



BRITISH BANKERS' ASSOCIATION

**Pinners Hall
105-108 Old Broad Street
London EC2N 1EX**

Tel: +44 (0) 20 7216 8800
Fax: +44 (0) 20 7216 8811

BBA RESPONSE TO FINANCIAL SERVICES AUTHORITY DISCUSSION PAPER DP 05/05 ON TRADING TRANSPARENCY IN THE UK SECONDARY BOND MARKETS

The British Bankers' Association represents more than 260 banks carrying on business in the United Kingdom. The majority of these banks come from outside the United Kingdom and our members cover the whole range of investment services. They are particularly active in the bond markets. The BBA is the principal banking association in the UK and speaks for banks representing 95% of the banking assets held in the UK.

The BBA welcomes Discussion Paper 05/05 as a timely and thoughtful contribution to the regulatory debate about appropriate levels of transparency in bond markets which has flowed from recent work by IOSCO and from the discussions about transparency in the context of the negotiation of the Markets in Financial Instruments Directive (MIFID). We agree with you that the introduction of TRACE in the USA also makes it timely to give fresh consideration to issues of bond market transparency in the UK bond markets – both sterling markets and more international markets.

The key points of our response are set out below. These are as follows:

1. We agree with the statement in para.1.10 of the DP that “there is probably no material market failure in the UK bond markets, at least at the wholesale end”.
2. We consider that the wholesale end of the market should be considered as including fund managers as well as other wholesale market participants whether or not they are acting for predominantly retail funds. The managers are professional regardless for whom they act.
3. We consider that the retail portion of the UK bond market is very small. If there are perceived to be any issues it is likely to be preferable to focus on the obligations of a firm when acting for a retail customer, rather than on transparency obligations, when considering whether any action needs to be taken with regard to retail customers. In particular the new best execution obligations that will be brought in when MIFID is implemented are likely to provide more proportionate safeguards than wide-ranging transparency requirements which would probably impact the whole market, rather than just those dealing with retail customers. Our members are not convinced that there is a material market failure in the retail portion of the market but would be happy to work with you on any proposals should you take a different view.
4. We consider that the main obstacles to retail participation in the bond markets are (i) high charges by financial advisors who advise retail customers on acquiring bonds (often driven by the small size of the transactions and the lack of

volume trading in the retail market) and (ii) the fact that many bonds are forbidden to retail customers either due to Listing Rules requirements which specify that many types of bonds should not be available to retail customers or through the Prospectus Directive provisions relating to qualifying investors. We consider that the restrictions imposed by the Listing Rules and the Prospectus Directive are sensible and intended for the protection of retail investors.


5. Whilst we agree with the FSA that there is an inter-relationship between trading in the cash and derivative markets. The main drivers for the cash bonds market are more likely to be: relative pricing, market trends and topical issues. Excessive transparency in cash bonds will distort the market and push both resource and capital into structured transactions. The most relevant information from the derivatives market is generally already available to professional market participants and taken into account in cash market pricing.
6. We consider that transparency in the bond markets is growing all the time with the development of increased electronic trading. However, inevitably it is greater for the more liquid bonds. For more illiquid bonds the practical issue will always be the small number of dealers who are willing to commit capital, and the fact that often there will only be one dealer who is prepared to make a market. This, however, is a perennial characteristic of the bond market – and not something that can be changed by greater transparency. In view of this, our members consider changes to the transparency regime are likely to be of marginal benefit and that there is a substantial risk that any utility would be outweighed by the risks and costs associated with potential changes.
7. In particular, regulators should consider that bid-offer spreads in the European bonds markets at present are generally tight and have been tightening over the past few years – partly as a result of the growth of credit derivatives as a hedging instrument and deleveraging of company balance sheets. This has meant that, although volumes have been growing as a result of the relative unattractiveness of equity markets, margins have been dropping. As the cycle appears to be moving towards a more benign environment for equities one would expect some decline in bond market volume. Moreover the margins available in the bond markets are significantly lower than the margins available in credit derivatives for example. This is fuelling a flight of talent and capital to the derivatives markets. Taken together there is a significant prospect that increased costs associated with any changes to the transparency regime, and increased risks to a dealer's capital, could lead to significant withdrawals of liquidity from the cash bond markets. Capital withdrawal by equities dealers was something which happened initially when SETS was introduced in the UK equities markets and changes had to be made quickly to SETS as a result. Therefore we agree with the FSA's statement in para. 1.14 that transparency should be viewed as a facilitator of market efficiency and investor protection, not as an end in itself. On balance we consider that as the markets are predominantly professional there is limited need to mandate greater transparency as it is growing all the time through investor demand and the provision of more data by market competitors. Transparency itself has not been the main driver of growth or increased competition but rather the other factors mentioned above.

