

IOSCO Consultation Report

Examination of Liquidity of the Secondary Corporate Bond Markets

ANSWER OF AMAFI

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities. Nearly one-third of members are subsidiaries or branches of non-French institutions.

AMAFI welcomes the opportunity to comment on IOSCO Consultation Report ((hereafter referred as to the "CR") on "Examination of Liquidity of the Secondary Corporate Bond Markets".

Indeed, for more than two years, the liquidity of secondary markets and more specifically, of corporate bonds markets has been discussed by various stakeholders (market participants, market supervisors and regulators, Central Banks, academics.....). AMAFI has contributed to the debate by issuing on October 2015 (AMAFI / 15-48) a document named "The Question of Market Liquidity: Taking the Measures of Current Developments to Respond Accordingly". The document is attached to AMAFI's answer as we believe that this report still provides useful insight together with several proposals.

In a nutshell, the AMAFI report expounds the mechanisms of current evolutions and evidences a very worrying **squeeze effect** combining on the one end the **increase of the demand for liquidity**, and on the other end, a **decrease of the supply of liquidity**. The report identifies a series of possible solutions that should be contemplated in a coordinated manner.

AMAFI is not in a position to provide IOSCO with relevant data given the time frame of the consultation. The following comments must be read having in mind that AMAFI members act on the corporate bond market either as market makers or as brokers.

AMAFI wishes to first give a series of **comments on the report itself (I.)**, before offering a focus on some **missing elements** in IOSCO's analysis, notably regarding the **monetary policy**, which is a critical element for the understanding of bond markets functioning today **(II.)**. Finally, the Association wants to draw some **perspectives on the market structure model** that is intended to be built, which should stand as a key element of the whole reflection **(III.)**.

I) Comments on the report itself.

We are concerned that "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 gap needs some further analysis in order notably to understand what aspects of market liquidity or market depth lack from the markets participants' perspective.

AMAFI is a member of the International Council of Securities Associations (ICSA), and actively participated in the writing of its response. It endorses the comments made on the report of IOSCO in ICSA's answer. On the interaction between prudential regulations and the evolution of business models and strategies, we would refer to the GFMA/ Oliver Wyman report published on August 9, 2016 ("Interaction, Coherence, And Overall Calibration Of Post Crisis Basel Reforms").

Moreover, the Association would like to add the following elements.

IOSCO analysis is based on data that can be questioned

Period of observation

The CR contains about 45 sets of data with about half of them ending at the end of 2014. This probably introduces a bias in the analysis because the impact of the additional capital requirements on bond inventories was not fully felt at that time. It is notably the case for the **Incremental Risk Charge (IRC)** models that came progressively live in 2013/2014. The IRC captures default and migration risks; as for migration, the CDS spreads matrix is calibrated on a stressed period, there is a potential overlap with the SVaR (computed since 2011). The current situation of the corporate bond market is probably much different.

Granularity of the data

The structure of the corporate bond market varies widely across segments and jurisdictions, where market structures can be completely different. More specifically, given the lack of comparable and reliable data reporting in the EU, it is impossible to have a clear picture of bond secondary trading in Europe and the large use of American data to draw conclusions on the European situation is problematic. As an alternative and before MiFID II reportings are in place, we suggest IOSCO could build on the recent findings of ESMA (EU corporate bond market liquidity – recent evidence¹) to complement its analysis, since the time span of the analysis cover a more recent period. For instance, , as per ESMA and based on MiFID II liquidity criteria only 1% of corporate bonds ISINs would be liquid (on 54,400 ISINs) but this 1% represent 55% of the trades which shows how corporate bonds trading is concentrated within liquid bonds. Or else, 77% of trades are concentrated within the 4% most liquid corporate bonds.

