



INSTITUTIONAL AND INTERNATIONAL RELATIONS

**Unicredit's Response**  
**to the Commission's Call for Evidence on**  
**Pre- and post- trade transparency provisions of the Markets in Financial**  
**Instruments Directive (MiFID) in relation to transactions in classes of financial**  
**instruments other than shares**

***Introduction***

Unicredit is the holding company of the Unicredit Group, resulting from the largest business combination at transactional level ever achieved in Europe – that of Unicredit, HVB and Ba-Ca. This business combination has led to the creation of the first truly European bank, which ranks among the top three players in the Euro zone<sup>1</sup> in terms of assets, with a relevant presence in 20 European countries, around 28 millions customers, more than 133 thousands employees and 7.320 branches.

Unicredit welcomes the opportunity to take part to the Commission's call for evidence in respect of transparency in non-equity markets and provides the following answers to the questions contained in Annex I.

***Question 1: Do you have any comment on the proposed scope of the Report?***

***Question 2: Do you consider this classification scheme to be sufficient for the purposes of the review?***

---

<sup>1</sup> In the global market, Unicredit Group is now the 16<sup>th</sup> world wide bank in terms of market capitalization according to FT Global 500 (June 2006)

We generally agree with the scope of the report. As for the classification of financial instruments, we equally agree that a first criteria of classification should relate to the type of instrument (i.e. bonds, ABS, derivatives and swaps). However, and consistently with what outlined below, we believe that further classification should be based upon market characteristics (meaning primarily its liquidity, and microstructure of relevant trading venues) or comparability with stock exchange traded instruments in terms of size, tenor, etc. rather than credit risk rating of the instrument. This is because the first ones, more than the latter one, are key in determining the effects and the relevancy in terms of economic rationales of the different transparency requirements. We therefore agree with the basic classification proposed (cash bonds, credit derivatives, ABS and other financial instruments), but favour a subsequent differentiation inside the class of cash bonds, between government and other bonds, and then, for the latter, based on the level of liquidity (measured primarily through trading volumes and frequency as well as average size of trades as available). Finance Derivatives, as classical OTC instruments with particular terms according to special clients' needs, should be outside the scope. Interbank transactions on IRS in contrast are often standardized transactions based on common terms (e.g. via Reuters) and are publicly available.

The classification of cash-bonds as belonging to a category of “emerging market” does not necessarily bring results for the proposed rationales and as a term seems to be vague. It should relate to the same factors described in 3.3.

Equally, we propose to amend the classification of Credit Derivatives taking IRS, Bond Options and Futures outside its scope as these instruments are Finance Derivatives rather than Credit Derivatives because their underlying is different to what might trigger a credit event.

***Question 3: Do you consider there are possible policy rationales for mandatory transparency we have not listed?***

We consider the policy rationales listed exhaustive for the aims of the report. Nonetheless, we would like to stress that an objective assessment requires a comprehensive cost-benefit analysis. It therefore requires not only that the possible relevance of these rationales is tested, but also that the potential negative effects of mandatory transparency according to the same criteria of market efficiency (namely liquidity and efficient price discovery) are accounted for. It is indeed well known in the

economic literature, as well as among practitioners, that higher transparency levels may have ambiguous effects on both liquidity and the level of trading activity, and on the relating information flow on the market.

***Question 4: Do you agree with our proposals for prioritisation of the review?***

We share the proposed prioritisation for analysis, as well as the reasons behind this choice.

***Question 5.: To what extent do you consider there to be:***

***a. observable or demonstrable problems with respect to the possible policy rationales for mandatory transparency identified above in relation to one or more of the instrument markets under review?***

***b. evidence that mandatory pre- or post-trade transparency would solve any of those problems?***

***Question 6: To what extent could recent and upcoming technological and market developments in relation to the instrument markets under review:***

***a. contribute to a relatively inexpensive extension of mandatory transparency?***

***b. render mandatory transparency unnecessary?***

***Question 7.: To what extent are non-equity financial instruments different from equities so that lower levels of mandatory transparency in those markets may be justified?***

***Question 8.: What data sources do you consider relevant to the issues you have raised (if appropriate, cross-refer to your answers below)? Would you or your organisation be prepared to provide any relevant data if necessary?***

First of all, it is important to stress that any conclusion drawn from the analysis of the equity markets, as far as transparency and regulation of trading activities are concerned, should not be automatically extended to the bond markets.

The latter have different characteristics and therefore require different arrangements. Indeed, bonds are generally less volatile and less liquid securities than equities. This is due mainly to the greater number of issues compared to the equity markets and the fact that more investors in bonds rely on a “buy and hold” strategy compared to equities, resulting in a lower and more dispersed trading activity. The well known features of bond market architecture should then be seen as a response to these peculiarities: it is mainly decentralized, less automated, based on bilateral negotiations with dealers who provide essential liquidity to the market in exchange for a fair remuneration for the

capital they commit and the risks they take. It is important therefore that any possible regulatory intervention is assessed against this background. Indeed, in this context, enhanced transparency (especially post-trade) will likely have a negative effect on overall market liquidity, because it will lower incentives for dealers to commit their capital by increasing the risk that the market will move against them once they take on a large position to unwind.

Having in mind this feature, and considering the current rather satisfying functioning of the bond secondary market, we believe that lower mandatory transparency requirements than those applied to the equity markets are well justified.

