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Big Benchmark Bonds – Dream or Reality?

Could we enhance the corporate bond picture by reducing the number of issues outstanding, concentrating trading activity and thus increasing 'liquidity'? Or, considering the disparate array of issuers, bond types and regulations in the market, is the wholesale creation of benchmark issues simply a dream?

Two weeks ago I called Larry Fondren, CEO of DelphX, with a simple question: How many USD denominated bonds did JP Morgan have outstanding? The answer to that question prompted more questions, and a picture gradually emerged from the DelphX database of 49,000+ fixed rate, floating rate, convertible, perpetual, index linked and zero coupon bonds, issued by 8,500+ entities, with a total notional outstanding exceeding USD13 trillion. This intricate mosaic of debt is more commonly known as the USD Corporate Bond Market.

Some would argue the USD Corporate Bond Market is not a pretty picture; it is too fragmented, issue sizes are too small, and reports of liquidity problems in the dealer-centric OTC trading environment are common. In contrast, the US equity market, which has a market capitalization of USD26 trillion, has a mere 5,250 listings across two exchanges, the NYSE and the NASDAQ (*source: WFE*), and liquidity is taken for granted, as is smooth trade execution.

The question that begs to be asked is: Could we enhance the corporate bond picture by reducing the number of issues outstanding, concentrating trading activity and thus increasing "liquidity"? To answer the question, the first thing we need to understand is:

Who has issued what?

As we look more closely at our mosaic, some interesting details begin to emerge. The first is that issuer and issue distribution effectively follows the Pareto Principle suggested by Joseph Juran, which states that "for many events, 80% of the effects come from 20% of the causes," commonly known as the 80/20 rule.

However, our bond market distribution is even more skewed than that; 5% of the total number of issuers – approximately 425 entities – have issued 55% of the total notional of outstanding bond issues. While that may be surprising, at the other end of the spectrum, the statistical mode shows us the most frequent number of issues per issuer is one! The modal notional outstanding is USD500,000. In other words, the opportunity for creation of benchmark issues and reducing the number of bonds outstanding applies to no more than 20% of current issuers.

BlackRock reported a similar finding in its Viewpoint article, "Addressing Market Liquidity," in which it commented on the fact that the Top 20 US and European issuers were responsible for 18,000 bond issues, while typically they had only one common equity outstanding. BlackRock also observed that most of these issuers' bonds had insufficient liquidity to be included in benchmarks such as the Barclays US Corporate Index. I found these statistics fascinating, and hence my call to DelphX.

Financial issuers responsible for the proliferation?

DelphX not only confirmed BlackRock's findings with very similar bond issuance statistics, but also broke down the issuance numbers by bond type. Looking at the detail of issuer industry sector versus bond types issued (*Figure 2, below*) we see that financial institutions issue the vast majority of bonds outside the normal fixed rate bond with which we are so familiar. On reflection, this should not come as a surprise, since bond issuance and facilitating investor goals are part of their business. For example, most of zero coupon bonds are small issues, linked to indexes and presumably issued to specifically targeted investors.

The top 5% of issuers are, therefore, not simply prolific issuers of bonds; they are pursuing a business strategy. Clearly, such bonds fall outside the universe available for our benchmark liquidity creation exercise, and if we exclude zero coupon, floating rate, adjustable rate and convertible bonds, we are left with fixed rate bonds, which represent about 62% of our universe in terms of number of issues. However, not all of that 62% are eligible for our liquidity enhancement exercise, as many of these belong to the 80% of participants that are low-volume issuers.

Turning the spotlight on the frequent issuers

Where is the opportunity for benchmarks? There are about 70 issuers that have more than 10 issues outstanding, with a total notional amount of greater than USD5 billion. This group of issuers represents around 2,600+ issues and a notional amount of USD1.4 trillion, (i.e., about 10% of the notional amount on which we started our exercise). While most of our bond market mosaic will still be composed of small fragments, we now understand why it is fragmented, and we have a targeted universe for our consolidation exercise. So let's turn to the mechanics of consolidation.

There are three main ways in which issuers could create liquid benchmarks, namely:

1. An exchange of all the targeted outstanding issues for a new set of benchmark issues. While BlackRock has presented a "before and after benchmark creation" illustration in the past, I don't believe it was seriously recommending a full-scale exchange (nor do I believe it is practical), and so we can discard this option.

2. Bundling their borrowing requirements into less frequent issuance events and issuing fewer maturities in order to create larger issues; or
3. Re-opening outstanding issues and increasing the notional amount rather than launching a new issue.

