FIXED INCOME MARKET REGULATORY UPDATE

May 2017

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

Canada

Bank of Canada Review

On May 11, 2017, the Spring 2017 edition of The Bank of Canada Review was published. Among the topics covered were insights on the effectiveness of some unconventional monetary policies (such as quantitative easing and negative interest rates) in a small open economy, how Government of Canada bonds are used throughout their life cycle, and how and why the Big Six Canadian banks choose their funding strategies.

Some of the key observations in the Review include:

- When conventional monetary policy is close to its limits, fiscal policy may be a more important complement to monetary policy in a small economy, particularly if global demand for safe assets compresses long-term interest rates.
- Shorter-term bonds are more prevalent in the repo market, while longer-maturity securities are more active in the securities lending market. Government of Canada securities play the most important role in core funding markets in Canada. From 2010 to 2015, they were used as collateral for more than 80 per cent of repo trade volume, constituted 60 per cent of all Canadian debt securities traded in the cash market and represented about 65 per cent of fixed-income securities on loan.

IIROC Proposed Provisions Respecting Client Identifiers

On May 17, 2017, the Investment Industry Regulatory Organization of Canada (IIROC) published for comment proposed rules aimed at boosting market surveillance by requiring firms to identify the clients involved in trades. The proposed amendments to UMIR and Dealer Member Rules would require client identifiers on each order sent to a marketplace and each reportable trade in a debt security. Dealer Members would need to provide client identifiers using a Legal Entity Identifier (LEI) for clients eligible to obtain an LEI or their account number for clients not eligible to obtain an LEI. The proposal would replace existing LEI requirements IIROC has in place in Rule 2800C.

In addition, IIROC proposes to introduce designations under UMIR to flag orders that are i) sent using direct market access, ii) entered under a routing arrangement and iii) entered through an order-execution only service.

The release of client identifiers to IIROC raises several questions on how the information will be used and how the privacy of client information will be preserved.

IIROC acknowledges the impact of the proposal on its dealer members and other stakeholders could be significant as systems and processes would have to be developed to comply with the proposed rules. Accordingly, IIROC seeks comments on potential costs, impacts and alternative approaches for consideration. However, what is likely to be the biggest issue is client acquiescence. The IIROC consultation will include at least two rounds of comments.

United States

Financial CHOICE Act

House Financial Services Committee Chairman Jeb Hensarling (R-TX) introduced the Financial CHOICE Act, which is the Republican alternative aimed at abolishing many aspects of the Dodd-Frank Act. The Financial CHOICE Act addresses areas including taxpayer-funded bailouts of large financial institutions; penalties on those who commit financial fraud and insider trading; greater accountability from Washington regulators, and regulatory relief for well-capitalized banks. In a statement, Treasury Secretary Steven T. Mnuchin welcomed the bill's reintroduction and applauded the work of House Financial Services Committee Chairman Jeb Hensarling (R-TX) and his colleagues.

However, Democrats have been very critical of the bill. While the House Financial Services committee is expected to advance the bill to the House floor, it is highly uncertain whether it will make it to President Trump's desk given concerns some Republicans have also expressed on aspects of the bill.

U.S. Ultra-Long Bonds

U.S. Treasury Secretary Steven Mnuchin has indicated a strong probability that the U.S. government will pursue the sale of ultra-long bonds to help finance infrastructure financing plans. Market participants, however, have expressed serious reservations about the government's plans. In a May 3, 2017 letter to Mnuchin, the Treasury Borrowing Advisory Committee, a group of financial market experts on the government bond market, said that a 100-year bond is not worth considering. One ultra-long issue that the letter states might be worth investigating further is a zero-coupon ultra (e.g., 50-year STRIPS). This product would provide pensions and insurers a security to maximize duration per unit of portfolio market value. There would, however, be several issues that would need to be addressed, including tax issues, potential complications with the government debt limit, and systems development. Few jurisdictions globally have demonstrated success with the development of an ultra-long bond program but should the U.S. proceed with this plan it will undoubtedly be highly monitored by other sovereign issuers.

