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EUROPEANISSUERS RESPONSE TO CESR/08-1014 CONSULTATION PAPER (19/12/2008) ON TRANSPARENCY OF NON EQUITY MARKETS

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EuropeanIssuers welcomes the opportunity to provide feedback to the CESR Consultation Paper (CP) on "Transparency of corporate bonds, structured finance products and credit derivatives markets". Our response will address only the issue raised in Part I of the CP covering the corporate bond markets.

Contrary to the main points of the previous CESR advice summarized in page 3 of the current CP, in our opinion in the corporate bond market:

a) there is evidence of market failures that would warrant regulatory intervention;
b) an improved transparency regulatory regime would not carry any adverse impact on market liquidity if appropriately designed to avoid unnecessary invasiveness;
c) the empirical research available in the academic literature is predominantly in favor of the beneficial effect of an increased post transparency regulatory regime;
d) it is appropriate to leave market forces to develop flexible ex ante transparency arrangements, but, at the same time, some regulatory requirements in terms of post transparency appear overdue, even more so now that the new MIFID requirements, *in primis* best execution, are in place.

Before providing the required answers to the CP specific questions, we motivate our ***general position*** on the issue of transparency in the corporate bond markets as hereinafter.

The main aim of Part I of the CP appears to ensure the integrity, fairness (towards all categories of investors) and efficiency (in terms of price discovery) of the trading in the secondary bond market.

We understand that, given the recent market turmoil and the heavy losses experienced by many investors, this appears as the most sensitive and visible issue to tackle. However, in terms of ex ante economic efficiency, ***the real cost of any secondary bond market failures and inefficiencies falls on the issuers***. Rational investors, aware of the risk corporate bonds expose them to, will insist for an extra compensation in terms of higher expected returns. Whenever a lack of transparency hamper market liquidity, a liquidity risk premium has to be added to the otherwise required bond yield. Issuers will then bear a financing cost higher than the amount justified by their own credit risk and by the liquidity implied by the size of the bond issue.

Sometimes the liquidity risk may become so relevant to cut off entirely the access of the issuer to the bond market.

From the issuer perspective, thus, any suboptimal system of transparency spoiling market liquidity is seen as a "tax" on its "financing transaction" with the investors in the primary market. The burden of this tax, in theory, would be shared by the investors (supply side of funds) and by the issuers (demand side of funds) in a proportion determined by the relative elasticity of their supply and demand curves. In practice, however, since the capital mobility is now extremely high, always chasing the best opportunity available around the world, the elasticity of supply is much higher than the elasticity of demand. The "liquidity tax" burden, then, is almost entirely shouldered by the issuers.

Issuers are then the party with the most direct and relevant interest in pursuing an optimal transparency regime for the corporate bond market since they bear the full cost of any inefficiency. They are even more so than investors, some of whom are hit ex post by losses, when the risk materialize and realized returns suffer, but all of whom are compensated ex ante, in terms of higher expected return, for the liquidity risk they willingly bear.

The overwhelming majority of comments in the first consultation on non equity instruments transparency came from financial institutions: banks, broker/dealers, exchanges. Since they all act as intermediaries in the bond market, their alignment of interest toward the aim of having an optimal transparency system is not clear cut. While part of the above mentioned "liquidity tax" takes the form of deadweight cost, part of it may turn to their advantage in forms of rent generated by the information advantage they enjoy in an opaque market. This may explain the dominant answer to the previous consultation claiming the absence of any evidence of market failures and, in any case, the need to limit any intervention aimed to address possible market unbalances to some form of self regulation.

An improved regulatory framework for transparency in the bond market is desirable. Under normal market conditions, both rallies and declines, it may help, in turn, to increase liquidity, decrease the liquidity premium investors ask for, lower the funding cost for firms, foster firms' investment and help long term economic growth.

There are two main parts to a transparency regime: ***pre-trade transparency and post trade transparency***:

In our opinion, many of the arguments the respondents to the first consultation rose against regulatory requirements and in favor of a market driven transparency mechanism are valid if confined to the pre-trade transparency.

When a dealer posts "buy/sell" quote to the public it offers a put/call option for free to the public. The value of this option can be very high in view of the peculiarities of the trading in corporate bond markets, mainly infrequent trading. Any regulatory intervention in this respect may end up being either not binding or too cumbersome, discouraging market makers to post quotes. It appears appropriate, then to let markets forces design the most suitable transparency regime given the market condition and the type of securities.

With respect to the post trade transparency, instead, we consider appropriate and desirable to introduce a regulatory requirement for reporting and disseminate information in real time (for instance, along the line of the TRACE system implemented in the US market).

We acknowledge that there are two main, if not two only, objections to the introduction of regulatory requirements for post trade transparency in the EU bond market. The first is based upon the claim that a real time dissemination of trade prices and volumes may discourage a market maker from supplying immediacy since he will be afraid other dealers may learn of his desire to unwind the position just built and adjust their quotes accordingly. The second objection relies on the claims that the EU does not need post trade transparency regulatory requirements since the bid/ask spreads are already much tighter than in the US bond market, despite the TRACE system implemented there.

