

29 September 2016

**PUBLIC COMMENT**

**IOSCO Consultation Report**

***Examination of Liquidity of the Secondary Corporate Bond Markets***

The regulatory community and market participants have not yet found common ground on the issue of secondary corporate bond market liquidity. IOSCO finds “*No substantial evidence that secondary corporate bond market liquidity has deteriorated markedly from historic norms for non-crisis periods”*,while finding in its survey that 68% of the buy-side and 80% of the sell-side believe that liquidity has deteriorated.

This response presents a market interpretation of data used in the IOSCO report, as well as wider reaching data for a more complete picture (as requested) in support. Sources are the Oliver Wyman’s *Interaction, Coherence, and overall Calibration of Post Crisis Basel Reforms* (August 2016) <http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/aug/post-crisis-basel-reforms.pdf> and the International Capital Markets Association’s *Remaking the Corporate Bond Market* (July 2016) <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/survey-report-liquidity-in-the-european-secondary-bond-market-perspectives-from-the-market/> .

**IOSCO KEY METRICS**

IOSCO points to three measures – volume, bid/ask spread, and price impact of trades – which it believes indicate improving liquidity. One general remark is that the analysis draws conclusions on a very broad level and does not take into account differences within different regions, markets, and bonds.

**Volume**

IOSCO notes that volumes are increasing but not keeping pace with market growth. The market sees this as decreased liquidity. Using aggregated figures from IOSCO’s survey of regulators, corporate bond outstandings increased by about 22% while volumes increased by only about 8% from 2010-14. The OW report demonstrates declines in the all-important measure of turnover ratio (figure E, pg. xii and figure 5.12, pg. 64). ICMA shows euro and sterling corporate bond volumes (figure 3, pg. 12) lagging outstandings growth (figure 4, pg. 13).

**Bid/Ask Spread**

Central Bank rates and 10-year government bond yields in the U.S. and Europe/Germany have all fallen by around 400 basis points since the crisis. This forces compression of bid/ask spread.

IOSCO mentions the shift of dealers from an agency to principal model. Such a shift compresses spreads further as dealers do not earn a premium for taking risk and committing balance sheet. This new market dynamic means a decrease in liquidity, as dealers do not stand ready to buy and hold bonds to support investors who need to sell.

Bid/ask spreads quoted on trading venues are often only indicative, or for small sizes. This is particularly true given the decline in average trade size.

**Price Impact of Trades**

Much of the research cited by IOSCO supporting a decline in the price impact of trades is largely theoretical. The ICMA report, figure 5 (page 13) demonstrates a trend for bid/ask spreads on actual trades (which are what really count) to be significantly wider than those for indicative trades. Also, it is important to take into account the fact that price changes are not only due to changes in a bond’s market liquidity but also to other factors such as changes in the credit risk. The abundance of funding liquidity resulting from loose monetary policies has certainly contributed to limit the price impact in recent years.

The OW report cites a 2015 IMF study of European sovereign bond trades (figure 5.13, pg. 66) and a 2016 CGFS study of U.S. treasuries (figure 5.14, pg. 67) which demonstrate that the price impact of trades has increased.

**FURTHER METRICS**

**Credit Default Swaps**

CDS markets are important to the analysis of corporate bond market liquidity. CDS are key to hedging, promoting position taking and offering an alternative to dumping positions in stressed markets. The decline in single name CDS liquidity is an area of concern for bond markets.

**Repo**

It is widely acknowledged that repo is fundamentally important to bond markets, allowing for both the financing of positions and settlement efficiency. IOSCO survey respondents did not provide evidence that dealer-bank appetite to intermediate repo had declined, but extensive data is available to support this including:

* Balance sheet reduction for repo (OW, table B, pg. xi)
* Repo balances of European and U.S. banks (OW, figure 5.10, pg. 62)

The significant increase in the regulatory costs of the repo business (OW, figure 5.4, pg. 54) has diminished bank participation. The Leverage Ratio and NSFR alone are expected to increase the funding costs of low margin market making business such as repo by 60 – 110 basis points.

**Number of counterparties**

IOSCO cites a study where the Fed argues that historically low overall market making returns means that dealers aren’t cutting back market making. More direct evidence is available in the OW report:

* Balance sheet reductions (table B, pg. xi)
* Changes in structure/activities (figure 5.9, pg. 59)
* Examples of banks exiting/shrinking (table 5.2, pgs. 59-60)
* Net positions of U.S. primary dealers – corporate bonds (figure 5.5, pg. 55)

Increased regulatory costs (OW report)

* Basel III Capital Requirements (figure 5.2, pg. 52)
* Resource consumption (figure 5.4, pg. 54)

go a long way in explaining low profitability.

**Volatility**

The IOSCO report does not include an analysis of market volatility, which demonstrates that liquidity is less available when really needed. OW illustrates how declining dealer inventories (a reduction in dealers’ shock absorbing capacity) may be linked to higher volatility and lower liquidity (CMBS, figure 5.6, pg. 56 and High Yield, figure 5.7, pg. 57).

**CONCLUSION**

The regulatory imperative since the outset of the Global Financial Crisis has been to make banks safer and reduce the liability of the taxpayer. This means a new and increased reliance on market based finance. There is a strong consensus view across all parties that liquidity is vital, but given the new structure of the financial system it becomes even more serious. The regulatory community has accepted liquidity conditions they perceive as not worsening, but steps are needed to actively fortify liquidity for difficult markets that will inevitably come in the future. We cannot expect markets to provide more while allowing them to function less effectively.

Extreme and unprecedented monetary policies are being employed to promote stability and growth. These measures are propping up liquidity in a highly substantial but artificial manner. Over time these policies create major imbalances and market anomalies, and must be withdrawn at some point to restore discipline, order, and sensible risk/return.

The IOSCO study focuses on liquidity in non-crisis periods. But it is in crisis situations when liquidity becomes perhaps the most important element of all. One is reminded of criticisms of VaR, where “you have an airbag that works unless you have a car crash.” An understanding of likely effects on liquidity in times of stress is vital. Central banks and governments are highly experienced in intervening in banks in times of turmoil, but it is less clear how stability could be achieved in the new and expanded financial markets without liquidity.

**INDUSTRY “ASK”**

This response supports the following “asks”:

* Seek to avoid regulatory duplication or conflicts in an effort to grow liquidity
* Perform a cumulative assessment impact of the full set of regulations
* Make full use of metrics, including relative holdings of institutional investors, dealers, banks, and central banks
* Survey the “real” industry users of markets – the *issuers* of corporate debt as well as *investors*

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