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LETTER FROM THE PRESIDENT

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Global Credit Markets: Prospects for Increased Fragmentation, Looming Brexit and Liquidity Concerns

Observations at the 49th ICMA AGM & Conference | May 4-5, 2017

HIGHLIGHTS:

The global markets have coped with fragmentation across OTC derivative markets from the outcome of the G20 reforms. The Brexit negotiations, rise of protectionism and uneven deregulation of capital markets threaten more widespread fragmentation.

It is too early to predict the Brexit impact on UK single market access for financial services. Possible outcomes range from a complicated access arrangement to a financial settlement paid by the UK in exchange for single market access to Europe. What is certain is the final outcome will be a cliffhanger.

Central banks, acting through the BIS and FSB, are closely monitoring liquidity of the critical repo markets. It is as yet unclear whether or what remedial actions will be forthcoming.

In early May, I was invited to attend the International Capital Market Association (ICMA) Annual General Meeting (AGM) and Conference. ICMA represents more than 500 sell-side and buy-side financial institutions in the international capital markets. ICMA has set market conventions and standards in international debt markets for nearly fifty years.

The ICMA AGM and Conference featured keynote addresses and panel sessions that provided comment and perspective on major global market and regulatory themes.

WORRISOME FRAGMENTATION OF GLOBAL MARKETS

Global prosperity depends on open capital markets to accommodate international trade flows and cross-border investment. Highly integrated capital markets, particularly credit markets, are at risk of fragmentation from a range of factors. The European Commission has heretofore placed high priority on the integration of Europe's capital markets through the Capital Markets Union (CMU) initiative. The CMU sets out provisions to achieve greater commonality in disclosure regimes, tax systems, insolvency regimes, and securities laws across European jurisdictions to improve the functioning of capital markets.

Efforts to expand the range of funding options for SMEs, improve incentives for large and small investors, and boost capital formation and growth in Europe were the key driving force for the CMU. Further, promoting the market financing of securitized bank loans through greater standardization of disclosure would facilitate the bundling of business loans off bank balance sheets and stimulate increased lending to small business.

These efforts to strengthen European credit markets have now been put at risk. The Brexit result, the rise of populism and protectionism across Europe and elsewhere, and the push for deregulation and dismantling of existing regulations, threaten fragmentation of capital markets across Europe and across the global marketplace, resulting in the less efficient functioning of markets and higher intermediation costs.

1. Brexit

There is growing uncertainty and greater pessimism about the prospect of reaching a mutually agreeable outcome between the remaining EU27 and the UK, with signals from EU officials insisting on tough financial withdrawal terms, such as the short two-year timeframe for negotiations. On the other hand, Theresa May's call for a UK General Election on June 8 could be a positive step for negotiations, as a strong majority would give the UK government a mandate for some accommodation of EU control over immigration and jurisdiction of the European Court of Justice to retain access to the single market.

The initial UK approach to obtain access to the European single market is to establish and maintain equivalence in capital market regulation between the UK and EU27, with an independent third party resolving disputes. It is not yet clear if this would be practical, nor an accepted approach by the negotiators. An alternative is for firms engaged across the EU to have separately authorized, capitalized and staffed affiliates, both in the UK and EU27, if not authorized already.

The risks from Brexit would be greatest if negotiations fail to produce an agreement at all, and the UK must fall back on trading with the EU27 under World Trade Organization (WTO) rules–the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services

(GATS). Additionally, the majority of UK financial services legislation derives from EU directives and regulations. This could result in significant regulatory divergence between the UK and EU27, raising costs for firms operating in two separate jurisdictions rather than the single market at present, and could lead to the UK creating less stringent or different regulations—a regulatory "race to the bottom"—to attract non-European companies to the UK. It would be a cause of concern from a financial stability perspective as well as the real prospect of fragmentation of European markets. Fragmentation would be exacerbated if trading marketplaces and Central Counterparties (CCPs) are required to be domicile and operate in the EU27 area.