IOSCO should also look at other factors

Lack of data on the immediacy dimension of liquidity

IOSCO recognises that the metrics used may not properly reflect the immediacy dimension of liquidity that is the temporal dimension attached to exit a position, while recognising in its footnote 44, p.21: '*IOSCO found some academic evidence to support the notion that the cost of immediacy for corporate bonds may have risen since the 2008 credit crisis in certain situations*'. The fact of not investigating further in this direction considerably weakens the value of the analysis, since immediacy is recognised as a fundamental aspect in liquidity, and many market players indicated that it has degraded according to many market participants.

¹ https://www.esma.europa.eu/sites/default/files/library/2016-666_opinion_on_draft_rts_2.pdf

II) An essentially biased environment: exceptional monetary policy as well as risk situations should be examined more closely

We believe that the panorama on market liquidity developed in the IOSCO analysis is incomplete, it is important to take into account the overall macroeconomic context marked by the use of unconventional monetary policy tools as well as stressed situations so as to give a proper assessment of market liquidity.

The omission of this structural element limits the accuracy of the picture. The exceptional nature of monetary policy in major monetary areas deeply affects indeed the functioning of financial markets and creates uncertainty as to the fundamental level of liquidity.

Exceptional monetary policy significantly affecting financial markets

The picture of financial markets given in IOSCO study among others does not sufficiently take into account the effects of monetary policy, which may bring a temporary/ circumstantial liquidity, leading to the yet well-evidenced 'liquidity illusion'.

Following the crisis, central banks have largely extended their interventions, through repeated programmes commonly known as quantitative easing (QEs), comprising different sorts of **LSAPs** (large scale asset purchases).

If the large scale asset purchases interventions can undoubtedly **provide additional market** liquidity when they support market flows and if they are carried in a proportionate manner, **they also raise a number of questions**.

These interventions clearly distort markets and can have some unexpected consequences. In his presentation on May 3, 2016 at the Federal Reserve Bank of Atlanta Financial Market Conference ("Getting a Grip on Liquidity"), Ulrich Bindseil, Head of the ECB Directorate General Market Operations underlines that there is a need to specify LSAPs towards (i) market neutrality and (ii) re-channelling of securities to market through securities lending.

However, the conditions described by Bindseil in order to ensure market neutrality (share limit, flexibility at ISIN level, avoid buying bonds trading special in repo markets and bonds held made available for securities lending) may appear not to be sufficient to address completely the issue of market liquidity:

- It seems that market makers and other market participants take into account the eligibility criteria so that securities that are not eligible to QE (e.g. high yield) might suffer from a **crowding out effect**. The formation of **two distinct markets** with on the one hand eligible securities and on the other one non-eligible securities, seems already visible, since data shows that in the past few months, the basis between CDS and bonds is showing that liquidity on (eligible) bonds is increasingly higher compared to the CDS market, especially in the wake of the British referendum vote. It could be worth completing the IOSCO approach on liquidity bifurcation by an assessment of the number of outstanding issues that are less liquid. The idea that QE has a generally positive impact on all debts is probably too optimistic. Apparently, QE has distributional impacts including on market liquidity.
- Moreover, the relaxation in funding and monetary conditions may in some instances **undermine the price discovery process**, leading to apparently stable prices, an under-pricing of tail risk and insufficient compensation for liquidity risk; the liquidity risk premia may have been compressed to artificially low levels; liquidity risk premia have actually fallen to below their long-term average, as feared by Dame Clara Furse, member of the British Financial Policy Committee, in her speech dated Feb. 2015.

Investors are engaged in a search/hunt for yields, that would enable them to cope with their fiduciary/ contractual obligations, and seem more prone to accept additional risks: very long durations and "peripheric" risk" up to a certain point.

