

Secondary Market Practices Committee

Meeting of the ICMA SMPC, September 24th, 2019

The meeting was held at T. Rowe Price, London, and Chaired by David Camara

Attendees

In the room:

David Camara	Goldman Sachs	(Co-chair)
Aalok Gupta	BAML	
Andrew Wallhead	Barclays	
Daniel Mayston	BlackRock	
Silas Findley	Citi	
Alex Orr	Credit Suisse	
Kate Finlayson	JP Morgan	
Angela Lobo	Morgan Stanley	
Frank Cerveny	MTS Markets	
Uwe Hillnhutter	Tradeweb	
Andre Nogueira	Virtue	

Andy Hill	ICMA	(Secretary)
Liz Callaghan	ICMA	
Paul Richards	ICMA	
Rowan Varrall	ICMA	

Guests:

Ian Sloyan	ISDA
Ian Shea	Jane Street

On the line:

Chloe Ong	ANZ
Yannig Loyer	AXA IM
Virginie Saade	Citadel
Dominic Wright	Credit Suisse
Lea Bentzen	Danske Bank
Nathalie Masset	Euronext
Mattias Remnefjord	FIS
Tony Baldwin	LCH
James Carey	RBC
Tim Cole	RBC
Danny Ramos	Santander AM
Emma Loko	SIG
Paula Alves	Societe Generale
Sylvie Bonduelle	Societe Generale
Mathieu Casadevall	Societe Generale
Sharon Ruffles	SSGA
Dan Hinxman	TP ICAP/CrossTrade
Paul Cable	T. Rowe Price
Christopher Hock	Union Investment

Agenda items

1. Fixed income ETFs – market evolution and trends

Presentation and discussion led by Ian Shea, Head of European Fixed Income Trading at Jane Street

Fixed income exchange traded funds (ETFs) have grown at a rapid pace over the last 11 years. Much of this growth has taken on an exponential trajectory starting in the early 2010's. In the US, ETF assets under management (AUM) have grown from \$605bn in 2007 to \$3.8tn in 2019. In the same time fixed income ETF AUM has grown from \$35bn to \$770bn, while the number of FI ETF products has increased from 39 to 389, although new products can come and go quickly.

In terms of sourcing ETF liquidity, RFQ (request for quote) adoption is continuing to grow globally, particularly for block trades. However, APAC respondents report much lower utilization. Asia has displayed a historical preference for working orders through chat (40%) and telephone (24%). With the fragmented liquidity of many, ETFs, given their multiple listings, RFQ's can help investors in evidencing best-execution. The primary drivers of growth are workflow efficiency, the desire to see competitive quotes, and (particularly in Europe) regulation.

Secondary market liquidity is either on exchange, quoted similar to equities, or off-exchange, which tends to be more like fixed income with market makers committing capital. The former tends to be more suited for smaller trades, while the latter tends to facilitate block trading. Primary market liquidity is enabled by the creation and redemption process. Authorised participants (APs) are the only entities that interact directly with the ETF issuers. APs receive requests from market makers to create ETF shares. The AP then facilitates this request by delivering underlying securities to the ETF issuer, who provides the EFT shares to the AP. In the case of redemptions, the market maker will pass ETF share to APs, who in turn deliver the ETF shares to the ETF issuer, who redeems the shares and delivers underlying securities to the AP. It should be noted that the AP can also be a market maker.

In the creation and redemption process, the APs and ETF issuers do not exchange the full basket of securities underlying the ETF. Rather they exchange a smaller, proxy basket which will have a high correlation (low tracking error) with the ETF basket. The creation and redemption process also ensure that the price of the ETF is closely related to the net asset value (NAV) of the underlying portfolio

Data shows that volumes in ETF trading tend to increase during times of volatility, suggesting that they provide a second level of liquidity to which market participants can turn when liquidity in the underlying market is stretched. Other benefits of ETFs include the ability to increase or decrease beta exposure quickly, an efficient means to transfer risk, and a useful price discovery tool.

Discussion

It was asked whether fixed income ETFs tended to be more standardized than equity ETFs. It was explained that the range of equity ETFs is far broader, and includes more bespoke underlying baskets,

while fixed income ETFs tend to be based on more standardized indices, such as the various global aggregates.

