European Banking Federation

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EBF RESPONSE TO CESR CONSULTATION ON TRANSPARENCY OF CORPORATE BOND, STRUCTURED FINANCE PRODUCT AND CREDIT DERIVATIVES MARKETS

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General remarks

1. The European Banking Federation (EBF)[1] welcomes the opportunity to respond to CESR's consultation on the transparency of corporate bond, structured finance product and credit derivatives markets. On a general note, the EBF finds CESR's approach to the topic systematic and well-reasoned.

2. The EBF also finds important the distinction that CESR makes between on the one hand, corporate bond markets, and on the other hand structured finance products and credit derivatives markets, which demonstrates well that there are major differences but also mutual impacting issues. Nevertheless, the EBF underlines **that in terms of traded instruments and market functioning, the differences are of great practical significance so that both markets should be analysed in separation from each other – and in separation from equity markets – as regards appropriate transparency levels and solutions. These differences include in particular the degree (or lack) of product standardisation; liquidity levels; and market participants.**

3. In response to CESR's announcement, in April 2008, of its intention to reconsider its advice to the Commission on the functioning of cash corporate bond markets in light of the credit crisis the EBF wrote to the Committee to underline that it did not agree that such a link be made. The EBF nevertheless appreciates CESR's preference to address the questions that have been raised by the Financial Stability Forum and others around market transparency in a comprehensive approach, i.e. by considering different markets and instruments. At the same time, CESR's nuanced preliminary thinking is welcome in its distinction between different ways of providing transparency and in its attention to not useful or even potentially harmful disclosures.

4. In this context, the European Banking Federation believes that it is important to also make a **clear distinction between different concepts of "transparency".** The reluctance of market participants to trade in a wide range of instruments that has been experienced over the recent months is linked to **uncertainty around the substance and performance prospects of certain sub-group of financial products, rather than a lack of trading information**.

[1] Set up in 1960, the European Banking Federation is the voice of the European banking sector, with 2.4 million employees in 31 EU and EFTA countries. The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.

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5. The non-existence or lower volume of market transactions is furthermore not a market failure *per se*, but can be the simple expression of a situation where there is no equilibrium price between buyers and sellers of a specific product. In an environment of uncertainty about economic prospects, fast dropping asset prices and high default levels, expectations are likely to change quickly and market participants may adopt a waiting attitude and defer trading decisions. Although undesirable in outcome, this is a natural market reaction where the underlying market mechanisms as such continue to work normally.

6. The EBF also wants to comment on CESR's general considerations with regard to possible market failures in paragraph 2 of its consultation. CESR refers to possible market failures in the form of: externalities; information asymmetry; market power; and sub-optimal supply of public goods. The EBF believes that out of these four, information asymmetry with regard to the structured finance products has been one of the factors that have contributed to the financial crisis. This is as opposed to the other three potential kinds of market failures, which the EBF would not identify as significant factors in the crisis from today's point of view.

7. Rather, as the European Banking Federation has previously outlined **professional market participants feel that they have sufficient access to information about volumes and prices in the markets.** Various market-based solutions are in place which provide the price transparency needed by professional investors, including notably several electronic trading platforms. In addition to these platforms, price information can furthermore be extracted from bond indices, which often provide up-to-date market quotes of the bonds included in the index in addition to the quote for the index as a whole.

8. In addition, the current situation where some market participants invest to acquire some superior knowledge has the function of improving on the situation where market asymmetries prevent some trades from happening. Market makers incur the cost of acquiring additional information because of the expectation that as a result, they will be preferred as a trading counterparty by other market participants. If there was an attempt by regulation to interfere and force informed parties to disclose the superior information in which they have invested, this would remove the incentive of acquiring such information – i.e., the market would be brought back to the initial situation of a yet reduced level of relevant information about issuers and products.

9. In light of the above the great majority of EBF members do **not expect that a more formalised post-trade transparency regime would in any way alleviate the liquidity shortages and wide spreads that are currently observed in the fixed-income markets**. Indeed, already today there are post-trade bond market transparency solutions in place in some EU jurisdictions, e.g. in Italy and Denmark, which do not appear to have had any alleviating effect in either regard.

