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Dear Mr Comporti

Consultation Paper: Transparency of corporate bonds, structured finance product and credit derivatives markets

We welcome this opportunity to respond to the CESR consultation of 19 December 2008. We consider the CESR paper to be thoughtful, well balanced in its approach and accessible in style. We thank you for this.

The IMA represents the UK-based discretionary investment management industry. Our members include independent investment managers, the investment arms of retail and investment banks, the managers of occupational pension schemes and CIS managers. Our members are responsible for the management of over €4 trillion of assets, of which about €1.4 trillion are fixed income assets.

Our members' interest is principally in the section relating to corporate bonds. Whilst our members do use structured finance products and the credit derivatives markets, their exposure to these is of considerably less significance to underlying investors than their investment in vanilla corporate debt, and their associated use of secondary debt markets.

Bond marketstructure

Our views on bond market transparency in relation to dealer markets are already in the public domain, through responses to consultations by the European Commission (Call for Evidence, response 15 September 2006), CESR (CESR/07-10, response 4 April 2007) and the Financial Services Authority (DP05/5 responses 14 December 2005 and 31 May 2006).

Since the earlier consultations, however, the financial landscape has changed substantially. It is not clear now, and may not be for some time yet, whether there will ever be a return to the trading arrangements that had previously made up the secondary corporate bond markets. To all intents and purposes, therefore, our earlier comments relate to a market that, in structural terms, can no longer be said to exist.

Prior to the onset of the crisis in the credit markets, and more widely, UK institutional investors were able to access liquidity with relative ease through dealers employed by the investment banks. Since the credit crisis began in earnest in the summer of 2007, that liquidity has been withdrawn almost entirely leading to very significant difficulties for investors in getting business done. In the UK there is, for corporate bonds, traditionally very little in the way of agency broking taking place (there are only 3 firms which undertake agency broking for fixed income as a dedicated activity). Although the bank dealers have provided some agency broking support, this does not work well. The dealers are not versed in the art of agency transactions and moreover remain conflicted in terms of proprietary holdings that are still on their books or indeed in relation to the very limited liquidity which from time to time they may make available as market makers.

Transparency

We remain convinced that the questions around transparency should not be separated from the structure within which the corporate bond market operates. Changes to pre-trade transparency go to the heart of how the market works in practice and therefore require a prior evaluation of the overall structure, not merely the transparency arrangements. Changes to post-trade transparency will have an impact on market behaviour and should therefore be assessed to take this into account before introducing change. As before, our members would support the introduction of some post-trade transparency but believe strongly that this should be considered in the context of how liquidity is provided in the changed market they are now experiencing. In the absence of dealers undertaking risk trades in the market, the impact of transparency has changed and this should be assessed. It is important that any changes to transparency arrangements should unequivocally be designed to improve market operations, in particular depth of liquidity as this is now heavily impaired.

As in previous consultations, our members continue to believe that regulators should not seek to replicate MiFID transparency provisions for equity markets for use in bond markets.

A comment in respect of post-trade transparency is that it would have to strike a careful balance between providing enough information to be of use to the market whilst at the same time not unduly exposing the underlying investor position. Time delays would therefore be helpful, most particularly for large trades until these are completed in full. We comment on this more fully in question 28.

The practical issue of delivering transparency needs to be handled carefully, particularly now that the investment banks are providing little in the way of service to this market. The cost of delivering transparency is likely to fall disproportionately on investors. Regulators should weigh up the costs as well as the benefits of any proposed change, taking into account the shift in market arrangements away from the dealer market.

Valuations

As things stand, the issue of most concern to institutional investors is that of valuing their fixed income assets. Again, however, we do not believe that transparency on its own will provide the answer to the problems experienced by those valuing assets. There are too few trades occurring to permit firms to be able to rely on post-trade transparency, should it be made available and, as regulators will be aware, the quote data published now for fixed income markets is significantly awry in comparison to the price at which actual trades take place. This should not be read as a rejection of further transparency, merely that we believe that the valuation difficulties would not be addressed simply by improving transparency. Additional transparency, particularly post-trade, would nonetheless be helpful.

