
Briefing Note

MIFID & Fixed Income Post Trade Transparency

April 2012

Introduction

AFME fully supports the European Commission's proposal to extend public post trade price transparency requirements to the Fixed Income secondary market under MiFID II. Transparency, in the form of publication of trade details after a transaction, has important benefits such as improved price discovery and price formation. There are however certain risks, which can lead to increased transaction costs for investors and increased borrowing costs for issuers such as governments and corporates. These risks can be contained by having a proper calibration.

In its proposal, the Commission has identified the core features of a properly calibrated regime: reporting time delays are to be determined by the *size or type of the transaction* and, in certain circumstances, the volume of the trade may be excluded from reporting (Volume Omission). It is vital that these elements remain in the regulatory proposal to ensure that the risks are mitigated while optimising the beneficial effects of post trade transparency.

To further optimise the transparency regime and mitigate risks, the proposal also needs the following important adjustments: (i) the definition of 'transaction type' –for the purpose of the calibration of the framework- should include the liquidity profile of the instrument; (ii) the calibration should be dynamic to take account of changing asset characteristics and market conditions; (iii) the scope of the regulation should exclude bespoke transactions such as private placements; (iv) phased implementation should be allowed for.

Based on the principles of the regulation, the Commission and ESMA are charged with drafting a proposal for delegated acts that specify the detailed calibration of a post trade price transparency regime. To facilitate this process, AFME is leading a cross-industry initiative to develop and implement a transparency framework for fixed income cash bonds. The framework will include a calibration model and an implementation plan.

This note elaborates on the essential characteristics of a post trade transparency framework from the perspective of limiting adverse impacts for investors and issuers while optimising the benefits of transparency. Finally, on the basis of these characteristics, it explains the basics of the AFME cross industry initiative to develop a calibration model and an operational plan.

Essential characteristics of a calibrated post trade transparency framework

To maximize the positive effects of transparency while minimizing the risks, the regulation should reflect the following recommendations.

- i. **The Commission's proposals to allow for reporting time delays - based on size or type of the transaction- and to exclude, in certain circumstances, the volume of the trade from reporting, should be maintained in the text.**

Appropriate time delays in combination with volume omission, where appropriate, are needed to ensure that increased transparency does not cause adverse impacts. Time delays and volume omission allow a market maker to facilitate investors' demands to buy and sell, without exposing them to adverse price movements (the winner's curse), which in turn leads to higher transaction costs for investors and ultimately higher borrowing costs for issuers such as governments and companies.

The role of the market maker in the fixed income markets

While the high turnover and the wider number of market players in the equity market allows for a continuous order driven two-way market, mostly organised on exchanges, liquidity in the bond market is provided almost exclusively by market makers (or 'dealers'). These market makers stand ready on a continuous basis to engage in transactions with investors. This means that, instead of engaging in an excessive search for another investor who is willing to buy or sell at a specific point in time, investors turn to a market maker who is the buyer to every seller and the seller to every buyer. The service a market maker provides is 'immediacy'; the ability to immediately absorb a client's demand or supply into its own inventory. As opposed to a broker, who merely matches buyers and sellers, a market maker itself buys and sells assets, placing its own capital at risk of adverse price movements. Market players in the fixed income markets are exposed to a higher market risk as prices can deviate significantly. For example, in a normal day, the price of a 1 million equity share could move between 1 to 2 % whereas the price of a bond could move between 4 to 5%.

To manage the amount of capital a market maker puts at risk, he needs to 'hedge' himself; i.e. engage in an offsetting transaction. A market maker is not an investor; every bond he buys from an investor will need to be sold at a later stage. Fluctuations in market price between a buy and a sell transaction are an inventory risk for the market maker that needs to be hedged.

Price transparency and the winners' curse

In the market maker model, transparency can create a 'winner's curse', making it costly for a dealer to hedge his position. This works as follows. After a market maker executes a transaction with an investor, he enters the interdealer market to hedge the risk. If however, because of the publication of trade information, the other dealers can predict this dealer's need to hedge, they can benefit by taking up contrarian positions in the interdealer market, thereby making it difficult for the successful bidder to offset the risk of the position.