Note: There is another reason for fragmentation, and that is due to regulatory rules. For example, Verizon issued a total of USD16.5 bn split into three equal tranches: Global Note, Reg S and 144A. Clearly, the targeted investor base required such an action under current regulations, but one issue would have been more advantageous in terms of liquidity.

Option 2 could potentially be used when a borrower has additional borrowing requirements within 3 or 6 months. For example, Apple issued 9 bonds this year for a total notional amount of USD13.35 bn (*Figure 3, below*). BlackRock points out that larger, more liquid issues will carry a lower "liquidity premium" and additionally, borrowers will be able to issue at tighter spreads in the future. Investors hold the trump card here, as they are the buyer. Investors could influence the actions of the borrowers by offering incentives. I am interested if investors who are worried about liquidity actually offered lower costs to Apple for increased issue size. Does investors' interest in higher returns trump that of their interest in liquidity until they need to sell? Maybe most investors are "buy and hold to maturity" investors and, therefore, unlike investors that run funds, they prefer yield to liquidity.

Re-opening old issues

Many of the issuers in our target group have two or three issues of the same maturity. For example, one issuer has the following two bonds: USD1.25 bn, 2.375%, Sep 14, 2017, and USD1.1 bn, 1.375%, Mar 17, 2017. The first was issued in 2012 and the second in 2014. Would investors have preferred the issuer to re-open the original issue and to have bought the bonds at a premium in the interests of liquidity? Would they have gone so far as to offer the issuer a discount in yield to avoid another issue? Or would investors have bought the new bonds at the prevailing rates, pocketed extra Alpha if the liquidity spread narrowed, and promised the issuer "jam tomorrow" in terms of tighter spreads when the issuer brought another new issue? Of course, the same questions could be asked relative to the Apple example we considered earlier.

The IRS hurdle

There is a major hurdle to be cleared before re-opening issues can be considered a viable option. The hurdle is not investor behavior; nor is it issuer behavior – it is IRS rules/Treasury regulations. The issue hinges on obtaining fungibility with the original issue for the new bonds, without which the exercise is pointless. To share a CUSIP/ISIN, the bonds not only must share exactly the same terms and be issued under the same indenture, they also must share the same tax treatment and be considered a "qualified re-opening" under Treasury Regulation 1.1275–2(k) issued in September 2012.

The requirements boil down to one element: Original Issue Discount (OID). Essentially, when re-opening an issue by issuing new bonds at a discount, one of three conditions must be met to become a "qualified re-opening" and to achieve fungibility with the original issue:

1. De-minimis OID. Both the original and the new bonds must be issued with a price discount of no more than 25 bps times the number of years to maturity.
2. Re-opening an issue within 6 months of the original issue date. The yield of the original bonds on the re-issue date (and therefore the new bonds as well) cannot be more than 110% of the yield of the original bonds on their original issue date.
3. Re-opening an issue more than six months after the original issue date. The test is as in point 2, but the threshold is dropped to 100%.

The issuer in our example above could have conducted a "qualified re-opening" of the original 2.375%, Sep 14, 2017 issue, as yields had fallen and the new bonds would be issued at a significant premium. However, in the case of Apple, the new bonds would not pass the test to become a "qualified re-opening" due to the difference in yields and therefore, fungibility would be impossible to attain.

Clearly, in a rising interest rate environment, Treasury regulations effectively preclude attaining fungibility and the re-opening of recent issues. The door is not entirely shut, though, as there may be some old high coupon issues out there, but it is certainly not an option for market participants seeking a wholesale creation of benchmark bonds.

Dream or reality?

The verdict, in my opinion, is that wholesale creation of benchmark issues appears to be a dream. There are certainly some instances in which liquidity could be improved. However, considering the disparate array of issuers, bond types and regulations in the whole mosaic, what appears to be a large opportunity when it is viewed from a distance becomes a jumble of incongruent pieces upon closer inspection.

Frequent issuers may present some opportunity for larger issues, if investors offer them sufficient incentives and don't simply expect them "to do the right thing" as "custodians of the market" or jump for the promise of "cheaper borrowing rates tomorrow." Moreover, current IRS rules effectively thwart the promising option of re-opening an original issue.

Restructuring issues and changing issuance behavior, while perhaps bringing a small measure of relief, are not going to solve the USD corporate bond market liquidity problem either in the short or long term. It is time to stand back, look at the picture from a different angle and explore other options.

As readers will know from my earlier article, "Corporate Bond Market Liquidity – The Way Ahead," I favor the development of new technology platforms and new derivative and futures contracts that create synthetic benchmarks and put the USD corporate bond market on par with other major markets. Such instruments and platforms would enable issuers to manage their requirements as they see fit and deliver the liquidity outlets that investors need.

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