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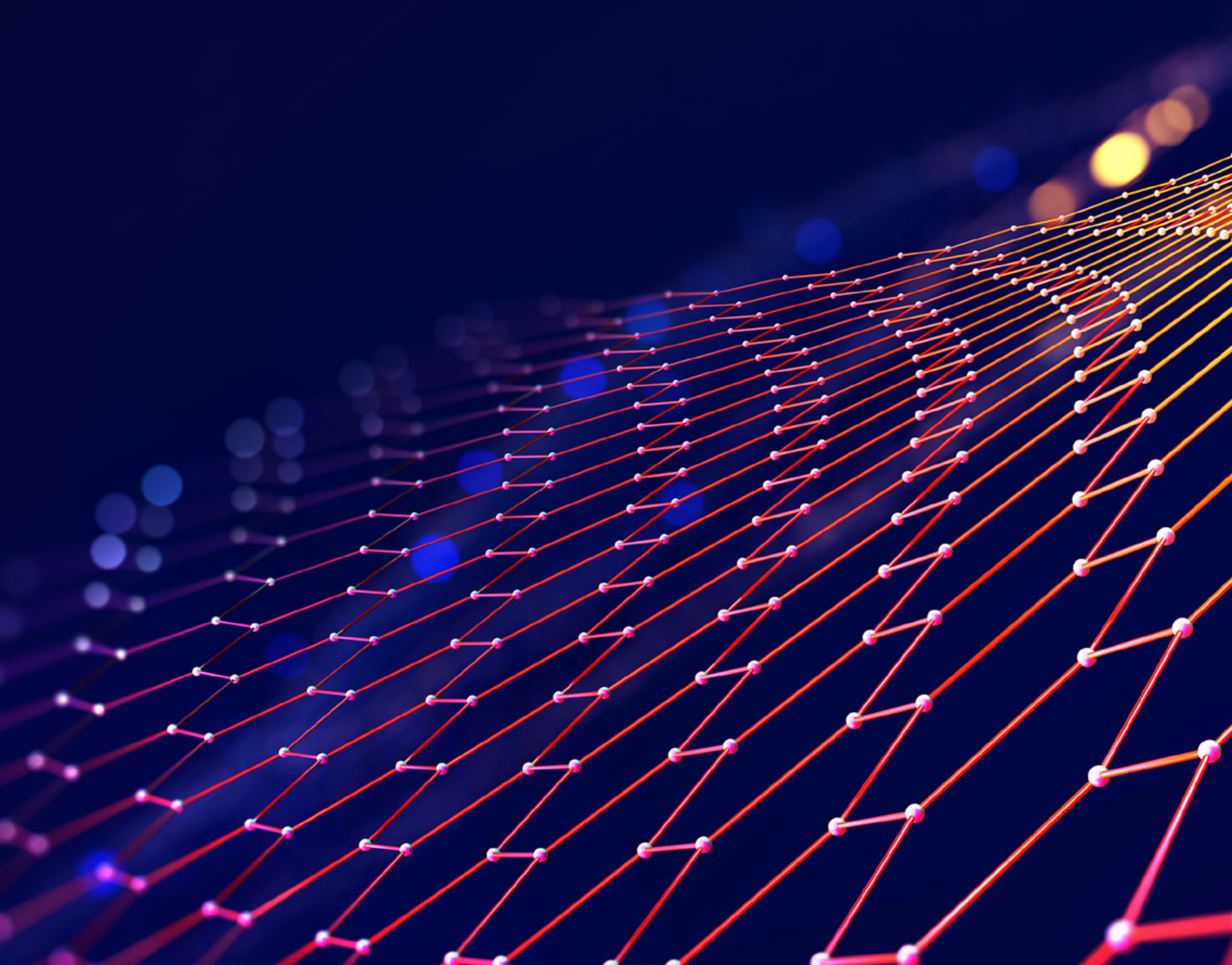
Total Connectivity: The Power of Technology to Increase Efficiency and Reduce Risk in the Primary Bond Market



Foreword

As the focus on technology in capital markets continues to increase, much has been made of the fact that the primary market lags behind secondary in terms of automation.

Whilst this is undoubtedly true, primary has not stood still. Progress has been made on the sell-side over the last 15 years, where we have seen the electronification of deal and order communication in real-time.