10. However, in an effort to deliver more transparency on the markets as a whole as well as making markets more accessible and enhancing ease of understanding by

the general public, voluntary industry initiatives are being considered by the industry in some EU Member States.

11. These self-regulatory initiatives are with regard to plain vanilla corporate and public bond markets, in which there might be direct participation of retail investors. **The EBF continues to believe that there is no case for any legislative measures, given that the necessary information is in principle available**.

12. Furthermore, there **should be no pre-trade transparency arrangements** which would indeed risk to further decrease liquidity as a result of their dissuasive effect. This also seems to be acknowledged by CESR as the Committee's questions refer specifically to post-trade transparency.

13. **Whilst recognising the major shortcomings that have become apparent in the structured products markets the EBF does not believe that these could be usefully addressed through a post-trade transparency framework.** Given that these products are not harmonised such information would not be of any use to the market. Instead, the information gaps that have been encountered in these markets are with regard to the products themselves. The **industry has engaged in a number of initiatives to improve product transparency and valuation in these markets**. **Further measures to enhance investors' information about structured products are currently being discussed in the form of possible amendments to the Capital Requirements Directive.**

14. **In terms of financial stability, the EBF is involved in discussions for setting up a central clearing party (CCP) for credit default swaps (CDS) from which relevant information could flow to the competent authorities.**

15. In the light of the above considerations the detailed responses to CESR's questions below are only with regard to the corporate bond markets, whereas observations of a more general nature are provided on the structured products markets.

Responses to CESR's questions

Part I: Corporate Bonds

Section 2 – Recent financial market turmoil: evidence of market failures in the corporate bond market and lack of post-trade information available in this market

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

16. There is no doubt about the difficulties in the functioning of the bond markets over the past several months, with a severe retreat of liquidity accompanied by widening bid-offer spreads as accurately described by CESR. There are several reasons for these developments, including notably:

- general uncertainty about the future economic outlook and future overall default levels;

- uncertainty about the prospects of individual firms and the assets of financial institutions;

- de-leveraging efforts by financial institutions that recognised the need to hold higher levels of capital to prepare for future losses.

17. In consideration of these circumstances it can however be argued that the reaction of the bond markets from the summer 2007 onwards was a rational one and rather indicative of the proper functioning of this part of the market.

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

18. A certain degree of information asymmetry between market participants is typical of many markets. However, this is with regard to the products themselves rather than their trading and has not proven problematic in the classical corporate bond markets. Moreover, market participants feel that in terms of market prices and volumes they have access to sufficient information and that existing structures deliver these in a cost effective way.

Market liquidity

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?

19. These reasons included a sharp deterioration of economic fundamentals and the loss of confidence in the economic prospects of corporate bond issuers, in some cases re-enforced through the downgrades of issuers and products by the rating agencies. In this environment of uncertainty, investors were increasingly reluctant to execute trades and rather preferred to further monitor market developments.

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?

20. In the above-described situation the retreat of liquidity as such should not be interpreted as a market failure. A formal post-market transparency framework could not have prevented these developments.

Bid/ offer spread

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

21. The European Banking Federation agrees with CESR's analysis in that the widening of bid-offer spreads was a result of the increased uncertainty and volatility in stressed market conditions, i.e. the same reasons that led to decreased levels of liquidity. The EBF would also mention a certain supply/ demand imbalance that came as a result of many market participants' de-leveraging efforts. Furthermore, widening bid/ offer spreads were a natural reaction to the increased risks incurred by market makers.

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 corporate bonds?

22. No. The widening spreads were a result of lower liquidity levels and higher levels of risks incurred by market makers. They would not have been reduced through more post-trade transparency.

CDS/ corporate bonds relationship

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

23. Market participants themselves will be best placed to provide detailed comments on their use of CDS prices for the pricing of corporate cash bonds. However, CDS prices are indeed one important factor for the pricing of cash bonds in that they have proven a good proxy of issuer default risk in normal times. This is besides other significant pricing factors which include in particular nominal interest rates and duration/ maturity of the bond.

