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

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 23-16
ICI GLOBAL TRADING & MARKETS COMMITTEE No. 34-16
INTERNATIONAL COMMITTEE No. 37-16
SECURITIES OPERATIONS ADVISORY COMMITTEE RE: IOSCO ISSUES CONSULTATION REPORT EXAMINING LIQUIDITY OF THE SECONDARY CORPORATE BOND MARKETS

Recently, the Board of the International Organization of Securities Commissions ("IOSCO") published a consultation report on the liquidity of the secondary corporate bond markets. [1] Although IOSCO found meaningful changes to the characteristics and structure of the secondary corporate bond markets, it did not find substantial evidence of material deterioration of liquidity in those markets. After examining a number of different metrics, IOSCO found mixed evidence of changes in liquidity. IOSCO also did not find reliable evidence that regulatory reforms have caused a substantial decline in the liquidity of the markets.

IOSCO requests comment on the analysis, data and conclusions of the Consultation Report. In particular, IOSCO requests data relating to liquidity, including specific dealer inventory levels of corporate bonds held for market making purposes, statistics concerning dealer quoting behavior, information about the number of counterparties with which buy-side and sell-side firms are trading, any data related to orders that investors tried to execute but could not, and any data regarding the time it takes participants to execute trades. Comments are due on September 30. We summarize the Consultation Report briefly below.

Summary of Consultation Report

The Consultation Report provides an overview of the secondary corporate bond markets and the metrics used to assess the liquidity of those markets. The Consultation Report also discusses further work on corporate bond transparency.

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 market liquidity to have decreased, these perceptions generally are based on personal experience and not supported by data.
- Corporate Bond Issuances: Issuances have reached record levels, and the growth in the primary market has increased 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.
- 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 focused its analysis on the metrics that have garnered general consensus as being the most relevant. An analysis of these metrics shows a mixed picture of liquidity and suggests that the nature of trading may be changing along with participant behavior and market structure.

The Consultation 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 (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 decline 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 U.S.), transactions prices are not generally reported or disclosed to any central repository. IOSCO noted the difficulty in examining the liquidity of the secondary corporate bond markets because of differences in methods of collecting data as well as in the scope, quality, consistency, and availability of data. IOSCO is of the 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. [2] IOSCO expects to discuss in more detail the relationship between transparency and liquidity as part of that examination. IOSCO also will review and update the 2004 recommendations as appropriate.

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endnotes

[1] 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").

[2] 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.