8. Regulators should also consider that the corporate bond market in the UK, and the European corporate bond market generally, is quite a young and immature market. It is only with the advent of the euro some five years ago that the corporate bond market has begun to expand significantly. Consequently our members' view is that it would be premature to introduce a system such as TRACE at this stage. The US corporate bond market is much more developed and includes many more liquid bonds. There is also a much larger investment community participating in it. Moreover, our members are not convinced by the assertion of an academic study that the introduction of TRACE has led to tighter spreads in the USA. Our members advise us that there is considerable unhappiness with TRACE in the dealer community at present and they also point out that it has not yet been tested in a bear market. Our members would support further independent analysis of the impact of TRACE.
9. Our members would oppose the imposition of the pre-trade transparency requirements in Article 27 of MIFID to the European bond markets. A post trade transparency regime is preferable. There are a variety of reasons for this. The principal reason is that the characteristics of the bond market are completely different from the characteristics of the equity market. We agree with the FSA's description of the bond markets operating out of the UK. As stated in para. 1.15 of the DP the differences compared with equities include the very much larger population of less liquid bonds, the large trading sizes and low trading frequency and the short life liquidity of many bonds. These characteristics, and the fact that there is much greater diversity in the different types, and maturities of bonds, make it inappropriate to impose regulatory pre-trade requirements. A post-trade regime is preferable, and exists already, and there is no need of the real time price information which is made available on equities markets. Moreover Article 27 has been drafted to fit equities markets and would not work for fixed income markets. We would also agree with the FSA that, in any event, there is considerable pre-trade information already available to professional participants in the UK markets and members consider that there is no need to mandate this as a regulatory requirement.
10. If a post-trade reporting regime were introduced we consider that end of day reporting would be sufficient. We note, in particular, the table on page 16 of the DP which shows the frequency of daily trades in a universe of 5,273 issues traded on a typical day in June 2005. This shows that fewer than 500 of these issues traded 10 times or more and fewer than 40 traded 50 times or more. This contrasts with equity markets where trading would be much more frequent on a daily basis. Should the FSA take a different view we would want to have pre-consultation discussions with you about alternatives.
11. We support the FSA's view that the European Commission, when conducting its review, should first identify what problems, if any, exist in the EU secondary bond markets, before determining whether additional transparency is required. As we have said, we do not consider that there is a market failure. We welcome DP 05/05 as a document which sets out a considerable amount of helpful data about the bond markets which should assist in carrying out such a review. We look forward to supplying more data at any further consultation.

In the Annex to this letter we have set out our answers to the questions which the FSA asked in the DP.

We are happy to discuss this paper with you in more detail. If you have any questions about it please contact me on 7216 8858 or Ross Barrett on 7216 8841.

Yours Sincerely



Michael McKee
Executive Director
Wholesale and Regulation

Ross Barrett
Director
Wholesale and Regulation

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

There is currently no demonstrable failure in the bond market. Therefore the FSA should be cautious in bringing in prescriptive regulation where there is no driver for this. In paragraph 5.15 of the FSA Discussion Paper the FSA state that:

“We are not aware of any complaints from retail investors regarding best execution in UK bond markets.”

Market forces have continued to increase both transparency and volumes in the bond market. Organic growth and improved market conditions are preferable to regulations intending to achieve the same effect. If further transparency is needed it should be focused in the retail area of Best Execution arrangements. The FSA should take a focused approach to bond market transparency.

2. 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?

The price formation process is different for corporate, government and high yield bonds, there is not one homogenous “bond market”. Gilts will exist at one end of the scale and complex tranching bonds from SME’s will inhabit the other end. Each point on the scale will have its own intricacies and price formation issues.