Academic research

In the autumn of 2007, the Board of the IMA decided to commission a further piece of independent research into the credit markets. Their motivation was to ensure that the investor experience of the corporate bond market, as the credit crunch unfolded, did not go unexamined. This research followed our participation, in 2005/6, in commissioning and publishing two pieces of independent research into, respectively, European government and corporate debt markets. (The 2006 research was commissioned jointly with the Association of British Insurers, the City of London Corporation and 4 organisations representing brokers - LIBA, ICMA, EHYA and EPDA. Amongst other things it examined secondary market trade and quote data for three years, 2003-2005.)

Drawing from the earlier research, which had in general terms found the secondary corporate bond markets operating with a reasonable degree of efficacy for the period covered, the researchers were asked to focus in particular on the structure of the secondary market arrangements and to assess whether there were structural problems in the market arrangements that could be addressed. The researchers chosen for this project are led by Professor John Board and Stephen Wells, from the University of Reading.

The brief provided to the researchers included the following:

> *"The credit problems arising in summer 2007 and beyond and associated liquidity squeeze have had a sharp short term impact on wholesale market players, but may also prove to have a profound long term impact on the way debt markets operate.*
>
> *"Our primary interest is in the cash markets, as IMA members rely substantially on secondary bond market trading (government and corporate) to complement their investment through primary issuance activity. We therefore expect the research to focus on the impact of the credit squeeze on cash fixed income markets. However the research should take account of what has happened in related debt markets in order to assess across the piece the direct or indirect impact on institutional investors.*
>
> *"The proposed research will be composed of two parts, firstly evidence, secondly analysis.*
>
> *"Evidence will be collected on:*
>
> *a. The pricing and valuation of debt as the credit squeeze continued, and how this impacted on institutional investors;*
> *b. The knock-on effect of the asset-backed crisis to other parts of the debt market, and what this meant for the asset managers;*

c. The impact on institutional investors of a collapse in investment ratings, in particular in forcing asset sales whilst the market had effectively ceased to function.

"The analysis should focus on what the credit squeeze could mean for future market structure, for example in what form the market maker structure may survive and whether issues of transparency become more important. The analysis should also consider whether access to the market is optimal through the market makers."

This research will shortly be published. We expect to submit a copy of the research to CESR by the end of the month.

The research, in effect, will provide much of our response to the CP. On a preliminary basis, the researchers appear, to date, to have drawn out several key threads which are briefly described below.

<u>Market disruption is real and is damaging the buy-side</u>

The market for sterling corporate bonds has suffered severe disruption since the start of the credit crisis in July 2007. Symptoms of this have been:

- Much wider spreads – empirical evidence and interview evidence strongly support this. Spreads have widened considerably for all types of bonds but the greatest impact has been on those bonds perceived as having higher risk namely bonds issued by financial institutions, longer dated bonds, lower rated bonds (BBB), subordinated bonds and collateralized bonds (which have generally suffered irrespective of collateral quality). Spreads on the more risky bonds have more than trebled and even spreads on relatively safe bonds, for example AAA corporates, have approximately doubled.

- Absence of markets or one-way markets – traditional trading mechanisms, namely the dealers, have dried up. Where previously dealers were willing to quote two-way prices in size to take an entire order, possibly improving on indicative quotes for long-standing customers; they are frequently unwilling to quote at all or if they do the quotes are likely to of poor quality in a number of ways.

- Greater price uncertainty – interviews and empirical evidence support the claim that prices were far less certain after the start of the credit crisis. The Sterling bond market historically had little pre-trade (or post-trade) transparency, but the relatively low volatility has meant that the sort of indicative information availablehas sufficed. In a much faster moving market the absence of much information and the severe deterioration in the quality of what is available (for example the much wider spreads quoted for indicative prices) has meant that buy-side investors have been largely trading blind.

Evidence on volumes is unclear.

Dealer market has failed and is not likely to recover

The Sterling bond market operates as a traditional dealer-based market largely reliant on telephone quotes and negotiation. Innovations such as electronic trading platforms have made far less impact than has been the case in markets for other assets and in larger bond markets. In many ways the market resembles the UK equity market of 25 years ago.