Furthermore, in the context of the **liquidity squeeze** described in our study on The Question of Market Liquidity (*AMAFI / 15-48*), with on the one hand the higher demand for resilient liquidity (due notably to the increase in the inventories of asset managers who are subject to daily NAV and redemption rights and to the large issuances) while on the other hand a diminishing offer of resilient liquidity (inventories of banks/ market makers have reduced), this mispricing can have particularly pernicious consequences, with some investors willing to sell "first" the assets they consider as mispriced (or above their "long term risk appetite") leading to a sell-off. These turbulences could likely happen before any QE unwind, but rather when the Central banks start to slow down their purchase programmes.

In total, the temporary effect on liquidity of these large asset purchases programmes can prove to be misleading, notwithstanding the many questions posed by the exit strategy, these interventions not being supposed to be permanent.

Considering the continuing fragility of some markets in spite of their repeated interventions, certain central bankers have even evoked the possibility of intervening as **market makers of last resort** (MMLR). As such, the activity of MMLR appears far more risky than the traditional lender of last resort standing of the central bank, and presents risks still difficult to correctly assess, because there is no collateralisation as in the activity of banker of last resort (see Paul Tucker, BIS Papers 84, May 2016).

A challenge for the business model of market makers

From a more microeconomic perspective, in this context of easy money and close to zero lower bound interest rates, associated with the post-crisis re-regulation phase described by Paul Tucker, the business model of market makers is especially strained, and should continue to deteriorate.

These essential liquidity providers indeed face a squeeze effect with reduced gains and relatively higher charges.

On the one hand, market makers face reduced possibility to make gains due to:

- extremely low or negative interest rates, which have a direct effect on the bid-offer spread
- a diminution of rotation of investors' portfolio in the QE context, the directional monetary policy creating a certain passivity, while the level of interest rates make by comparison the transaction costs quite expensive,
- the reduction of the volume in general considering that many issuances which are now detained by players adopting a buy and hold investment profile

This is associated on the other hand by higher capital and liquidity/ funding requirements while the cost of capital (as assessed notably by the EBA) remains high. This has been acknowledged by officials such as John Berrigan, director at DG FISMA of the European Commission who stated in his speech at the EIFR on 28 September: "we have made market making more expensive and less attractive".

Capital allocated to the trading activities seems to be the primary constraint in a context where banks are seeking to reduce RWAs and costs.

In the end, the profitability of these players is substantially undermined. This movement explains the closing of several desks that has already happened.

The importance to consider situations of stress and the challenges ahead

The whole analysis is based on normal conditions, while the real challenge would come in case of a liquidity shortage, which can be caused by a sudden and often unexpected disruption provoking a rapid drying up of markets.

AMAFI is aware that it is difficult from a methodological point of view to envisage stressed environments, as IOSCO makes it clear in its report. It is nonetheless important to take into consideration the situation of market liquidity in these very instances, and several episodes of volatility have been registered and can offer interesting insight on the actual situation of liquidity and liquidity providers, such as the episodes of flash crashes.

It would also make sense to consider the consequences of Brexit on the European bond market, since market European framework can be overwhelmed and need a rethink if Britain becomes a third-country.

III) Envisaging the future market model

AMAFI is convinced that beyond the question of market liquidity lies the question of what market structure will best fulfil its commonly accepted function, as being at the service of investors as well as project holders. There is a need to better understand what the dynamics currently at play will produce in terms of risks for these different players and the whole system.

Tendencies pointing towards a new market structure

Corporate bond markets are changing quickly in their structure, and AMAFI thinks it is time to link the question of market liquidity to the market structure model that will result from the undergoing evolutions in these markets. A detailed analysis of the **avenues to explore and the trends already at play** is available in the last part of our study on The Question of Market Liquidity (*AMAFI / 15-48*), published last year. AMAFI would like here to summarise these conclusions and try to put them in perspective.

Electronification, the increase of asset management holdings, the development of agency models among other tendencies redesign progressively market structure where traditional OTC dealers' activity is not anymore as pivotal as it were. These changes must be pondered considering its potential impacts on systemic risk and on their distributive effects on different market players.

