



Electronification in primary bond markets

by Gabriel Callsen

Primary bond markets fulfil a vital function for the real economy, allowing borrowers to obtain funding and investors

to generate returns. Whilst the uptake of technology in investment grade (IG) primary bond markets remains limited in comparison to secondary or repo and collateral markets, it is arguably an area which offers potential for further electronification. This is reflected by a growing number of FinTech initiatives in relation to the IG bond issuance process and life cycle, whether leveraging existing technology or early experiments building on distributed ledger technology (DLT). As a result of discussions with investors, issuers, bank syndicates, law and technology firms, this article seeks to summarise trends in primary markets from a technology and innovation perspective and identify the direction of travel.

Investors' perspectives

From investors' perspectives, it is essential that technological solutions in primary bond markets increase efficiencies and deliver straight-through-processing (STP). For example, from communicating with syndicates throughout the book building process; to providing feedback before deal completion; to exchanging information on and disclosing final pricing. Process electronification would thus enable a reduction in manual input and operational risk, notably for deals involving multiple syndicate desks.

However, the issuance process remains complex, and reducing this complexity would be welcome, for instance by standardising term sheets and deal documentation, enhancing access to prospectuses, and improving the allocation process and standardising timeframes for communication. This is particularly important for investors with global operations and diverging regional market practices. To enable greater technology uptake, an open-source infrastructure utility would be desirable to allow connectivity to multiple technology providers and across multiple asset classes.

Issuers' perspectives

Efficiency considerations, STP and the benefits of an infrastructure utility are shared by issuers. From their perspective, the bond issuance process remains an equally manual and time-consuming process. This is partly due to legal and regulatory requirements, for instance in terms of required documentation for bearer notes, anti-money laundering rules, or policing requirements under MiFID II.

Technology has the potential to streamline both pre-book and book-building processes, improve pricing efficiency, and create greater transparency. Clearing and settlement, as well as liability management processes also lend themselves to greater electronification. In the same vein, direct connectivity and communication between issuers and investors would lead to greater efficiencies. However, there are currently no common industry standards for electronic book building, which would be helpful for the uptake of technology.

Syndicates' perspectives

Bank syndicates are supportive of electronification and STP, which is critical to speed up the execution of bond issuances, for example by entering orders electronically, enhancing the flow of information, and allocating internal resources more efficiently. However, faster execution may not necessarily help investors in regard to cash management and underlying client interaction.

Standardisation of term sheets and timeframes is possible to some degree, but market practices diverge depending on the currency, issuer and regional specificities. Understanding how primary and secondary markets interact, and how to create synergies in terms of connectivity is important. Nonetheless, from an organisational perspective, it is worth bearing in mind that many banks are siloed across products, while investors often have a single desk both for primary and secondary bond markets.

Furthermore, costs are an important consideration, even more so in view of costly IT requirements for regulatory compliance under MiFID II or the upcoming SFTR reporting regime. While there is clear potential for process electronification in IG primary bond markets, it is also a matter of perspective. In comparison to high yield or loan markets where processes are more cumbersome and settlement cycles longer (eg T+14), efficiency in IG primary bond market is markedly higher.

Lessons learned from electrification in secondary markets

In secondary bond markets, electrification gained traction as a result of banks' shrinking profit margins, reduced balance sheets, and liquidity concerns. What has been pivotal in this process is the standardisation of trading protocols such as the Request-for-Quote (RFQ) protocol and price discovery mechanisms ie the dissemination of bond inventories.

Similarly, the development of rules and common standards would be critical to facilitate electrification of IG primary bond markets. Also, primary markets may follow the trend towards differentiation between high touch (eg for illiquid, large sizes) and low touch business (eg liquid, small sizes) and automation of the latter.

Views from law and technology firms

Technology itself is not the catalyst of evolution, but remains market-driven. To facilitate innovation in primary bond markets, rules, common standards and integration with existing systems are key. For example, minimum common standards for data protocols allowing data exchange in an open-source network; and integration of clearing and settlement functions on platforms into existing systems. The development of Legal Mark-up Language (LML), an open source standard to help translate legal documents into machine readable format, has allowed coupling of legal contracts and transaction execution.

In recent months, a number of proofs of concept for the issuance of bonds based on DLT have been developed. While there is a degree of uncertainty with regard to the regulatory treatment of public blockchains, DLT and digital assets, the adoption and roll-out of DLT is a slow and difficult process. That being said, the appropriate choice of technology depends on the problem to be solved, and in many cases, it is not necessarily DLT.

Importantly, technology may alter the role of intermediaries but there is a common view that banks will not be disintermediated. That is because banks perform regulated activities and play a key function by providing balance sheet, undertaking risk transformation, ensuring compliance for Know-Your-Customer (KYC) or Anti-Money-Laundering (AML) purposes, and acting as an intermediary and trusted party.

Furthermore, the legal and regulatory framework is not specifically adapted to new technologies, and any

technological innovation in bond issuances has to be accommodated within the existing framework. At the same time, regulation such as MiFID II has created binary choices, which in some cases provides greater clarity and can be more conducive to the development of tailored electronic solutions.

From a cost perspective, a limiting factor is that most platforms rely on fees from the sell-side while issuers and investors tend to have free access. Wider adoption of technology solutions would therefore require further engagement from the latter, which might notably be challenging for smaller firms. A one-stop, cross-asset infrastructure utility would be more palatable from a budgetary point of view than separate services.

Conclusion

In IG primary bond markets, a common theme of the discussion on technology with investors, issuers, bank syndicates, law and technology firms is the creation of greater efficiencies. Process electrification and STP are key, notably for firms that operate across different markets and currencies. However, the challenge lies in striking a balance between process standardisation on the one hand, and flexibility on the other, according to funding needs, cash management requirements as well as local market practices.

From a technology perspective, minimum common standards for communication, data exchange, and end-to-end connectivity are critical to reduce operational risk and eliminate inefficiencies. From a legal perspective, the standardisation of legal contracts and the development of LML has facilitated the adoption of technology in the bond issuance process. However, the cost model of technology solutions has implications for its uptake and sharing the cost more equally with all involved parties would facilitate wider adoption.

Finally, a scalable infrastructure utility, based on open-source standards allowing for connectivity to multiple technology providers across asset classes is strongly preferred to a monopolistic, commercial infrastructure. There is a common view that, whilst technology may alter the role of intermediaries, the functions fulfilled by banks are and will remain crucial for IG primary bond markets.

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