Association française des marchés financiers
FINANCIAL MARKET PROFESSIONALS

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CESR Public Consultation

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Comments by AMAFI

1. *Association française des marchés financiers* (AMAFI) has more than 120 members representing over 10,000 professionals who operate in the cash and derivatives markets for equities, fixed-income products and commodities. Nearly one-third of the members are subsidiaries or branches of non-French institutions. AMAFI welcomes the opportunity to comment on the CESR consultation on "Transparency of corporate bond, structured finance product and credit derivatives markets".

2. AMAFI would like to point it out the quality of CESR's document which provides the industry and the regulators with a deep and sound analysis of the current situation of the markets involved by the consultation.

3. Some of our members are active market participants on the corporate bond market. Therefore AMAFI's answer is focused on this market. Nevertheless, our general comments address also structured finance products and credit derivatives markets.

4. Before answering the specific questions raised by CESR in the consultation paper, AMAFI would like to emphasise some general comments.

I) GENERAL COMMENTS

A) Corporate bond market

➢ ***AMAFI's previous analysis on bond market transparency.***

5. In 2006 (call for evidence of the European Commission) and 2007 (call for evidence of CESR), AMAFI stated that there were no clear evidence of market failure in the European bond market and that it was also not clear that mandatory transparency would create benefits for the market in general, and for the investors in particular.

➢ *AMAFI's current position on corporate bond market transparency.*

6. The impacts of the current market crisis on the corporate bond market cannot be denied. It is characterised by a lack of liquidity, a widening of bid-offer spreads, weakening relationship between CDS and corporate bond market and valuations difficulties. The origins of this situation are well known. The sharp reduction in liquidity in secondary trading has been caused by tightening credit conditions. Market participants have sought to protect their balance sheets through asset sales and tighter credit supply. This has resulted in a large number of sellers with no buyers, leading to further asset price falls and increased market volatility. Liquidity has been further constrained by the increasing difficulty experienced by dealers in hedging their portfolios through CDS.

7. AMAFI does not believe that these failures were mainly caused by a lack of post-trade transparency. Indeed it must be noted that the markets subject to a mandatory post trade transparency regime (ie in the USA and in Italy) face the same problems than other markets. We continue to consider that any regulation on trade transparency should be based on the following.

a. Pre-trade transparency would be counter productive. It would have a dissuasive effect on market makers to offer a bid and ask for corporate bonds and therefore would certainly be detrimental to liquidity.

b. A post-trade transparency regime should be finely tailored in terms of size of transaction and delays of reporting. Some market participants consider that mandatory post trade transparency would have a negative impact on liquidity.

8. This does not mean that it is not legitimate to consider whether there is a need to improve (on a regulatory basis or on a market driven solution) transparency in corporate bonds in order to improve the functioning of the secondary market. The transparency regime would have to take into account the specificities of the corporate bond market, that is to say:

a. Corporate bond markets are by nature primary markets. In Europe, where about 200,000 corporate bonds are listed, less than 10% of them can be considered as liquid (traded more than once a day) the others being traded less than once a day. Generally the secondary market exists only for one month after the issuance. After such a period, the institutional investors, who are insurance companies, investment funds, pension funds, intend to hold the bonds until maturity.

b. Corporate bond markets are mainly wholesale markets whose functioning relies on the competition between market participants which are market makers and brokers. In Europe the level of competition is huge due a large numbers of market participants. Wholesale investors do have the capacity and the tools to shop around in order to obtain the best price for the size of corporate bonds they intend to buy or sell.

c. In France, and in most European countries, retail clients are not active on the secondary market and keep bonds (mainly bonds issued by the banks where they have their cash accounts) until maturity.

➢ *Retail client issues.*

9. Even if the corporate bond market is mainly a wholesale market, CESR's consultation paper considers the question of putting in place a specific and proper post-trade transparency regime for retail markets.

10. AMAFI considers that the first question is to determine whether corporate bonds are proper and/or useful products for retail clients. A positive answer to that question is needed before examining how to improve both primary and secondary markets in order to fit the retail needs.

11. As stated above, in France, retail clients are not active on corporate bonds market. They operate on this market only when they are offered corporate bonds by the banks which have their cash accounts and keep them until maturity. Therefore they do not operate on the secondary market.

12. The reasons why retail clients are not active are not clear. Some market participants consider that corporate bonds are not adapted for this type of investors because they are unable to understand the pricing of this type of product. Others believe that this situation is not due to the product in itself but to the way primary and secondary markets are currently organised.

13. Therefore AMAFI encourages all the stakeholders (regulated markets, issuers, investments firms and regulators) to work together in order to determine if and how the corporate bond market should or could be developed and offered to retail clients. One condition to develop corporate bond markets for retail client could be to have them traded on regulated market. In that case, sufficient transparency would be available for retail clients.

B) Structured finance product and credit derivatives market.

14. Even if our members are not real market participants in these markets, we would like to point it out some general comments on these products.

