APPENDIX 1

Association of British Insurers 51 Gresham Street, London EC2V 7HQ Tel: 020 7600 3333 Fax: 020 7696 8999

ABI RESPONSE TO FSA DISCUSSION PAPER 05/5 TRADING TRANSPARENCY IN THE UK SECONDARY BOND MARKETS

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1 INTRODUCTION

1.1 The Association of British Insurers (ABI) welcomes the opportunity to respond to the FSA Discussion Paper of September 2005 and has noted the report of the seminar of 14 November 2005 held at the FSA.

1.2 The ABI is the trade association for the UK's authorised insurance companies. Its membership, some 400 companies, provides over 94% of the insurance business undertaken by such companies.

1.3 They provide a diverse range of protection, investment and pension products and services to institutional and retail clients within both the UK and outside.

1.4 In the course of their business ABI members manage assets of the order of £1,100bn (€1,600bn) across all asset classes of which equities and fixed interest are the largest. At the end of 2004 ABI members, purely as insurers, held fixed interest instruments valued at over £490 bn in their worldwide general business and long term business investment holdings (of which overseas assets accounted for nearly one third).

2 GENERAL COMMENTS

2.1 The FSA is aware of the research into the sovereign and corporate bond markets commissioned by certain UK trade associations, including ABI, and the Corporation of London. The results of this fundamental research will not be available until after the response date for the Discussion Paper. Consequently the response given here to questions raised in the Discussion Paper reflects members' current views and are potentially subject to revision when the research results are available

2.2 The Discussion Paper demonstrates concisely the complexity of the bond markets, the importance of London in the international capital markets and the dominant role of institutional investors. Members consider this nexus of circumstances valuable to their interests and those of their beneficiaries. In a global market any European unilateral regulatory action which caused markets to migrate outside the EU would be viewed with concern.

2.3 Bond markets are dynamic and members note the very significant changes in liquidity and price transparency brought about in the last few years by the advent of electronic trading and developments of credit default swaps. These changes, which have largely impacted on sovereigns and liquid corporates resulting in their commoditisation, are expected to migrate down the credit quality curve.

2.4 A further two electronic trading platforms will come into operation in 2006. The possibility of such trading platforms acting in an exchange-type role, with data providing for transaction cost analysis for example, is deemed a realistic prospect. This rate of change underscores that any market analysis must factor in potential technical developments when considering the review required under MiFID Article 65.

2.5 Notwithstanding the review of academic analysis of TRACE in the Discussion Paper, we note the short time in operation of the fully implemented system and at the same time the anecdotal comments of market participants that its extension to the whole of the US market has had a damaging effect on liquidity in certain sectors, such as high yield. A longer period may be required before a full assessment of TRACE can be made.

2.6 Whilst recognising the legitimate desire to facilitate suitable and appropriate access to this asset class for the retail investor, ABI members are concerned that this should not be at expense of other market participants, i.e. increased cost without commensurate benefit to the markets and all those who investment in them, whether directly or indirectly

2.7 ABI members recognise the importance of protecting retail investors as well as the role they play in certain European markets. But retail access to bond markets is likely to be appropriate in most cases through advised sales or discretionary portfolio management (and therefore subject to MiFID and the obligations it places on firms). In such circumstances it is difficult to envisage that the benefits (to retail) of transparency imposed by regulation would exceed the costs (to the market as whole).

2.8 Overall, the European markets are primarily institutional and trading is dominated by London. Professional investors are able to judge credit risks better than retail and to manage holdings of instruments whose liquidity is limited. It is probable that many of these securities are inappropriate for retail investors investing directly in the markets. On the other hand liquid issues from highly rated borrowers, such as the European Investment Bank, are available with a high level of price transparency.

2.9 ABI members recognise that there is a varying balance to be drawn between transparency and liquidity dependent on the bond market in question. This theme is developed in the responses to the questions. To reiterate members are particularly concerned that the imposition of a formal pre-trade transparency regime could have potentially damaging impact on liquidity, in less liquid markets. Ultimately this could raise the cost of investment to their beneficiaries.

2.10 Our members also consider that a far greater impediment to the development of the market lies in the difficulty facing investors in protecting themselves against event risk. This cannot be anticipated or analysed in the same way as credit risk and investors are vulnerable to weak covenants. We believe that, for the present, focus should be on this problem rather than liquidity, although we are currently optimistic that dialogue at European level between issuers, investors and intermediaries should also help us to make progress. We believe that the support of regulators for this initiative is important.

