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IOSCO Issues Discussion Paper on Corporate Bond Markets and Their Experiences During March 2020

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TO: ICI Members
ICI Global Members SUBJECTS: Exchange-Traded Funds (ETFs)
Fixed Income Securities
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Trading and Markets RE: IOSCO Issues Discussion Paper on Corporate Bond Markets and Their Experiences During March 2020

In April, the International Organization of Securities Commissions (IOSCO) issued a discussion paper on the corporate bond markets, focusing on their experiences during the COVID-19 induced market stress of March 2020.[1] This paper summarizes the results of IOSCO's market analysis during that time and solicits feedback from stakeholders.

Comments are due to IOSCO before July 8.

Summary of the Discussion Paper

In preparing this discussion paper, IOSCO first conducted a data-driven review of the corporate bond markets' liquidity during the COVID-19 induced market stresses. IOSCO then analyzed in greater depth market participant behavior and its drivers during this period, along with possible vulnerabilities in market structure.

IOSCO acknowledges that the "March 2020 episode was a sharp and short-lived market liquidity crisis triggered by a shock originating from outside the financial system."[2] In its view, however, "[t]he COVID-19 induced market stresses in March 2020 highlighted the potential systemic importance of liquidity dysfunction in corporate bond markets."[3]

IOSCO seeks stakeholders' feedback on ways to help improve market functioning and liquidity provision.[4]

In addition to its executive summary, the paper has four sections:

- Section A provides background information and a brief description of the main features of the corporate bond markets.[5]
- Section B summarizes the state of liquidity during the March 2020 stress.[6]
- Section C analyses the supply of and demand for liquidity, including how market participants (e.g., insurance companies, pension funds, asset managers, and hedge funds) drove the demand for liquidity during the market stress and how dealers supplied liquidity to the market.[7]
- Section D analyses corporate bond market structure and investigates how the evolution of corporate bond markets has impacted the provision of liquidity.[8]

Analysis of Open-End Funds

As noted above, Section C discusses March 2020 behavior of those investors that "demand" liquidity, including open-end funds (OEFs). In this sub-section, IOSCO draws the following conclusions about OEFs during this period:

- Some OEFs contributed to selling pressure in some jurisdictions, driven by investor redemptions mostly related to the flight-to-quality and the dash-for cash.
- In March 2020, many OEFs faced liquidity pressures, dealing with large outflows and deterioration in market liquidity.[9] While data are not available on the global proportion of corporate bonds held by OEFs, IOSCO and Financial Stability Board member jurisdiction estimates for the share of corporate bonds held by OEFs ranged from 13 to 25%.
- Overall, fund suspensions were modest and restricted mainly to those OEFs invested in real estate.
- To the extent that OEFs were not able to meet redemptions through free cash flow, there is evidence that some funds deployed a horizontal slicing approach (i.e., used cash and sold the most liquid assets first), which may have contributed to cash demand.

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endnotes

[1] Corporate Bond Markets - Drivers of Liquidity During COVID-19 Induced Market Stresses, IOSCO Discussion Paper (April 2022) ("Discussion Paper," or "paper"), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD700.pdf.

[2] Discuss Paper at 4.

[3] Discussion Paper at 1.

[4] For a list of the discussion questions, see Discussion Paper at 41-42.

[5] Here, IOSCO observes that:

- Corporate bonds are essentially buy-and-hold investments. Corporate bond markets are less liquid than some other traded markets, and the number of individual corporate debt securities that trade regularly is small.
- Corporate bond markets have grown significantly over the past decade, with new issuance volume almost tripling in certain jurisdictions.
- Primary markets are important to overall market liquidity.

[6] Here, IOSCO finds that overall, the broader corporate bond markets showed reduced liquidity during the market turmoil, particularly as measured by primary market activity and transaction costs (e.g., bid-ask spreads). Data on secondary market trading activity were mixed.

[7] Here, IOSCO finds that:

- It is difficult to assess whether corporate bond market liquidity primarily dried up because of reduced liquidity supply by dealers, increased liquidity demand by investors, or a combination of both.
- On the demand side, evidence on the influence of long-term investors in corporate bond markets is mixed (due to variation in behavior by jurisdiction, the nature of investors' investment strategies, and the extraordinary speed of the crisis and subsequent recovery).
- On the supply side, dealers did not contribute to selling pressure as they did during the Global Financial Crisis. However, their behavior had little dampening effect to the extent that dealers did not expand their market-making activities to meet increased liquidity demands and were inclined to reduce pre-trade transparency to the market.

[8] Here, IOSCO finds that the structure of the corporate bond markets also contributed to the constraints in meeting demand for liquidity during March 2020. Other topics addressed in this section include general market features, the role of dealers, the nature of corporate bonds (e.g., their large number and heterogeneity), trading (e.g., typical trade sizes), the growth in electronic trading, and data and transparency.

[9] For instance, "In the US, investors withdrew more than $200 billion from US taxable bond OEFs in March 2020. In Europe corporate [high yield] bond OEFs faced cumulative redemptions of 5% of total net asset value (NAV) within a month. From an ESMA sample, net outflows in UCITS represented 5.9% of NAV, while alternative investment funds (AIF) in the sample overall recorded small inflows from 17 February to 31 March." Discussion Paper at 22.

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