➢ *The analysis provided by CESR is pertinent.*

15. The quality of descriptions made by CESR on the functioning of theses markets and the cause of the current crisis must be underlined. We share CESR's analysis that theses markets are purely wholesale markets and generally "buy and hold" markets. Concerning the crisis we also consider that the main causes are the following :

a. Regulatory and accounting incentives which pushed financial institutions to put in place off-balance sheet funding and investment vehicles.

b. Misunderstanding by the investors of the nature of the products they bought.

c. Lack of transparency of the underlying products.

d. Over confidence in Credit Rating Agencies notation.

➢ *Post trade information is not the key element to solve the various issues.*

16. As it is recognized by CESR, insufficient post-trade transparency is not the key reason behind the market turmoil and additional post-trade transparency is not a mean to solve the different problems experienced in the structured products market.

17. Before considering if and where more post-trade transparency should be required, CESR has to take into account the actual nature of the market. As AMAFI pointed it out in November 2008 (Reforming the Global Financial System – AMAFI / 08-51 EN), one of the lessons of the crisis is that **there are markets and markets**.

18. For AMAFI, the reference for a well-functioning market is namely the organised-market model. Here, orders for products subject to regular, regulated disclosures and numerous competing financial analyses are matched actively and continuously, offering a substantial level of liquidity. Equity markets, for instance meet the criteria of the organised market model.

19. Other businesses that came to be called "financial market activities" do not possess all the qualities of the organised market model. These include the structured products at the root of the crisis, the market of which is very different make-up from the above mentioned financial markets and do not look bound to change. Others, however, lie somewhere in-between and could – and now therefore should – be brought closer to the organised market model, either for trading or clearing. This is of course the case for credit default swaps (CDSs) but doubtless for other interest rate products too.

20. AMAFI considers that the first step to create a sound secondary market is standardisation of the products. Standardization can be achieved for some kind of products but not, of course for all the products (eg structured products). For instance the setting up of a Euro zone Central Clearing House would be a proper driver to enhance the standardization of the CDS's markets. Standardisation creates liquidity and liquidity requires transparency. Given that the closer to the organised market model a market is, the greater the need of post-trade transparency is.

21. Beside that to improve the functioning of the markets and restore confidence, other aspects of transparency, which are not directly in the scope of CESR's consultation paper have to be taken into account: transparency of the underlying assets, transparency of the structure of the product, transparency of the positions taken by investment firms or general information about the market.

22. To solve some of these issues and increase transparency in the markets, the commitment of EU industry must be noticed. For instance, in the field of securitization, there was a strong commitment of the main European associations (EBF, ESF, LIBA, SIFMA, ICMA, CMSA, ESBG, EACB) to report quarterly the transactions carried out on these markets and settled through both ISCDs, CSDs and custodians. There were also commitments to define properly and make transparent the products themselves, in order to identify and assess the underlying credit risks.

II) CESR QUESTIONS

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

23. The situation described by CESR reflects the current situation of the market: lack of liquidity, widening of bid-offer spreads, weakening relationship between CDS and corporate bond market and valuations difficulties. But it is certainly not to due to a lack of pre or post-trade transparency

24. Since August 2007, and as documented in the consultation paper, conditions in European corporate debt markets have altered in response to severe external shocks ultimately caused by market failures in more complex structured products markets. At the heart of these failures was the inability of market forces to create incentives for market players to undertake appropriate risk assessments prior to decision making to buy and sell in those markets, and to employ adequate risk management practices more generally. These failures did not emanate from the European corporate bond markets, but dealers in these markets have had to manage the associated capital constraints and market volatility.

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

25. Because the corporate bond market is mainly a wholesale market, we do not perceive asymmetry of information between market participants. In terms of market prices and volumes, market participants have access to sufficient information and existing structures deliver these in a cost effective way. It should be added that the experience shows that, in many cases, information is not used by market participants.

26. Of course, there is a clear distinction between retail and wholesale market but, as mentioned above, retail clients are not active on this market. The developing of the quotation of corporate bonds on regulated market would improve the information of retail client at a lower cost. Nevertheless, it is to be expected that transaction costs per se for retail trades will be significantly higher than those for wholesale trades. CESR's paragraph 70 expresses shock that 'retail trades carry transaction costs about five times the size of those for institutional trades'. This is not a sign of the market failure or abuse of a trade advantage. It simply reflects the fact that, in every market, financial and non-financial, in bulk is cheaper per unit than buying just a few units. For example, in Euronext, the client orders represent 10% of the trade volume but 30% of the fees: it means that the retail client orders are worth three times more than the wholesale orders.

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?

27. The main reasons are the general market volatility that occurred, the reduced primary activities and the lack of diversity among investors profile.

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?

28. Liquidity relies much more on capital commitment and confidence than on post-trade transparency.

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

29. We believe that the widening bid/offer spreads can be ascribed to increases in the risk of corporate bond positions and to increases in the supply versus demand for such bonds. The main reason for the widening of bid/offer spreads for European corporate bonds is that lenders are increasingly risk averse due to tightening credit conditions and fears of a global recession. Thus, secondary market prices currently embody significant discounts for illiquidity and uncertainty. Another reason for widening bid/offer spreads has been hedge fund redemptions and banks de-leveraging and removing credit from their balance sheets, which has resulted in an excessive supply of bonds.

