FIXED INCOME MARKET REGULATORY UPDATE

March 2017

Staying informed on recent policy and regulatory developments shaping credit markets in Canada & abroad

Canada

2017 Federal Budget Measures

On March 22, 2017, the federal government released Budget 2017, which includes details of its Debt Management Strategy for the coming fiscal year. To finance a growing budget deficit, gross bond issuance in 2017-18 is expected to be $142 billion—an increase of about $7 billion from 2016–17 levels. Total borrowings, which includes treasury bills and foreign currency issuance, is projected to reach $286 billion. No changes from the prior year are planned to the bond maturity pattern or benchmark target range sizes. The government's *Debt Management Strategy for 2017–18* continues to have an increased focus on the issuance of short- and medium-term bonds (2-, 3- and 5-year maturities). The number of planned auctions in the 2-year sector is 16, while eight auctions are planned in each of the 3-year and 5-year sectors. This strategy promotes liquidity in the short-end of the market while also satisfying the government's objectives of achieving stable, low-cost funding. Also noted in the Budget, the government may issue ultra-long bonds on a tactical basis if they are seen to contribute to the government's debt strategy objective of stable, low-cost funding, and if market conditions are favourable.

The government also announced it will discontinue the sale of Canada Premium Bonds (CPBs) and Canada Savings Bonds (CSBs) as of November 2017. The Canada Savings Bonds Program is no longer a main component of the federal debt management strategy given the overall decline in sales, the access to alternative investment vehicles for retail investors and the administration and management costs of the program.

Budget 2017 also targets tax treatment of certain derivative transactions. The government is proposing a rule targeting "straddle" transactions as well as allowing mark-to-market elections when derivatives are held on income account.

Canada's Implementation Timeline for the Net Stable Funding Ratio (NSFR)

On March 6, 2017, the Office of the Superintendent of Financial Institutions (OSFI) announced that it intends to extend the domestic implementation timeline of the NSFR by one year to January 2019. OSFI's decision largely stems from the increased likelihood that key foreign jurisdictions will not be able to implement the standard by the initially targeted January 2018 period. OSFI also indicates that they plan to meet with industry stakeholders in the coming months to review its guideline implementation plans and to clarify the remaining details of the NSFR rules as they relate to the Canadian market.

OSFI's decision to defer NSFR implementation helps ensure Canadian market participants are not disadvantaged by an otherwise earlier adoption of NSFR relative to competing jurisdictions. The stakeholder consultation announced by OSFI also provides an opportunity for market participants to further engage OSFI in dialogue surrounding the potential effects of NSFR on market functioning.

United States

T+2 Settlement Cycle for Securities Transactions

On March 22, 2017, the Securities and Exchange Commission adopted an amendment to shorten the standard settlement cycle for most broker-dealer securities transactions including bonds and municipal securities from three business days (T+3) to two (T+2). The amended Rule 15c6-1(a) would prohibit a broker-dealer from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than T+2, unless otherwise expressly agreed to by the parties at the time of the transaction. Currently, the standard settlement cycle for these transactions is three business days. The amended rule is designed to enhance efficiency, reduce risk, and ensure a coordinated and expeditious transition by market participants to a shortened standard settlement cycle. Broker-dealers will be required to comply with the amended rule beginning on Sept. 5, 2017, which is consistent with the target implementation date set by the Industry T+2 Steering Committee.

House Committee Hears Volcker Rule Testimony

On March 24, 2017, the House of Representatives' Subcommittee on Capital Markets, Securities, and Investment held a hearing entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation". According to the Staff Memorandum, the objective of the hearing was to examine the impact of the Volcker Rule on the U.S. capital markets broadly, including its impact on the liquidity and functionality of the fixed income and securitization markets; the ability of U.S. and international businesses to finance their operations; U.S. competitiveness; and job creation. Representatives from industry associations, academia, and think tanks testified before the Subcommittee calling for revisions or repeal of the Volcker Rule. Speaking on behalf of the Securities Industry and Financial Markets Association (SIFMA), Ronald Kruszewski, chairman and CEO of Stifel Financial, called for a reversal of language forcing firms to prove that trades were not proprietary as well as clarification of vague or undefined terms in the regulation. An archived webcast of the testimony is available here.

