EFAMA
European Fund and Asset Management Association

CONSULTATION REPLY

Brussels, 7 July 2022

EFAMA RESPONSES TO THE DISCUSSION QUESTIONS WITHIN THE REPORT "CORPORATE BOND MARKETS – DRIVERS OF LIQUIDITY DURING COVID-19 INDUCED MARKET STRESSES"

EFAMA is appreciative of the opportunity to comment on this major IOSCO study on the dynamics of bond market liquidity during market stresses. We provide some detailed responses below, but would reiterate a few high-level points here:

- The analysis could better reflect the different public policy responses in Europe and the US, given that the timing and duration of major central bank interventions were not aligned.

- The unique nature of the health crisis and the ensuing policy response should be reflected in the analysis, and clear distinction made between this crisis and other external shocks.

- We see a natural area for further analysis on the role of ETFs in FI markets during the crisis.

- A consolidated tape for bonds would provide greater transparency which is particularly important in times of market volatility, for market participants but also for regulators for market surveillance purposes.

- We see important potential in all-to-all trading, standardization and electronification of trading. Yet the impact today is still limited to improving diversity of trading platforms more than increasing available liquidity.

- Some post-GFC policies we believe exacerbated the liquidity squeeze during the Covid crisis and would benefit from a review: bank capital rules, and 'dash for cash' effect made worse by margining requirements that do not recognise a broad enough list of eligible collateral.

CORPORATE BOND MARKETS – DRIVERS OF LIQUIDITY DURING COVID-19 INDUCED MARKET STRESSES

1. What are your views on the key outcomes drawn from IOSCO's analysis of the corporate bond markets? Are there any aspects of the diagnostic analysis and the key outcomes with which you disagree or that would benefit from more nuance? Are there additional regional or jurisdictional specific considerations? Please be specific to each observation and indicate why.

As a general comment, we believe it is risky to set policy based on a single event such as the March 2020 market turmoil. Major policy changes should be based on a more comprehensive view of market situations, failing to do so might result in policies that are inappropriate in different circumstances.

Moreover, in our view the IOSCO's report does not sufficiently differentiate between the US and EU market situations, where for instance we observed that:

- the turmoil was far stronger in the US as compared to the EU (in particular given that in the EU the Quantitative Easing (QE) policy was still positively ensuring more market liquidity than in the US where QE had been officially stopped in 2014);

- the behaviour of central banks was again different in the US than in the EU. For instance, US fund managers benefited from a last resort intervention from the US Federal Reserve, while the EU fund managers were not allowed to benefit from such access to the central bank money.

We also believe that the IOSCO report does not sufficiently reflect the fact that the Covid crisis was did not originate in the financial markets but was driven by an extraneous health crisis **– this is in start contrast to the 2008 financial crisis. In 2020, there were several clear stages:**

- a health crisis leading to global lockdowns;

- a policy decision based on health objectives leading to global economic freezing;

- the financial markets had to centrally adjust to that global economic lockdowns;

- then governments, through budget and fiscal policies, as well as central banks through monetary policies, injected respectively public expenses and money in the system to avoid both economic and financial crashes.

In addition, we question the decision to limit the report to corporate bonds when similar behaviour and lack of liquidity was also observed in SSA and Government bond markets, in some cases negating the supposed "flight-to-quality" value of a given issuer (i.e US Treasuries, EIB etc).

Finally, we believe that irrespective of the current analysis and ensuing recommendations, one consistent objective should be better coordination and trust:

- between securities regulators and central banks;

- at domestic and cross-border levels.

2. Does the report capture and accurately describe the main features of the corporate bond markets? Is there a particular aspect (or aspects) that may be missing?

We refer to the points made under question 1, notably that the report would benefit from separate analyses around the US and EU where the turmoil was felt differently, and public policy interventions were different in time and scope.

Also, it would be of great value to further investigate the role of ETFs in the underlying bond market, and their role in price discovery. Some firms have provided evidence that during the March 2020 period the ETF structure was shown to be resilient, allowing investors to move in/out of positions in corporate bond markets, in certain circumstances, without necessitating trading in the underlying. ETFs were also found by FSB/IOSCO to have acted as a price discovery vehicle.

In addition to the role of ETFs, more in-depth research should include analysis on new trading practices: RFQ platforms, but also algorithmic and portfolio trading.

3. Are there ways to improve the market functioning and liquidity provision in corporate bond markets, notably under stressed market conditions? If so, please explain how and the extent to which this could be addressed at an international level?

Market crisis and deteriorating liquidity always have and always will go hand-in-hand. The post-GFC forces impacting bank balance sheets have made it even more of a problem with banks not having much of an ability to work as a buffer anymore, instead essentially reducing themselves to matched principal agents. Non-bank liquidity providers have indeed added some market depth but ultimately are less likely to be able to trade blocks. Capital charges on banks need not be so restrictive that banks are unable to play their market intermediary role particularly in crisis times. Solutions hence would either suggest hoping for an ongoing evolution of the FI market structure to become more Equity-like – progress here is slow but incremental - or there is an acceptance of the role banks (and now non-bank liquidity provides) play in FI and hence some of the most stringent and capital markets activity-related capital requirements on banks should be reconsidered.

Finally, the concentration of activity into the hands of a few main and major players on the sell side with most non-global houses reduced to niche players has only added to the lack of market depth in times of crisis. Questions of scale, shareholder value and many others play a role here.

