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Bond Markets Face Big Challenges.

The Libor transition, credit risk in municipal bonds, best execution and remote access for trading platforms are just some of the pressing challenges facing tomorrow's bond markets, according to fixed income experts.

On Oct. 5, the Securities and Exchange Commission held an open meeting of its Fixed Income Market Structure Advisory Committee (FIMSAC), whose members include investors, bond issuers and dealers, trading venues, academics, data providers and more.

Monday's meeting of the minds provided not just context around recent events, but also a rare sneak peek into what could become the regulatory agency's future priorities for the fixed income markets.

What The Meeting Covered

Monday's sessions ranged far and wide. To start, the committee deliberated how best to define "electronic trading," so as to allow for a regulatory framework that could be consistent and consistently applied.

That was followed up with in-depth conversations about structural strengths and challenges in the corporate and municipal bond markets; then a postmortem on how bond ETFs fared during the market volatility in March and April. (Spoiler alert: Despite a few isolated bumps, mostly they worked as intended.)

However, one of the most interesting bits came in the closing comments, where FIMSAC members shared where they felt the committee's future priorities ought to lie.

Generally, the committee agreed that the fixed income market is structurally sound. But it could use a few key updates and modernizations.

Facing The Libor Transition Head-On

One of those modernizations is already taking place: the global phaseout of Libor in favor of the secured overnight financing rate (SOFR).

Currently, the London interbank offered rate, or Libor, is the world's most widely used benchmark for short-term interest rates, tied to hundreds of trillions of dollars in loans, mortgages, corporate debt, derivatives and other instruments. Libor is calculated by averaging several bank funding rates across five different currencies and seven different borrowing periods, ranging from overnight to one year.

But Libor has some issues. Its calculation methodology is clunky and outdated, and the pool of banks who report their rates has shrunk since the 2008 financial crisis. That's led to greater reliance on subjective estimates and "expert judgment" to calculate moves in the rate. Plus, by the nature of representing banks' average borrowing costs, there is some built-in credit risk to the Libor.

Ushering In SOFR

For those reasons, Libor is being retired in favor of SOFR—at least for dollar-denominated loans and securities. SOFR is a median of overnight cash borrowing rates in the Treasury's repo market.

Yet transitioning from one rate to another isn't as easy as just hitting Ctrl-F on a Word document. An entire indexing and investment infrastructure has been built up around Libor, and thousands of existing financial instruments are foundationally based on the existing reference.

Multiple FIMSAC members pointed to this transition as one of the most pressing concerns of the next year, indicating that there was still a lot of work to be done, both in identifying potential market challenges and addressing any credit-sensitive impacts.

How Best To Protect Best Execution?

Many committee members also expressed concerns about how to improve and ensure best execution across the fragmented fixed income market, where most trades still happen in opaque, over-th--counter matchups.

The potential was floated for additional national best bid and offer (NBBO) regulation for corporate bonds. Such regulation would require brokers to source the best prices when trading on behalf of clients—meaning, they must trade at the highest bid and lowest ask.

Current NBBO regulation only applies to stocks, however, and the equity market is much smaller and more transparent than the bond market.

Whereas the equity market comprises roughly 3,500 securities, there are tens of thousands of corporate bond issues alone, with thousands more launching every year. (One FIMSAC member, academic and former SEC Chief Economist Larry Harris, even brought this up as a potential avenue of further inquiry: How can the agency encourage the issuance of fewer bond securities?)

Fleeting Pricing Confidence

Reggie Browne, principal of market-making firm GTS, also championed the idea of NBBO in fixed income when we spoke to him in March: "You don't have anyone disseminating nationally and instantaneously the best bid/best offer and where the last trade occurred. You have issues around confidence about the ability to transact in corporate bonds." (Read: "Why Many Bond ETFs Now Trading At Discounts.")

Relatedly, other committee members raised the question of how best to disseminate pricing data and data about new issuers, including identifiers, maturity date, coupon and so on. This data is critical for any bond trade, yet access to it can vary substantially depending on which platform is used.

"Without this data, [investors are] hampered in their ability to trade these issues on equal footing," said Lynn Martin, president and COO of ICE Data Services.

A number of committee members suggested improvements to FINRA's over-the-counter real-time price dissemination service, Trade Reporting and Compliance Engine (TRACE), as well as the possible introduction of a corporate bond pricing reference service that would offer impartial, equal access to trading data for all market participants.

Trouble Brewing In Munis?

Notably, several committee members raised concerns about rising credit risk in the municipal bond market.

With the COVID-19 pandemic depressing economic activity across the nation, state and local governments are seeing reduced tax revenues—the same revenues they use to pay off their debt obligations. Should conditions persist or worsen, Mark Kim, COO of the Municipal Securities Rulemaking Board, wonders if these governments will be able to continue making timely payments.

“Munis have proven themselves resilient in the face of shocks, but markets don’t like surprises,” he noted.

Other commenters questioned whether municipals were being fairly rated, given the difficulty in acquiring timely financials from municipalities. Better disclosure for munis is needed, said former SEC chairman Elisse Walter, adding that “fixing that may do much to fix transparency in the municipals market.”

E-Trading Can Be Made More Efficient

Finally, many FIMSAC members pointed to the opportunity and challenge of the market’s increasing reliance on remotely accessed electronic trading (“e-trading”).

E-trading of bonds is nothing new. But when the pandemic struck and lockdowns were implemented overnight, nobody really knew how smoothly trading technology would function in a 100% work-from-home setting. (Read: “For ETFs, Trading Floor Closures Mean Little.”)

Fortunately, it did work, both for bond traders and for dealers. Still, there’s more work to be done in making efficient, secure platforms available across all bond markets—indeed, some illiquid corners of the market still place trades by phone—and to make these platforms accessible to everyone, not just a subset of traders.

“The whole life cycle needs access to this, not just traders, but clients, compliance, risk officers, the variety of participants in the market,” said Tradeweb CEO and Co-Founder Lee Olesky.

“We’re not out of the pandemic yet,” he added. “We still have a ways to go.”

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