Market makers will need to compensate for this risk of adverse price movements by increasing the transaction costs they charge to investors. Investors will require compensation for these increased costs from the issuers of bonds (governments, companies), in the form of higher borrowing costs.

Solution for winner's curse: time delays and volume omission

These adverse effects of transparency can be prevented by allowing dealers time delays to hedge their risk *before* the trade is made public. It can also be prevented by volume omission, the masking of the size of the traded ticket for tickets above a certain threshold. Volume omission makes it easier for a

dealer to hedge; it reduces the time delays that are needed before publication of the trade information.

It follows that the right combination of both factors optimises the beneficial effects of post trade transparency while limiting the drawbacks of higher transaction costs for investors and higher borrowing costs for governments and companies. It is therefore essential that both elements remain in the proposal of the Commission.

ii. The definition of 'transaction type' should be specified to include the liquidity profile of the instrument.

As explained above, time delays- based on size or *type of the transaction*- and volume omission are crucial for a post trade price transparency framework. To decide in an objective and transparent way how long the delay should be for a certain trade or above what trade size a volume should be omitted, it is crucial to take account of the *liquidity* of the instrument. Therefore, 'transaction type' should be specified to include the liquidity profile of the instrument.

A liquid asset is one that can be bought or sold without significant movement in the price of the asset. The less liquid a bond is, the greater the risk that the price moves away from the market maker when he tries to hedge his position. This means that the damaging effects of a winners curse (and hence of increased transaction and borrowing costs) are the greatest for the least liquid assets and the smallest for the most liquid assets. These risks can be mitigated by having longer time delays for less liquid assets and shorter time delays for more liquid assets.

Importantly, liquidity can be measured objectively and transparently. For the purpose of the AFME cross industry initiative to develop a calibration model and an operational plan, and using a large universe of trade data from industry sources, AFME has identified the defining characteristics of the liquidity of an asset in a way that is both simple and efficient. This is explained below in more detail.

iii. The calibration framework should be dynamic to take account of changing asset characteristics and market conditions

It is important that the need for a dynamic calibration is reflected in the regulation to account for the decrease or increase of liquidity in the market or of specific assets. As explained above the liquidity of a financial instrument is a crucial parameter to determine the right delays and size masking thresholds for the framework. However, the liquidity of fixed income assets can differ greatly over time. First, liquidity generally changes over the maturity of a bond. A bond is most liquid right after issuance, after which it becomes significantly less liquid the closer it gets to its maturity date. Second, events may cause liquidity to change. An example of this is how the liquidity of Spanish government bonds changes by the week (or even by the day), depending on developments of the Eurozone crisis.

The changes in the liquidity of an asset and the can be captured by a dynamic calibration. This would mean that the assessment of the liquidity of an asset, for the purpose of the calibration of the framework, should take place at regular intervals. In the example of the AFME cross-industry initiative, as explained below, the liquidity of a bond is calculated at monthly intervals.

iv. The scope of the regulation should exclude bespoke transactions such as private placements

For the purpose of limiting adverse impacts for investors and issuers while optimizing the benefits of transparency, it is important to clearly define the scope of the regulation. Due to their bespoke and illiquid nature, some types of transactions, including primary issuance, intra-group, structured notes and private placements should not be included within the scope of a standardised reporting framework. Specifically, we agree with the Ferber report that primary issuance and intra-group are pure OTC trades; therefore, these should be exempt from post trade reporting. Structured notes and private placements often have non-standard tailored terms, such as structured coupons or redemption amounts, multiple transaction legs (multiple derivatives in various asset classes) making it very difficult to meaningfully disclose trades in a standard reporting framework. Furthermore, the pricing information would be of little use for the objective of improved price discovery and price formation as these bonds are typically distributed to single buy and hold investors and no active secondary market exists.