The consensus of those we spoke to and of the empirical evidence as that the dealer market had pretty much disintegrated since July 2007. The traditional long-term relationships between dealers and customers have largely broken down and buy-side traders are having to operate in an unfamiliar world. There is little expectation that normal service will be resumed any time soon – buy-side traders understand that the profitability of the dealers from this part of their business has never been high (given the smallness of the Sterling market) and the credit crisis has merely anticipated something that was part of a trend anyway.

Many are responding by examining alternatives and there is a growing statement of willingness to, for example, pay commission to brokers for execution. Similarly there is an awareness that the traditional block-trading practice may have to give way to more patient trading styles when the situation of the order does not justify the cost of immediacy.

However these developments do not sit easily with the current nature of the market. The lack of transparency and trading infrastructure are barriers as, indeed, is the need for new skills to support a market where the execution of orders becomes much more a part of the fund management process.

Absence of data restricts evidence-based policy

The study was planned as a largely empirical study. Unfortunately this has not been possible because of the absence of market data relating to trading on the Sterling bond markets. Had we been asked to examine other substantial markets in the UK – such as the equity market or the futures markets – then comprehensive data on transactions and pre-trade prices would have been available.

For the Sterling bond market the only available data consisted of:

- Indicative end-of-day quote data for a limited number of stocks
- Case-study trading data supplied by a small number of buy-side institutions

The literature survey was only able to find two empirical studies relating to the UK bond market – and one of those was a price-based study. In contrast the US market can show a large number of studies relating to many aspects of trading and pricing. Much of the US work has been produced following the introduction of the TRACE reporting requirement and the compilation of that data into a dataset which has been opened to researchers. Such data is collected in the UK but has not been made available to researchers.

The thrust of regulation and development strategies in recent years has been towards evidence-based rather than anecdote-based policy. The absence of data relating to the Sterling bond market means that regulatory other development initiatives cannot be based on evidence since there is so little evidence. This is akin to the situation in the UK equity market in the early 1980s when policy and regulatory decisions were driven by market sentiment rather than empirical examination.

Answers to CESR's questions on corporate bond markets

Q1: Do you believe the situation described above may be symptomatic of a market failure?

If there is a market failure it relates to the market structure proving inadequate to support trading when the market intermediaries, who are the dealers within the banks, cut liquidity provision to clients (and of course to issuers in the primary markets). In effect, the market has operated (for many years successfully) on the basis of Plan A, with no Plan B as a back up. Plan A no longer works.

Q2: Have you perceived a potential asymmetry of information between market participants?

Asymmetry of information is a feature of most dealer markets and continues to be a feature of the cash corporate bond markets. There is currently real poverty of information within the market. Whether it is still asymmetric is harder to establish as the activity in the secondary market is at very reduced levels and information is both scattered and frequently stale.

Q3: In your view, what were the key reasons which have led to sharply reduced liquidity in secondary trading of European corporate bonds since 2007?

The withdrawal of liquidity provision by the market intermediaries, the bank dealers, consequent on problems experienced in valuing their wider credit exposures. The position was exacerbated by the very high degree of concentration within the market on dealer based liquidity.

Q4: Do you believe that additional post-trade transparency of European corporate bonds would have helped maintain liquidity in stressed market conditions? Can you please explain why?

Please see our comments in the main part of the letter. In the absence of dealers making markets, liquidity could not be conjured up. The current market structure in effect stands in the way of deals being done as there is no realistic alternative trading mechanism to take the place of the dealers.

Q5: In your view, what were the key reasons for the widening of the bid/offer spreads for European corporate bonds?

See Q3.

Q6: Do you believe that greater post-trade transparency would have been helpful in limiting the widening of the bid/offer spreads we have observed for European corporate bonds?

See Q4.

Q7: Do you use CDS prices for pricing European corporate cash bonds? If so, what are the key benefits?

Yes, investors will refer to derivative pricing to help establish pricing for cash bonds. This reflects the relative liquidity of the markets, although of course it has been more difficult to find any reliable information on pricing since the credit crisis began.

