INVESTMENT MANAGEMENT ASSOCIATION

A position paper written by the Investment Management Association to accompany publication of a report by Professor John Board

"The Impact of the Credit Crunch on the Sterling Corporate Bond Market"

This paper is intended to initiate a debate on appropriate reforms to promote a well functioning market in sterling corporate bonds.

Conclusions of the Research

IMA notes the conclusions reached by the researchers, namely that:

- The disruption in sterling corporate bond markets is real and is damaging the buy-side of the market: this is evidenced through much wider spreads, by an absence of two-way markets and at times an entire absence of market making, and by significantly increased price uncertainty;

- The dealer market structure has failed (over the period studied) and may not recover in its previous form: this is evidenced by significantly diminished market quality indicators (over the period studied), whether assessed empirically or anecdotally through the experience of market users;

- The risk of the sterling corporate bond market becoming a backwater has increased: with a consequential knock-on effect, should this continue, of significant future funding problems for UK corporates, including banks, both in terms of lack of funding and, where funding is available, higher cost of funding; and investment problems for long term UK investors such as pension funds and insurance companies;

- The absence of data is a significant impediment to evidence-based policy making; indeed it is also an impediment for market participants.

Importance of a well-functioning Market

The sterling corporate debt market is an important part of what needs to be re-built if the UK economy is to continue to flourish. There are many strands connecting those who rely on the secondary corporate bond market and each has an equally important claim on the market working well:

- Investment managers rely heavily on the secondary market in corporate bonds to complement investments made through primary issuance. The market provides the "oil" that allows the managers to adjust their portfolios to respond to changes in market conditions and stocks, to inflows and outflows of investment and to mandate and benchmark changes;
- Authorised funds, through their managers, have a particular need to access a ready source of liquidity through the secondary market to respond to investments and disinvestments made by underlying clients on a daily basis, many of them retail investors;
- Many market users, including fund managers and institutional investors, place reliance on secondary market information flows to assist them to value corporate bond holdings;
- The existence of a secondary market in corporate bonds, at least for some period of time after issuance, in turn supports attractive primary issuance. Whilst primary debt issuance is what provides funding to the issuers, it is the secondary market in sterling corporate bonds that services much of the needs of the investors in these assets: it is not therefore possible to separate the two activities and still have a meaningful market model;
- Policymakers have a long term interest in ensuring that businesses can operate without undue disruption to their flow of funding.

It is no easy task to move from one market structure to another. But if the sterling corporate bond market is to survive and to flourish, that is what should happen. The current market structure remains based almost exclusively on a market maker model. What the credit crisis[1] has highlighted is that the real inefficiency in the secondary market was the concentration in one form of trading.

The limited empirical research available for European bond markets[2] (including sterling) did not produce clear cut results. That research noted that the market maker model had certain inherent problems and suggestions were made for improvement. Equally some beneficial competition effects were observed, mostly reflecting competition between dealers. Of course, the near collapse of market maker activity for a considerable period after the credit crisis began meant that dealer competition barely existed for that period

[1] For the purposes of this note we date the credit crisis as beginning in the UK from July 2007

[2] *European Corporate Bond Markets: Transparency, Liquidity, Efficiency* Biais, Declercq, Dow, Portes and Von Thadden (May 2006); *European Govenment Bond Markets: Transparency, Liquidity, Efficiency* Portes, Dunne, Moore (May 2006); see also Research references

Although regulators have for some years toyed with the idea of requiring better pre- and post-trade transparency in the secondary market, this has not been implemented other than in the USA. The outline proposals that were considered within Europe were somewhat insensitive to the limited life of many bonds in the secondary market and to the impact on market behaviour of introducing partial transparency. Moreover there was little supporting analysis of the impact on liquidity, and pricing, of introducing transparency to a market model that was entirely built around market makers putting at risk their own capital. This was perhaps the principal reason for the resistance to change seen across the market in the period running up to the start of the credit crunch.

Radical changes to market structure are not unprecedented. The London Stock Exchange moved from a telephone-based market maker structure to a central, anonymous (and highly transparent), electronic order book in 1996 after significant pressure was brought to bear by the regulator[3]. NYSE Liffe[4] was unable to effect a change from floor trading to electronic order book trading for their main contracts until, in the space of a few weeks in 1998, it lost the long bund contract to an electronic trading book offered by the Eurex exchange. There are other similar examples outside the UK. What is notable is that change usually follows an event of some significance, commonly pressure brought to bear by competition and regulatory authorities or a significant adverse impact on commercial interests. By contrast what is notable about the impact of the credit crisis as regards the sterling corporate bond market is that there has not been clear, directional pressure, either regulatory or commercial, to effect change to trading structures.

Recommendations

It is in the light of this state of affairs, and with the aim of supporting the tentative signs of recovery in the secondary sterling corporate bond market, that we propose the following actions:

1. The Bank of England should consider, in the short term (not more than a year), engaging further in the corporate bond market in two discrete ways.
    a) Firstly, the Bank should add to its present activity of purchasing gilts and small amounts of high quality corporate bonds under the Asset Purchase Facility (APF) by also actively selling corporate bonds back into the market.
    b) Secondly the Bank should ensure that its buying and selling activity is accessible by authorised investors rather than requiring, in some instances, that the counterparty also carries out market making functions.Exchanges and MTFs should consider whether there is a further role that they could play in offering anonymised trading systems, supported by both market maker and agency brokers, with a wider choice of third party clearing arrangements (to remove counterparty risk from trade execution). For securities that trade rarely, exchanges, MTFs and firms could consider providing more in the way of "bulletin board" facilities.

[3] Securities and Investments Board: *Equity Market Review* (1995)
[4] At the time the London International Financial Futures Exchange

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3. The Financial Services Authority should engage actively with liquidity providers, exchanges and MTFs to secure several outcomes:

    a) Supporting change with the aim of bringing about a much wider set of choices in relation to trading functionality.

    b) Ensuring that changes to market trading arrangements bring about fair market access. This would include, for example, by requiring that information about market trading facilities is made available on a widespread basis and that pricing for services offered is fair and transparent.

    c) Using the transaction reporting information that is reported daily to them in relation to sterling corporate bonds (amongst other instruments) to analyse market quality and assess the ability of the market to deliver best execution given the available trading options.

    d) Ensuring that any future publication of post-trade information occurs on a basis that is fair and reasonable for all market participants. As a starting point, we draw attention to our response dated 19 February 2009 to the Committee of European Securities Regulators' consultation on the transparency of corporate bond markets, answer to question 28 http://www.cesr-eu.org/popup_responses.php?id=4544

    e) The European Commission should consider undertaking further reviews of market quality in corporate bond markets across Europe with a view to compare and contrast experiences and improvements year-on-year.

IMA intends to review the outcomes in one year, but in the meantime wishes to encourage further dialogue between all market participants and is willing to provide an appropriate forum.

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