However, many manual processes remain, particularly when it comes to the interaction between sell-side and buy-side. The buy-side is becoming more vocal about these inefficiencies and the regulators have started to notice.
A number of systems have emerged recently to address these issues. IHS Markit's InvestorAccess was the first to launch and has gained significant adoption in the market. However, if we are to do away with all the manual effort still required today and minimise operational risk, then the ultimate goal must be to deliver true STP [Straight Through Processing] for all deals and orders.

Progess is being made here, but there is a risk that further progress will be slowed. For instance, there could be a reluctance among some to change traditional market behaviours. In addition, a lack of interoperability may persist between the new platforms that are meant to be delivering those efficiencies.

Overcoming these potential blockers is important to drive greater efficiency and transparency in the primary market. In turn, achieving this will require greater interoperability between platforms and systems, which can only come from closer collaboration between all market participants.

Greater automation is coming to the primary bond market. The next few years could be transformative.

Nick Hall, managing director and global head of fixed income, IHS Markit

"The ultimate goal must be to deliver true STP [Straight Through Processing] for all deals and orders."

Why the new bond issue process needs to change

The global primary bond market has never been busier.

The total value of annual issuance over the past couple of years has breached a record $10 trillion, propelled by governments, public sector institutions, and companies taking advantage of historically low rates to raise unprecedented amounts of bond funding.

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>
> **Jean-Luc Lamarque**
> **global head of syndicate, credit trading & sales**
> **Crédit Agricole**

Yet, amid such activity, signs of strain between investment banks, investors and issuers are emerging in the primary market, where some of the practices and processes involved in the sale of bonds are seen, by some, as unfit for purpose in this modern digital age.

Indeed, for as much as electronification and technological advancement has transformed many areas of the capital markets, including equities, foreign exchange, and parts of the secondary bond market, it has not had the same impact on the process around new issue bonds sold in the US, Europe, or Asia-Pacific.

At the heart of this global issue is how banks and investors interact during the new issue process, a short and intense period of engagement that still relies mostly on the manual exchange of deal information via telephone and real-time messaging services.

While this form of interaction has existed for decades, it has become ever more problematic as bond issuance has soared (see Fig 1), increasing the pressure on a process that for many buy-side firms is suboptimal for them in facilitating the high volume of deals executed in today's market.

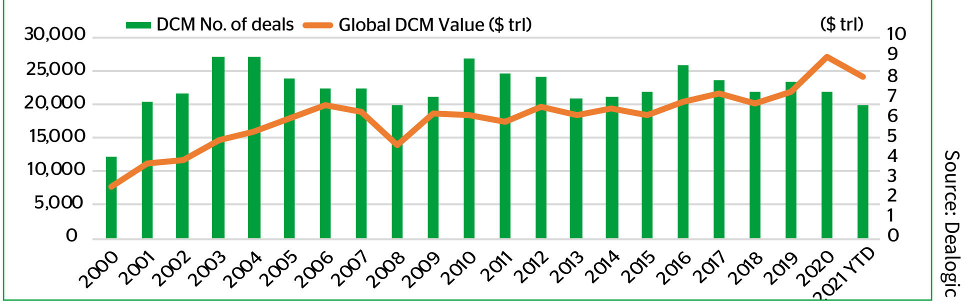
Compounding the problem is almost every new bond issue being handled by several banks (see Fig 2), each of which tends to communicate separately with the same investor. Errors inevitably occur in the process and in the deal and order information, in turn disadvantaging some investors.

This is why financial regulators including the Securities Exchange Commission (SEC) in the US and the International Organization of Securities Commissions (IOSCO), the regulator of regulators, have been paying closer attention to this issue. The European Central Bank, through its European Distribution of Debt Instruments Initiative, and most recently, Hong Kong's Securities and Futures Commission, have also been focusing on this area.

For the SEC, and specifically its Office of the Investor Advocate (OIA), which looks after investor interests, there are a number of reasons why the "the [corporate bond] market does not function as seamlessly as might be presumed," including the inconsistent deal information banks can relay to investors, and the discretion they have in deciding which investors to sell bonds to.

One of the SEC's main concerns is that the marketing process for new issues "does not provide buy-side participants an adequate opportunity to make informed investment decisions," according to a recent OIA report.

