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The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

Finance Watch
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Finance Watch and BETTER FINANCE comment on the final report of the European Commission's Expert Group on Corporate Bonds

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On 20 November 2017, the European Commission's Expert Group on Corporate Bonds issued its final report on improving European corporate bond markets.[1] Finance Watch and BETTER FINANCE attended the group as observers. The final report provides a comprehensive overview of the financial services industry's concerns and makes a number of useful recommendations for the better functioning of these markets.

Unfortunately for the general public, the report and recommendations lack balance, possibly a reflection of the composition of the group, which consisted almost exclusively of the financial services industry and large market participants. A more diverse composition, including independent academics and other non-industry interests, could perhaps have helped turn the spotlight towards some of the larger underlying issues, which were acknowledged in passing as having a potentially large bearing on the matter at hand but which were not explored in adequate detail.

Issues needing further exploration

- The analysis does not attempt to capture and quantify the undeniable, but still poorly understood, impact of the European Central Bank's unconventional monetary policy measures on fixed-income markets. Even the supporting research did not go beyond a cursory acknowledgement of that issue. Despite an increase in corporate bond issuance, the ECB's CSPP programme has absorbed a significant amount [currently ca. 10%] of the total outstanding volume of Eurozone corporate bonds. On the basis that these volumes are not traded but held to maturity, these purchases would result in a commensurate, observable reduction in liquidity. In the absence of a precise, empirical analysis of the impact of these policy measures it appears difficult to conjecture on the role of other factors, such as post-crisis prudential regulation.

- There is a need to distinguish between different sources and types of liquidity. Procyclical liquidity that enters the market in upswings and evaporates suddenly in downturns has been identified as a major source of systemic instability during the last financial crisis. A significant part of the prudential regulatory effort since then has been directed at containing these procylical flows and placing tighter prudential limits on risk-taking by market-makers. The group's remit would have allowed for a long overdue discussion about the declining marginal contribution of incremental liquidity and the appropriate balance between the overall level of liquidity and the quality and resilience of that liquidity. Unfortunately, that opportunity, too, has been passed up.

- The report focuses on the market for corporate bonds issued by companies from outside of the financial sector – at present, they account for only 15% of all long-term corporate bonds currently in issue in the Eurozone. By contrast, nearly half [45.7%] of all corporate bonds were issued by banks.[2] Bank bonds are known as a key vector of systemic risk, which is why they are subject to a different legal regime than other corporate bonds. In its recommendations, however, the report does not differentiate between the two groups. Many of the prudential provisions criticised in the report, in particular those related to market-making, were put in place specifically to address the risks related to trading in bank (and other financial sector) bonds.

Improvements that Finance Watch and BETTER FINANCE would support

Subject to these general observations, the report highlights a number of potential improvements in corporate bond markets that Finance Watch and BETTER FINANCE would be happy to support.

- Finance Watch and BETTER FINANCE would welcome measures to remove distortions in the primary markets, e.g. by promoting transparency and ensuring fair allocations in high-yield issues and by preventing the over-sizing by some market participants ("artificial inflation") of primary orders in all bond offers;

- Private placements of corporate bonds could facilitate market access for smaller issuers. We would, however, strongly recommend restricting the marketing of such issues to qualified institutional investors. While we are generally in favour of improving smaller issuers' access to the bond market we maintain that a reduction in disclosure standards is not a valid approach, given that the primary purpose of a prospectus is the adequate information of investors;

- We agree that collective investment schemes, such as the proposed Pan-European Personal Pension Product (PEPP), ETFs, or other PRIIPs, could be viable ways for retail investors to tap into the EU corporate bond market. Retail investors' investment choices should not be confined to packaged products, however, given that many of these products are managed expensively and perform poorly. Retail investors should also be able to invest directly, particularly in liquid, "plain vanilla" investment-grade issues, and should therefore be furnished with the appropriate information and disclosure. The availability of research on debt and equity issues under MiFID II rules should be monitored, with an emphasis on promoting independent providers over captive, sell-side research;

- Harmonisation of insolvency frameworks, in particular the ranking of creditors in insolvency and definition of insolvency triggers, at the EU level would be highly beneficial, not only in respect of improving the integration of debt capital markets but also as a way of facilitating trade in goods and services by improving legal certainty;