CFTC Looking to Simplify and Modernize Commission Rules

The U.S. Commodity Futures Trading Commission (CFTC) is seeking input from industry, other stakeholders and interested parties, and the broader public on where the CFTC rules can be simplified and made less costly to comply. CFTC Acting Chairman J. Christopher Giancarlo initially announced Project KISS, which stands for "Keep It Simple, Stupid," in March as an agency-wide internal review of CFTC rules, regulations and practices.

Earlier this year President Trump issued an executive order furthering his regulatory reform agenda to stimulate economic growth. The President's executive order directed federal agencies to designate a Regulatory Reform Officer and establish a Regulatory Reform Task Force. While the CFTC is not directly covered by the President's order, Mr. Giancarlo said the agency will review all CFTC rules with the goal to reduce regulatory burdens and costs for participants in the markets the agency oversees.

Europe

Bank of England Releases UK Money Markets Code

The Bank of England released a new voluntary UK Money Markets Code, setting out the standards and best practice expected from participants in the deposit, repo and securities lending markets. The Code supersedes and substantively updates existing guidance for participants in these markets. The Bank of England's Money Markets Committee (MMC)—comprised of market participants from a wide range of banks, other financial and non-financial institutions—has endorsed the Code.

The Code is underpinned by the key principle that participants should always act in a manner to promote the integrity and effective functioning of these markets. It also outlines six high-level principles including ethics, governance, risk management, confidentiality, execution and settlement.

Euribor Changes Stall

In the aftermath of the various benchmark scandals, the European Money Markets Institute (EMMI) announced plans to reform its Euribor methodology to anchor it in real market transactions. On May 4, 2017, EMMI announced that analysis it conducted to determine the feasibility of a seamless transition to a transaction-based Euribor concluded that under the current market conditions it will not be feasible to seamlessly evolve the current Euribor methodology to a fully transaction-based methodology. Over the coming months EMMI will focus instead on developing a hybrid methodology, supported by transactions whenever available and relying on other prices when necessary. The EMMI believes this hybrid approach will be better capable of adapting to the prevailing market conditions. On the heels of the EMMI announcement, the European Central Bank has indicated it will consider launching its own index of lending between banks. The European Securities and Markets Authority (ESMA) and the Financial Services and Markets Authority (FSMA) of Belgium also issued a joint statement acknowledging the EMMI decision and indicating that the college of Euribor will continue to engage with EMMI on alternative plans for Euribor reform and transition.

EU Reaches Agreement on Reviving Securitization Market

The European Parliament, the Council and Commission have agreed on a package that sets out criteria for simple, transparent and standardized securitization (STS). The deal is viewed by the European Commission as pivotal for building a single market for capital in the EU while extending the benefits of the securitization market to the real economy. The new regulatory framework agreed by co-legislators sets out a risk-sensitive, transparent and prudential treatment of securitization. At the same time, the package also ensures an appropriate capital treatment of securitization instruments in general. Next steps will include further technical talks to finalize the text to be contained in the package. An important objective of EU regulators is to restore an important funding channel for the EU economy without endangering financial stability.

Repricing Risks in Fixed-Income Markets

In its latest Financial Stability Review, the European Central Bank indicates repricing risks in fixed income markets remain significant but financial market stress overall is largely contained. Significant vulnerabilities do, however, remain for euro area banks according to the report, which sites several pressures on bank profitability including low interest rates, large stocks of non-performing loans, structural challenges and cost-inefficiencies. A prolonged period of geopolitical uncertainty could also hamper economic growth and lead to higher risk premiums. This would increase funding costs and could trigger debt sustainability concerns in some countries.

New Issue Standards for Fixed-Income

On May 2, 2017, the FICC Market Standards Board (FMSB) published final guidelines that clarify expected behaviour during the new issue process for fixed-income bonds in Europe. The standard covers a range of topics from the granting of a mandate to the publication of deal statistics.