The question of automation was raised. It was suggested that in the redemption and creation process, where possibly hundreds of securities (in small sizes) are exchanged between the AP and issuer, the underlying trading of these bonds is highly automated, and so there is a lot of technology underpinning ETF trading.

The relationship between NAV and the ETF price was queried, and how stable this is. While the redemption and creation process ensure that the NAV and price do not deviate too much, in stressed markets it may be difficult to get a true value of the NAV. However, there will still be a bid for the ETF (from market makers), which will provide investors with a facility to liquidate as well as a means to value the underlying securities.

Members discussed liquidity. The view was that there was generally a healthy secondary market for ETFs, including for block sizes. It was much easier for retail to access the market, with tighter bid-ask spreads than mutual funds. There was also good transparency, and a broad range of buyers and sellers with different strategies and motivations. The fact that ETFs offer far more product standardization and homogeneity than the underlying securities also helps, as does the additional layer of liquidity that comes from the creation and redemption process.

2. Common Domain Model

Briefing and Q&A led by Ian Sloyan of ISDA

The ISDA Common Domain Model is a machine-readable and machine-executable data model for derivatives products, processes, and calculations. The objective of ISDA CDM is to standardize how derivatives are traded and managed through their lifecycle. This will help to reduce the costs associated with current manual processes, especially related to:

- trade affirmation and trade management,
- collateral management,
- regulatory reporting,
- reconciliations,
- exercises and settlements,
- portfolio compression,
- novation and transfers.

The catalyst for the CDM has come from the fact that over time, each firm has established its own systems and its own unique set of representations for events and processes that occur during the life of a trade. This has no commercial advantage. On the contrary, it results in firms continually reconciling their trades—a big drain on resources. It also curtails the potential for greater automation, resulting in increased operational risk. New technologies offer the potential for greater automation and efficiency, reducing complexity and costs. But effective automation can only be built on standardization.

Derivatives market participants are looking at ways to reduce costs and improve the efficiency of back-office processes. An opportunity exists to create standards that support innovation and promote the adoption of new technologies.

The ISDA CDM 2.0 is the full version of the ISDA Common Domain Model for interest rate and credit derivatives, made available to market participants and technology providers to adopt, implement and deploy in their own projects. This version of the CDM is open to all market participants under an open license, allowing firms to use the model without charge.

The ISDA CDM enables interoperability between systems and services, removing burden of setting up connections to different systems or entities, laying groundwork for straight-through processing. It further promotes transparency and alignment between regulators and market participants (facilitating direct regulatory reporting), and it will also help to speed up development of new solutions for the market by allowing providers to focus on what they specialize in –the technology –rather than requiring them to interpret and represent market events and processes individually. The resulting technology solution will also be interoperable with other offerings which are using ISDA CDM.

ISDA explained that they are currently working closely with ICMA to extend the scope of the CDM to include cash (bond) transactions and repurchase agreements. ICMA confirmed that this was a key strategic priority and that it was actively seeking the engagement and cooperation of members in developing the CDM for cash and repo markets.

In answer to a question on adaptation, it was explained that originally it had been anticipated that the banks would be the main drivers with a view to benefiting from the potentially significant efficiency gains and cost savings. However, most of the impetus seems to be coming from the vendor community, perhaps with one eye on the advantages with respect to standardized connectivity.

The SMPC members agreed that this was a valuable initiative, that the market and related technologies were in much need of greater standardization, and that ICMA should continue to work with ISDA to develop and extend the scope and benefits of CDM across the entire market.

3. Consolidate Tape for fixed income

Briefing

Liz Callaghan (ICMA) updated the SMPC on the recent ICMA response to the ESMA consultation on consolidate tape and on a request from the European Commission for ICMA to support its work on establishing a bond market consolidated tape in the EU.

On September 5, 2019, ICMA responded to the ESMA Consultation Paper on the *MiFID II/R review report on the development in prices for pre- and post-trade data and on the consolidated tape for equity instruments*. While the consultation focused primarily on the development of a consolidated tape for equity markets, ICMA saw this as an opportunity to articulate members' views on the importance of developing an affordable, usable, single-source consolidated tape for EU bond markets.

The response¹ was drafted with direct input from a dedicated taskforce of 12 firms, which were part of a larger consultative working group consisting of 63 member firms, representing sell-side, buy-side, trading venues, and data providers. Members also viewed this as an opportunity to outline the market specific considerations that underly the creation of an appropriate consolidated tape for fixed income, and the importance of recognizing the differences in instrument characteristics and valuation dynamics between equities and bonds.