In other words, most bonds are on average less volatile than equities, effectively making the benefits of transparency, in terms of price discovery and best execution, less relevant (less volatility means lower price uncertainty, reducing the costs normally associated with more market opacity). On the other hand, as underlined before, the loss of liquidity produced by higher transparency requirements is considerably higher, given the characteristic market architecture. The resulting balance between benefits and costs suggests that less mandatory transparency compared to equity markets would be optimal.

This seems especially true for government bonds, which are usually less volatile and more liquid. They do not require further provisions regarding transparency in our view. As to corporate bonds, we believe that the degree of pre-trade transparency already provided by existing electronic quote dissemination systems, such as that provided by IIC with IBoxx, is sufficient and in any case very costly to enhance (quotes are often provided by dealers by phone in the current environment).

At the same time, a moderate mandatory post-trade transparency regime might prove a reasonable cost-effective way to improve compliance with best execution obligations and to promote competitive effective spreads on the market, especially for smaller investors. To avoid any significant adverse effect on liquidity provision, delayed reporting of closed trades should be allowed, with a delay ranging from some minutes to a whole day depending on each security turnover. Less frequently traded bonds should benefit from a complete exemption.

***Question 9.: Are there academic or institutional papers or ongoing work that should be considered in preparing the Report not included in our bibliography?***

***Question 10.: What conclusions do you draw from the existing academic debate and the work being conducted by other interested parties?***

We believe that most literature on the matter underlines the existing differences between equity and bond markets and the risk that excessive transparency might prove detrimental for the smooth and efficient functioning of the latter.

For further input to the analysis, we suggest in addition to the proposed bibliography, the following papers:

- Bloomfield, R., O'Hara, M., 2000, "Can transparent markets survive?", *Journal of Financial Economics*, 55, 425-459
- Bessembinder H., Maxwell, W. F., Venkataraman K., "Market transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds", (October 2005). AFA 2006 Boston Meetings, Forthcoming Available at SSRN: <http://ssrn.com/abstract=644624> or DOI: 10.2139/ssrn.644624
- Harris, L. E., 1997, "Order Exposure and Parasitic Traders", Working Paper, University of Southern California.

***Question 11.: In your view, how applicable is the academic or institutional literature concerning transparency in the cash equities markets to the present discussion?***

We think that literature on equities markets is useful to give a sound methodological background to the analysis and to help understanding more clearly the close relationship between the key drivers of liquidity and market efficiency and the effects that different transparency regulations might have on them. On the opposite, we caution against adapting, *sic et simpliciter*, the conclusions drawn from equity markets to bond markets.

***Question 12.: What similarities, and what differences, are there between US and EU markets that should be borne in mind when seeking to draw inferences from the TRACE experience in the US?***

We think that caution is required when looking at the experiences in the US. The cash bond market is much more liquid there than in Europe (overall turnover is six to seven times larger). This of course entails a different balance between benefits and costs of diverse transparency regimes. Moreover, the key role of primary dealers in the European countries dose not find a similar counterpart in the US government bond

market. The adoption of a TRACE-similar system in Europe is likely to produce very different results. It is therefore necessary to carry out a careful cost-benefit analysis to assess the optimal transparency level for European bond markets.

***Question 13.: To the extent that you have identified problems or believe that others might do so, do you agree that only EU-level action would be appropriate in the present case?***

We believe that whatever the conclusion of the report will be, a common approach for the entire EU financial market should be followed. This will avoid any harmful effect on fair competition between market participants, thus ensuring a full level playing field. MiFID represents a good example in this regard.

***Question 14.: If you have identified problems or believe that others might do so, to what extent do you consider those problems would disappear as a natural product of market evolution in the short-to-medium term?***

We doubt that market evolution alone will deliver a solution to whatever problem will be identified, as transparency shows the typical public-good features.

***Question 15.: In respect of both pre- and post-trade transparency, are the four options the right ones to consider, and in particular should other options be considered?***

***Question 16.: Would you, in light of your answers to the other questions, favour any of the four options in relation to pre- and post-trade transparency (or another option you might propose for consideration) in respect of transactions in any of:***

- cash government bonds;***
- cash investment-grade corporate bonds;***
- cash high-yield corporate bonds;***
- asset-backed securities;***
- credit default swaps, interest rate swaps and bond futures; or***
- any other financial instrument you consider relevant?***

We do not consider any of the options regarding pre-trade transparency to be suitable to market reality, cost efficient, and appropriate from a cost-benefit analysis viewpoint. As outlined before, we are in favour of a mandatory post-trade transparency *mild* regime only for more liquid corporate bonds, with carefully calibrated delayed reporting to avoid harmful consequences to overall market liquidity. The technical implementation

of a system like this should rely as far as possible on market solutions, and at least on open and flexible architectures. Extensive consultation of market participants to deliver an efficient outcome and avoid an excessive burden is necessary. Less frequently traded bonds should benefit from a complete exemption.

A complete exemption should also apply to OTC Finance Derivatives like IRS which are designed and structured for special clients' needs and which cannot be compared with other similar instruments. Standardised Derivatives traded via MTFs (e.g. IRS via Reuters Dealing or Bloomberg, Swaps Electronic Trading) are already transparent and any reporting obligation should be fulfilled by the MTF according to Articles 29 and 30 of the MiFID.

\* \* \*

For any clarification on the above, please contact:

Andrea Di Biasio Planning, Strategy and Research UniCredit Via Tommaso Grossi, 10 Milan, Italy Andrea.DiBiasio@unicreditgroup.eu.	Costanza Bufalini EU Institutional Relations UniCredit Via del Corso, 374 Rome, Italy Costanza.Bufalini@unicreditgroup.eu
--	--