With respect to the post trade disclosures in respect of bonds and structured finance products, we note that the current scope as defined by Article 20 in MiFIR includes all products admitted to trading or for which a prospectus has been published. We believe that this is currently too broad as there are many products which are listed and admitted to trading for which purpose a prospectus is required to be issued under Art 3(3) of the [Prospectus Directive] but which are in fact privately placed and not widely distributed. Therefore, the scope should be narrowed to those instruments for which a prospectus has been published in compliance with Article 3(1) of the Prospectus Directive for the purposes of making a public offer of such bonds or structured products.

vi. The regulation should allow for a phased implementation

It is essential that the regulation allows for a gradual implementation. The risks associated with price transparency can be further contained if the transparency requirements are implemented gradually. This would allow for the market impact to be studied and the calibration to be adjusted if required. It would also enable market participants to prepare the operational requirements of the framework. As an example, publication could start with the most liquid bonds (so called 'benchmark bonds'), gradually expanding to the less liquid parts of the market. A similar approach was followed in the US when price transparency was introduced under the TRACE (Trade Reporting and Compliance Engine) label.

The AFME framework for post trade price transparency

Based on the essential characteristics of a calibrated post trade transparency framework, as set out above, AFME is developing a framework that calibrates the publication of post trade price information in a way that maximises transparency while minimising the negative effects on issuers, investors and market makers. The framework has been developed after significant modeling of real trade data and extensive cooperation between investors and dealers. For simplicity, there is only one model for all

bonds in all fixed income asset classes. The model has a limited number of categories and parameters; all of which play a role in determining the liquidity of the asset. On the basis of the liquidity the publication of a trade can be delayed and/ or its size is omitted.

Using a large universe of trade data from industry sources, AFME has identified the defining characteristics of the liquidity of an asset in a way that is both simple and efficient. These characteristics are; (i) Ticket size, (ii) Issuance size, (iii) Monthly volume traded, (iv) Monthly number of tickets traded.

(i) Ticket size A large ticket size or ‘block trade’ takes a while for the market to absorb without adverse price movements for the market maker. Instead of hedging his position all at once, a market maker may therefore want to execute several smaller trades over a longer period of time. This limits the possibility of an adverse market movement caused by other market participants being alarmed and trying to exploit the dealer’s change in position. This longer timeframe is however another risk, because meanwhile external factors may cause the market to move further against the market maker.

(ii) Issuance size is another important factor for determining liquidity. If a bond has a large outstanding amount, this increases the likelihood that there is a good amount available which investors may want to sell or buy at any point in time.

(iii) Monthly volume traded and (iv) monthly number of tickets traded give a very precise picture of the state of the market in that bond. The 2 parameters are interlinked; a bond which trades only once per month, in a ticket of €100 million, is less liquid than one that trades 20 times in ticket sizes of €5 million.

To take account of the dynamic nature of liquidity, the liquidity of a bond is evaluated on a periodic basis (e.g monthly). The model can be adjusted to allow for a phased implementation.

Table 1: The AFME post trade price transparency framework

→ Decreasing liquidity

Liquidity Category							
		A		B		C	
Issue Size	Trade size	Time delay + volume omission	Threshold	Time delay + volume omission	Threshold	Time delay + volume omission	Threshold
>V	Size A	t+m		t+q, volume omitted		t+s, volume omitted	
	Size B	t+n		t+p		t+r	
	Size C	T		T		t	
			X volume & Y trades		A volume & B trades		C volume & D trades
<W	Size A	t+m		t+q		t+s, volume omitted	
	Size B	t+n		t+p		t+r	
	Size C	T		T		t	
			E volume & F trades		G volume & H trades		J volume & K trades

Table 1 provides a sketch of the model, which is currently being back tested. Time delays and/or volume omission of an individual trade ticket are determined by its relative liquidity. The vertical axis categorizes a trade based on liquidity parameters *monthly volume traded* and *monthly number of tickets traded* (based on thresholds of e.g. X volume and Y trades). The other 2 liquidity parameters, *the issue size of the bond* and *the size of the trade ticket*, are plotted on the horizontal axis.

Over the next months, AFME will continue with market participants and policymakers to finish the calibration of the framework and develop a plan for its implementation.

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