Fig 1. Annual DCM issuance is at record high levels



Sure enough, the amount of time between a bond being announced and the deadline given to investors to submit orders is sometimes as short as fifteen minutes – barely enough time to read and understand the full and specific contractual terms of a deal.

Such concerns echo those already raised by IOSCO in 2019, although the international regulatory body went further, highlighting conflicts of interest and associated conduct risks during the capital raising process. That centred on the banks performing multiple roles and providing a wide range of services for issuers, often while having a proprietary interest in the transactions they are managing.

IOSCO said such activities carry an inherent risk of conflict and conduct risks that may impede investor choice, returns and protections, and ultimately jeopardise fair, orderly and transparent markets.

“Many people forget that this is a tailor-made instrument, each and every bond issue is different.”

Head of funding, European financial institution

Process automation

Initially there was some reluctance from the big US banks to change; they saw automation as too great a threat to the status quo. Yet, the US banks have come around and, together with their sell-side peers elsewhere, accept that automation in parts of the primary market is going to happen.

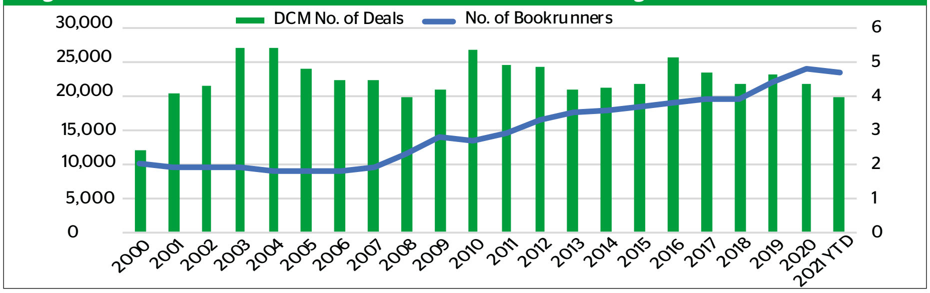
In practice, not everywhere in the process can be automated. The unique characteristics of each bond, for instance, makes that challenging.

“Many people forget that this is a tailor-made instrument, each and every bond issue is different,” says the head of funding at a European financial institution and frequent borrower. “It’s not a bulk product like swaps, which you can do through all types of platforms. So, a lot of manual work still has to be done on these bond trades.”

Importantly, change in the process has happened. Certainly, from the days in which pricing details were shared via spreadsheets and often expressed in multiple currencies (in European markets), syndication has come a long way.

Banks today routinely use desktop messaging services to publish details of new issues, including a range of data fields that are becoming more standardised over time. In addition, in documents shared ahead of transactions, banks provide information on matters including relating to the issuer, financial data, and risk factors. The exchange of order and allocation information between underwriters has also been automated through the use of a shared network, called IssueNet, which is run by IHS Markit.

Fig 2. The number of bookrunners has more than doubled since the global financial crisis



Source: Dealogic

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>
> **Norbert Stahl, head of cross asset execution new issues, Credit Suisse Private Banking**

"I think we are heading in the right direction," says Jean-Luc Lamarque, global head of syndicate, credit trading and sales at Crédit Agricole CIB. "Over the years, the market has become much less fragmented and more efficient, which has enabled banks to disseminate information accurately and execute transactions in a day or less."

Few issuers and investors would disagree with that; progress and improvements have been made. But more change is needed. Some perennial issues remain.

"Over the course of running a few thousand new issues a year, we see that there is very fragmented information distribution," says Norbert Stahl, head of cross asset execution new issues at Credit Suisse Private Banking. "The reality is that the investment managers depend on having an active relationship with syndicate banks to receive deal information, which is primarily distributed via Bloomberg."

For those investors that are participating, once the order book is closed, banks over a short period are required to consolidate orders on any deal, and mistakes can creep in, says Stahl. "The order confirmations are keyed in, and it's possible to miss a limit on part of or the whole order. Particularly on multi-tranche deals, there is a risk that investors are allocated the wrong amount of tenor due to multiple media breaks in a fragmented process."