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?

30. Greater post-trade transparency would not have been helpful in limiting the widening of spreads as these were caused by tightening credit conditions rather than any lack of post-trade transparency. Moreover, widening spreads are not necessarily indicative of a lack of liquidity and vice versa.

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

31. In normal market conditions, the CDS market is used by market participants as a means of price formation for the underlying cash bond markets. It is a very sound proxy.

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?

32. We consider that in the current situation, the CDS market is no longer a reliable indicator for bond price valuation. This is due to the today's lack of liquidity on the CDS market because of the lack of confidence between counterparties (counterparty risk).

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? How do you assess the situation since mid-September 2008?

33. Yes, the widening of the spreads between the CDS and corporate cash bonds makes it more difficult to price European corporate bonds. The situation since mid-September 2008 is worse due to reduced liquidity. CDS market is under the spotlight and has to deal with a need for reducing the outstanding and monitoring counterparty risk.

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?

34. It is important to restore the relationships between the CDS market and the cash bond market. Therefore it is **crucial to set up in the Euro zone and under the supervision of the European Central Bank, a central clearing house for the CDS in order to deal with the counterparty risk.**

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

35. Market participants have experienced difficulties in valuing corporate bonds. These difficulties have been primarily caused by a lack of transactions and instability in the CDS market rather than by any lack of post-trade transparency which would in any case have been of limited use and perhaps even misleading in an illiquid market.

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

36. We do not believe that additional post-trade transparency in distressed market conditions would necessarily help valuation. Trade prices can reflect one of three views: (1) fair value; (2) liquidation value; or (3) distress value. Trade prices in an illiquid market are inherently unreliable when attempting to assess the fair value of an instrument.

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.

37. We do agree on the drawbacks described, especially the negative impact on liquidity of a greater post-trade transparency.

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

38. The implementation of a greater post-trade transparency solution could generate considerable cost in infrastructure. Market participants may not have existing capacity to accommodate those. Therefore, any change in the post-trade transparency regime should be based on a sound cost-benefice analysis.

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.

39. Our members do not have a large experience with the TRACE system implemented in the USA. Therefore AMAFI is not able to answer this question.

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?

40. See answer Q15 above.

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.

41. See answer Q15 above.

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?

42. Our members are not aware of SIFMA initiative to extend its US retail-focused fixed income website. We are in favour of such an initiative, but we consider that there is also a need to asses whether an actual trading of corporate bonds on regulated markets could be implemented for retail clients.

Q19: Please provide comments on the characteristics that market-led initiatives should, in your view, have

43. See answer Q18 above.

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?

44. As we considered that the market failures that have occurred were not related to the availability of trading data, we do not expect that this would be the case.

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?

45. No. It is likely to be counter-productive, especially if measures are not well targeted and the beneficiaries of the additional transparency are not correctly identified. As stated above, liquidity in bond markets is highly dynamic and additional post-trade transparency would not increase liquidity in normal market conditions. On the contrary, we feel that additional post-trade transparency would serve to actually reduce liquidity and widen bid/offer spreads

Q22: To what extent can corporate bond markets be characterised as wholesale or retail markets?

46. For most of Europe, corporate bond markets are almost entirely wholesale markets. There are a few jurisdictions in Europe, such as Italy, where there is active retail participation in the market. On the other hand, in the UK and France, for example, corporate bond markets are characterised by a predominance of wholesale participants.

47. The retail markets can be characterised by a larger number of tickets. Wholesale markets, on the other hand, have larger volumes. One way to distinguish between retail and wholesale trades would be to use a €1million ticket size as a threshold. Trades which are less than €1million could be characterised as retail while trades which are more than €1million could be characterised as wholesale.

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

48. The transparency regime between the wholesale market and the retail market could be different, but there is no doubt that the regimes have to be harmonised within Europe.

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?

49. We do not believe that more post-trade transparency is a condition to restore reliability of the CDS market as a proxy to calculate the prices in the cash market. The setting up of a European Clearing House would be much more efficient.

Q25: Do you think that transparency requirements could help address wider issues such as those relating to accurate valuations?

50. Price transparency does not necessarily make portfolio valuation easier and more objective. In extreme circumstances such as illiquid trading or outsized position, price information would be misleading.

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.

51. Probably, and for both markets, an industry–led solution would be the most cost effective.

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.

52. The framework should be more oriented towards an end of day price consensus for liquid bonds, rather than solution with a trade by trade reporting. At least, there must be a condition of a proper delay after which the reporting is done.

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?

53. Not applicable (see Q27).

Question 29: Would you see some benefits in a step-by-step implementation, starting with the most liquid bonds, as employed when TRACE has been introduced?

54. A step by step implementation would certainly be preferable.

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