In September 2019, ICMA was asked by the European Commission to assist its work in reviewing the regulatory parameters and assessing the feasibility of implementing a consolidated tape for EU bond markets. The European Commission further asked that ICMA work with its diverse membership to produce an “intelligence report” that seeks to address four specific topics:

- (i) The importance of an EU consolidated tape in bond markets
- (ii) An in-depth study of FINRA’s Trade Reporting and Compliance Engine (TRACE), including observations and market impacts
- (iii) An understanding of the current state of play regarding post-trade data operation and aggregation
- (iv) An understanding of the desired ‘end-state’ for an EU bond consolidated tape, including operating model

The final report is due at the end of Q1 2020. In the meantime, ICMA committed to providing an interim report to the European Commission by December 15, 2019. This would also be an opportunity to receive feedback from the European Commission on the scope and content of the report, and to identify areas for further development as well as any critical information gaps that can be addressed in the Final Report.

Liz Callaghan was currently in the process of mobilizing a project ‘taskforce’ to undertake the work required in producing the interim report. This would be made up of sell-side, buy-side, trading venue, and data provider representatives. SMPC members

4. Benchmark reform

Briefing

Paul Richards (Head of Market Practice and Regulatory Policy, ICMA) updated the SMPC on recent developments in the global initiatives related to benchmark reform, particularly from the perspective of bond markets.

Since Andrew Bailey, the Chief Executive of the FCA as regulator of LIBOR, announced in July 2017 that the FCA would no longer intend to persuade or compel banks to submit contributions for LIBOR after the end of 2021, considerable progress has been made in transitioning from LIBOR to near risk-free rates² in

¹ See: www.icmagroup.org/assets/documents/Regulatory/MiFID-Review/ESMA-CP-on-CT-ESMAMDAICMARESPONSEFORM-5-Sept-2019-060919.pdf

² In all the main jurisdictions, the chosen risk-free rates are overnight rates: ie SONIA in the UK; SOFR in the US; €STR in the euro area; SARON in Switzerland; and TONA in Japan. A common objective is to make risk-free rates as robust as possible, with robustness measured primarily by the volume of underlying observable transactions.

the bond market, in particular in the UK through the adoption of SONIA in new bond issues. Since June 2018, 82 new FRNs referencing SONIA have been issued with a value of £40 billion; and 25 distributed securitizations with a value of £10 billion. These transactions have all used the same market conventions: overnight SONIA compounded over the interest period, with the margin added, and with a five-day lag before the end of each interest period.

But challenges remain. The biggest challenge in the bond market is how to handle legacy bonds referencing LIBOR

Following the adoption of SONIA, new public issues of sterling FRNs are now referencing SONIA rather than LIBOR. Consequently, there is no longer a need for fallbacks from sterling LIBOR to SONIA in new bond market documentation. But fallbacks already used in legacy bond contracts referencing sterling LIBOR complicate the transition to risk-free rates in the bond market, as many will fall back to a fixed rate when LIBOR is permanently discontinued.³ These fallback clauses are of three main types:

- *Type 1:* Before Andrew Bailey's speech in July 2017 announcing the potential discontinuation of LIBOR after the end of 2021, most FRNs referencing sterling LIBOR include fallbacks which do not contemplate the permanent discontinuation of the original rate and rely on the application of the last available rate. When LIBOR is permanently discontinued, such fallbacks will result in the rate being fixed for the remaining life of the bond. Some legacy bonds may have no fallback provisions at all.⁴
- *Type 2:* Since July 2017, many FRN fallback clauses referencing sterling LIBOR have been drafted to take account of the permanent discontinuation of LIBOR and provide for the application of a successor or alternative rate.
- *Type 3:* Some more recent FRN fallback clauses referencing sterling LIBOR also take account of a possible future declaration by the FCA that LIBOR is no longer representative of its underlying market and so apply on the basis of this "pre-cessation" trigger

The Risk-Free Rate Working Group in the UK is encouraging the transition of as many legacy sterling LIBOR bonds as possible to SONIA using market-based solutions, with the objective of reducing dependence on LIBOR and taking LIBOR risk out of the financial system. This is because LIBOR is certain to end, but it is not at this stage clear whether it will be possible to introduce legislation to solve the legacy sterling LIBOR bond problem.

