Association of British Insurers

Transparency of corporate bond, structured finance product and credit derivatives markets

The ABI's Response to CESR 08-1014

The Association of British Insurers (ABI) is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters.

At the end of 2007 ABI members, on account of their various insurance business lines, managed assets of the order of £1,200 bn as well as assets for third party clients. ABI members' assets under management broadly classified as fixed income (purely for insurance funds) totalled over £600 bn.

The ABI welcomes the opportunity to respond to CESR 08-1014. As the largest body of institutional investors in the UK our members are significant providers of capital to the UK and European corporate sector. These investments underpin the liabilities taken on for millions of policyholders, savers and pensioners.

Our response focuses on the cash corporate bond markets. Our views remain substantially the same as those articulated in previous responses to consultations on this subject. Liquidity is the key issue for efficient functioning of markets; transparency is an ancillary feature. We favour an increase in post-trade transparency but managed so that liquidity provision is not impaired. Our members need to effect block trades efficiently. We value the contribution that post-trade transparency can make to pricing and valuation, recognising at the same time that the majority of corporate bond issues are illiquid stocks. Consequently transparency without adequate volume does not resolve pricing and valuation issues. We are greatly concerned that post-trade transparency, if mandatorily imposed, would add an extra cost layer without commensurate benefit to our clients. Any cost benefit analysis to be undertaken should star from a fundamental review of log term market structures and operations.

<u>Part 1 Section 2 Q1 – Q12: Market failure, lack of post-trade information</u>

We are in broad agreement with the analysis in Section 2. However, whether the situation as described is symptomatic of a market failure (Q1) remains an open question. More pertinent is whether events since mid 2007 have lead to a transformation in the non-equities markets so that a 'normalisation', or return to the pre mid-2007 status quo ante, is no longer a prospect. More specifically since mid-2007 we have moved in Europe from cash bond markets being primarily broker dealer driven to now predominantly agency broker driven. In the longer term we are hopeful that broker dealers ie banks, will devote more capital than currently to trading. This does not appear to be an immediate prospect. Simultaneously to the market developments described above continuing technological developments appear to offer the prospect of further significant changes in market structure and operation.

A feature of the period since mid-2007 has been the inability of the market to price efficiently bonds on an intraday and close of business basis. Our members have an obligation to clients to value funds appropriately, often on a daily basis. As noted earlier the majority of bonds in issue can be catergorised as illiquid. Pricing points may be weeks or months apart. Moreover in the current market transactions may be dominated by forced sellers. Pricing from such transactions can lead to valuations of portfolios below managers' views of fundamental value. The negative effect of these factors demonstrate the potential benefits of improved post-trade transparency but does not in itself evidence market failure, but a market under severe stress. The possible need for an independent central organisation to consolidate data and assist with the identification of price levels is raised by some of our members.

Asymmetry of information between market participants (Q2) continues to be a feature of these markets. Asymmetry is a natural feature of OTC dealer markets (brokers will see many trades but buyside dealers only their own), and we generally applaud transparency as a means of reducing these asymmetries. However, we express two caveats. Transparency, as an end in itself, should not be pursued to the detriment of the overall functioning of markets and in particular, where it still applies, to providers' willingness to supply liquidity to the markets. Secondly regulators should show caution in encouraging retail investors into markets (through reducing asymmetries) which are more naturally the preserve of professional investors.

Our view is that the sharply reduced liquidity in secondary trading of European corporate bonds since 2007 is primarily the result of the withdrawal of liquidity by broker dealers (Q3).   Contributory and reinforcing factors were the deleveraging across all asset classes and the increased use of derivatives by both buyside and sellside in the face of difficulties in transacting in the cash markets. Additional post-trade transparency (Q4) adequately managed to preserve liquidity would generally not have hindered the situation but would not have made a material difference. But in the current dislocated markets it is possible to envisage a situation where more transparency might impact behaviour so as to deter trading.