So far, the continuing fragility of market liquidity evidenced during bouts of stress recently registered shows that a new equilibrium has yet to be reached for markets to be resilient. It could be a sign that the closing off of several dealer desks and the diminution of broker-dealer exposures have not been offset by sufficient new alternative liquidity sources. In fact, asset managers' claim to replace sell-side players as new market makers has so far been largely theoretical and remains "capped" by the fiduciary duty owed to their investors. In reality, asset managers are tied to their commitments to act in their clients' best interests. They would enter into or exit a position only if this is in their clients' best interest but do not have as a mandate from their clients to provide liquidity to the market. The liquidity asset managers can bring to the market is only the consequence but not a purpose of their acting on behalf of their clients. Policy makers should not rely on positive consequences that an activity can bring but merely on concrete and robust solutions which main objective are to make this bespoke market function efficiently.

Different evolutions point to the emergence of a new equilibrium based on more long-term investment, with less rotation of stocks and less liquidity demand. The development of private placement goes in that direction of accepted illiquidity for certain securities, and in this respect a series of initiatives are welcome, such as the development of services to issuers. AMAFI is more reserved as to the true benefits for issuers at large brought by bonds standardisation; issuers need to be in a position to manage adequately

their issuing programme in order to adapt these issues to their financing needs (acquisitions, investments etc) and to smooth redemptions. Electronification mainly focuses on the large standardised benchmarks and does not provide to date an adequate solution for smaller issuers/ bespoke issues. These could contribute to the further bifurcation of liquidity between liquid and illiquid securities, increasing clients and products segmentation and designing a two-tier market. The bespoke character of the European corporate bond market is also considered by ESMA² which states that *“While it is correct that the corporate bond turnover ratio has declined over the last years, in some segments of the bond markets trading volume has increased. **Recent studies point to a bifurcation of liquidity of bond markets** with stable liquidity for benchmark sovereign bonds and deteriorating liquidity in those markets segments which have been historically less deep”*

It is also important to take note of the fact that in this new model, execution risks are more often borne by clients and that new position takers bear a risk without being limited by as many regulatory safeguards as dealers are in the post-crisis environment.

Beyond these “macroeconomic” aspects, it would be worth considering other evolutions such as clients and products segmentations and their consequences on the efficiency of financial markets.

The market liquidity factor to be taken into account by new regulations

The objective of more resilient intermediaries is crucial and new regulations were undoubtedly needed after the crisis. Nonetheless, market structure can be significantly and adversely impacted by leverage and risk capital requirements. These measures influence strategic decisions with lasting consequences on the provision of liquidity, ultimately weakening markets.

With a view to ensure the viability of liquidity providers, without which corporate bond markets will not be able to function efficiently, it is urgent to carefully weigh the choices being made in the prudential and market standards. These reflections were designed in consideration of the European regulatory framework, where they are particularly relevant since market intermediaries obey to many rules that were designed for banks.

According to AMAFI, these conclusions should first lead to a **systematic assessment of the consequences on market liquidity of new regulatory measures**. It is also crucial to carry out an **in-depth review of existing regulations** with a view to identify and clearly balance the trade-off between transparency and liquidity in market regulations and between certain prudential ratios and the liquidity provision capacity of intermediaries. This should ideally be complemented by the introduction of **streamlined prudential treatment for assets issued by SMEs and mid-tier firms**, following the special treatment offered to these assets in the banking book in Europe.

Apart from this adapted prudential treatment, AMAFI considers that a reflection on **accounting standards**, questioning the mark-to-market in some instances, and **taxation** is needed, as well as a more sharpened approach to market regulatory interventions, which should be given new tools in period of distress. Our policy contribution aiming to introduce the liquidity factor in authorities’ toolkit is developed in the last part of our aforementioned study on market liquidity ([AMAFI / 15-48](#)).



² https://www.esma.europa.eu/sites/default/files/library/2016-666_opinion_on_draft_rts_2.pdf