The level of pre-trade transparency is considered sufficient by members. Sell side should provide pre-trade transparency, but there should be no regulatory rule requiring it. This is currently well catered for, as can be seen in the continuing trend toward narrowing bid-offer spreads and increasing transparency driven by electronic trading platforms. Clearly there is an interaction between the cash bond market and derivatives in price formation. Influence can flow in both directions to drive price formation.

3. 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?

The UK bond market is overwhelmingly an inter-professional market, with participants being classified either as eligible counterparties or professional clients. As mentioned in the cover letter we consider that a better approach would be to ensure that direct access retail customers receive best execution. These best execution requirements should be carefully scoped so as to avoid instituting costly requirements that professionals neither need nor want.

It is vital that the professional – retail distinction, with its differing requirements is very clear. Any requirements should avoid creating the incentive for client drift, that is for clients to slide down the scale of client classifications in order to gain extra protections. Inter-professional trading should not be inhibited by retail client style requirements. Any

extra requirements on best execution etc must be tailored. The introduction of MiFID represents an opportunity to use this approach.

The FSA should take account of the sheer number of bonds that are in the market. For frequent borrowers there could be as many as 500 or more different bonds. It has been estimated that to print all the bond prices in the FT would take considerably more than a double page spread. The FSA should consider what investors would be able to interpret from this torrent of information if the focus was on greater transparency.

4. 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?

We consider that the main obstacles to retail participation in the bond markets are (i) high charges by financial advisors who advise retail customers on acquiring bonds (often driven by the small size of the transactions and the lack of volume trading in the retail market) and (ii) the fact that many bonds are forbidden to retail customers either due to Listing Rules requirements which specify that many types of bonds should not be available to retail customers or through the Prospectus Directive provisions relating to qualifying investors. We consider that the restrictions imposed by the Listing Rules and the Prospectus Directive are sensible and intended for the protection of retail investors.

Increased transparency will not necessarily increase retail participation. Partly there is less retail participation in bonds as it is simply a more complicated market than equities. Transparency is only one element in a blend of factors that are required to aid retail participation. Giving retail investors a vast amount of transparency information in a market they do not understand, does not help them.

The UK retail market bond market is small in comparison to professional trading, with almost no direct investment in these instruments. The FSA discussion paper raised issues such as pre-trade transparency, appropriateness and best execution. These are less significant in the majority of bond trades in the London market, where the counterparty is nearly always a professional.

It is not a lack of transparency in the bond market, but rather the Independent Financial Advisor's fees that represent a significant barrier to retail participation. Shining the regulatory spotlight at this issue may be lead to the greatest marginal benefit for the retail bond market.

Members have highlighted that many of the bonds available in the cash market were issued under the old Chapter 23 of the Listing Rules, (Rule 23.1). These bonds were specifically prohibited from being sold to retail clients. The Prospectus Directive has various provisions designed to constrict the form of products that can be sold to retail clients. The Prospectus Directive (PD) requires a full PD compliant prospectus to be published in relation to any offer of securities to the public except where reliance can be placed on one of the specified exemptions. In the debt market, reliance is often placed on one of these exemptions, either by making the offer exclusively to "qualified investors" or by offering securities with a minimum denomination of EUR 50,000. Reliance on either of these exemptions will mean that the securities in question are not offered to retail investors.

There is historic, current and future legislation designed to keep retail investors out of the corporate bond market. The drive to create greater participation by retail clients is inconsistent with previous and current initiatives on a European and UK scale to protect them from uneven interaction with professional participants.

Finally, the suitability and appropriateness requirements imposed by MiFID that banks have to carry out with potential investors means most of the retail client market would be prevented from investing anyway. Our members consider that onerous transparency provisions that are costly to implement, that inhibit liquidity and drive away capital are unnecessary in a market where there is no demonstrable market failure.

5. 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 stated above our members do not perceive that there is any material market failure in the bond market.

It is important to note that greater transparency in the market is, in any event, evolving naturally, for example with the growth in use of electronic systems and trading. This organic process should be allowed to continue.

6. 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?