In recent years, technological advancement has helped streamline primary market activities between sell-side participants, and, importantly, the sell-side and buy-side, especially in areas such as deal data transfer and order management. Some providers, such as IHS Markit, have been at the forefront of this. Several others are now following with their own platforms and solutions.

Market participants generally welcome these initiatives as a driver of efficiency, transparency and fairness. Yet, they also acknowledge there is a challenge around the number of solutions in the market, amid varying operating models, data standards, and commercial priorities.

"Through automation, we gain time and flexibility to work with our clients on the deal and discuss topics around new issues," says Stahl. "However, right now, there is no standardised solution, and no platform has every syndicate member bank on it, so that is something we would like to see some progress on."

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>
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Can tech solve the allocation issues?

Of all the primary market issues that technology may help solve, bond allocation is probably the most contentious. Investors frequently complain they do not get allocated the bonds they want, while the banks complain of inflated investor orders and last-minute participation.

This issue is complex, and for banks, often essentially requires “working out what is reasonable,” says Ruari Ewing, senior director, EMEA and Asia syndicated new bond issuance market practice and regulatory policy, International Capital Markets Association (ICMA).

Yet this is difficult under time pressure and amid a throng of investor communications on orders, which can come from different parts of the same firm. This can lead to their total aggregated orders exceeding the entire deal size.

“If some investors are regular inflaters they get treated accordingly,” says Ewing, which can mean orders being downsized, written off completely, and or the firm being reported.

Guided by the issuers, the discretion the banks have in choosing the investors that are and are not allocated the bonds does contribute to order inflation.

To help address this, some banks have moved to a more “rules-based approach whereby allocations are based on investor characteristics,” says Kerr Finlayson, head of frequent borrower group syndicate at NatWest Markets. “Ultimately the aim is to ensure that the issuer gets some high-quality support and that there is sufficient liquidity in the secondary market. It's a process that must be done quickly, so you need to be speedy and base your decisions on the information you have in front of you.”

This highlights the human judgement involved in the process, which, together with some of the manual processes involved, can mean that – while rare – mistakes in the book happen.

Technology won't eradicate the mistakes completely, but greater automation of the communication between sell-side and buy-side could materially reduce them at the same time as enhance efficiency and increase banks' and investors' ability to better manage their engagement in the new issue process.

Platforms such as IHS Markit's InvestorAccess are providing a solution, offering standardised messaging from all relationships, the ability for investors to electronically enter orders for new issues securely, and create and manage orders in a centralised location, among other benefits.

Such solutions may not be a panacea, but they could smooth some of the order allocation frictions between the buy and sell-side.

Issuer Case Study

While investment banks are responding to rising demand among investors and regulators for change in the new issue process, change may happen more quickly if the issuer community demands it. Issuers are, after all, the most important participant in the process.

Publicly, most issuers shy away from tackling the issue due to the political sensitivities of it. Privately, most probably agree that certain parts of the new issue process can be improved and made more efficient through greater use of technology and automation.

The head of funding at a European financial institution is one issuer who does agree with this and feels the efficiency and accuracy of the bookbuilding process, in particular, could be improved. However, he is not entirely convinced that bookbuilding via a platform is as beneficial for them as it might be for a large investor.

"I can't imagine big investors like being called-up by however many investment bankers on any given day to sell them bonds, so greater automation in the process, where they can place orders directly in the order book via an electronic platform, is going to be attractive," says the head of funding.

"But as much as there are benefits for investors and for us, the issuers, I worry about what we may lose if everything is done over a platform. The personal interaction between the issuer and the banks, and the salespeople and the investors, is really valuable and important, and especially in volatile markets."

Indeed, such is the importance of this interaction for some investors, it can determine whether they participate in a deal or not. "We recently visited a large European insurance investor and asked them whether they wanted to put their orders directly [via a platform] into the order book," says the head of funding. "They said they weren't convinced of this as they always want to have the salespeople on the phone, to judge their tone and get a feel for the deal and the market."

Importantly, this interaction can and does still happen between investors and the salespeople; platforms such as InvestorAccess don't prevent or reduce the need to do that, and can actually enable interactions due to some parts of the process being automated.

What could become problematic, however, is the proliferation of different electronic platforms with zero to little interoperability between them, says the head of funding.

"There are only a handful of banks participating in some of these platforms, so not all banks are involved in one, and that makes it complicated for issuers like ourselves."