One way of addressing the legacy sterling LIBOR bond problem is to amend the interest rate provisions in bond contracts through a process of consent solicitation. This is an existing market practice for individual bonds. Issuers can propose to undertake consent solicitations if and when they wish. Successful completion is dependent on consent thresholds being met by investors. Following ABP's pioneering transaction in June 2019, seven other consent solicitations have been successfully completed by Lloyds Banking Group, Santander and Nationwide with a value of over £4 billion.⁵ Successful consent

³ This is also the case with legacy FRNs referencing US dollar LIBOR.

⁴ Where derivatives are used to hedge legacy bond contracts which fall back to a fixed rate when LIBOR is permanently discontinued, there may be a hedging mismatch, as derivatives will fall back to an alternative rate in accordance with their own terms.

⁵ Figures to mid-November 2019.

solicitations, and other liability management exercises – such as bond exchanges or buy-backs – reduce the amount of legacy sterling LIBOR bonds outstanding.

Where sterling LIBOR is replaced by SONIA for outstanding legacy bonds, a fixed credit market adjustment spread is needed to address the economic differences between LIBOR and SONIA.⁶ The credit adjustment spread used in consent solicitations to date is a market rate using the forward-looking basis swap market over the relevant period. This forward-looking market rate for consent solicitations taking place between now and permanent discontinuation of LIBOR is expected in the market over time to converge on ISDA's proposal for a fixed adjustment spread based on a backward-looking historic mean/median approach, which would apply on the permanent discontinuation of LIBOR.

Finally, as LIBOR is used globally in contracts governed by a range of different laws in different jurisdictions, official intervention would preferably need to be agreed internationally and coordinated globally (eg by the FSB Official Sector Steering Group) for all jurisdictions using LIBOR, especially the US, which would represent the largest component.⁷ Work would take a considerable period to plan, and the market would need to be consulted.

5. ESMA's stress test simulation for investment funds

Briefing and discussion

Arthur Carabia (ICMA, secretariat of the Asset Management and Investors Council) updated the SMPC on ESMA's recently published stress test simulation for investment funds.

Following recommendations from the FSB,⁸ ESMA issued on September 5, 2019 its first sector-wide stress test simulation for bond funds.⁹

The first part of the report gives an overview of stress simulation in the fund industry: stress tests as a risk management tool, stress-tests performed by supervised entities according to supervisory scenario and stress simulations led exclusively by supervisors. It is worth noting that in this part ESMA recalls that "as highlighted by the FSB (2017), investment funds (IF) have generally not caused financial stability concerns in recent periods of stress and heightened volatility, with the exception of some money market funds. However, given their sheer size, it is important to ensure that any risks stemming from IF are properly understood and addressed."

The second part of the report consider modelling options available for sector wide simulation, depending on the objective and data constraints. To ensure that the simulation remains realistic the report formulates guiding principles on the three main components of the stress simulation: (1) definition of the redemption shock: historical vs event study

⁶ A dynamic spread has been ruled out. See: Andrew Bailey, *LIBOR: Preparing for the End*, New York, 15 July 2019.

⁷ It is understood that there are no current plans to replace EURIBOR.

⁸ [FSB Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities 2017](#)

⁹ [ESMA Economic Report Stress simulation for investment funds 2019](#)

(2) impact of the shock on IF: assessment of the liquidity of IF (HQLA vs time to liquidation), liquidation approaches (slicing vs waterfall), ability of IF to face large redemptions (redemption coverage ratio vs fund liquidity coverage ratio)

(3) impact on markets and investors: price impact, fund liquidity channel and second round effects.

The last part covers the actual simulation conducted by ESMA. The European supervisor has used a sample of around 6,600 UCITS funds (EUR 2,500bn NAV) investing primarily in fixed-income instruments (“since they are the more likely to face a liquidity mismatch than equity funds”) and classified into five categories: High-Yield, Emerging bond, euro fixed-income, global fixed-income and mixed funds. The simulation concludes that:

(1) impact on IF: “overall most funds are able to cope with such extreme but plausible shocks, as they have enough liquid assets to meet investors’ redemption requests. However, pockets of vulnerabilities are identified, especially for High Yield (HY) bond funds. Under the severe but plausible assumptions of our simulations, up to 40% of HY bond funds could experience a liquidity shortfall (...).”