In 2016, the House of Representatives introduced the Financial CHOICE Act, a Republican alternative to Dodd-Frank, which included various repeals including to the Volker Rule. There are little prospects for the proposal to make its way successfully through the Senate; however, it promotes a revisit of Dodd-Frank by the House and Senate. Any amendments will, however, take time. In the interim, new administration at the SEC have indicated greater emphasis on capital formation rather than enforcement. This may give some comfort to market participants who have found full compliance with complex legislation such as Volker difficult and have relied on a best efforts approach.

Europe

London Stock Exchange's New Venue for Primary Debt Issuance

The London Stock Exchange Group (LSE) has announced plans to launch a new facility, the International Securities Market (ISM), for primary debt issuance. The facility aims to promote liquidity in the market by offering global issuers a new listing option, while also providing institutional and professional investors with a place to access new debt issues. The exchange-regulated multilateral trading facility (MTF) market will operate alongside LSE's other markets. LSE will publish a market consultation on the ISM's proposed rulebook, prior to the launch of the ISM expected in Q2 2017.

International

Basel Committee Publishes Basel III Monitoring Results

The Basel Committee on Banking Supervision published its latest Basel III Monitoring Report based on data as of June 30, 2016. The report includes some analysis of the capital impact of the *Fundamental review of the trading book* (FRTB). Concerns have been raised by market participants over the Report's FRTB impact assessments. Specifically, critics argue that the forecast figures may underestimate the likely increase in minimum capital requirements stemming from FRTB.

Basel Committee Issues Second Set of FAQs on the Net Stable Funding Ratio

The Basel Committee on Banking Supervision has issued a second set of frequently asked questions (FAQs) and answers on Basel III's Net Stable Funding Ratio (NSFR). These respond to a number of interpretation questions received by the Basel Committee related to the October 2014 publication of the NSFR standard. The aim of the FAQs is to promote consistent global implementation of the NSFR requirements.

Research Corner

BIS Releases Working Paper on FX Liquidity

The Bank for International Settlements (BIS) Monetary and Economic Department released a working paper entitled "Foreign Exchange Liquidity in the Americas." The report discusses FX liquidity metrics and their drivers, reaching four conclusions. First, changes in FX markets have reduced the usefulness of some conventional FX liquidity metrics; several metrics need to be assessed together to give a better picture of market liquidity. Second, some metrics suggest that liquidity in FX markets has declined during some recent episodes of market stress. Third, technology appears to have changed liquidity dynamics—enhancing liquidity in normal conditions and offsetting the impact of market fragmentation, but also adding to FX volatility in stressed market conditions. Fourth, the impact of post-crisis regulatory change on FX market liquidity remains unclear and requires further study.

IOSCO Report on Secondary Corporate Bond Market Liquidity

A report published by the Board of the International Organization of Securities Commissions (IOSCO) indicates no substantial evidence showing that liquidity in the secondary corporate bond markets between 2004 and 2015 deteriorated markedly from historic norms for non-crisis periods.

The report concludes that while some of the relevant metrics (turnover ratio, dealer inventories, and block trade size) might indicate potential signs of lower liquidity, most metrics reviewed show mixed evidence of changes in liquidity (bifurcation of trading, average trade size, and average number of counterparties or market makers) or some evidence of improving liquidity (trading volume, bid-ask spreads, and price-impact measures).

The report, however, also notes that the level of post-trade transparency (i.e., publicly released data concerning executed trades) in the corporate bond markets may impact liquidity. IOSCO has mandated a committee to review regulatory reporting and transparency in the corporate bond markets to examine the relationship between transparency and liquidity and the decisions regulators have made to address it (volume caps, delayed dissemination, etc.)