

ZENTRALER KREDITAUSSCHUSS

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Comments of the Zentraler Kreditausschuss (ZKA)¹ on the CESR Call for Evidence “Non-Equities Markets Transparency“

Ref: CESR/07-108

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The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VdH)*, for the mortgage banks. Collectively, they represent almost 2,500 banks.

I. General comments

We would like to thank you for giving us the opportunity to provide comments on the Call for Evidence dated 6 February 2007 and are pleased to submit herewith our answers to the questions of the Call for Evidence. First, we would like to comment on some basic aspects of the planned examination.

In the cover letter to the current consultation paper, the Commission is quoted as saying that the initial request to CESR was a "limited fact-finding exercise in relation to cash bond markets" and that for this reason the second request concentrates primarily on these products. The cash bond market is indeed important because of its large scale, therefore a more detailed examination seems to be appropriate. However, it is important to avoid any impression that this new and focussed examination alone is an indication of subsequent regulatory measures. In the interest of all market participants, this examination should be open-minded. It is generally acknowledged that the European bond market is highly integrated already today and works efficiently. Therefore no direct analogous conclusions can be drawn from the MiFID provisions on shares with respect to the bond market.

We agree that CESR's answer to the Commission (CESR/06-599) contains mainly factual information and the responses by the market participants to the Commission's Call for Evidence are rather general. Nevertheless, the allocation of responsibilities, in particular according to the better regulation approach, should be considered in this context. It is not the responsibility of the market participants to prove by submitting market-specific, detailed information whether or not markets are friction-free. It must be the responsibility of the legislator to justify its regulatory actions by providing convincing evidence of market failure. Furthermore, by self-regulatory mechanisms, the market shows its ability to respond individually to the needs of market participants (cf. Answer 6).

Reference is made to the response submitted² to the Commission's Call for Evidence whose points remain valid but are not re-submitted here in order to avoid repetition of the arguments stated, as requested by CESR. We would also like to clarify that the points below refer to all three classes of cash bonds defined by the Commission unless specific classes are explicitly mentioned.

² Available under http://ec.europa.eu/internal_market/securities/isd/consultation/mifid_replies_en.htm

1) Does CESR consider there to be convincing evidence of market failure with respect to market transparency in any of the instrument markets under review?

We do not see any indication of market failure in the markets under review. However, we welcome the clarification that a mere presumption based on appearance is not regarded as sufficient but convincing and reliable evidence is explicitly requested which moreover clearly qualifies as suboptimal transparency. Only in this case might an extended transparency obligation be a suitable instrument to overcome the existing situation - provided that the cost-benefit balance is proven to be positive and market-induced efforts are not to be expected.

In addition, the scope of the investigation should be narrowed on listed securities/ cash bonds only. The question of inefficiencies through fragmented markets and therefore different prices between on-exchange traded bonds versus OTC traded bonds makes only sense in the case of a listed security. In the off-exchange area, a diversity of information tools is standing ready for the investor to keep him- or herself informed about the current prices of cash bonds. A lot of sources are quite well known and mentioned in detail in the answers to the consultation of the European Commission which we do not want to repeat here but underline the growing tendency of this sort of online information. In addition, legal obligations for banks exist for fair prices in their trade business.

2) What evidence is there that mandatory pre- and post-trade transparency would mitigate such a market failure?

Since we cannot identify any particular market failure, we are unable to assess or evaluate the effects extended transparency requirements might have. However, certain conclusions can be drawn from the literature and observations relating to the effects of transparency on the existing market situation.

The assessment of the effects extended transparency has on market liquidity can be described as at least controversial. For instance, Scalia³ and O'Hara⁴ conclude that an extension of transparency requirements has negative consequences for market liquidity. Lagana⁵ examined the effects of transparency on the liquidity of corporate bonds. As far as pre-trade transparency is concerned, the authors come to the conclusion that the content of information is reduced as a consequence of a

³ A. Scalia and V. Vacca, 1999, "Does Market Transparency Matter? A Case study" Discussion Paper 359, Banca d'Italia

⁴ M. O'Hara, 2004, "Liquidity and financial market stability"

⁵ M. Lagana, M. Perina, I. von Köppen-Mertes, and Avinash Persaud, Implications for liquidity from innovation and transparency in the European corporate market", Occasional Paper Series 50, ECB

transparency obligation because traders would merely state wider ranges in order to comply with this obligation without running too high a risk. At the same time, they state, market-induced pre-trade transparency is greater in European markets than in the US.

Following the arguments of Lagana (cf. essay of Lagana, page 14), regulatory transparency requirements could lead to negative consequences for the behaviour of some market participants (e.g. herding behaviour) compared to market driven transparency.