It is difficult to predict how the Brexit negotiations will evolve over the next two years. The consensus view is that the negotiations will go the distance, with both sides engaged in brinkmanship eventually reaching a deal in the run up to the final deadline. Related transitional arrangements would be part of the deal to avoid market and business dislocations and disruptions. One intriguing comment from a respected observer with close government relations inside Europe is that both France and Germany place significant priority on a financial settlement, with estimates from EU officials as high as 100 billion Euros, as the quid pro quo for UK access to the single market in tandem with UK immigration control and sovereignty of UK law. A sufficiently large cash settlement to the EU27 members provides scope for EU members to cushion adjustment to implement badly needed structural reforms. The talk of a withdrawal penalty has been portrayed in the British media as punishment for UK exit from the EU. However, a negotiated deal on a financial settlement could be the key to retaining a strong trade relationship between the EU27 and UK, and achieving an acceptable Brexit. Given the short negotiating timeframe, the realization of this deal would likely go right down to the wire.

2. The rise of populism and protectionism

U.S. rejection of the Trans-Pacific Partnership (TPP), stalled negotiations on a U.S.-EU Transatlantic Trade and Investment Partnership (TTIP), the re-negotiation of NAFTA and other measures to impede international trade flows in response to political and populist pressures will inhibit cross-border financial flows and decouple regional markets. This is particularly the case in North America, and across the European continent.

The outcome of recent elections in the Netherlands and France may suggest populism is on the wane; however, it will depend on how successful incumbent centrist governments are in exerting the political will to undertake necessary structural reforms, for example to labour markets and public finances, to improve private sector investment and growth.

The biggest threat to the disintegration of the EU economy and capital markets may not be the UK, but the broad implications of a continued serious divergence in broadly based economic prosperity between France and Germany, a concern highlighted in an ICMA AGM keynote speech by a prominent EU businessman. These two countries, founding members of the EU and its predecessor the European Economic Community (EEC), have been aligned over the past 60 years in building an integrated single European market and common currency zone. The continued divergence in economic philosophy and strategic policy-making in the past ten years or so, however, has caused Germany to question whether the two largest countries in the EU are still aligned. The view is that the newly elected President of France, Emmanuel Macron, has a "window of opportunity" to undertake the needed structural reforms in the French economy, to promote private sector capital formation, improve languishing productivity and stimulate growth. These reforms are a pre-condition to France and Germany taking the leadership to overhaul the Euro-zone framework, to build a proper banking union, integrated capital markets and a more integrated fiscal framework.

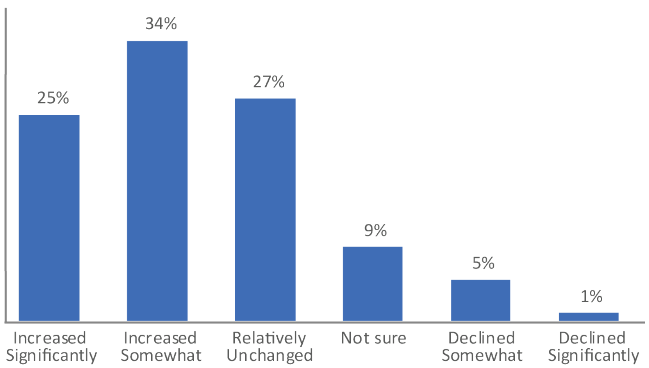
3. Deregulation and reform

The multinational regulators in the global financial markets, including the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO), and the regulators in the U.S. and Europe, are in the throes of a massive review of the existing regulations put in place in the aftermath of the 2007-2008 global financial crisis. These regulators are undertaking the necessary analysis and consultations to determine whether reforms have gone too far, weighing down global growth and setting in train unintended consequences. This process is moving at varying pace across the different jurisdictions, with considerable inertia among some regulators, recognizing the increased risks to financial stability from too sweeping a rollback of reforms. Aside from the risks of greater financial instability, the deregulation effort is further complicated by the fact it is largely uncoordinated across jurisdictions, risking fragmentation across global markets as deregulation occurs in some markets more quickly than others, resulting in the inefficiencies and costs to intermediaries, and interruption of cross-border capital flows.

