Comments on behalf of The Association of Corporate Treasurers on: *Discussion Paper 05/5: Trading transparency in the Secondary bond markets*

A Discussion Paper from the Financial Services Authority, September 2005

Introduction

The Association of Corporate Treasurers (ACT)

Established in the UK in 1979, The Association of Corporate Treasurers is a centre of excellence for professionals in treasury, including risk and corporate finance, operating in the international marketplace. It has over 3,500 members from both the corporate and financial sectors, mainly in the UK, its membership working in companies of all sizes.

The ACT has 1,500 students in more than 40 countries. Its examinations are recognised by both practitioners and bankers as the global standard setters for treasury education and it is the leading provider of professional treasury education. The ACT promotes study and best practice in finance and treasury management. It represents the interests of non-financial sector corporations in financial markets to governments, regulators, standards setters and trade bodies.

Contact details are provided on the last page of these comments.

These comments are on the record and may be freely reproduced or quoted

Background to the treasurer's stance

In general corporate treasurers tend not to be active buyers or sellers of bonds in the secondary market, however they do have a strong interest in the secondary market on account of their involvement in the primary markets. Major corporates will use the US, UK and Euro bond markets for launching new issues of bonds as part of their capital raising activities. For a corporate new issue the price and yield at which they can successfully launch their company's bond issue will be one of the prime elements for consideration. The yield at launch will be based on the secondary trading levels of their existing bonds or of near comparable credits and adjusted for other factors such as maturity, amount of issue, any special terms and conditions and the general state of the markets. CDS (Credit Default Swap) markets are also a pricing reference point as stated later in this paper.

However the secondary corporate bond markets and to a lesser extent the CDS markets are inherently illiquid. For many bond issues where the entire issue size amounts to only a few hundreds of millions the volume of secondary trading is bound to be small or negligible. Secondary market bond pricing is therefore not a perfect indicator of new issue pricing.

However, since the new issue market is to an extent dependent on the health of the secondary market there can be several aspects of the secondary market the corporate treasurer will nonetheless take an interest in:

Liquidity: A buyer of a new issue, even if they plan to buy and hold, will take comfort from the ability to trade a bond if need be and therefore an adequate degree of liquidity is desirable. While true liquidity is unlikely, the issuer and investors will expect the original lead managers to be prepared to quote a price.

Accuracy of pricing: The issuer will want to ensure that the price and yield with which it comes to market are a fair representation of the 'correct' level that matches its reputation and credit rating.

Traditionally, the pricing of a new issue has been rather more an art than an exact science, although it is worth considering whether this has been because of some market deficiencies. Currently most issues are launched with an indicative spread over the swap rate or government benchmark. The issuer and his syndicate of banks determine this from the secondary bond market and from the credit derivative market where credit default swaps (CDS) are traded on a similar basis by reference to a credit spread. Theoretically one might expect the bond spread and CDS spread to be very similar but there can be technical reasons why they diverge. The lead managers will then build an order book based on the indicative spreads and by closing will be able to judge the 'right' launch spread.

Corporates will tend not to be directly involved in the secondary bond markets. However certain issuers may be active purchasers of their own debt in the secondary market when they have a specific reason to retire debt, eg to remove certain covenant restrictions, or when they wish to adjust their maturity profile or take advantage of other refinancing opportunities. The fact that arbitrage type opportunities can sometimes exist may indicate a deficient market pricing or it may be caused by a justifiable factor such as investors seeking to sell out of an old illiquid issue and reinvest in a larger more liquid new bond.

Conclusions

We believe that market price transparency is generally helpful for facilitating market efficiency and is to be encouraged. However we believe that there is not sufficient evidence of a fundamental failure of the markets in this area, to justify the imposition of some new reporting regulation. Many information providers already exist and no doubt with time and as the technology improves the data provided will also improve. If users of the market value data such as post trade information, then one might expect that the market will evolve a voluntary reporting post trade which will ultimately benefit of all the market.

The characteristics of bond pricing are different from that of equities and is in a way a rather more certain process involving as it does a measurement against a swap rate or benchmark government rate. This rather more mechanical process and the existence of a closely related credit default swap market means that prices can be generated independently from specific dealer quotes in the secondary market and thus can be used as a check on those dealing prices.

The important point is that the corporate bond markets are intrinsically different from the equity markets so there should be no automatic logic that measures appropriate to the equity markets must be applicable to the bond markets.

Specific Questions

Q1. Are there any market failures in bond markets? If so, what are they and how do they arise?

A1. Trading volumes in a given issue once the initial flurry of activity after a new issue is over, will tend to be fairly low, which might imply the market is not working. However the more likely cause is that that is an inherent feature of the market and there is no very strong desire for participants to trade.

Q2. To what extent is the price formation process for different types of bond efficient or inefficient? Do you have evidence that would illustrate your view – for instance, regarding bid-offer spreads or price dispersion for trades in the same bond?

A2. Corporates do find that they can occasionally arbitrage their own issues, but this is not necessarily on a exact like for like purchase and reissue. There may be structural reasons for these sorts of discrepancies or it may be indicative of inefficient price formation We are aware of an example where cross border arbitrage arose. In the case of one of our members a foreign currency bond issue became significantly expensive as compared to the £ CDS. The contributory factors were we believe the extreme illiquidity in the bond market and the reluctance of bond holders to make use of cross currency derivatives
The CDS market is now regarded as more actively traded than the bond markets and therefore has to an extent become the determinant of bond credit spreads and presumably will help minimise bid offer spreads – although it can be more volatile.