Q8: Which methods of bond price valuation do you use in the current market turmoil? Do you think that the CDS market is still a reliable indicator for bond price valuation?

All valuation methodologies currently present difficulties in terms of their reliability. Investors will bear this in mind whilst valuing portfolios, but there is no clear-cut solution at present.

Q9: The spreads between the CDS and corporate cash bonds have widened significantly in the first quarter of 2008. Did this widening of the spreads make it more difficult to price European corporate bonds? If so, do you think that additional post-trade transparency of corporate bond prices would have helped you to price European corporate bonds? How do you assess the situation since mid-September 2008?

This question appears to be addressed to those offering prices.

Yes it makes it more difficult to price bonds. More post-trade transparency might have helped to price these bonds, but it would not have offered a complete solution because much of the problem for the investor was that the dealers did not have sufficient capital allocation to deal in the normal way, or even at all. The situation within the secondary bond market remains difficult for everything but the highest quality debt – and even to an extent for that.

Q10: Do you expect that the relationship between the CDS market and the cash bonds market will return to what has been observed historically once market conditions stabilise? If not, can you please articulate the reasons?

It is impossible to tell.

Q11: Have you experienced difficulties in valuing corporate bond holdings? If so, what were the main reasons?

All investors have experienced difficulties in valuing corporate bond holdings. The main reasons refer to stale quotes, very wide spreads, a lack of information in the market about trades and a lack of actual trades.

Q12: Would additional post-trade trade transparency in distressed market conditions help valuation?

Yes – but not necessarily significantly if little trading occurs, which has been the case since the start of the credit market crisis.

Q13: Do you agree with the potential benefits and drawbacks described above? Please provide evidence supporting your opinion. Please explain how the potential drawbacks might be mitigated.

Q14: Are there other main benefits or drawbacks of increased post-trade transparency in the bond markets which CESR needs to consider?

Broadly speaking, yes. However, we draw your attention to the main section of the letter as regards the current state of the market and the reality that no-one knows whether, or when, the market will return to its earlier condition. The main benefits would be to improve the information available to all market participants, improve valuation inputs and permit better monitoring of dealer margins for matched business.

Q15: What are your personal experiences with TRACE? Please specify whether you are directly trading in the US corporate bond markets on the buy or sell side.
Q16: Do you see other benefits or drawbacks of the introduction of a TRACE-like post-trade transparency regime for OTC trades in corporate bonds in Europe?
Q17: Are you of the view that the more notable volume declines experienced for 144a securities, compared to securities which are covered by TRACE, is due to a lack of post-trade information? Please provide a rationale.

European and US corporate bond markets have differences in market structure that make the introduction of a TRACE-like regime hard to draw firm conclusions on. Whilst many investors would welcome additional post trade transparency, they would seek also some delays in reporting and this is not a significant feature in TRACE. Regulators should take account of the changes to the European market since the start of the credit crisis in that it is not at all clear who is now best placed to provide a mechanism of this kind.

Q18: Please provide information on your experience, if any, in terms of timing, content and access to information of the market-led solutions outlined above. What is your assessment of the effectiveness of the present self-regulatory initiatives?
Q19: Please provide comments on the characteristics that market-led initiatives should, in your view, have.

These questions appear to be directed to the dealers and are not directly relevant to our members, the institutional investors. Investors do not usually have in place arrangements to carry out market services, of which transparency is one. Investors are, of course, users of these services/

Q20: Do you think that the introduction of additional post-trade information on prices could help restore market confidence and maintain market liquidity in times of future crisis?
Q21: Do you believe that additional post-trade transparency of European corporate bond markets would contribute to liquidity in normal market conditions? Can you please explain why?

At this time it is hard to say what normal market conditions are, as this assumes a return to dealer markets. It is not clear that a market which has proved fragile in stress for such an extended period of time remains an appropriate long term model. We refer to the comments in the main part of our letter as regards the structure of the market.

Q22: To what extent can corporate bond markets be characterised as wholesale or retail markets? How would you distinguish between wholesale and retail markets? What are the differences across the EU?

