Addressing the Liquidity Challenge
Corporate Bond New Issue Standardization

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The challenge – deteriorating liquidity in the corporate bond market

Challenged secondary market liquidity in the corporate bond market has been a topic of increasing concern to both institutional and retail investors for the past several years.

**WHEN THE DEALER STOPS DEALING**
US Primary Dealers' Corporate Bond Inventory, 2001–2013

![Graph showing the trend of corporate bond inventory from 2001 to 2013.](image)

Notes: The left chart contains some non-corporate securities such as collateralized mortgage obligations issued by entities other than US federal agencies or government sponsored enterprises. In April 2013, the position reporting structure changed to give the more detailed breakdown of corporate positions shown in the pie chart.
Secondary market liquidity has deteriorated as the corporate bond market’s size has grown in recent years, driven by record issuance.

Source: MarketAxess. As of September 2014.
Note: Line represents 12 month rolling value of trade as share of outstanding debt.
Addressing the challenge

Numerous efforts aimed at addressing the challenge of deteriorating liquidity are being explored by market participants. Most are focused on new trading venues—client-to-client trading, exchange-like venues with a central order book.

- Several dealers have developed proprietary electronic trading platforms.

To date, little focus on the impact of new issue practices on market structure.

- New issue activity is critically important to the structure of bond market, far more so than in equities.
New issue practices have contributed to a market structure that is inherently illiquid

Companies tend to issue bonds whenever financing needs arise or opportunities present themselves

By staggering issuance schedules and diversifying maturities, companies can minimize risks of refinancing and higher rates when credit markets are expensive (or closed)

As a result, trading is fragmented across thousands of bonds of varying maturities

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Bonds in Barclays US Corporate Index</th>
<th>Share of Dollar Amt Outstanding</th>
<th>Total Bonds Outstanding</th>
<th>Common Equity Securities</th>
<th>Preferred Equity Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of America</td>
<td>53</td>
<td>46%</td>
<td>1,295</td>
<td>1</td>
<td>33</td>
</tr>
<tr>
<td>General Electric</td>
<td>48</td>
<td>36%</td>
<td>905</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Verizon</td>
<td>42</td>
<td>83%</td>
<td>73</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>45</td>
<td>40%</td>
<td>1,695</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>28</td>
<td>44%</td>
<td>1,488</td>
<td>1</td>
<td>8</td>
</tr>
<tr>
<td>Citigroup</td>
<td>42</td>
<td>35%</td>
<td>1,865</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>27</td>
<td>42%</td>
<td>1,331</td>
<td>1</td>
<td>13</td>
</tr>
<tr>
<td>AT&amp;T</td>
<td>43</td>
<td>63%</td>
<td>85</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>Wells Fargo</td>
<td>37</td>
<td>39%</td>
<td>304</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>Comcast</td>
<td>36</td>
<td>88%</td>
<td>56</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

Sources: Barclays and Bloomberg, April 2014. Note: Table shows issuers with the largest notional amount outstanding in the Barclays US Corporate Index. Reference to issuers is for illustrative purposes only, and should not be construed as investment advice or investment recommendation of those companies.
Several market changes can contribute to an environment of improved liquidity

There is no “silver bullet” which will cure the liquidity challenge

However, there are four drivers which, in concert, have the potential to substantially improve liquidity

- Standardization of new issue activity – the focus of this discussion
- Broadening of trading to an all-to-all environment, uncovering latent liquidity
- Adoption of new eTrading protocols, reducing reliance on scarce dealer capital
- Behavior changes by market participants that recognize the fundamentally changed landscape

Of the above drivers, electronic trading venues have seen the most activity to date

- Broader eTrading activity will be an important driver
- However, without a concurrent change in the underlying market structure, will simply transfer voice activity, rather than truly broaden liquidity
More standardized issuance – a tool to help enhance liquidity, transparency, and access

Standardization would reduce the number of individual bonds - via steps such as issuing similar amounts and maturities at regular intervals and re-opening benchmark issues to meet ongoing financing needs. This would cut down the jungle of bonds and create a liquid curve for individual issuers.

Standardized terms would improve the ability to quote and trade bonds.