3) To what extent can the implementation of MiFID be expected to change this picture?

If the comprehensive transparency requirements under the MiFID for share transactions turn out to be positive for the market, this could provide the initial spark for further market-induced efforts with respect to other classes of securities. However, CESR and the Commission should be aware that if additional transparency fails to grow, this is no indication of market failure but rather of a lack of necessity for more transparency. The transparency existing already now in the cash bond markets demonstrates that general adaptability to the needs of the market participants does exist. However, should no further demands for transparency arise in the market with respect to bonds, despite the example of greater transparency of share transactions, this would be due to the fact that this is not considered to be necessary, and not due to poor functioning of the market.

A further incentive to market-induced transparency extension could result from the best execution regime. For instance, individual trading platforms might choose to offer more transparency in order to acquire more business. However, also in this context, the Commission should acknowledge that best execution may result in incentives to more transparency, but an obligation to increase transparency cannot be concluded.

It has been said repeatedly that due to technological progress in connection with the MiFID, it would be possible to extend the transparency requirements at lower costs. This argument does not speak in favour of but against regulatory actions. This would eliminate any hindrances that may prevent market participants for cost reasons from taking any initiative as to more transparency that may be required. Should nevertheless no additional transparency mechanisms develop, this would again speak more in favour of a lack of necessity.

As mentioned above, the obligation for banks for fair prices exist already and will be confirmed and sharpened by the transposition of the MiFID.

4) Can CESR indicate and describe a significant case or category of cases where investor protection has been significantly compromised as a result of a lack of mandatory transparency?

One example that is often quoted is the Parmalat case. However, this was a case that involved criminal activities which could not have been prevented by extended transparency requirements in bond trading. In this case, even major institutional investors lost large amounts of money.

Endeavours should therefore focus on reporting obligations of issuers and their supervision rather than pre- and post-trade transparency. An effective corporate governance structure could also be a more worthwhile and powerful countermeasure to financial fraud.

That trade transparency can hardly prevent such cases can be explained, for instance, by the frequency in which bonds are transacted. The majority of all bonds are traded not even on a daily basis. In addition even in the event of full pre- and post-trade transparency, this type of information would be of little value given the time transpired.

Rather than not enough transparency the lack of appropriateness seems to be the problem for retail-investors. In particular for this class of investors an insufficient know-how of financial products and an underestimation of risks incurred with these products could lead to losses which are preventable.

5) Could it be feasible and/or desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors?

Unfortunately, this question does not make clear according to which dimensions the different market segments are to be separated. A classification according to different trading platforms (RM, MTF, OTC) is hardly conceivable because the object of the MiFID was precisely to make the competitive conditions between these different trading places consistent.

As the examinations by the Commission differentiated between classes of securities to be reviewed already in the first Call for Evidence, a more detailed consideration of different regulations for different securities classes that may have been addressed by this question can not be deduced self-explanatory.

Should the Commission be able to prove market failure and the advantageousness of regulation for individual market segments, there might nevertheless be arguments against regulation. The interdependence between markets, in particular between cash markets and the derivatives markets pertaining thereto is so close and yet so complex at the same time (cf. essay by Lagana) that

regulation of a single market segment which, from an isolated point of view, may seem to make sense, could nevertheless have a negative impact on the market as a whole.

To some extent, the level of transparency is different between the market segments for government bonds and corporate as well as high yield bonds depending on factors like liquidity etc. However, it is to say that a general lack of transparency does not exist in any of these market segments and in addition that the degree of price information in all of them is sufficient. This is also true for retail as well as wholesale markets.

6) What criteria does CESR recommend should be applied by the Commission in determining whether self-regulatory solutions are adequate to address any of the issues above?

In general, we think that it should be the market who determines whether certain mechanisms are adequate. This is even mandatory, unless there is strong evidence of frictions in the market that prevent the development of such mechanisms from the outset. This results, on the one hand, from the better regulation approach and on the other hand from the risk that transparency requirements defined specifically and with great care for certain trading places are deprived of their optimality by levelling requirements imposed from outside.

It seems unlikely to us that market failure could really be proven to exist. But even if this were the case, self-regulatory mechanisms might have to be preferred over regulation by the state. For this purpose, the Commission could develop certain fundamental principles in cooperation with the market participants concerned that would have to be met. Their further structuring could be left to the own responsibility of the market participants with the Commission verifying whether the agreed fundamental principles are sufficiently complied with in the detailed structure.

The fast growing development of the support of electronic market information with regard to timeliness as well as scope of information is suited to make mandatory transparency obligations useless. Nevertheless, when assessing potential self-regulatory solutions aimed at improving market transparency for cash bonds, the most important criterion should be the balance between costs and benefits, as well as the impact on market efficiency.