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?

24. The CDS market can indeed only serve as a proxy for issuer default risk in normal market conditions. In the past months bonds were therefore increasingly valued directly on the basis of market quotes.

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?

25. Market participants make use of direct price quotes from market makers, which they believe are more accurate than post-trade data. This practice is also in line

with the International Financial Reporting Standards (IFRS). As opposed to this, individual price quotes from rare transactions in an illiquid market would not be a satisfactory basis for "Fair Value" valuations.

26. On the other hand it is true that the CDS market has come under the spotlight in its ability to deal with market participants' desire to reduce overall risk positions and to monitor counterparty risk. This is however an issue of financial stability rather than asset valuation.

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?

27. The EBF expects that the situation will eventually stabilise as market participants are able to improve their capital positions and exploit arbitrage opportunities. However, some fundamental issues about the functioning of the CDS markets will need to be addressed on the way, including the current size of this market which a number of market participants feel is too large; as well as the counterparty risk where initiatives for clearing houses have been started.

<u>Valuation</u>

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

28. Valuation difficulties have indeed arisen in a number of situations where there were no bid quotes for cash bonds.

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

29. No. Data on distressed and disorderly trades would most likely be too dispersed to be of any added value. Instead, both IFRS and US-GAAP accounting standards require the modelling on the basis of the expected discounted cash flow, where institutions retain a significant degree of freedom in the design and calibration of these models.

Section 3 – Potential benefits and drawbacks of increased post-trade transparency

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.

30. Generally the evidence regarding both potential benefits and drawbacks of increased post-trade transparency is weak. It must also be taken into account that the corporate bond market comprises a large number of individual securities with divergent features, rendering the interpretation of price data complex.

31. With regard to CESR's arguments on the benefits of improved post-trade transparency for retail investors it should be noted that there are already a number of tools available for retail investors to access bond price information, including recent industry initiatives. Additional initiatives are currently being considered on a national level in some EU Member States.

32. The EBF agrees however with the potential risk of post-trade transparency impacting negatively on liquidity as a result of reduced incentives for liquidity providers to participate in the bond markets.

33. The EBF furthermore concurs with the arguments of potentially re-enforcing herding behaviour in distressed market conditions; and of potentially further decreasing liquidity for already thinly traded bonds.

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

34. The EBF does not have any other considerations to add to CESR's detailed analysis.

Section 4 – Experience in the US market: the TRACE system

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.

35. Not applicable.

Q16: Do you see other benefits of drawbacks in the introduction of a TRACE-like post-trade transparency regime for OTC trades in corporate bonds in Europe.

36. For the reasons outlined above the European Banking Federation does not support a legal post-trade transparency framework for corporate bonds. The EBF would on the same basis disagree with FINRA's argument that increased post-trade transparency would help to alleviate the difficulties that are currently being encountered in the bond markets.

37. Besides the fact that the consequences of TRACE have been inconclusive to date, the starting point in the US was a different one, with much wider bid/ask spreads than those encountered on the European markets.

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.

38. The EBF is not in a position to comment on this question.

Section 5 – Market-led initiatives in the trade transparency area

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?

39. Bond markets are mostly wholesale markets. Where there is involvement of retail investors, these investors typically adopt buy-and-hold strategies and do not have the intention of selling the bond before its maturity date. Ongoing price quotes should therefore be of little relevance to them.

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

40. Notwithstanding the remarks above, there are some additional industry initiatives are under way in some EU markets, with the objective of enhancing the general public's access to ongoing price and volume data and, arguably more importantly, of improving the public perception about a lack of transparency in the financial markets. These initiatives will carefully consider already existing solutions. In any case there is a need for a certain threshold of transaction volumes to establish which bonds to include in the system; and reporting must occur with a certain delay. It is important that these initiatives remain market-driven, so that market participants can interact to shape the different initiatives in a mutually complementary way.

Section 7 – Conclusion and recommendations

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 crises?

