CMU WORKSHOP ON CORPORATE BOND MARKET LIQUIDITY
BRUSSELS, 26 JULY 2016

This workshop brought together around 80 policy makers, researchers, market participants and end-users of corporate bond markets to assess the functioning of corporate bond markets in Europe. The aim was to have a constructive forward-looking discussion and to generate practical insights on how corporate bond market liquidity can be improved. Discussion was held under Chatham House rules.

Session 1 – Current state of play

The workshop began with opening remarks from the workshop participants about the current state of play of corporate bond markets in the European Union. The first question for policy makers was how to assess corporate bond markets: what is the correct benchmark and what is the "new normal"? Participants were asked what they believe the indicators of performance reveal. Policy makers noted the positive and strong growth of corporate bond markets as a source of funding, which had been particularly valuable in the context of an impaired bank lending channel. It was clear that identifying the "new normal" is difficult as the market has witnessed a number of structural breaks, including the introduction of the euro and the great moderation.

Following an interactive panel session involving issuers, investors, market makers, regulators and data providers it became clear that the indicators do not point all the time in the same direction. It was reported that there have been changes in terms of trade size, volumes, performance during times of stress and an emerging gap between the supply of liquidity by market makers and the demand from asset managers. Some market participants argued that hard quality data is not enough as there will always need to be an element of qualitative assessment when looking at market liquidity (illiquidity is mainly what is not traded). There was agreement that there had been a significant change compared to the situation before the crisis. Some questioned if the situation before the crisis was normal.

Many participants stressed that the European Commission should not be analysing the corporate bond market in isolation, but should rather form a more comprehensive view, including an assessment of the impact of the functioning of the repurchase agreement (repo) and credit default swap (CDS) markets and clearing on corporate bond market functionality. Some issuers and investors pointed to frictions and tensions in primary markets (in terms of pricing and availability of funding), which had stemmed from the situation in the secondary markets and stated that both should be looked at together. Some market participants raised concerns about the poor quality of information available to them and regulators in corporate bond markets. There was an open question whether an appropriate balance had been struck by current rules on disclosure, information flow and transparency in bond markets.

Session 2 – Causes and drivers of market liquidity

The second session focused on identifying the main drivers of the market trends in corporate bond market liquidity. There was reasonable consensus that a multitude of factors are at play, which are interacting with each other. Specific concerns were raised about the cumulative impact of regulation on the business model of market makers and the impact of low interest rates, forward guidance and asset purchasing of central banks on market liquidity. The collapse of yields and the effects of monetary policy were clearly important factors. Concentrations of investor holdings in bonds, as well as the changing market structure were also identified as contributing to the market trends. There was some discussion about the possible negative consequences of transparency, mandatory buy-ins and electronification (referring to high-frequency trading activities and vulnerabilities in the exchange traded fund market).

On the role of regulation, some participants felt that reduced market liquidity might be a price worth paying if overall the financial system is strengthened. Other participants felt that the cumulative impact of regulation had become too burdensome, particularly with respect to market making, and did not see who else could replace the role of market makers in corporate bond markets. Policy makers recalled the benefits and costs of the recent regulatory changes for market liquidity and a need to split between the cyclical and structural factors. Market makers highlighted that different collateral behaves differently in stressed conditions and since the withdrawal of market makers there had been increased correlation of trading positions (i.e. less players willing to take the other side of the trade). It was reported that concentrated and unstable secondary market liquidity is making positioning very challenging, which is impacting on portfolio management choices. Following on from the previous session, participants stated that it would be important to consider the effects of regulation on repo markets, given the links to corporate bond financing.

Session 3 – Future regulatory pipeline

The third session explored the impact of forthcoming regulatory initiatives on the functioning of corporate bond markets. The Commission opened the discussions by providing an overview of the replies to the Call for Evidence on market liquidity, where many had raised concerns about declining market liquidity, particularly in corporate bond and repo markets.

A number of industry participants argued that the crisis-calibrated regulations should be adjusted accordingly by defining the level of risk that policy makers are willing to tolerate against the funding needs of the economy. One regulator pointed out that many regulations have already been tweaked quite a lot in response to industry concerns (e.g. the material deviations from Basel standards in the Liquidity Coverage Ratio (LCR); the use of initial margin in the leverage ratio and the adjustments made to the calibrations for MiFID II pre-trade transparency). An industry association representative reported that trading activities are more affected by the leverage ratio than by risk-based measures.

Some market participants argued that the Net Stable Funding Ratio (NSFR) is very detrimental to market making activities for banks as it locks scarce and expensive long term funding for a short term activity, and increases operating costs. There were also remarks about the treatment of derivatives in the NSFR calculation, in particular the restrictions on netting of derivative exposures.