Standardized issuance would:
- Enhance secondary market transparency and encourage liquidity
- Greater transparency and access for retail investors
- Lower new issue concessions, lower volatility, and more reliable market access for issuers

Adjacent markets such as government bonds, credit default swaps, and agency & supranational bonds have all experienced standardization in the preceding two decades.

To date, the corporate bond market has not demanded standardization due to the strong demand for credit over the past several years.

With greater focus on secondary market liquidity and the risks arising from a rising rate environment, this dynamic is poised to change.
What is corporate bond standardization?

**Guiding principles**

**Enhance liquidity in OTC corporate bond markets via 3 inter-dependent components of new market structure**

- Issuance of standardized corporate bonds
- Increased use of standardized index products, such as ETFs and others
- Increased use of standardized hedging tools, including cleared interest rate swaps and credit default swap indices

**Concentrate liquidity by reducing the vast number of unique securities**

- Facilitate larger benchmark issues and ultimately reduce the number and size of relatively illiquid securities
- Increase in securities eligible as high quality collateral
- Applicable to both small and large, frequent and infrequent issuers

**Increase reliability of market access for issuers**

- More regular, predictable, reliable market access
- Dampen volatility

**Lower costs**

- Financing and issuance costs for corporate borrowers
- Transaction costs for investors

**Increase price transparency**

- Easier for regulators to monitor credit market conditions
- Facilitates greater retail market participation
- Enable corporate bonds to act as primary credit risk benchmark, instead of CDS
What is corporate bond standardization? Guiding principles (continued)

Enhance trading volumes
- Potential for greater use of electronic venues
- Improve ability for broker-dealers to make markets

Increase operational efficiencies

Increase capital formation
- Facilitates transition from bank lending in environments where bank capacity is reduced

Consistent with the spirit and aims of global regulatory initiatives post the financial crisis
What is corporate bond standardization?

Potential features

<table>
<thead>
<tr>
<th>Feature</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum tranche size</td>
<td>$750 million</td>
</tr>
<tr>
<td>Registration</td>
<td>SEC Registered</td>
</tr>
<tr>
<td>Coupon / Maturity dates</td>
<td>Semi-annual coupons, maturity on one of these four dates: 3/15, 6/15, 9/15, and 12/15</td>
</tr>
<tr>
<td>Call option for refinancing flexibility</td>
<td>3 month par call option prior to maturity date</td>
</tr>
<tr>
<td>Make-whole call option for early redemption</td>
<td>Set as 15% of initial credit spread, rounded to nearest multiple of 5 bps</td>
</tr>
<tr>
<td>Listing</td>
<td>Listed on exchange, ECN, or other regulator-approved platform</td>
</tr>
<tr>
<td>Issuance format</td>
<td>Underwritten</td>
</tr>
<tr>
<td>Credit ratings</td>
<td>Investment grade</td>
</tr>
<tr>
<td>Additional issuance</td>
<td>Eligible for re-openings / additional issuance</td>
</tr>
<tr>
<td>Post-trade reporting</td>
<td>TRACE</td>
</tr>
</tbody>
</table>
Successful market reforms will require behavior changes from all categories of stakeholders

1 INVESTORS: Are you ready to give up new issue gains and liquidity strategies for lower transaction costs, access to more bonds and the ability to buy (and sell) in size?

2 ISSUERS: Are you assessing the benefits of standardization (potentially lower issuance costs and lower legal fees) against the cost (a loss of flexibility and the risk of maturity walls)?

3 BANKERS: Are you preparing for a more standardized future by exploring ways to structure debt offerings to improve liquidity or do you think the status quo is sustainable?

4 TRADING VENUES: Are you developing new ways to trade beyond the standard client-to-dealer RFQ (request for quote) protocol, such as client-to-client order matching and a central order book?

5 REGULATORS: Given your concerns about market liquidity and transparency, should you think about standardization and how to promote it?
Key potential benefits of corporate bond new issue standardization

Higher secondary market liquidity

Greater pricing transparency
  - Increased ability for retail investors to participate

Reduced volatility

Lower transaction costs

Improved ability to tailor investment portfolios
  - Applicable to both active and index investors
Important notes

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