Corporate Bond Markets – Drivers of Liquidity During COVID-19 Induced Market Stresses

Feedback Statement to the Discussion Paper of April 2022

The Board

OF THE

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Executive Summary

This Feedback Statement summarizes the written comments received from stakeholders in response to IOSCO's published report on [corporate bond markets – drivers of liquidity during COVID-19 induced market stresses]() (the "Discussion Paper") as well as the outcomes from the joint IOSCO and OECD Conference on Corporate Bond Markets held on 24 June.

IOSCO sought views from stakeholders on possible ways to help improve market functioning and liquidity provision, such as assessing the feasibility, benefits and costs of mitigating shifts in liquidity demand and alleviating supply side market constraints. This included the potential unintended consequences from any prospective market changes. IOSCO was also interested in stakeholders' perspectives on how to advance the quantity, quality, and availability of public and private data.

At a high level, IOSCO finds the feedback to be consistent with the outcomes and observations contained within the report. The responses are also generally supportive of continuing work toward facilitating increased liquidity provision in corporate bond markets. Although respondents support further work, there is acknowledgement that there is no simple fix and no one solution. This is reflective of the fact that corporate bonds are traded infrequently, even in normal times, particularly compared to other large developed markets such as equities. As such, it would be unrealistic to expect rapid improvements.

Within this context, stakeholders are largely supportive of developments in all-to-all trading and further encourage its use and facilitation. Wider use of all-to-all trading could encourage market participation from new liquidity suppliers and reduce frictions for existing ones.

Similarly, respondents are almost universally supportive of further increasing transparency and the availability data, citing that these are vital components needed to improve fluidity in the market. These components would also aid in facilitating the use of all-to-all platforms. However, careful consideration would be needed to ensure changes are carefully calibrated and do not impede market makers' ability to effectively intermediate in the market.

Some respondents also suggested a cautious approach to exploring the benefits and draw backs of increasing standardization. Although introducing standardization should not be ruled out, any considerations in this regard would need to be analyzed carefully so that any unintended consequences are fully understood.

Some respondents suggested that the IOSCO's analysis lacked sufficient distinction between jurisdictions and would have benefited from a deeper quantitative analysis.

Regarding the last point, the Discussion Paper reflects a summary of a data-driven market diagnostic undertaken in 2021. This work included analysis on the trading activity during the COVID-19 induced market stresses across the major corporate bond market jurisdictions and provided a comprehensive factual account of events that relied on available supervisory transactional data. Although the full results of the underlying analysis were not published, the conclusions were reflected in the published report. While more extensive data analysis could be useful, the marginal benefits are debatable, as differences in data availability across jurisdictions would likely present similar cross-jurisdictional comparison challenges.

Nonetheless, the varied jurisdictional responses to the COVID-19 market stress underlies the important strategic point that it is presently unrealistic to formulate any 'one-size-fits-all' approach to improving liquidity in corporate bond markets

IOSCO is grateful to our external stakeholders for taking the time to comprehensively respond to the Discussion Paper. The feedback received will be instrumental in informing the next steps of IOSCO's work.

Background

Corporate bond markets are an important part of the global capital markets and play a key role in financing the real economy. As part of IOSCO's objectives, there is keen interest in ensuring the fair, efficient and transparent functioning of these markets and in reducing systemic risk. As part of its 2021-22 work plan, IOSCO established a Corporate Bond Market Liquidity (CBML) working group through its Financial Stability Engagement Group (FSEG). The CBML was tasked with analyzing the corporate bond market microstructure, resilience and liquidity provision during the COVID-19 induced market stresses of March 2020 and subsequent months.[1]

In April 2022, IOSCO published its report on *corporate bond markets – drivers of liquidity during COVID-19 induced market stresses* and invited stakeholder feedback on the analysis. The feedback received will inform IOSCO's ongoing review of the sector and future consideration on ways to improve market functioning and the resilience of liquidity supply under stress.

The Discussion Paper solicited views from external stakeholders on the key outcomes of the report via 23 discussion questions included within the document. To supplement the written feedback received from the Discussion Paper, IOSCO hosted a joint virtual conference on Corporate Bond Markets with the OECD on 24 June. The event provided a further opportunity for industry representatives, academics and senior policy makers to present and share views on relevant work, as well as explore ways to improve bond market resilience and liquidity provision.

