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IOSCO Research publishes paper on Corporate Bond Markets

The Research Department of the International Organization of Securities Commissions today published a Staff Working Paper entitled *Corporate Bond Markets: A Global Perspective*.

The report presents findings from an in-depth study on the development and functioning of corporate bond markets globally, and focuses on both emerging and developed markets. Its findings underscore the importance of corporate bond markets to economic growth, financial stability and economic recovery.

The views expressed in this Staff Working Paper are solely those of the authors and do not necessarily reflect the views of IOSCO or its members. Data have been aggregated from a sample of 91 emerging and developed countries.

On the report, the Chair of the IOSCO Board, Greg Medcraft says: *The report is a good example of IOSCO being proactive and ahead of the curve in its research efforts. Corporate bond market development globally is important for long-term investment and economic growth.*

The aim of the report is to:

- Provide an overview of corporate bond markets since 2000;
- Identify issues regarding market development, investor protection and systemic risk for further research; and
- Highlight data gaps with a view to improving future data collection efforts.

The main findings of the report can be summarized in the following key messages:

1. Corporate bond markets are growing in terms of size and importance to the real economy, and are extending their global nature.

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2. Since the onset of the crisis, corporate bond markets are beginning to fill a gap left by bank and long-term/infrastructure financing, and are showing potential for servicing small medium enterprises (SMEs).
3. These trends are in part fuelled by a search for yield. A changing interest rate environment may modify bond risks and raise new investor protection issues, especially from a retail investor perspective.
4. Meanwhile, secondary markets are evolving to accommodate a new economic and regulatory environment. Understanding this change is key to identifying both potential systemic risks and opportunities to develop these markets.

Developments, risks and opportunities in corporate bond markets

Corporate bond markets have almost tripled in size since 2000. While financial firms in developed markets are deleveraging, non-financial firms are tapping the corporate bond markets in growing numbers. Bank lending to non-financials is weak in the US and Europe, suggesting a move away from bank lending towards corporate bond financing in some developed markets.

The volume of corporate bond issuances has increased steadily, reaching almost $3.2 trillion in 2013, compared to $0.9 trillion in 2000. In the last 13 years, 27 new economies have recorded corporate bond issuances, most of these emerging markets. In fact emerging markets accounted for 30% of recorded issuance volume in 2013 vs just 5% in 2000. Interestingly, a growing number of emerging market issuances are 'puttable' (the bondholder can ask to reclaim their principal before the maturity date). In 2013, issuances of bonds with a put option in emerging markets reached $47 billion, compared to issuance of $1 billion in developed markets. If this upward trend continues, it could signal increasing volatility in financing of emerging market firms.

Long-term infrastructure projects and real estate property developers are also are raising financing on corporate bond markets. For example, between 2000 and 2013, $171 billion worth of infrastructure bonds were issued, the majority issued post-2007.

Meanwhile, a search for yield is driving investment in high yielding corporate bond markets: High yield issuances have increased from $72 billion in 2000 to $550 billion in 2013. Issuance of Paymentin-Kind bonds reached $18 billion in 2013, higher than pre-crisis levels. Contingent Capital bonds (e.g. CoCos and write-down bonds) reached $15 billion in 2013.

The report also identifies trends in financial vs non-financial firm issuance; local vs non-local currency issuance; issuances for refinancing purposes; and term length. These bonds are examined in the context of interest rate risk, default risk, call risk, rollover risk, foreign exchange risk and liquidity risk, with a focus also on retail investors.

Understanding liquidity and transformation in the secondary market

Finally, the report examines illiquidity in the secondary markets in the context of a changing regulatory environment. The report notes that before the crisis, corporate bond markets were awash with 'phantom liquidity' that has since decreased, creating higher liquidity risk for investors.

This 'phantom liquidity' refers to liquidity provided to the market on the back of potentially systemically risky practices. For example, before the crisis dealers could bundle illiquid bonds into structured debt products such as Collateral Debt Obligations, a move that helped amplify the financial crisis. In other words, phantom liquidity was offered to the secondary market, but at the expense of financial stability.

In the wake of the crisis, new regulation and internal bank controls curtailed the issuance of these structured debt products. Combined with the introduction of more transparency, this has made dealer banks step back from their market-making role, causing a reduction in phantom liquidity. Bond investors now face higher liquidity risk as a result.

Eventually, greater liquidity risk will be reflected in higher yields and push up the cost of borrowing on corporate bond markets. In this context, the report notes, electronic trading platforms could offer a channel for reducing liquidity risk.

Ultimately, the report posits that changes in the secondary markets may transform the primary corporate bond markets. Issuing firms may issue standardized issuances to facilitate electronic trading and/or continue to issue tailored bonds to meet specific financing needs. This could result in a segmented

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market similar to listed equity and private equity markets; or standardized and over-the-counter derivative markets.

The report suggests further research on secondary market transformation is needed to disentangle this 'phantom liquidity' issue and distinguish trends in 'real' liquidity.

Future Work

This staff working paper is the first in a three volume series. As **Volume I**, it provides a view of how global corporate bond markets have changed, comparing developed and emerging markets. **Volume II (emerging markets)** and **Volume III (developed markets)** will provide more granular country-by-country data and analysis, in recognition of the diversity within the different regions.

NOTES FOR EDITORS

1. This Staff Working Paper should not be reported as representing the views of IOSCO. The views and opinions expressed in this Staff Working Paper are those of the author and do not necessarily reflect the views of the International Organization of Securities Commissions or its members.

2. IOSCO is the leading international policy forum for securities regulators and is recognized as the global standard setter for securities regulation. The organization's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions and it continues to expand.

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