(2) impact on markets and investors: “overall price impact is limited for most asset classes, as sales by funds are only a fraction of aggregate trading volumes. However, for asset classes with more limited liquidity, such as HY bonds and Emerging Markets (EM) bonds, fund sales could have a material impact, ranging from 150 to 300 basis points, and generate material second round effects.”

ESMA suggests these tests could be conducted regularly and that assessment for AIFs could come at latter stage. It is important to highlight that the results does not conduct ESMA to recommend any policy/regulatory changes or definitive conclusion but is rather meant to inform asset managers and supervisors of the potential need for mitigating actions, including the use of liquidity management tools which are not taken into consideration for the purpose of the simulation. If ESMA points that this report could be used by regulators to simulate stress situations for different segments of the fund industry it also acknowledges in conclusion that the “modelling choices have had material impact on the results obtained.” ESMA indeed relies on HQLA to assess the liquidity profile of investment funds although it explains in the report “the HQLA approach penalizes funds investing in less liquid asset classes (HY and EM bond funds), and the HQLA measure might not adequately represent the level of liquidity risk faced by the fund.”

SMPC members, in particular buy-side participants, were asked to provide any thoughts or concerns that they or their firms may have on ESMA’s approach to the simulation, especially related to the reliance on HQLA to assess liquidity profiles.

6. ICMA’s 3rd study into the state and evolution of the European IG corporate bond secondary market

Update

Andy Hill (ICMA) updated the SMPC that while the underlying research and analysis for the study was now completed, due to a growing list of priorities and limited resources, the final study was unlikely to be published by the end of 2019, and would probably be published in Q1 2020. He confirmed that participating firms would receive advance copies for review and comments.

7. Working group updates

ETC & MiFID II WG

Liz Callaghan updated the group that as a result of the European Commission's request to produce a report exploring the feasibility of an EU Consolidate Tape for bonds, and the tight deadline in which to produce this, which would fall under the broader remit of the MiFID II/R Working Group, the ongoing work of the Electronic Trading Council would be pushed back until later in the year. However, the ETC would remain focused on delivering the projected white paper on automation and algorithmic trading in the bond market, and also best practice for electrified distribution.

CSDR-SD WG

Andy Hill updated the group on the ongoing work of the CSDR-SD WG. From an implementation perspective, the WG has continued to engage with AFME and others to draw up a proposal for a potential pass-on mechanism to enhance the CSDR buy-in provisions. The WG was also still waiting on ESMA to provide Level 3 guidance that both the buy-in and cash compensation differential payments could be paid symmetrically.

The SMPC was reminded that the plan was for ICMA to update its buy-in rules (part of the SMR&Rs) to align with the CSDR requirements, as well as including additional enhancements such as symmetrical payments and a pass-on mechanism. ICMA hoped to consult with members and the broader industry in early 2020 on the revised rules. This would effectively create a contractual framework and market best practice for implementation of the buy-in requirements in the international bond markets. That fact that members (and non-members) already incorporate the rules by reference in their terms of business should make the process highly efficient.

The SMPC were also updated that ICMA was undertaking a follow-up impact study of mandatory buy-ins on bond market pricing and liquidity. This would be similar to the 2015 impact study but would be more granular in terms of underlying bond sub-classes and would also engage buy-sides and repo and securities lending desks, as well as market-makers. The plan was to publish the final report by early November.

8. AoB

There were no other points of business.

Key calendar dates

- 16-17 October 2019 [Barclays DerivHack 2019](#)
Singapore, London, New York
In partnership with ICMA
- 6 November 2019 **ICMA German Regional Membership Lunch**
Frankfurt
- 15 November 2019 **ICMA European Repo and Collateral Council General Meeting**
Hosted by Euroclear Brussels
- 26 November 2019 **Provisional date for next SMPC**
Venue tbd
- 27 November 2019 **ICMA Asset Management and Investors Council (AMIC) Conference** 12-5pm BST
Hosted by BlackRock, London
- 26 or 27 February 2020 **Provisional dates for ICMA Secondary Market Forum**
Amsterdam tbc
- 24-26 June 2020 **ICMA Annual General Meeting and Conference**
Vienna

ICMA would confirm the date and venue of the next SMPC meeting soon. The provisional date was November 26, with ICMA London the likely host.

Prepared by Andy Hill
October 2019

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