He adds: "We'd like to see some agreement by all market participants on which platforms in the main will be used and ensure that there is interoperability between these platforms. That is very important."

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How the new bond issue process can change

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Transforming the new issue process cannot be achieved through technology alone. For technology to be effective, standardisation of practices and deal information needs to happen.

Over the past few years, there has been a lot of work done by both buy and sell-side industry associations and trade bodies to bring this about.

Last year, for instance, deal information relating to announced European investment grade bonds became more standardised, with 21 set data fields now needing to be populated. The initiative, led by ICMA, and involving consultation with syndicate banks, issuers, and investors, was a “huge step for the industry,” wrote Chetna Mistry, a senior trader at Western Asset Management, one of the world’s biggest bond fund managers.

As part of this, all deal information now also includes a Legal Entity Identifier, which determines the hierarchy of the issuing entity in the issuers’ respective capital structure. Writing in an ICMA review publication, Mistry added: “With changes being introduced to the prospectus regime we now see either a link to a prospectus or a preliminary prospectus attached. This has significantly reduced the time it takes the investment desk to get specific answers it needs, either during the security set-up or even during the compliance pre-clearance process.”

In the US, The Credit Roundtable (TCR), an investor trade association composing 39 members managing over $4 trillion of fixed income assets between them, has also been seeking to drive process change, including pushing for standardised offering protocols and reference data to improve investors’ ability to assimilate offering information more quickly.

For TCR, offering protocols should also include making a prospectus available immediately upon deal announcement, and allowing a minimum of 30 minutes between the start of the allocation process and the pricing of the deal. In addition, reference data should include such information as the bonds’ maturity date, the intended use of proceeds, and other bond characteristics.

Together with this, the Fixed Income Market Structure Advisory Committee (FIMSAC), an advisory committee to the SEC, is also pushing for improved corporate bond data, and the establishment of a new issue data service to provide corporate bond reference data to all market participants.

Standardisation of practices and deal information in the US and European corporate bond markets is therefore progressing, but it will take time. A clear next step for US market participants would be to agree on a similar set of standardised data fields to those in Europe.

Side by side with these industry developments, and in some instances earlier, market participants and technology and data providers, have been developing technology platform solutions.

These perform roles including helping banks build, manage, share and reconcile order books, and acting as conduits for the transfer of deal terms, orders, and allocations. There are also a range of monitoring tools that can be used by investors to view deals as they take place.

"For us, it makes a lot of sense to be able to receive information, or even place orders, via technology, rather than relying on messaging networks and chats," says Credit Suisse's Stahl. "There is a lot of upside to engaging with these solutions."

"We wanted the buy-side to be able to plug into that network, and to overcome difficulties they were facing in primary, such as receiving hundreds of messages from different syndicate banks."

Nick Hall, IHS Markit

Tech transformation

Over the past few years several technology platforms have emerged, some engineered by the banking industry, others by third-party technology, information and data providers.

Specifically, IHS Markit operates a global suite of fixed-income solutions, including a platform launched in 2017 called InvestorAccess, which securely connects the buy and sell-side electronically, enabling consolidated deal terms, documentation and updates for primary market deals to be communicated directly from the syndicate desk to the buy-side.

In addition, there is also DirectBooks, a communications platform for deal data, documentation, and information exchange, founded and led by a group of some of the biggest banks in the US and global bond markets, and Liquidnet, a US-based institutional investment technology provider. In Asia, there is also Covalent Capital, a Singapore-based fintech founded by former senior bankers at Deutsche Bank.

All of these platforms help address the issues that the buy-side and regulators have raised, ultimately seeking to enhance electronic connectivity, efficiency and transparency in the new issue process.

For Nick Hall, managing director and global head of fixed income IHS Markit, the evolution of InvestorAccess came from a realisation that it made sense for the sell-side to open-up IssueNet – a platform enabling the exchange of orders and allocations between banks during the bookbuild phase of the new issue process – to the buy-side, so that the two can interact more efficiently.

"We wanted the buy-side to be able to plug into that network, and to overcome difficulties they were facing in primary, such as receiving hundreds of messages from different syndicate banks, many of which were overlapping," he says. "In extreme cases this meant they were even missing deals."