Some of the main proposals in the standard are that:

- Lead banks should make their allocation policies, or a summary, available to issuers and all market participants.
- The issuer's preferences should be taken in account when deciding the allocation policy for a deal.
- Lead banks should disclose publicly to all market participants their general policy, or a summary, for how they select investors for market soundings and roadshows.
- Investors should only submit clear orders which are a true reflection of their demand.

The new standard is intended to apply in respect of all best efforts syndicated offerings of fixed-income bonds in the European wholesale markets, including investment grade, high yield, securitized and emerging market debt.

Asia-Pacific

HKMA and SFC Consult on OTC Derivatives Regulatory Regime

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have issued a joint consultation on the prescription of additional markets and clearing houses for the purpose of the over-the-counter (OTC) derivatives regulatory regime. The consultation is in response to a recent request from market participants that certain products be excluded from the second phase of mandatory reporting scheduled to take effect July 1, 2017.

The proposed prescriptions seek to address the concerns raised by excluding the following products from the definition of "OTC derivative product", and consequently from the mandatory reporting obligation:

- products traded on, and cleared through, the additional markets and clearing houses proposed to be prescribed; and
- Delta One Warrants, a certain type of warrant with a strike price set at zero or near zero.

HKMA and PBOC Approve Establishment of Bond Connect Program

In order to promote the development of the bond markets in Hong Kong and Mainland China, the People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) have announced the establishment of the Bond Connect Program. Bond Connect is an arrangement that will enable Mainland and overseas investors to trade bonds tradable in the Mainland and Hong Kong bond markets through connection between the Mainland and Hong Kong Financial Infrastructure Institutions. Bond Connect will abide by the relevant laws and regulations of the bond markets of the two places. Regulators of the Hong Kong and Mainland bond markets will enter into a memorandum of understanding on supervisory cooperation to establish effective supervisory controls over the Bond Connect Program.

Global

FX Global Code of Conduct Released

On May 27, 2017, the Foreign Exchange Working Group (FXWG), a partnership of central banks and Market Participants from 16 international jurisdictions, set up by the Bank of International Settlements (BIS) in the wake of scandals that plagued the Forex market between 2013 and 2014, released the FX Global Code of Conduct ("Code"). The Code represents a single set of global principles of good practice for the wholesale FX market which cover 6 main areas: ethics, governance, information sharing, execution, risk management and compliance. The Global Code will be promoted, maintained and regularly updated by the Global Foreign Exchange Committee, a forum set up to encourage greater openness and transparency in the forex market. Given the widespread support the Code has garnered from many central banks around the world we should expect to see heightened activity within local jurisdictions aimed at raising awareness of the Code and for putting it in practice. It remains to be seen whether a similar global code is developed for fixed-income markets. However, any fixed-income code will similarly require the concerted efforts and alignment among central banks.

Research Corner

Shadow Banking

On May 10, 2017, the Financial Stability Board (FSB) published the *Global Shadow Banking Monitoring Report 2016*. The report presents the results of the FSB's sixth annual monitoring exercise to assess global trends and risks in the shadow banking system, reflecting data up to the end of 2015. The Report shows that the global shadow banking business grew 3.2% in 2015 and driven largely by the growth of money market, real estate and bond funds. Shadow banking represents the equivalent to 13% of total financial system assets and 70% of GDP of the jurisdictions covered in the Report.

Regulations Reducing Bond Activity

According to a blog posted on May 24, 2017 by researchers at the N.Y. Fed, rules enacted in the wake of the financial crisis have had an adverse impact on bond-level liquidity. By limiting the ability of regulated institutions to increase their balance sheet size, reforms—such as the Dodd-Frank Act in the U.S. and the Basel Committee's Basel III bank regulations internationally—might reduce the total intermediation capacity of the financial system during normal times states the blog post. The researchers utilized TRACE data to construct trade-based measures of corporate bond market liquidity and to capture dealers' trading activity.