- Recommendations to improve pre- and post-trade transparency are welcome, in particular the proposed creation of a consolidated pan-European ticker at ESMA. We disagree, however, with the proposal of reducing, rather than enhancing, MiFID II post-trade reporting obligations for trading venues on individual trades. We also support the harmonisation of deferral regimes across EU jurisdictions, provided that such deferrals are handled restrictively and priority is given at all times to protecting the integrity of the market. Disappointingly, the group does not propose measures to improve pre-trade transparency, which could benefit greatly from encouraging a move towards all-to-all electronic exchanges;

- The fragmentation of fixed income clearing and settlement is a major obstacle on the way towards the creation of robust, integrated end-to-end trading infrastructures for corporate bonds. Initiatives towards better integration of clearing and settlement should, however, be closely coordinated with trading venues to integrate services and allow for reliable and cost-efficient end-to-end processing.

Areas of concern

A significant number of the group's recommendations aim mainly at rolling back existing prudential regulation, which Finance Watch and BETTER FINANCE strongly oppose.

- Calls for regulatory capital relief as a way of encouraging broker-dealers, mostly G-SIBs, to invest in market-making and holding inventories, are not a forward-looking solution. Following the last financial crisis, regulators consciously increased prudential requirements for market-making activities to reduce procyclicality and mitigate the systemic risk associated with these activities. CSDR mandatory buy-in provisions were introduced to address counterparty risk and limit speculation. There has been widespread consensus among stakeholders that a new, more robust architecture of the fixed income market is needed. Fixed income markets, like many others before, are already migrating towards electronic platforms. Forward-looking policies should be more concerned with facilitating the transition and shaping new environments than to preserve vested interests. Neither is there any evidence that European G-SIBs are capitalised in a way that would warrant major new concessions. Nearly one in two (6 out of 13) European G-SIBs still falls way short of the 5% leverage cap, the level at which a systemically important bank is considered "well capitalised" in Switzerland and the US;

- We do not believe that capital requirements for insurers should be designed to stimulate demand for specific asset classes. Solvency II already has a designed-in bias favouring fixed-income securities over equity – a questionable preference in a market such as the EU which is overly reliant on credit and short of equity capital. Already today, corporate bonds account for ca. 10% of insurers' investment portfolios, on average.[3] Further regulatory incentives in favour of

corporate bonds may lead to suboptimal long-term asset allocations, depriving EU companies of equity funding and policyholders of returns in times of perennially low interest rates.

The heterogeneity of corporate bond issues, e.g. by currency, maturity and other features, is often cited as one of the key obstacles to better liquidity. This problem could be solved by seeking a higher degree of standardisation for debt securities, an approach that is supported by the large majority of issuers and investors but runs counter to the interests of a small group of very large issuers and their syndicate banks. In line with the phasing-in of MiFID II/MiFIR (pre- and post-trade) transparency requirements, a policy-led regulatory effort would be desirable to promote the standardisation of issues and encourage a move towards electronic trading and settlement.

Conclusions

It appears, in sum, that the report and its recommendations primarily reflect the preoccupations of the financial services industry and some of the very largest market participants. Finance Watch is prepared to support those aspects of the proposed agenda that have a demonstrable benefit for all users of the European corporate bond markets and calls upon the Commission to place particular emphasis on facilitating a smooth transition towards mostly electronic, venue-based trading, better pre- and post-trade transparency, and the creation of a level playing field for retail investors in market segments that are suitable for them. We would, however, strongly advise against giving in to calls for regulatory concessions on prudential matters which would only serve a small group of global broker-dealers and rehabilitate the same outdated market-making structures that have proven so dangerous for the stability of the financial system during the last crisis.

[1] Final report from the Commission Expert Group on Corporate Bonds, "IMPROVING EUROPEAN CORPORATE BOND MARKETS", November 2017
[2] Risk Control, Drivers of Corporate Bond Market Liquidity in the European Union, November 2017, pg. 120
[3] On average 11% for life and 7% for non-life insurance; EIOPA, Financial Stability Report, June 2017; pg. 50