41. As there is no evidence that the difficulties that have occurred were related to the availability of trading data the EBF does not expect that this would be the case. Indeed, there is rather a concern that efforts to impose price transparency in the current distressed market conditions may have adverse effects and decrease liquidity even further.

Q21: Do you believe that additional post-trade transparency of European corporate bond markets would contribute to liquidity in normal market conditions? Can you explain why?

42. If anything, all evidence that is currently available rather points to the inverse, namely a potential decrease of liquidity as a result of additional post-trade transparency requirements.

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?

43. Corporate bond markets are traditionally mainly wholesale markets, with the largest number of investors being institutional ones rather than private individuals. The only major exception in this respect is Italy which has a considerable participation of private investors in the market.

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.

44. The EBF does not believe that a transparency regime would be of any benefit to the wholesale markets where market participants already feel that they have the information they need. The EBF would also be sceptical about the additional benefit of a transparency regime for retail investors which do not typically intend to trade their holdings.

45. In terms of downsides it is worth reiterating the potential danger of decreasing rather than increasing liquidity.

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 corporate cash bonds?

46. No. Market participants have been able to rely on price quotes for the purpose of bond valuation. This is besides the fact of the main rationale of CDS being that of hedging risks, rather than pricing instruments.

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

47. No. As per the remarks made above price quotes can be used for valuation purposes.

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

48. The EBF does not support a mandatory post-trade transparency framework. Some industry-led solutions are already in existence and others are currently being considered. Given that the primary objective of such initiatives is that of enhancing the general public’s understanding and easy access to information about the financial markets, rather than responding to a genuine information gap identified by market players, it is right that these initiatives are purely industry-driven.

Q27: Which should in your view be 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.

49. As the objective of the additional schemes that are being set up lies primarily in an enhancement of the general visibility of the financial markets and specifically the bond markets, disclosures should be designed accordingly. Arguably the primary emphasis should lie on easy accessibility and ease of understanding rather than the level of detail of the disclosures.

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?

50. Where additional voluntary schemes are being set up these will certainly have to put in place a certain volume threshold to establish what transactions should be disclosed. It would be practically near-impossible to disclose every bond transaction effected, nor would an unlimited scope be likely to be of real value to the broader public.

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?

51. On a general note the EBF does not believe that the experiences of TRACE can or should be mapped across to Europe. However, the industry initiatives that are currently being considered will also give thought to the possibility of starting with disclosures on the most liquid bonds and considering in a next step to what extent an extension would further benefit the public.

Part II: Structured Finance Products and Credit Derivatives

52. The EBF agrees with both CESR's analysis that there has been a market failure in the securitised markets and with most of its more specific analysis. Indeed, the issues to be considered for these markets are quite different from those addressed above for the corporate bond markets.

53. **The EBF does however not agree with CESR that there would be value in addressing these difficulties through a post-trade transparency mechanism. Instead, the right tool to address the issues that have been identified, in the view of the EBF, is enhanced transparency on the products themselves.**

54. Acknowledging regulatory authorities' concerns around financial stability issues arising from the credit derivatives market, the EBF believes that these are best addressed through the **setting up of a central counterparty (CCP)**, which would in a next step enable the authorities to obtain the necessary aggregate information.

55. In light of these considerations this paper makes below some general observations, rather than to respond to CESR's consultation question by question.

Differences between structured products markets and traditional bond markets

56. In response to CESR's questions around the possible establishment of a post-trade transparency regime for structured products it should be underlined that **structured products are very different from plain-vanilla bonds in their individualised nature and lack of standardisation**. It is therefore very difficult to make any comparisons between them, meaning that post-trading information would not be of any use to the markets. On the contrary, such information might mislead investors to make mistaken comparisons between actually quite different products.

Enhancing transparency on the products, rather than the markets

57. On the other hand, CESR is right to point out the asymmetry of information between sellers and buyers of asset-backed securities (ABS). Investors' need for more information is however with regard to the products themselves, rather than with regard to the trading of these instruments and the prices paid for other ABS.