However, we are not convinced by either of these objections.

While ***the first objection*** may, in theory, have some merit, it is doubtful it is material in practice. Market makers rarely need to cover quickly short positions they may have entered into, usually the riskiest possible situation. They almost never sell bonds which are not in their inventory since they are afraid it may take them too long to cover their shorts due to the infrequent trading and to the absence of a well functioning repo market for corporate bonds. On the other hand, market makers may desire to download any large long position in bonds built after serving as a counterpart to a selling investor. However, since bonds presents less volatile prices than equity and usually accrue interest, the market maker's need to download a position is less pressing and urgent for bonds than for stocks. They also need to carry some inventory at hand if they want to stand ready to serve also buyers, avoiding at the same time shorting the securities. Moreover, should the market makers doubt of their ability to conduct offsetting trades, the round trip spread should be wider, the larger the position they are dealing with due to the higher expected cost of remaining victim of informed traders. The empirical evidence, however, is exactly the opposite: spread for round trip transactions are higher the smaller the trades are. Rent extraction thanks to an opaque market, rather than risk of falling victim of informed traders, appears thus to be the name of the game.

Therefore, there should be then no valid reason for market makers to fear a real time dissemination requirement of post trade information. But, even if this were the case, an obvious way to deal with these fears would be to look at the approach of TRACE, imposing (at least for a certain transition period) a time lag between execution and dissemination, limiting the content of the information to be disseminated and introducing exemption provision for trades in bonds extremely illiquid. Progressively and with full success, TRACE has expanded the bond universe covered by the dissemination requirement and shortened the dissemination lag, while maintaining some disclosure limitation for large trades and very illiquid bonds.

As post trade transparency reduces the opaqueness of the market, it will definitely make the environment for securities intermediaries more competitive and tougher. Because of lower bid/ask spread, some intermediaries may stop finding profitable to act as dealers and switch to a pure broker role. Completing a sizable deal may become operationally more engaging since it may require contacting multiple dealers and eventually split it in different trades, rather than just executing it with a single counterparty, maybe the only one contacted. But the reduction of rents and a better pricing for final customers is exactly the whole point of fostering a more competitive environment.

The ***second objection*** to introduce post trade transparency requirements in Europe lies on evidence showing that bid/ask spreads in the European corporate bond market are on average smaller than in the US market (especially if denominated in €). This is explained with the supposedly more competitive EU secondary bond (denominated in €) market structure compared to the US market. The higher competition would be due to the larger number of banks and brokers-dealers that act as intermediaries in the bond market: just five or six in the consolidated US market; two or three for each of the medium and larger countries in the EU area.

We believe there are reasons for handling this type of evidence with some care due to the different nature of the market considered and to the different nature of the databases used in empirical studies.

In terms of the nature of markets, corporate bonds are a more established asset class in the US than they are in Europe where they become popular only with the introduction of the euro. The US bond market thus is more mature and allow access to a wider range of issuers, even those of marginal quality and size that is difficult to find in the European market. As a consequence, then, it should not come as a surprise that on average the bid/ask spread is larger in the US than in Europe. Far from being a negative attribute, this evidence should be evaluated positively for the US market since it reveals an easier access to bond capital for issuer of all types and sorts.

Even taken for granted that for large trades on investment grade bonds of large outstanding amount (the only subset of the market one for which a comparison may be attempted), the EU market is more liquid and cheaper than the US market, it appears how limited the scope of this comparison. It is therefore not justified to reject a call for increase mandatory ex post transparency on the basis of such evidence.

It seems self evident to us that post trade transparency requirement is also the only effective way to make sure best execution requirement is complied with and a consensus on a reasonable range of possible valuations of the same bond is achieved.

In short:

1. ***we strongly support the introduction of a regulatory system of post trade transparency on corporate bonds;***
2. ***in normal market conditions, besides protecting investors and providing them with the opportunity to trade bonds at a lower cost, this system may facilitate a cheaper access to funding for a whole range of issuers;***
3. ***for some issuers (small, low rated), the transparency regime may even open this opportunity for the first time;***
4. ***we do not believe that a regulatory system of post trade transparency would have help in any material way to contain, or even prevent, the current financial crisis;***
5. ***because of interplay of private and public interest, we do not believe that free market forces may achieve an optimal amount of post trade transparency through self regulation;***
6. ***we would, then, welcome the introduction of a regulatory system of post trade transparency requirements;***
7. ***the experience of TRACE should be closely looked at as a working basis.***

* * *

Here below, please find short answers to the specific question contained in the first part of the CP.

Question 1-2

Yes, the current financial crisis in credit markets is evidence of both market and regulatory failure that goes far beyond the transparency issue the CP is dealing with. In the credit markets there are huge information asymmetries among different participants. They, however, extend well beyond the content of trade prices and volumes.