Q3. Do you currently perceive any difficulties or concerns surrounding best execution in bond markets? If so, to what extent would these concerns be alleviated by greater pre- or post-trade transparency, or should another approach be adopted?

A3. To the extent that there are difficulties around best execution the concern is not likely to be transparency but rather the lack of buyers to provide liquidity, although for modest deal sizes there appear to be reasonable number of dealers prepared to quote dealing prices.

Q4. Do you think that retail investors face any particular difficulties in participating in bond markets? If so, to what extent do these stem from transparency-related issues, and to what extent from other factors?

A4. In the UK there is no significant retail bond market in corporate credits. While perceived high bid offer spreads must be a contributory factor for this, an alternative explanation is the lack of retail type channels for buying and selling bonds. There does not seem to be the culture of investing in bonds, as exists to a far larger extent in the US. Even the ability to hold bonds in a PEP when introduced some years ago did not stimulate any great demand. In order to get a good diversification of risk, retail bond investors might be expected to make their bond investments via a collective fund, but even here demand is not high and the suspicion must be that the high management changes are a disincentive.

Q5. If there are other material market failures, to what extent might greater transparency be a solution? Would it be pre- or post- trade? Or should a different solution be used to correct the failure?

A5. In your discussion paper you mention pre-trade information being available from data vendors such as Bloomberg, Reuters Trading for Fixed Income, Thompson, Telerate; multilateral trading systems from MarketAxess, EuroMTS, BrokerTec and Trade Web,

and; average or index information from the International Index Company, Fides, and MTSNext. On the face of it the market is well supplied, although there may still be questions about information on the more obscure issues at the margins. We understand that post trade information is not so readily available. Presumably if investors genuinely need this information then the pressure of their demand will cause the dealing system providers to include this data on their systems, at least to the extent that they have the information on the dealing volumes through their own platforms. For example Bloomberg already include the last weeks dealing volumes for their 50 most actively traded bonds.

Q6. What is your view on the relationship between transparency and liquidity in bond markets, distinguishing between liquidity provided by market makers, wholesale/institutional participants and retail investors? Does your answer differ according to the characteristics of the bond?

A6. In the corporate bond markets as opposed to the Government bond market we expect that the majority of issues, particularly small ones, will be so illiquid that even perfect price transparency would not really make a substantial difference. However we note that some of the research on TRACE implies that additional post trade transparency can lower spreads and can itself generate liquidity. Intuitively the evidence that there really is liquidity might be expected to give an added degree of confidence about liquidity that becomes self fulfilling and for low liquidity issues this could be helpful. Where liquidity is virtually nil one might expect the effects to be severely limited. Likewise if liquidity is already good then information confirming what is already known may not have that large an effect.

Q7. To what extent do you think that pre- or post-trade transparency requirements for a defined set of benchmark bonds (e.g. the most liquid corporate issues) would have beneficial spill-over effects for other types of bonds?

A7. Without supporting the imposition of any transparency requirements, we nonetheless believe that any pre and post trade price transparency for benchmark bonds would inevitably have a beneficial spill over effect for other types of bonds. A bond that is traded infrequently will never be able to benefit from direct transparency since even if all information on prices and volumes is promptly published this could well have become out of date if there are several weeks between market trades. What then becomes important is the extrapolation of movements in the benchmarks back to comparable illiquid bonds. Therefore good information on the benchmarks will contribute a spill over-effect, albeit not resolving the problems completely.

Q8. Would greater transparency in the bond markets bring any wider benefits, for example in aiding the pricing of bond portfolios and credit derivatives? Would pre- or post-trade information be of greater value?

A8. As discussed in the general section above better pre and post trade information in the secondary market would have the wider benefit of helping in the accurate pricing of new issues. We believe that the credit derivative market is rather more a driver of the bond spreads in most cases, but any improvements in one market are bound to have a knock on effect in the other market.

Q9. How does the inter-relationship between trading in the cash and derivatives markets affect the consideration of these issues?

A9. The two markets are inter-related. But this fact supports the argument that no external regulation of the price transparency in the markets is strictly needed. There should be sufficient market forces to ensure the market evolves to meet the needs of the various participants.

Q10. On the basis of the discussion in section 6, what practical issues do you think are important for regulators to consider in formulating policy in relation to transparency in bond markets? What costs would you foresee in any extension of transparency requirements to the UK bond markets? Are there particular practical issues that would have to be borne in mind in developing a pan-European approach to transparency?

A10. Just because a regulatory driven improvement to transparency was seen as helpful to the equity markets that is no reason to suppose that similar regulation will provide any great improvement to the bond markets

Contacts: Richard Raeburn, Chief Executive (020 7213 0734; rraeburn@treasurers.co.uk) John Grout, Technical Director (020 7213 0712; jgrout@treasurers.co.uk) Martin O'Donovan, Technical Officer (020 7213 0715; modonovan@treasurers.co.uk)	The Association of Corporate Treasurers Ocean House 10/12 Little Trinity Lane London EC4V 2DJ Telephone: 020 7213 9728 Fax: 020 7248 2591 Website: http://www.treasurers.org

The Association of Corporate Treasurers is a company limited by guarantee in England under No. 1445322 at the above address