CORPORATE BOND AND REPO LIQUIDITY

There is a vigorous debate, concentrated mainly among market practitioners and the regulatory community, on the evidence for weakened liquidity in debt markets. Market participants are concerned about eroding liquidity in credit and repo markets, particularly in conditions of market stress. Weaker liquidity is evident in the shrinking pool of liquid traded securities, the increased difficulty executing in large transaction size, the shift to agency trading in credit markets and the growing number of debt securities not traded at all. The results of formal quantitative analysis have been mixed, with industry-sponsored studies (PwC and Oliver Wyman) concluding credit markets are much less liquid in recent years, with regulatory studies on the same topic (SEC, IOSCO and FSB) generally concluding that liquidity has held up fairly well. Regulators, however, have acknowledged discrete liquidity problems evident in the difficulty in executing large-sized transactions and the intermittent seize-up in repo markets, particularly under stressed market conditions. The causes of the liquidity problems, however, still remain a matter of debate.

Change in the Share of Corporate Bond Trading Done on an Agency Basis Over the Past Two Years
(% of survey participants that trade corporate bonds)



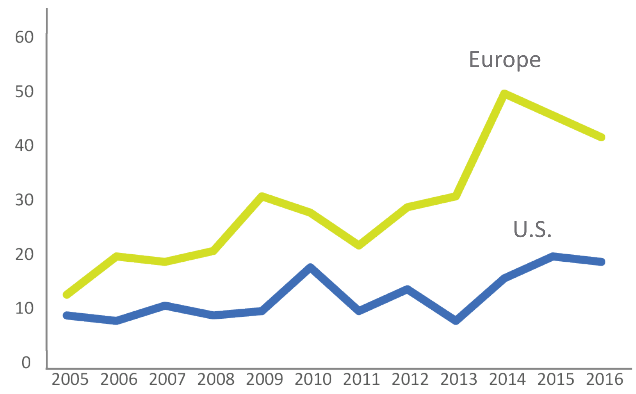
Data Source: Bank of Canada, Canadian Fixed-Income Forum (CFIF) Survey Results on Liquidity, Transparency and Market Access in Canadian Fixed Income Markets, October 2016

Market practitioners have argued further detailed analysis needs to be undertaken to reach definitive conclusions on the liquidity problem. In their view, analysis should take a more disaggregated approach, such as focussing on different categories of corporate bonds (i.e. by region, bond rating and class), and careful assessment of data integrity. In addition, qualitative surveys of secondary traded markets should supplement quantitative analysis to reach conclusions.

Market participants have identified the Basel III capital and liquidity requirements as the prime cause of the reduction in bond inventories and available collateral, contributing to reduced market-making. Regulators have taken a less definitive position, concluding that market liquidity is generally unchanged and that evidence of liquidity strains in certain markets reflects factors beyond just recent regulatory reforms, including a move to buy-and-hold portfolio strategies and weakened profitability from market-making related to the low interest rate environment. Further, even if reforms are identified as a negative factor on liquidity, regulators will be reluctant to make concessions, perceiving the costs from dismantling capital and liquidity measures and increased risk to financial stability outweigh the benefits to improved market liquidity.

There seems a consensus, even among regulators, that liquidity in repo markets are particularly vulnerable to market shocks, noting the seize-up of markets related to concerns over the outlook in China in January 2016, and a similar seize-up for other reasons at year-end 2016. The repo markets, or inter-financial system markets, facilitate market-making by enabling firms to fund long and short positions and cover short positions in the marketplace. In a low-interest rate environment, leveraged trading through effective functioning of repo markets is critical to the ongoing profitability of market-making.

