-side members onto the ICMA Board, like myself, will allow a more balanced, and hopefully fruitful, dialogue regarding market issues at Board level that will trickle down to the daily work of the association. BlackRock is already actively involved in different ICMA working groups and Committees, and engaged in furthering the debate. A platform where sell-side and buy-side can come together and discuss fully market efficiency issues, and keep abreast of market and behaviour developments, is needed in the context of changing market structures. It is key to be part of the discussion with regulators, and an association that is able to present both the sell-side and buy-side perspectives, as well as reconcile these views, will be in a strong position to provide constructive input to public authorities. The Board has made the coming together of the sell-side and buy-side constituencies a prime initiative for the association, and I hope to contribute actively to the effective implementation of this priority. ■

Times they are a-changin':

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

Andy Hill
Senior Director, ICMA

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]

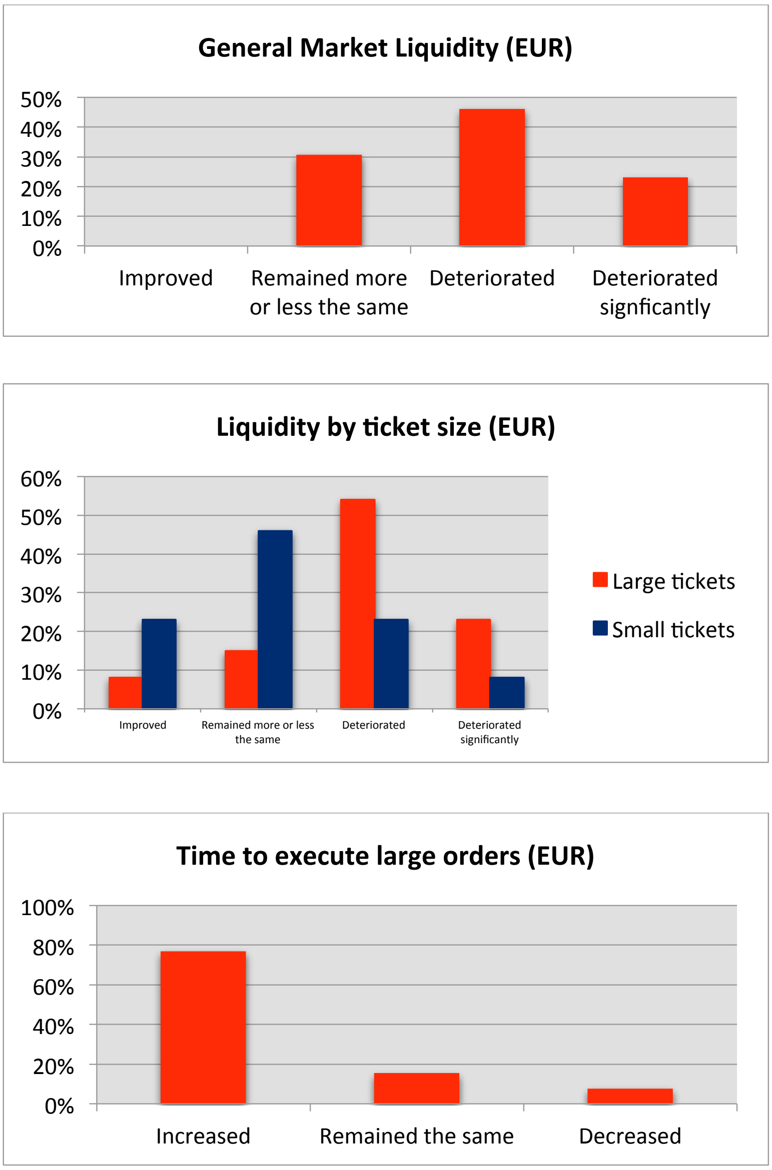
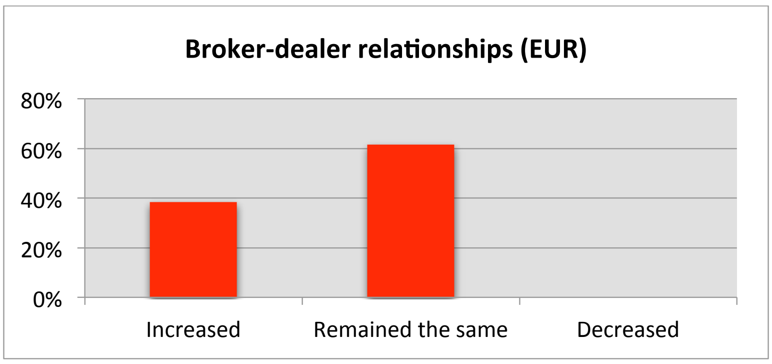
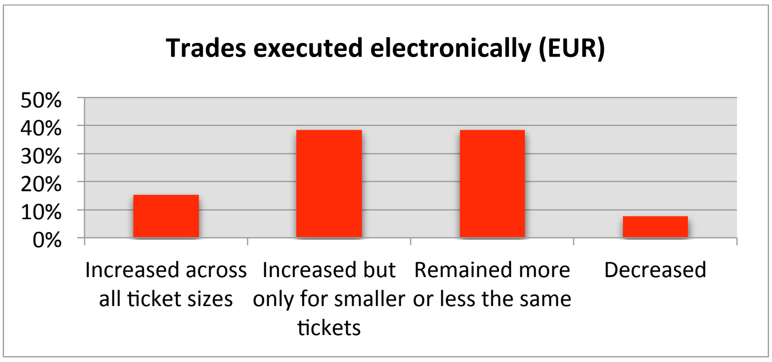


Figure 2: trends in dealer relationships over past 12 months (EUR IG)



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.

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