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IOSCO Issues Final Report Examining Liquidity of the Secondary Corporate Bond Markets

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TO: Equity Markets Advisory Committee
Fixed-Income Advisory Committee
ICI Global Trading & Markets Committee
International Committee
Securities Operations Advisory Committee RE: IOSCO Issues Final Report Examining Liquidity of the Secondary Corporate Bond Markets

The Board of the International Organization of Securities Commissions (IOSCO) recently published a final report on the liquidity of the secondary corporate bond markets.[\[1\]](#) The Final Report follows a consultation report last August in which IOSCO requested feedback concerning bond market liquidity.[\[2\]](#) In response to the Consultation Report, ICI Global filed a comment letter explaining that the corporate bond markets are undergoing significant structural transformations caused in part by regulatory reform in the aftermath of the financial crisis as well as by changing economics and technology.[\[3\]](#)

In the Final Report, IOSCO found a mixed picture of liquidity, suggesting that the nature of trading may be changing along with participant behavior and market structure. IOSCO did not find substantial evidence showing liquidity has deteriorated markedly from historic norms for non-crisis periods. IOSCO also noted that there is no reliable evidence that regulatory reforms have caused a substantial decline in the liquidity of the market. We summarize the Final Report briefly below.

Summary of Final Report

The Final Report provides an overview of the secondary corporate bond markets and the metrics used to assess the liquidity of those markets.

Characteristics of Corporate Bond Markets

Focusing on market participants, the use of technology and other factors that may impact liquidity, IOSCO made the following observations:

- *Industry Perceptions*: Although buy-side and sell-side participants perceive a decrease in market liquidity, these perceptions generally are based on personal experience and not supported by data.[\[4\]](#)
- *Corporate Bond Issuances*: Issuances have reached record levels, increasing the number of corporate bonds available for trading in the secondary markets and the total amount of debt outstanding.
- *Dealers and Market Making Model*: Dealers continue to play a dominant role in the secondary corporate bond markets. The role of dealers in the markets, however, may be changing from a principal to an agency model.
- *Investors*: Institutions remain the dominant investors in the corporate bond markets, and the group of institutional investors is becoming more diversified with increased participation of asset managers and hedge funds. IOSCO also noted an increase in indirect participation by retail investors through mutual funds and exchange-traded products.
- *Technology*: Technology is facilitating communications and trading between dealers and their clients and execution on electronic trading venues.[\[5\]](#)
- *Transparency Requirements*: Although transparency could encourage broader participation in the market, tighten spreads, and contribute to price discovery, transparency also could affect liquidity.
- *Other Factors*: Cyclical factors, the market for credit default swaps, and the repo market may impact secondary corporate bond market liquidity.

Metrics to Assess Liquidity

IOSCO examined several different metrics in aggregate to see a more complete picture of corporate bond market liquidity. IOSCO focused its analysis on the metrics that have garnered general consensus as being the most relevant. IOSCO noted that not every metric may continue to be a good indicator of liquidity as markets change and the relevance of certain metrics should be considered. The Final Report examined the following metrics and made the following observations:

- *Trading Volume*: Trading volume or notional amount traded has increased in the majority of IOSCO jurisdictions. Although some market participants have reported “bifurcation” in the secondary corporate bond markets in which there are actively traded markets and more sparsely traded markets, a recent Financial Industry Regulatory Authority (FINRA) study may contradict this contention.
- *Turnover Ratio*: Turnover ratio (*i.e.*, the ratio of total trading volume per year to total debt outstanding) seems to have decreased or been flat because primary market growth is greater than secondary market trading volume.
- *Average Trade Size*: Evidence is mixed regarding a possible decline in average trade size, and there is little evidence that any decrease in size is due to a decline in liquidity rather than market structure changes. Although a number of buy-side market participants reported increasing difficulty in executing large size trades, the data show that there has not been a major shift in trade size.
- *Size of Block Trades*: Some evidence suggests that the average size of block trades is declining. Although this evidence may support claims that it is difficult to execute large trade sizes, it also could indicate greater electronification of the market.
- *Price-impact Measures*: Evidence indicates a steady decline in the price impact of trades (*i.e.*, the effect trading volumes have on market prices).
- *Bid-ask Spreads*: Most measures of bid-ask spreads (*i.e.*, the difference between the price at which dealers are willing to buy and the price at which dealers are willing to

sell) show a substantial decrease in spreads.