Bid/offer spreads for European corporate bonds (Q5) widened because of the reduced capital applied by dealer brokers to markets combined with their risk averse strategy and the desire to keep trading profitable with reduced volumes. In addition the deleveraging across asset classes reduced the number of potential counterparties

We believe there is little evidence available to determine whether or not greater post-trade transparency would have been helpful in limiting the widening of bid/offer spreads for European corporate bond (Q6). We suspect not.

Given developments in 2008 our members are not inclined to use CDS prices for pricing European corporate cash bonds (Q7) but retain an interest in the correlation between the two. Increasingly the view is taken that the limited time history of the CDS market has been insufficient to test it against the economic cycle. It is difficult for us to access the methods of bond price valuation that our members currently use. However, it is clear that the CDS market is not regarded as a reliable indicator for bond price valuation (Q8). In current market conditions and the widening of spreads between cash and CDS, it is not all clear that additional post-trade transparency of corporate bond prices would have greatly assisted our members in pricing European corporate bonds (Q9), given the illiquidity of many bonds. Moreover, as noted above the CDS market has not been tested through an economic cycle. It is difficult to predict an historic relationship between the CDS and cash bond markets particularly, as the case may be, if markets are being transformed at the same time (Q10).

We have experienced difficulties in valuing corporate bond holdings (Q11). The secondary market has effectively been frozen with little ability to trade in size thereby limiting the post-trade date available. As noted already there is no central body aggregating closing prices and limited confidence from both buyside and sellside in those that are currently published. The experience of pricing date providers based on quotes has been at variance with members' direct contact with brokers. This is reflected in the recent changes in iBoxx methodology. Notwithstanding the description above our members prefer an environment where multiple sources of pricing inputs are available and the value of which they can judge for themselves. Therefore, even in distressed market conditions, additional post-trade transparency would not be unhelpful for valuation purposes (Q12), subject to sufficient volume of trades.

<u>Part 1 Section 3: Q13-14: Benefits/drawbacks of increased post-trade transparency</u>

We agree with the analysis of benefits and drawbacks in broad terms (Q13) but caution its value if markets are in the process of a radical transformation. As institutional investors a prime concern for our members remains that a rigid post-trade transparency regime should not deter liquidity providers if they re-emerge (paragraph 55). In current market conditions the ability to transact at all has taken precedence over other regulatory requirements in best execution.

In a ‘normalised’ market the benefits would be a more level playing field for all market participants, improved valuation inputs and a greater ability to monitor broker dealer margins where business is matched.

The challenge in how to aggregate, analyse and disseminate data are not ot be underestimated. It will involve process changes and investment in systems.

Part 1 Section 4: Q 15-17: The TRACE system

As noted academic research on TRACE has been limited. This together with the difference in market structures between North America and Europe make it difficult to draw conclusions as to the benefits and drawbacks of a TRACE – equivalent in Europe (Q16). Whilst some members see considerable value for price discovery and valuation in the post-trade data available through TRACE- equivalent, a greater proportion would be concerned as to the impact on liquidity.

There is no single body in Europe that could operate in the same way as TRACE. Its creation would add another layer of reporting and costs. The scope and delays in reporting (to avoid deterring liquidity) would need to to vary between different classes of assets and sizes of trades in those classes.

Part 1 Section 5: Q18 – 19: ICMA/SIFMA initiatives

These initiatives are not directed at our members who are institutional investors.

Part 1 Section 7: Q20 – 29: Conclusions

Additional post-trade information, by replacing rumour with fact should help to stabilise markets in most circumstances and assist in valuation but there is no evidence to suggest it would maintain liquidity in future crises (Q20). Similarly there is no evidence that transparency of itself would contribute to liquidity in normal market conditions (Q21). However, indirectly transparency should contribute to greater confidence in the market.

We do not see the reduced reliability of the CDS market as an indicator/proxy for calculating the value/price in the cash market as a specific reason for more post-trade transparency in cash corporate bonds (Q24).

Transparency requirements, adequately managed, could help address wider issues such as valuations (Q25).

We generally prefer industry-led solutions as being more cost-effective (Q26) but in the absence of this some members would accept mandatory regulatory requirements. This could be restricted to the wholesale market with industry-led initiatives left to deal with the retail market.

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