[1] IOSCO has previously undertaken work to better understand how corporate bond markets function, including during periods of stress. For example, in 2017 IOSCO published a report by its Committee 2 on Secondary Markets (C2) examining liquidity in corporate bond (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf) markets and in 2018 published recommendations by C2 to improve regulatory reporting and transparency (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD597.pdf). In addition, in 2019, the IOSCO published a report by its Committee on Emerging Risks (CER) that examined how liquidity in corporate bond markets might behave under conditions of market stress (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD634.pdf).

Overall summary of feedback received

IOSCO received 15 responses to the Discussion Paper from a variety of respondents, consisting of trade associations, asset managers, exchanges, as well as regulators. Responses were from a mix of geographic regions, but predominantly Europe and the US. Responses also represented a diverse set of perspectives, particularly from trade associations, which represented views across both the buyside and the sellside.

Most of the feedback was framed within each of the 23 discussion questions included in the Discussion Paper. However, some responses consisted of broader, general assessments on the drivers of liquidity for specific regions, specific asset classes, or specific investor types.

In terms of overall feedback, most respondents broadly agreed with the key outcomes of the Discussion Paper, the report's description of the main features of the corporate bond market as well as the description of market events. In particular, respondents agreed with the observation that the corporate bond market has grown, while dealer intermediation has not kept pace with this growth.

Several respondents, warned against setting policy based on a one-off, tail-end market event such as the COVID-19 market stresses. These respondents noted this type of market event may not be a good representation of market functioning, particularly given the necessity for central bank intervention to stabilize markets. Some others remarked that, in some jurisdictions, the corporate bond market functioned well under the circumstances and may not benefit from reform.

Some respondents remarked that the Discussion Paper did not sufficiently distinguish between the European and the US corporate bond markets, noting that the market function and structure of these markets are substantially different. More specifically, respondents argued that the market turmoil in the US was more extreme than Europe, citing increased trading volumes in the US. Further, that Europe, prior to the COVID-19 market stresses, already had a quantitative easing program in place, though European participants did not benefit from direct access to central bank facilities in the same way that US market participants did.

More generally, it remarked that the European IG corporate bond market, in part due to the central bank's quantitative easing program, has experienced strong demand for primary issuance with tight spreads for some time, resulting in a difference between the liquidity of primary and secondary markets.

Some respondents remarked that the report would have benefited from a deeper quantitative analysis, particularly for distinguishing between market segments. As noted above, there are inherent data limitations, these include differences in post-trade transparency across jurisdictions and also differences in available information on counterparty type (e.g., dealer, hedge fund/pension fund, insurance company, etc.).

Some respondents suggested additional clarification on the source of the COVID-19 market stresses, particularly that the increase in credit spreads was more extreme than the market stress exhibited through increased bid/ask spreads and that this could be better accounted for.

Some respondents remarked that the Discussion Paper did not have sufficient analysis on the role of both the credit repo and single name credit default swap (SN-CDS) markets which they argue are fundamental (in some regions) in supporting liquidity provision for corporate bond markets. For example, a respondent noted that there was a significant reduction in the depth and breadth of the SN-CDS market, as well as poor liquidity in the credit repo market.

Some respondents noted that the Discussion Paper does did not capture the wider sell-off of all risk assets, the substantial increase in default risk as well as the initial difficulties caused by remote working.

On the demand side:

Respondents generally agreed with IOSCO's analysis on the drivers of liquidity supply.

Some respondents remarked on the positive role of ETFs in price discovery and how, in normal market conditions, ETFs can help support bond market liquidity. However, there were mixed views on the influence of ETFs during the COVID-19 market stress. Some respondents noted that the one directional flow of orders in ETFs may have exacerbated market moves, while others remarked that ETFs provided an additional layer of liquidity through easier access and exit for the underlying assets.

Some respondents argued against the role of investment funds in driving demand during the COVID-19 market stress, noting that, according to survey research, investment funds (in the US) sold relatively a small number of investment grade bonds and thereby accounted for a smaller portion of the increase in yield spreads during the month of March.

Several respondents suggested that the main concern for long-term investors (such as insurance companies) was not so much liquidity, but rather the increased possibility of credit defaults. One respondent, from a European market perspective, suggested that the behaviour of long-term investors had little influence either in driving or mitigating liquidity demand during the COVID-19 market stress.

On the supply side:

Respondents generally agreed with IOSCO's analysis on the drivers of liquidity supply.

Some respondents noted that, due to the additional capital costs introduced post-2008 GFC, as well as restrictions on proprietary risk taking, the ability for dealers to hold positions (both long and short) has become more constrained. However, others noted that the increased trading volume observed during the COVID-19 market stress was indicative of higher levels of intermediation by dealers.