There is no evidence of disintermediation in the bond market. Transparency should not be considered a panacea for any issues in the bond market. Enhanced transparency is only useful if there is significant volume and regularity of trading. Transparency is the flip side of liquidity. In the corporate bond market, when there is an event of significance in the market, the liquidity often disappears.

Knowing that a small trade went through a week ago does not aid the investor in gaining a clear understanding of what the price of a large trade in the same bond will be today. Therefore transparency cannot be considered in a vacuum. It must work in harmony with other elements. This is especially relevant when considered with the concept that onerous post trade transparency obligations will reduce incentives for market makers to provide liquidity. The FSA should not assume that dealers make a profit on every trade. The market maker is required to always provide liquidity, and in doing so will lose on some deals. Greater transparency must not undermine the liquidity of bond markets.

As outlined in the discussion paper, transparency is not an end in itself. If too much transparency is brought into the market too quickly, liquidity will decrease as dealers withdraw capital. It is arguable whether liquidity in the US has improved as a result of TRACE.

For many bonds at any given point in time there may only be one market maker who is prepared to provide a bid/offer price. The FSA need to take into account the concept of

capital at risk, when considering liquidity in the bond market. Increased transparency may lead to reduced margins and profitability for banks providing market making services. There is already a shift by banks of their capital from cash bonds into derivatives. A drop in margins and therefore profitability will only accelerate this process of capital (both human and monetary) away from the secondary cash bond market and into derivatives. This will be a negative result for the cash market in general and especially for retail investors as without the volume and liquidity there can only be limited transparency. As an example of the impact of lack of liquidity, when SETS was first introduced the initial liquidity was very low, leaving orders hanging waiting to be filled.

Members have highlighted the fact that firms providing liquidity to the US Corporate bond market can be targeted by clients and other market participants who simply watch the TRACE tape and then manipulate the price of securities to the detriment of the price provider, this has provided a disincentive to provide liquidity. This issue is particularly acute for high yield and distressed bonds. This will not only impact on the high yield bonds but also the private equity market, which relies on the repackaging of loans into high yield bonds. By making these high yield bonds less attractive it will have repercussions for private equity. This is a very important market for the UK and one that is growing faster than hedge funds.

7. 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?

The appropriate perspective is not just UK or European, but rather global. If excessively costly transparency requirements are instituted on the UK (or European) bond markets some of the volume and liquidity will move into more attractive regimes or alternative products that are not so heavily regulated. Many of the corporates issuing bonds are multinational institutions and the costs of issuing in alternative markets outside the UK or the EU would always be considered when issuing bonds. Liquid bond markets are vital in order for corporates to raise funds. Any significant withdrawal of liquidity from the secondary bond market could potentially harm corporate bond issuance, with all the knock on effects that implies.

8. 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?

As has been outlined in our response to previous questions, the current state of pre-trade transparency is considered sufficient. We also consider that post-trade bond information is widely available to trading platform participants on a real-time, slight delay or end of day basis. Post-trade prices in approximately 11,000 corporate bonds are available via ICMA's TRAX system on a next day basis. On balance any focus should be on post-trade rather than pre-trade transparency.

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

As stated in our cover letter, whilst there is an interaction between these two markets. The credit derivatives markets are not seen by our members as the primary driver of price formation in the cash market.

10. 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?

It is vital that a full cost benefit analysis is carried out on any proposals for bond market transparency. The FSA should provide a number of possible alternatives for the industry to comment on rather than just one. System changes are extremely costly, not only in terms of hardware but also retraining of staff. Greater transparency means more internal procedures, therefore requiring more staff resource. Regulators need to take into account the already very substantial and costly system changes that will be associated with the introduction of the Capital Requirements Directive and the Markets in Financial Instruments Directive in 2007/8.

Within the CBA, the cost of setting up and maintaining any transparency system must be considered. If any TRACE-like system is to be free at the point of use then dealers will have to build in any costs or fees into their spreads.

The UK and international bond market is the largest in Europe providing access for firms to a flexible source of funds, with a range of maturities and characteristics. To unduly inhibit the growth, or depth of liquidity in the bond market would lead to an increased cost of capital for a wide range of large and small corporates, with knock on effects for EU economies.