- *Market Making*: There has been a small to significant decrease in dealer inventories allocated to market making activities, which vary considerably by firm. There also appears to be a modest reduction in the number of market makers in corporate bonds although the average number of counterparties is increasing.

IOSCO did not examine other measures of liquidity, including dealer mark-ups, immediacy measures (such as time-to-enter/time-to-exit), the spread over the benchmark, total number of transactions, analysis of quotes or pre-trade information (such as order to trade ratios in OTC markets or on electronic request-for-quote platforms), and number of zero trading days.

Data Needed to Assess Market Liquidity

IOSCO found that, with a few exceptions (such as TRACE in the United States), prices for corporate bond transactions generally are not reported or disclosed to any central repository. IOSCO also noted that, differences in methods of collecting data as well as in the scope, quality, consistency, and availability of data make it difficult to examine liquidity of the secondary corporate bond markets. IOSCO emphasized its view that regulators should have access to timely, accurate, and detailed information regarding secondary markets and changes to market structure to assess adequately changes in the secondary markets and monitor trends in trading and trading behavior.

IOSCO plans to begin work on a transparency project to examine in detail the transparency regimes and regulatory requirements in IOSCO jurisdictions that have developed since 2004 to update its report on the transparency of the corporate bond markets.^[6] IOSCO expects to discuss in more detail the relationship between transparency and liquidity as part of that examination. In conducting its work, IOSCO intends to review and update the recommendations in its 2004 report as appropriate. The purpose of this project will be a detailed examination of transparency regimes and regulatory requirements in place in IOSCO member jurisdictions.

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endnotes

^[1] IOSCO, *Examination of Liquidity of the Secondary Corporate Bond Markets, Final Report*, (February 2017), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD537.pdf> (Final Report).

^[2] IOSCO, *Examination of Liquidity of the Secondary Corporate Bond Markets, Consultation Report*, (August 2016), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD537.pdf> (Consultation Report). For a summary of the Consultation Report, see ICI Memorandum No. 30138 (Aug. 17, 2016), available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo30138>.

[3] See Letter from Dan Waters, Managing Director, ICI Global, to Alp Eroglu, International Organization of Securities Commissions, dated September 30, 2016, *available at* <https://www.iciglobal.org/pdf/30289.pdf> (ICI Global Comment Letter). The letter also described how ICI members perceive liquidity in the corporate bond markets, provided some additional data to inform further study of these markets, and encouraged IOSCO to continue studying the corporate bond markets as they continue to evolve and as new and more data become available outside the United States.

[4] ICI Global's comment letter explained that the data presented in the Consultation Report presented mixed evidence of the status of liquidity in the corporate bond markets. Some metrics, such as trade volume, indicate that liquidity has increased in recent years, while others, such as turnover ratio, suggest a modest decrease in liquidity. ICI Global presented data that was generally consistent with the Consultation Report's findings. See ICI Global Comment Letter at 3.

[5] ICI Global submitted data showing that new technology has introduced trading protocols that did not exist in fixed income markets even a few years ago. These new technologies and innovations provide market participants with additional means to trade corporate bonds and enhance the ability of market participants to adapt to dealers' changing role in corporate bond markets. See ICI Global Comment Letter at 7.

[6] Technical Committee, *Transparency of Corporate Bond Markets*, International Organization of Securities Commissions (May 2004), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD168.pdf>.