Some respondents suggested that there should be more consideration for the constraints under which dealers operate, particularly in times of market stress. For instance, the varying economic incentives that drive allocation of balance sheet which can compete for resources in times of stress as well as the role of transparency and some prudential rules such as the leverage ratio.

On improving market functioning and liquidity provision:

Although supportive of exploring improvements to market functioning, commenters' responses on the best ways to do this was mixed. Some topics had a greater degree of consensus, such as broad, but varied, support for all-to-all trading, improved data, and increasing post trade transparency. Responses were more diverse with respect to standardization.

Most respondents agreed that all-to-all trading has helped (and would help) liquidity provision. However, respondents also noted it was not a 'fix all' solution to improving liquidity in corporate bond markets. For instance, some argued that this type of trading would still need to rely on dealers for intermediation. Other respondents noted that all-to-all would help enable non-dealers become liquidity suppliers, particularly large asset managers, thereby reducing the reliance on dealer intermediation.

Other respondents remarked that the current market structure should not be changed, citing the importance of dealers intermediating the market and that a move away from that would shift principal-based trading to agency based, reducing liquidity intermediation. On the other hand, several respondents remarked that increased competition in the dealer-intermediated market would be beneficial.

Some respondents suggested that "cross-trading" between investment funds should be promoted as it could help improve liquidity and reduce reliance on dealers. However, this should be balanced against concerns for investors as well as any potential conflicts of interest.

Regarding standardization, there was limited consensus, with some members supporting increasing standardization in corporate bond markets, while others explained that standardization would remove the bespoke and flexible nature of corporate bonds (a key attraction for issuers). Further, that the standardization of maturities would concentrate refinancing risk for issuers and could make it more difficult for investors to establish relative values between bonds with different tenors. Overall, even those respondents who supported standardization noted that a balanced and cautious approach would be crucial to ensure an appropriate balance between flexibility and enhancing liquidity.

On electronification, respondents were generally supportive of advances in this area, but did not think it had a direct impact on the availability of liquidity. They noted that electronification serves as means to simplify the trading process but does not alter the supply of liquidity.

Most respondents supported increased trade transparency, though some respondents warned against "too much transparency", particularly for more illiquid bonds or large size trades which could cause undue risk to the market makers. There was near unanimous support for enhancing post-trade transparency, with some respondents suggesting it was a vital piece in increasing resilience and facilitating liquidity (including the use of all-to-all trading).

In terms of other areas for further work, some respondents suggested investigating the role of ETFs in the underlying bond market, and their role in price discovery.

Some respondents suggested further investigating the interaction between prudential regulatory requirements on dealer capacity alongside transparency rules, and how execution capacity is changing over time.

IOSCO/OECD Conference on Corporate Bond Markets

IOSCO held a joint conference with the OECD on the liquidity, structure and resilience of corporate bond markets on the 24^{th} of June. The conference featured a roundtable on IOSCO's Discussion Paper. Overall, the outcomes of the conference coincide closely with the written responses received from the Discussion Paper.

The roundtable discussants were diverse (e.g., buyside, sellside, academics, public policy, market maker) and, expectedly, shared many differing perspectives on the best ways to improving market functioning. The key themes that emerged were:

- The importance of enhancing transparency, including further improvements to the US Trace system (although this is notably more advanced than the European Markets). This was caveated that this would need to be carefully considered as not to impede market efficiency.

- Continued encouragement for the consolidated tape in Europe.

- Central clearing could also be considered as a means to improve liquidity intermediation.

- The importance of promoting further electrification of primary, secondary, and interdealer markets. This also included discussions around improving the quality and availability of data.

- Consideration for improving ways to connect long-term investors with sellers. This was in consideration that long-term investors, such as insurance companies and pension funds, play an important role in liquidity intermediation but are less effective during times of market stress.

- There was agreement that standardisation could promote more fluidity, but there was scepticism regarding the overall benefit considering the bespoke nature of corporate bonds.

- Others argued that corporate bonds are so different from equities or government bonds that similar levels of liquidity and trading is unrealistic to expect (or to strive for).

Next steps

The feedback received will inform IOSCO's ongoing review of the sector and future consideration on ways to improve market functioning and the resilience of liquidity supply under stress. The balance of the evidence as presented in the Discussion Paper, as well as the feedback received, suggests that there may be potential to improve liquidity supply, at least in some bond markets.

IOSCO will work to scope further work on improving liquidity supply for consideration in IOSCO's forthcoming 2023-2024 workplan, including coordination with other international organizations, as appropriate.