3 RESPONSES TO QUESTIONS

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

Our members' believe regulation of markets is justified only when a mischief or detriment to the efficient operation of the market in question (and resistant to normal correcting processes) is identified.

The Discussion Paper alludes to the diversity of the bond markets (sovereign, coporates, high yield, emerging markets etc). Varied market structures are a natural result. ABI members see no evidence of market failures on a systematic basis. The markets are dynamic and inefficiencies are usually subject, over time, to market forces and particularly developments in information technology.

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?*

It is the combination of market conditions, size and market participants, together with the mediating influence of developing technology and market infrastructure, which sets the efficiency of a market at any particular time.

Bid-offer spreads or price dispersion, of themselves, are not seen as an indicator of efficiency. To function some markets, such as emerging debt, require high bid-offer spreads to allow the necessary degree of profitability to draw participants into the market.

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?*

Our members have not advised any difficulties or concerns surrounding best execution. The development of electronic trading in certain of the bond markets has been beneficial in proving best execution. Migration of electronic trading down the credit quality curve will extend this benefit. The restatement of the rights and obligations of market participants under MiFID is noted. These arrangements should be allowed to bed in before other major changes in market practice are contemplated.

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?*

By their nature, infrequent transactions, large lot size etc, certain bond markets are not retail-friendly. It is difficult to see how greater transparency would ameliorate this situation. A more logical expectation might be that in less liquid markets enforced transparency would lead to liquidity providers withdrawing from the market or a widening of spreads or indeed, providing only a bulletin board-type service.

If retail participation is deemed to require a level of investor protection synonymous with the equity markets, then retail investors should be guided to those bond markets, sovereigns and highly liquid corporates, which have the greatest similarity to equity markets and to those forms of investment, collectives schemes, which provide risk diversification and clear exit mechanisms.

Our members have noted the widely-held assumption that retail investors are mainly buy-and-hold and that therefore secondary market characteristics may be of less concern to them than primary market characteristics. Nonetheless our members would agree that such investors should be able to exit the market when they need to.

An unintended consequence of the Prospectus Directive is that most issues, currently, are above the €50,000 threshold and therefore outside the scope of the retail market. The conclusion that has been drawn from this is the need to guard against the unintended consequences of regulation.

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?*

As noted members have not advised any material market failures.

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?*

The conventional wisdom of declining liquidity, shortly after issue in the corporate markets is noted. We await the results of the research output before commenting further.

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?*

Members have offered no views on this question.

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?*

In previous discussion with FSA a selected group of members had indicated a view that greater post trade information would likely be of benefit, subject to the proviso that the cost of providing this transparency did not detract from investors' returns. During this consultation a wider range of views was encountered. In this case at one extreme greater transparency, both pre trade and post trade, was opposed as deterring liquidity providers and exposing investors' asset allocation strategies to other market participants.

Most respondents however, still incline to the view that, subject to appropriate safeguards maintaining the balance between liquidity and transparency, greater post trade transparency would be beneficial. Particular stress was laid on the provision of turnover data to complement that of price and spread. Ironically the development of credit default swaps on certain issues makes turnover data in these cases less valuable.

Some regret was expressed at the lack of a commonly accepted valuation basis in the corporate bond market equivalent to equity markets, notwithstanding the artificiality of such mechanisms.

However, the development of the iBoxx bond index is seen as a significant step forward in valuation processes.

On the other hand the willingness of certain investors to exploit information asymmetry was seen as a fundamental aspect of the bond markets.

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

The recent development of credit default swaps in certain issues is regarded as a market transforming factor. The ability to arbitrage improves the efficiency of markets in which these instruments are available.

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?*

Members are concerned as to the potential for unintended consequences of regulatory initiatives, particularly on the provision of liquidity. Consequently there is a preference for market-driven solutions which extend beyond the national level. For example there are at least two market-wide initiatives (i.e. issuers, investors and intermediaries) in Europe which are examining market activities with a view to enhancing best practice. These are being undertaken under the auspices respectively of AMTE (The Euro Markets Association) and the ABI and BVI. Though not concerned with market transparency as such they provide examples of cross industry concern with market efficiency issues.

A key practical issue would likely be the systems costs, one off and recurring, for reporting in relation to any transparency requirements imposed by regulators.