Any continued de-globalisation and fragmentation of financial markets - often/mostly based on political developments - will only exacerbate this issue. There also exists a false interpretation of electronic trading capabilities and impact - it does NOT bring any additional liquidity – and is probably not helpful for the less initiated and may have added a false sense of security

6. Does the report accurately describe the state of liquidity in corporate bond markets during the COVID-19 induced market stress across the three stated measures employed in the report?

It is important to make distinctions between different jurisdictions. In fact, during the Covid crisis there was already a Quantitative Easing programme in place in Europe while this was not the case in the US. The credit spread was therefore narrower in Europe.

In the US the spread began to normalize, after a sudden increase in March 2020, following the Fed's announcement of a series of programs focused on financial markets. But, in Europe there was still a QE effect.

These elements support the fact that the corporate bond market in Europe was not in distress to the same extent as the markets in the US.

8. Are the main demand side drivers of liquidity by investor-category accurately described and reflective of events in your experience of the COVID-19 induced market stresses?

The main concern for long-term investors was not, as such, a liquidity one but rather a credit default concern.

Regarding the role of open-ended funds, clients redeemed as they needed cash to meet different liabilities due to the pandemic and its real economic consequences. This type of intermediation through investment funds was therefore not the issue as the clients needed cash in any case: similar investors who needed cash and accessed either financial markets directly or indirectly through investment funds, behaved in exactly the same manner. This demonstrates that the open-ended funds were not an accelerator of financial market stresses.

9. Who in your view were the main drivers of liquidity demand during the COVID-19 induced market stresses and why?

The market stress induced by the COVID-19 pandemic was a shock that originated outside the corporate bond markets, which resulted in a flight to safety and a dash for cash. This meant that market stress was centered around the US Treasury market, with spill over effects across markets, including the corporate bond market. Raising cash to meet liabilities, to meet margin calls and rebalances were the principle drivers of the liquidity demand.

10. Given mixed evidence, how significant was the behavior of long-term investors in driving or mitigating liquidity demand during the COVID-19 induced stresses?

We agree that the evidence gives a mixed picture - some long-term investors arguably proved to be exactly that while others may well no longer want to be considered long-term after the crisis.

14. Do you agree these are the core features of the corporate bond market? Please be specific and explain why.

We generally agree with the study's identification of the core features of the corporate bond market, notwithstanding our comments under questions 1 & 2.

Also, another important point to consider, the equity market is centralized and anonymous, which the corporate bond market is not. This explains the limiting factors on the adoption of all-to-all trading in corporate bond markets.

16. What could help the market diversify sources of liquidity supply and/or become less reliant on dealer intermediation, particularly in times of stress? Consider both market-led as well as potential regulatory-led solutions.

There are certain market and regulatory led reforms that could help towards the diversification of liquidity supply. For instance, all-to-all trading requires greater data and market practice standardization, and this should be supported. Also, a fixed-income consolidated tape as a single source of reference data could enhance the use-case for electronic trading systems. An appropriate calibration of the deferral regime would be required to maintain the right balance between trade transparency and liquidity provision.

17. What are your views on standardization in corporate bond markets? What do you think are the pros and cons of increasing standardization and its feasibility?

Standardization with a materially reduced number of ISINs is likely going to be of some benefit to liquidity and would also reduce the ability for fund managers to create alpha via bond selection.

18. What are your views on electronification of the corporate bond markets? Has it improved the provision of liquidity?

Electronification in the main has not improved liquidity. It generally adds scale and efficiency but does not create additional liquidity out of a vacuum beyond that.

19. Is the electronification (and any resulting increase in liquidity) of government bond markets over the last decade illustrative of how corporate bond markets could evolve? How and why?

Liquidity and behaviour of individual securities is a product of a number of factors - size of bond, age of bonds, rating, main investor base etc. Improving/changing only one of those elements will only have modest positive benefits on liquidity.

20. What aspects or developments could help to further support increased levels, and the resilience of electronic trading both in normal times and in stress (e.g., availability of data)?

Consolidated Tape initiatives will arguably help price discovery, transparency and overall liquidity though only if introduced with the right balance, given the inherent FI market structure (reliance on sell side), ie deferral periods for block trades that are sensible and avoid dealers fearing information leakage and footprint issues beyond any reasonable expectations.

21. Would an increase in all-to-all trading help the provision of liquidity? Is it feasible to increase its use? What are the pros and cons?

All-to-all has long been considered the upcoming paradigm and while growth trends are positive, today it is still viewed as contributing to trading diversity rather than bringing additional market liquidity.

22. Do you think there should be more transparency in the corporate bond market, including the level of consolidated information? In which segments of the corporate bond market do you think transparency is most needed?

See responses to questions 16 and 20.

23. Would you consider that pre-trade transparency and post-trade transparency are equally important?

Post-trade transparency should come first and will arguably be an important input into pre-trade in any case. Definition of pre-trade is more difficult and would once again have to consider adverse impact on banks' willingness to provide liquidity.

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ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 27 member associations, 59 corporate members and 25 associate members. At end Q4 2021, total net assets of European investment funds reached EUR 21.9 trillion. These assets were managed by more than 35,000 UCITS (Undertakings for Collective Investments in Transferable Securities) and more than 30,000 AIFs (Alternative Investment Funds). At the end of Q3 2021, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 31.3 trillion.

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Contact
Susan Yavari
Senior Regulatory Policy Advisor – *Capital Markets*
Susan.yavari@efama.org | +32 2 548 26 55