58. Following the burst of the housing bubble in the US this recognition has led the industry to put in place the number of **industry initiatives** that CESR accurately describes in its consultation paper. In addition to providing regulators with information considered relevant to analyse market developments from a financial stability angle, these initiatives have the objective of providing investors with better access to information. To the extent possible this will also increase standardisation and comparability of products, as well as valuation methods. However, this is in a much more thorough and granular approach than what could be achieved through a potential post-trade information framework which would unavoidably lead to over-simplification.

59. As also described by CESR, the same considerations have led to proposals for a number of **amendments to the Capital Requirements Directive**, and in particular in Article 122. The proposed amendments - still under discussion at the European Parliament - foresee that originators provide to investors detailed information about the exposures underlying their securitisation positions. On the basis of that information, credit institutions would be requested to establish formal procedures to monitor on an ongoing basis and in a timely manner "performance information" on the exposures underlying their securitisation positions. That "performance information" may include aspects such as exposure type, the length of time the exposures have been held by the originator, the percentage of loans past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy.

Establishing a central counterparty for credit default swaps

60. The EBF recognises that in a post financial crisis environment, **supervisors** have a legitimate expectation of information from firms that trade credit default swaps

(CDS) surrounding where the underlying and final counterparty credit risk lies. **The EBF has supported efforts underway to establish central clearing of CDS in Europe** to firstly strengthen the infrastructures that support the over the counter (OTC), or bilateral, inter-bank derivative markets but also to provide a mechanism through which supervisors can obtain information on counterparty risk.

61. **Careful thought ought to be given therefore to the right of access of European supervisors to the DTCC's Data Warehouse.** In parallel, and assuming that one or more CCPs are established in Europe to clear CDS, CESR should also consider what would be necessary in Europe to capture similar information to assuage concerns surrounding the impact of CDS on financial stability, especially with respect to the European reference entities underlying the CDS contract. Price data related to CDS, especially the variance of basis point spreads, would undoubtedly facilitate supervisors' understanding of the health of the market.

62. Consequently, providing that the unique features of derivatives products and markets are taken into account in its design, **the EBF would support the eventual establishment of a data warehouse in Europe which would rely on access to the European CCP(s) set up to clear CDS.** A series of follow-up questions would then need to be answered in terms of which entity would be best placed to design and build such an entity and whether the venture should be in public or private hands.

63. Specifically as regards a post trade transparency regime for CDS, **the market believes that there is already a good level of transparency available in the market on CDS contracts,** including for trades that do not take place between dealers. CDS prices are typically the function of bilateral negotiations and do not therefore reflect the bare underlying value to the trade. A post trade transparency regime for CDS would not therefore add value and could in fact prejudice current efforts and the related benefits from establishing CCP clearing in Europe for CDS.

Concluding remarks

64. The European Banking Federation recognises general efforts of improving the transparency on the financial markets, both in consideration of financial stability concerns and to respond to the general public's interest to better understand the functioning of the financial markets as such. The EBF and its members are participating in various efforts to respond to both concerns.

65. On the one hand, with regard to the corporate bond markets the EBF underlines that there is no lack of trading information, and certainly not from the viewpoint of professional investors. Also retail investors do in principle have access to the necessary price information where they seek exposure to corporate bonds. What is more, reduced liquidity and widened spreads over recent months were a normal and in itself "healthy" response to the uncertainties in the markets.

66. However, the industry has recognised the existence of general interest in more accessible information about the developments in the financial markets also to the wider public and has engaged in a number of initiatives to deliver this information in an appropriate format.

67. On the other hand, the structured product markets are quite different in nature. Whilst serious shortcomings have been encountered in these markets, including information asymmetries, this was however with regard to the substance of the products themselves rather than with regard to the markets where these products are traded.

68. The EBF has participated in initiatives to enhance investor information about these products to reduce the information asymmetry around them and expects that the amendments to the CRD will further help to address these issues.

69. The EBF is also open to the possibility of setting up a central counterparty for credit default swaps, although a number of questions yet need to be addressed.