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Alp Eroglu
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: Examination of Liquidity of the Secondary Corporate Bond Markets

Dear Mr Eroglu,

CFA Institute appreciates the opportunity to respond to this consultation report on secondary corporate bond market liquidity.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 140,000 members in 150 countries and territories, including 133,000 Chartered Financial Analyst® charterholders, and 147 member societies.

We wish to contribute to IOSCO's consultation report by sharing the results of a survey conducted among CFA Institute members. This survey was conducted during September 2016 and comprised 14 questions relevant to the debate on bond market liquidity. The detailed survey report is attached to this letter.

Summary

The most striking results are summarised below. Respondents from the Americas (AMER) and Europe and the Middle East (EMEA) report that, over the last five years, they have observed:

- A decrease in liquidity of high yielding and investment grade bonds corporate bonds and no change in the liquidity of government bonds.
- A decrease in the number of active dealers making markets.
- An increase in the time taken to execute trades.
- A lower proportion of bonds being actively traded.
- A higher proportion of unfilled orders.

These respondents also noted that bank capital and liquidity regulations have had a significant impact on bond market liquidity, and that removing impediments to the smooth functioning of institutional wholesale markets is most important.

Respondents from Asia-Pacific (APAC) report that, over the last five years, they have observed:

- No change in the liquidity of high yielding corporate bonds, but an improvement in the liquidity of investment grade corporate and government bonds.
- An increase in the number of active dealers making markets.

- No change in the time taken to execute trades.
- A higher proportion of bonds being actively traded.
- No change in the proportion of unfilled orders.

These respondents also indicated that there is no single macro factor, which has had a very significant impact on bond market liquidity. They also identified encouraging retail investor participation as a more important policy priority than improving institutional wholesale market functioning.

Specific comments

Around 68% of the survey respondents invest in the United States bond markets, 37% in the Eurozone, 23% in the United Kingdom, 12% in Japan, and 25% in other Asia-Pacific countries. Around 18% of respondents invest in more than one region. The plurality (i.e. the largest share of the vote, but less than a majority of 51%) of respondents across all regions reported that sourcing liquidity and executing trades in their relevant market was neither very difficult nor very easy. The exception was the United States, where respondents considered it relatively easy to source liquidity and execute trades, reflecting the general perception of US bond markets being relatively more liquid than their international counterparts.

One determinant of changes in bond market liquidity may be the number of market makers (dealers) and the scale and frequency of market-making activity. In the last five years, most respondents have observed a reduction in the number of dealers making markets in secondary corporate bond markets, particularly in the AMER region. However, the plurality of respondents in the APAC region observed a moderate or significant increase in the number of market makers in secondary corporate bond markets.

The survey continued by focusing on the liquidity of different types of bonds as well as geographic segments. Excluding “not sure” responses, the plurality of respondents noted a decrease in market liquidity in high yield corporate bonds (both financial and non-financial) as well as investment grade corporate bonds (both financial and non-financial). The only exception to this finding were government bonds for which respondents did not observe a noticeable change in liquidity over the last five years.

The results showed some variation by region, with respondents from the AMER and EMEA region being particularly sensitive to the perceived decrease in market liquidity for high yield corporate bonds (both financial and non-financial). The APAC results were noticeably different with respondents reporting mostly no change in liquidity, or improvements in liquidity (specifically for government bonds and investment grade financial corporate bonds).

Another way of approaching the question of bond market liquidity is to look at the time taken to execute trades in secondary bond markets. Excluding ”not sure” responses, the results once again show a plurality of respondents reporting a deterioration in market quality because of increased time to execute trades over the last five years. Similarly to the previous question, government bonds were the noticeable exception to this with respondents reporting no change in time to execute. The regional breakdown of results again shows the AMER and EMEA respondents reporting a similar deterioration in execution times while respondents from the APAC region mostly reporting no changes in time taken to execute.

A consistent set of responses was observed regarding the proportion of corporate bonds that are actively traded, with 72% of AMER respondents and 67% of EMEA respondents reporting a lower proportion of bonds being actively traded, compared with five years ago. In contrast, a plurality (46%)

of APAC respondents report a higher proportion of bonds being actively traded compared with five years ago. Continuing this theme, a majority of respondents in the AMER and EMEA regions reported a higher proportion of unfilled orders over the last five years (58% on average), while 45% of APAC respondents reported no change in the proportion of unfilled orders.

In contrast to the above results, all regions agree with the statement that dealers are increasingly focusing on servicing larger clients at the expense of smaller clients, with an average of 69% of respondents choosing this option irrespective of their region. Similarly, a plurality or majority of respondents report technological changes in the secondary corporate bond market (such as the growth in electronic trading facilities) have had little to no impact on liquidity.

A very high majority (over 80%) of AMER and EMEA respondents reported that bank capital and liquidity regulations, which limit the ability of banks to act as market makers, have had a significant or very significant impact on secondary corporate bond market liquidity. This was followed by loose monetary policies (EMEA respondents), which reduce the propensity of investment funds to trade bonds, and poorly functioning repo markets (AMER respondents) limiting the ability of dealers to manage risk. Other issues reported included the primary market being more attractive and there being more liquidity in pension funds.

Standardising or “equitizing” corporate bonds is sometimes promoted as a way to improve secondary market liquidity. A majority of APAC and EMEA respondents agree that such standardisation is a desirable goal, while only a plurality (46%) of respondents in the AMER agree that equitization is desirable. Across the three regions, a small plurality of respondents agree that exchange traded funds improve overall bond market liquidity.

The survey asked whether or not there was a trade-off between financial system stability (e.g. through increased capital requirements) and reduced corporate bond market liquidity. The follow-up question was whether or not this trade-off was acceptable. The results show that all regions agree that the trade-off exists (over 75%). However, a while a plurality of respondents (48%) in the Americas think this trade-off is unacceptable, a majority of Asia-Pacific respondents (51%) and a plurality of EMEA respondents (42%) think this trade-off is acceptable. It should be noted that a very significant contrarian minority exists among the AMER and EMEA respondents.

Finally, the already observed split between AMER/ EMEA, and APAC respondents is also present in the final question which asks whether encouraging retail investor participation or removing impediments to institutional wholesale markets is more important for regulators to focus on. A majority of AMER/EMEA respondents consider removing impediments to the smooth functioning of wholesale markets should be the main focus for regulators, while APAC respondents suggest encouraging greater retail investor participation is relatively more important.

Concluding Remarks

CFA Institute welcomes the opportunity to comment on IOSCO's work on secondary corporate bond market liquidity. We trust that the results of our member survey will prove useful in your further deliberations on this important topic. Please do not hesitate to contact us should you wish further elaboration of the points raised.

Yours faithfully,

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