With respect to the impact of the Central Securities Depositories Regulation (CSDR) mandatory buy-in, participants pointed to the results of a recent ICMA study suggesting that even the most liquid sovereign bonds will see bid-offer spreads double, while secondary markets in less liquid corporate bonds may effectively close. A few market participants saw the value of the buy-in rules, but they emphasised the importance correct calibrations to avoid strongly dis-incentivising dealers from trading in corporate bonds.

Industry participants called for exemptions for market-making activities, pointing to the examples of the US Volcker Rule, the EU, French and Belgian bank structural reform rules to show it is possible. Others expressed doubts on the extent to which these examples were appropriately calibrated.

With respect to the forthcoming rules on transparency under MiFID II, many industry participants welcomed the recent regulatory technical standards published by the Commission, but maintained that the calibrations do not go far enough to solve the problems.

Institutional investors referred to the increasing market-making role of the buy-side players and emphasised the importance of the traditional market makers remaining in the corporate bond markets. It was noted that some new market-maker firms are emerging to fill the gaps of the incumbents. It was questioned if these firms would be regulated to the same extent as the larger players. One participant thought the combined impact of the Bank Recovery and Resolution Directive (BRRD) and the Total Loss Absorbing Capacity (TLAC) would lead to a huge amount of bank bonds issued on the market that will compete in terms of risk-adjusted yield with non-financial corporate bonds.

The session concluded with a reminder that procyclicality in regulation should be avoided, while acknowledging that there are spillovers from one area of regulation to another. Regulators cautioned against using the impact of regulation of individual banks as a proxy for the whole sector. Policy makers suggested that current regulation should be assessed in light of the need to prevent another crisis occurring, stating that while it was possible to tweak regulation to correct calibration errors, it is important to be mindful that the new regulatory framework was put in place to avoid the problems and mistakes of the past.

Session 4 – Looking forward

The fourth session looked ahead at the opportunities and risks of the market trends.

The first trend discussed was the increased pressure on market makers for a mix of reasons, including regulation. Participants reported market makers moving towards an agency-based business model. Given that this has happened, there was a discussion about how the market would live with this evolution, what could fill the gap, and what could complement the traditional market makers, including organised trading facilities, exchanges, and platforms.

Participants also reported a decreasing head count of sell-side players commensurate with the increase in capital costs of the business line. There was a general feeling that trading outcomes are likely to become more disparate and there will be a talent shift from the sell-side to the buy-side. On the buy-side, participants reported witnessing an increasingly active role of institutional investors. Some reported frustrations with getting access to the corporate bond asset class in both the primary and secondary markets. Another reported trend was the growth in corporate funds.

On the technology side, the emergence of multiple new platforms (buy-to-buy, buy-to-sell and all-to-all) was cited as an interesting trend to follow as the market focus shifts from the sell-side to the buy-side. Investors reported difficulties determining the fair price on these platforms, especially for buy-side to buy-side platforms. The market infrastructure providers outlined a number of trading models and services that they are developing, and a need for all stakeholders to work together to build solutions for the new market structure and environment.

Most participants felt that there would continue to be a role of market makers in corporate bond markets going forward. There were concerns about who would replace the role of traditional dealer banks, given the decreasing presence of hedge funds and a complete removal of proprietary desks. Dealers reported that most business is now being done with the fund industry. A number of participants were concerned that a reduced diversity of the corporate bond market would make it less resilient to future shocks. Some participants felt that the market structure for corporate bond trading would naturally evolve, irrespective of regulatory change, and that other factors (e.g. technology) would probably be the driving force. It was also reported that market participants are increasingly using substitutes to corporate bonds, e.g. via derivatives or exchange traded funds. Others suggested that electronic crossing could be part of the solution.

A number of participants raised again the issue of information provision (particularly pre-trade). There were concerns that that a wedge is developing between high yield and investment grade corporate bonds.

Participants repeated again the need to take a systemic view for the CMU review on corporate bond markets, including looking at spill-overs and knock-on effects of the functioning of the repo and CDS markets on the corporate bond market. Finally, there was an emphasis on the need for the corporate bond markets to work primarily for business as an effective funding channel. There was a desire for an efficient European corporate bond market that is efficient and has scale across different geographies in Europe.

Overall, workshop participants were more concerned by the future prospects of corporate bond market liquidity in three years' time than its situation today. There was a general worry about the number of sharp movements in recent periods that are not understood. While some thought this set of events might indicate a potentially large vulnerability in the system, others were less worried about the impact of such short term volatility on the real economy. Finally, there was a call to better understand how regulations impact right down to a trading desk decision.

The Commission concluded the workshop by agreeing that there are more questions than answers and that the discussion in this workshop will act as a launch pad and to help find the correct focus for the rest of the CMU work on corporate bonds.