Corporate bond markets in the UK are almost exclusively wholesale and as many of the dealers are located in the UK, the markets offered are much wider than Sterling. Given the complexity of corporate bonds, of the dealer market structure and of the difficulty of pricing and valuing the instruments traded, we do not believe that the market is well suited to retail investors and this is something that regulators should focus on, in terms of education. That having been said, we certainly do not oppose direct retail participation in these markets, with appropriate risk warnings. But we note that, as it is both difficult and expensive for small players to access the market, the instruments can be highly complex and investors face prospective illiquidity on most bonds, the question of suitability should be kept foremost.

Q23: What would be the benefits and the downsides of a harmonised pan-European transparency regime for:
  a) the wholesale market;
  b) the retail market.
Please provide arguments and fact-based data on the potential impact.

See Q22 on retail involvement. The sizes within which wholesale and retail market participants trade would have to be taken into account if the market were to become more transparent.

Q24: Is the reduced reliability of the CDS market as an indicator/proxy for calculating the value/price in the cash market under certain market conditions an issue which calls for more post-trade transparency of cash corporate bonds?
Q25: Do you think that transparency requirements could help address wider issues such as those relating to accurate valuations?

See above.

Q26: What would be the most cost-effective way of delivering additional transparency an industry-led solution, possibly based on a road map set by regulators, or mandatory regulatory post-trade transparency requirements?
  a) the retail market.
  b) the wholesale market
Please, provide a rationale.

In general we prefer industry-led solutions, but draw attention to the difficulties currently faced in establishing who in the industry could lead a project, and in particular whether this would ensure investor interests are properly addressed and protected.

Q27: Which should be in your view the key components of a post-trade transparency framework for corporate bonds? Please provide your view with respect to depth and breadth of information as well as to timeliness of data as described above.
Q28: Should the information on the volume be reported only below a certain size, what would be the threshold to avoid any risk of market impact?

The corporate bond market is fairly polarised between a strong retail presence in the market in some European countries (notably Italy and Germany) and an almost exclusively wholesale market in others, including the UK. The size of trades is equally polarised. It is therefore important that post trade publication takes account of the different needs of both types of investor.

Reporting with a 15 minute delay is appropriate for retail size trades.

End of day reporting could be appropriate for all other trades.

However, the important caveat is that our members would not want the size of large deals to be revealed to the market. Trades of large size should therefore be reported in terms along the lines of: “trade over Euro/£xxx”. If the size of the trade were large, such as Euro/£5 million, and this trade was required to be shown to the market in full, it would very significantly reduce the ability of our members to get these large size deals completed, even given that the trade was subject to end of day reporting. This would act to the disadvantage of underlying clients such as the pension funds.

The question then is how to determine the value of what is retail, what is wholesale and what is large in size. We suggest three possible divisions:

- Anything over Euro/£ 1 million should be treated as large in size, and not be subjected either to size disclosure or to same day disclosure (ie publication would be end of day and disclose “trade over £1 million”).
- Retail trades have, in other contexts, had a cut-off applied of £50,000. This would indicate that trades below £50,000 should be subject to 15 minute publication, with size of trade shown.
- The space between £50,000 and £1 million would then besubject to end of day publication, as with other wholesale deals, but unlike deals that were large in size these dealscould show the size of the trade when published.

Q29: Would you see some benefits in a step-by-step implementation, starting with the most liquid bonds, as employed when TRACE has been introduced?

We do not yet have concluded views on these questions, other than in the general terms already described. When the consultation process first began, some years ago, we strongly supported a “controlled” experiment for introducing post trade transparency into the bond markets. However, given the changed conditions in the market we do not think an experiment of this nature would be feasible, as the market is both too thin, in terms of trading, and no longer fairly described as a working dealer market. Regulators should consider these points before following the TRACE route, bearing in mind that TRACE was introduced at a time of strong liquidity in the US market.

As mentioned earlier, we expect to submit a copy of the research to CESR by the end of the month. We would be delighted to arrange for a presentation to be provided by the researchers to CESR members and staff, allowing regulators and others to ask questions about methodology and findings as you wish.

If you have any queries please do not hesitate to contact me.

Yours sincerely

Jane Lowe

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