Aside of connectivity, there are many other capabilities to InvestorAccess, some of which directly address the recommendations made by CRT on updating of deal information. Furthermore, the platform already imposes a mandatory set of fields at deal announcement, ensuring that every message received by the buy-side is standardised.

In receiving deal terms electronically, rather than through emails or messages, buy-side firms can much more efficiently manage the flow and detail of transactions. In addition, with all data transmitted in machine readable format, they can marry solutions with their order management systems. Moreover, data is automatically passed to compliance engines, so that firms do not miss deals waiting for compliance approval. Once deals are priced, allocations are transmitted through the same pipeline, rather than being communicated by salespeople.

"Many of the conversations that currently take place between the buy-side and sales team will still need to happen," says Hall. "But where we can add value, for example, is where a private bank wants to amend its order multiple times. All of that can be automated, and they can do it themselves without needing to connect offline with people at the syndicate banks."

This undoubtedly increases the efficiency in the process, an outcome that all the platforms aim to achieve. Yet while they have a similar mission, the motivations for launching vary.

The need for interoperability

DirectBooks is different from the other platforms because it was created and launched by some of the biggest bond underwriting banks.

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>
> **Christopher Sztam, managing director and head of the global markets group at IHS Markit**

Importantly, this was in response to the demand from the buy-side, rising regulatory pressure, and the banks wanting to develop their own platform instead of using an external provider's.

The motivation for doing so is understandable – the banks involved want to protect their bond underwriting business and controlling their own platform is seen as strengthening their position.

However, there are a number of challenges with this, including the current lack of interoperability between the platforms and market participants, and the broader issue of fragmentation in platform providers.

For Christopher Sztam, managing director and head of the global markets group at IHS Markit, there is room in the market for a few different platforms, but in the end, and for the benefit of all market participants, "they have got to work together – interoperability is fundamentally important."

Indeed, if multiple systems are not enabled to interact and communicate seamlessly, then the efficiency gained by developing them in the first place is impaired, says Hall.

"From our perspective, it is helpful that the whole sell-side is already on one network [IssueNet] and that we have APIs to connect into that network, so in that regard we're focused on delivering efficiencies and working on making it easier for everyone in the market."

He adds that there is going to have to be some kind of compromise, where there is collaboration. "I don't think the market is going to sustain separate systems, that don't talk to each other, doing the same thing," he says. "The buy-side don't want that. And the banks won't want to have to pick which system they're going to use depending on whether they're running a deal in the US, Europe or Asia. They want either one platform or at least multiple platforms that can interact with each other."

Transforming the bond issue process in the way that is needed will take time, but it is critically important to "provide more efficient access for all market participants," says Sztam. "The bond market has seen some automation on the sell-side, but further market integration is required in order to bring greater transparency and efficiency."

Conclusion

While bond issuance globally is soaring, the practices and processes supporting and facilitating capital raising are seen by some as outdated, overly manual and under increasing strain.

Most investors, some banks, and an increasing number of regulators see this and want reform in the primary bond markets.

The most recent regulatory call for action came from the Hong Kong Securities and Futures Commission. In October, as part of their effort to clean up "undesirable behaviours," the SFC published the conclusions of its consultation on bookbuilding, pricing, allocation and placing of equity and debt capital markets transactions.

Although the SFC's focus covers equity capital markets and some of the practices are peculiar to the Hong Kong market, its overall objective is shared by other financial regulators – to enhance the transparency, fairness and orderliness of primary market activities.

The SFC's move may be the latest by a regulator, but it is unlikely to be the last if the pace and extent of change in primary markets practices and processes is insufficient.

Importantly, change has been happening across markets, and continues, driven by buy and sell-side led technology solutions.

These solutions directly address some of the issues investors and regulators have raised, and will help bring the primary bond market into the modern digital age.

That is a beneficial development for all market participants, even if it means some having to change how they have been doing things more than others.

Yet, greater collaboration and interoperability between these platforms is crucial. Providers and consumers of capital are increasingly demanding it, as this report has helped show.

It's now up to the platforms and intermediaries to respond to this call.

"Change has been happening across markets, and continues, driven by buy and sell-side led technology solutions."

To contact us and for more information on IHS Markit's suite of fixed income issuance solutions please visit this webpage.