INVESTMENT COMPANY INSTITUTE

MEMO# 31850

July 12, 2019

IOSCO Issues Final Report on Liquidity in Corporate Bond Markets Under Stressed Conditions

[31850]

July 12, 2019 TO: Equity Markets Advisory Committee
Fixed-Income Advisory Committee
ICI Global Trading & Markets Committee RE: IOSCO Issues Final Report on Liquidity in Corporate Bond Markets Under Stressed Conditions

The Board of the International Organization of Securities Commissions (IOSCO) recently issued a final report examining the factors affecting liquidity in secondary corporate bond markets under stressed conditions.[1] The final report is the latest in a series of IOSCO publications intended to improve the understanding and enhance the functioning of corporate bond markets.[2] IOSCO's prior reports found no substantial evidence that liquidity deteriorated in secondary corporate bond markets between 2004 and 2015. Corporate bond markets, however, have developed substantially during the past 15 years and IOSCO believes that corporate bond liquidity under stressed conditions remains understudied. The final report aims to improve IOSCO members' understanding of the behavior of corporate bond markets under stressed conditions by answering the following questions:

- Who might be forced to sell and who might sell opportunistically during times of market stress?
- Who might be buying under these conditions, and for what reasons?
- What are the implications of these behaviors for liquidity and pricing?

The findings were drawn from a review of the literature on liquidity in corporate bond markets under normal and stressed conditions, an examination of past episodes of stress in corporate bond markets, and discussions with a broad range of industry stakeholders. The final report cautions that no definitive answer is likely to emerge from the study, as any attempt to predict how liquidity might behave in a corporate bond market is "necessarily speculative."[3]

This memorandum describes IOSCO's approach to analyzing liquidity in corporate bond markets and summarizes the key findings of the final report.

IOSCO's Approach to Analyzing Liquidity in Corporate Bond Markets

The final report explains that dealers historically have supplied most of the liquidity in secondary corporate fixed income markets, but they have generally reduced their market-making activities as a result of post-crisis regulatory reforms, diminished risk tolerance, and technological developments. The changing nature of dealer activity raises questions about the extent to which liquidity will be available in the event of a market-wide crisis.

The final report refers to liquidity as the ability of buyers and sellers to transact in a market, within a given period of time, without causing a significant or sharp movement in price or otherwise disrupting the market.[4] IOSCO also establishes an inclusive definition of "market-wide stress" as a situation where a sudden and strong change in attitude towards one or more financial assets among market participants results in a significant increase in demand for liquidity on one side of the market, possibly at the same time as the supply of that liquidity on the other side becomes significantly constrained or disappears.[5] This disparity disturbs the normal operation of the market, causing difficulty for some participants in finding the liquidity they need to trade out of their positions and/or into new positions. As a result, price movements become stronger as participants attempt to raise or lower their bids and offers to find liquidity.

Summary of Findings

The final report explains that changes in the structure of secondary corporate bond markets have altered the way that liquidity is provided in these markets. These changes result from developments including post-crisis regulations that have reduced the capacity of intermediaries to provide liquidity in secondary corporate bond markets; greater risk aversion on the part of intermediaries; the gradual introduction of electronic trading; and significant growth in the size of these markets resulting from central banks' quantitative easing policies and low rates of return on other financial assets. As a result, the prices of investment-grade and high-yield bonds in the United States and Europe—and potentially other areas—may experience increased volatility during market stress, but this is not necessarily a cause for alarm.

The report finds that bond markets, including corporate bond markets, have shown signs of significant resilience and even counter-cyclical behavior. The report makes three observations based on case studies of the behavior of market participants and market liquidity during ten episodes of bond market stress over the past 25 years.[6] First, none of the ten episodes clearly showed that market volatility was caused by, or systemically exacerbated or aggravated by, the sale of assets by investors, including investors in bond mutual funds. Second, the episodes demonstrated that investors differentiated between different types of bonds and bond funds, and moved their investments between different bond funds, depending on financial conditions. Third, some investors, including institutional investors, bought bonds even during stressed conditions.

The report concludes that bond mutual funds that have well-developed liquidity management practices are unlikely to be a source of either considerable selling or price volatility in stressed market conditions. IOSCO cites data showing that selling by mutual funds under stressed conditions has not created problems in the market or caused adverse externalities.[7] Bond funds "demonstrated that they were able to handle significant requests for liquidity over extended durations" and that the failure of an individual bond mutual fund "caused no wider problems either for other bond funds or for the underlying bonds." Moreover, bond exchange-traded funds (ETFs) "played an important role during episodes of stress in enabling the ongoing functionality of price discovery and liquidity provision."[8] Importantly, IOSCO also recognizes that mutual funds, along with other institutional investors, may be a source of market-stabilizing demand under stressed conditions.

The final report concludes that: 1) periods of stress are relatively common in corporate bond markets and have consistently not proven to be strong amplifiers of stress starting elsewhere in the markets or the economy; and 2) corporate bond markets rarely have "seized up, even in the face of significant selling pressure."[9] The report urges market participants, particularly asset managers, to "avoid complacency and to institute and maintain sound liquidity-risk-management practices."[10]

Sarah A. Bessin
Associate General Counsel

George M. Gilbert
Assistant General Counsel

Sofya Bakradze
Legal Intern

endnotes

[1] *See* Final Report: Liquidity in Corporate Bond Markets Under Stressed Conditions, IOSCO (June 2019), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD634.pdf.

[2] IOSCO published a report examining liquidity in secondary corporate bond markets in 2017 and issued recommendations to improve regulatory reporting and transparency in these markets in 2019. *See* Final Report: Examination of Liquidity of the Secondary Corporate Bond Markets, IOSCO (February 2017), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD558.pdf and Final Report: Regulatory Reporting and Public Transparency in the Secondary Corporate Bond Markets, IOSCO (April 2018), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD597.pdf. For ICI commentary, *see* ICI Memorandum No. 30658 (March 2017), *available at* https://www.ici.org/my_ici/memorandum/memo30658 and ICI Memorandum No. 31176 (April 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31176.

[3] *See* Final Report, supra note 1 at 8.

[4] *See id*. at 8.

[5] *See id.* at 4-5.

[6] *See id.* at 26-42. The ten episodes included, among others, the Federal Reserve rate hikes of 1994, the global financial crisis of 2008, the UK Brexit vote, and Argentinian financial stress of 2018.

[7] *See id.* at 20, 23 (discussing the study undertaken by BlackRock and the feedback by the market participants).

[8] *See id.* at 41.

[9] *See id.*

[10] *See id.* at 42.