Question 3 and 5
Without any particular order of relevance, the main factors behind the liquidity shortage we have experienced are: the deleveraging process; the hedge funds redemptions; the increasing aversion to risk in general, and to credit risk in particular; the increasing preference for liquidity; the high uncertainty fuelled by a distrust of ratings. Bid/ask spread widened because of the extremely high volatility and low liquidity induced by the factors just mentioned, the same factors that happen to become predominant whenever a financial bubble burst.

Question 4 and 6
No, the bubble was of such an order of magnitude that no post trade transparency system would have either provided any material relief or limited in a perceivable way the widening of the bid-ask spreads.

Question 7-8-9
N/A

Question 10
Yes, part of the large deviation between the CDS market and the cash bond market is now due to the diverging and overwhelming relevance assumed by the counterparty risk (in CDS pricing) and funding risk (in cash bond pricing) under the current financial distress. Once markets are back to more normal conditions, a relationship between the two markets closer to the historical norm will reemerge.

Question 11-12
Over the past few months, valuation has been difficult because of a lack of reliable market prices, gigantic bid-ask spread (if quotes were available at all), the impossibility to provide a stable estimate of both the credit risk premium and the liquidity risk premium for any meaningful cash flow valuation exercise. Given the extent of the financial turmoil, post trade transparency requirement might have been of not much help.

Question 13-16
Please refer to the introductory part of our response, to gain knowledge of our positive stance towards a regulatory system of post trade transparency for the EU market inspired on TRACE.

Question 14
Among the additional collateral benefit a post trade transparency regime may deliver, there are, as mentioned above:

- the liquidity/valuation externalities;
- the possible incentive for greater pre trade transparency;

- the lower cost of capital for firms;
- an easier access of marginal issuers (small, lowly rated) to raise capital in the bond market.

Question 17
N/A

Question 18
N/A

Question 19
We feel a transparency regime inspired on TRACE could be beneficial. Aggregation of trade data, daily delays in disseminating data, excessive limitation of transactions/bonds covered should be avoided.

Question 20
Yes, they may have beneficial effect and foster integrity, efficiency (both operationally and informative), fairness and liquidity. However, they cannot do much with respect to violent crisis due to the bursting of big financial bubble.

Question 21
Yes, in normal market conditions, both in up and down market, post trade transparency requirement should provide the best contribution to an orderly function of liquid market (please refer to the introductory part of this response).

Question 22
At this point we do not believe to have enough information to provide a definitive answer.
However, with respect to the issue of post trade transparency, we believe there is no point in discriminating the wholesale from the retail segment of the corporate bond market. The aim pursued is not limited to the protection of retail investors, encompassing also price discovery efficiency and market integrity.
Limiting the post trade transparency requirement to one of these two segments would be inappropriate. It would not provide much benefit in terms of market integrity and price discovery process (large trade may carry more informational content than small trade) and, paradoxically, it could even foster price segmentation and increase the rents extracted from retail investors.
Our preference goes to one single ex post transparency regulatory system. To secure protection of market makers in unwinding their positions, the amount of information to be provided on trades exceeding a certain size could be limited (i.e. no trade volume) and/or slightly longer dissemination delay may be allowed. Again, the TRACE experience may provide useful guidance.

Question 23
The benefit of a system of post trade transparency requirements will accrue mainly to the retail market participants and to the small professional traders who will be less exposed to the pricing power of the market makers and who will enjoy a more reliable implementation of the best execution principle. However we do not envisage any meaningful disadvantage even for the wholesale markets. As stated before, if, on one side, there may be the risk of a withdrawal of immediacy, on the other hand the richer information set allow better risk sharing among dealers. Moreover, empirically, the TRACE experience offers no evidence supporting the claim of withdrawal of immediacy, while there is a clear consensus on the reduction of the round trip trading cost over orders of all size.

Question 24-25
In our opinion, transparency requirements clearly help in addressing wider issues such as:
a) the need of more accurate valuation;
b) a more prompt reassessment of the credit risk, since it is well known that rating changes dramatically lag any shift may occur in the merit of credit of a bond.
The more erratic relations between CDS market and cash bond market may offer a further rationale to claim the need of post trade transparency, but, for us, it is not a major one.

Question 26
In terms of post trade transparency, we deem a regulatory intervention necessary. In fact, while the interest of issuers and investors are perfectly aligned towards implementing an optimal level post trade transparency system, the same cannot be said for the financial intermediaries acting in the corporate bond market to which the design of a self regulatory system would be entrusted. For them, higher transparency means more competition and tougher operating condition.

Question 27-28-29
The design of TRACE and its sequential process of implementation can provide a useful working basis with the aim to establish and implement a post trade transparency system in Europe. Building on the experience of TRACE and, taking advantage, of the claimed more liquid nature of the European bond market, we would welcome a quicker implementation of this post trade transparency regime than seen in the US and a shorter maximum delay time in disseminating trade information.

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