Electronic Trading in Investment-Grade Corporate Bonds
(% of total market volume)



Data Source: Greenwich Associates, 2016 North American Fixed-Income Research Study

Central banks are particularly concerned about liquidity trends in the repo markets, given the importance of these markets to promote financial market-making and secondary bond market liquidity, to the transmission of monetary policy and to facilitate new issuance of sovereign bonds. In the past year the Bank of International Settlements (BIS) has undertaken a massive comprehensive study of the structure and workings of global repo markets. The Study reached no definitive conclusions on the extent of reduced market liquidity. The FSB is continuing to seek further comment from market practitioners on the evolution of these markets. It seems clear, however, that central banks, likely in coordination through the BIS, will examine carefully the causes of recent market disruptions and evidence of reduced liquidity in repo markets. If the Basel III capital and liquidity requirements, notably the Net Stable Funding Ratio (NSFR) and Supplementary Leverage Ratio (SLR), are identified as impairing the workings of the repo markets, it is possible that careful discreet adjustments could be taken to support market functioning, in a manner not to put at risk overall financial stability.

FINTECH

The ICMA conference presentations pointed to the expanding application of technology in fixed-income trading. Much of this technology has been directed to the operations of electronic trading platforms. While these platforms still account for less than 20 percent of the turnover in debt markets, market participants are increasingly turning to these platforms as a source of liquidity as traditional market-making deteriorates. Electronic trading is dominated, at present, by Bloomberg and MarketAxess, but the landscape is cluttered with many smaller electronic platforms searching for opportunity.

It has been difficult for market participants to transact in sufficient size or frequency, as desired, on all-to-all trading platforms (no restrictions on buy-side participants), reflecting the inability to identify sources of liquidity through the trading platforms. By the same token, dealer-driven trading platforms that operate on a request-for-quote (RFQ) trading basis, such as Tradeweb, limit the range of traded securities.

The biggest transformation now underway in secondary markets is the phenomenon of "liquidity intelligence", which merges the trading platform with big data. These electronic platforms provide buyers and sellers in specific securities with the precise location of pools of liquidity scattered around the bond markets, harnessing trading technology with big data and algorithms to make financial trading connections. The software offers predictive capability to track continuous bids and offers in the marketplace to identify where sources of liquidity can be found for certain bonds. Companies such as Algomi and Mosaic Smart Data are on the front lines of this emerging technology.

YEAR OF IMPLEMENTATION

2017 will be a year of regulatory implementation in European capital markets. The massive MiFID II rule-making effort has now been completed and firms are required to implement the rule package to meet the effective date of January 2018. The rule framework is complex and extensive, embracing reporting requirements for dealers, pre-trade and post-trade transparency requirements for debt and equity securities, and the unbundling of research costs typically embedded in transaction fees.

The precise details of what will be required for compliance with MiFID II is not always clear. The hurdles for full compliance with the new rules are high given the needed changes in business operations and the required IT. Moreover, the implications in terms of additional regulatory costs and unintended consequences have not been fully scoped out.

CONCLUSION

In the years following the 2007-2008 financial crisis, the key focus of global debt market participants was overreach of the regulators and structural changes in capital markets from competition and technology. Regulatory reform has been sweeping, in terms of transparency and market practice and conduct, particularly in the EU with MiFID I and II. Markets have changed considerably, with increased trading through electronic trading platforms and clearing through CCPs.

Perhaps one of the biggest threats to global market stability and efficiency that has now come to the scene is politics. Politics is exerting an impact on markets as populist pressures opposing globalization and liberalized trade and markets, and growing anti-immigrant sentiment, come to the fore. This rising populism, as it acts to impede trade flows and growth, fragments global credit markets and increases the inefficiencies of financial flows.

It is interesting that in a recent speech, former Federal Reserve Chairman Ben Bernanke said he finds it puzzling "that markets are very blasé about political risk until the last minute."

Yours sincerely,

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