

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER HYPOTHEKENBANKEN E.V. BERLIN

**Comments of the
Zentraler Kreditausschuss (ZKA)¹
on the
IOSCO report of May 2004
*Transparency of Corporate Bond Markets***

16 December 2005

¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,300 banks.

A. General comments

1. The IOSCO report *Transparency of Corporate Bond Markets* examines in detail whether it would be in the interests of market efficiency and the protection of retail investors to introduce post-trade and/or pre-trade transparency requirements for OTC transactions in non-government bonds. In Europe, this issue was discussed in depth with respect to *share* trades during consultations on the Markets in Financial Instruments Directive (MiFID).
2. European legislators came to the conclusion that pre-trade transparency should be introduced for systematic internalisers and post-trade transparency for all OTC trades in listed shares in which investment firms are involved. A conscious decision was taken not to extend these pan-European transparency requirements to bonds so that practical experience could first be obtained with pre- and post-trade transparency in Europe's share markets.
3. This has proved a judicious decision from the perspective of both regulators and market participants. It also makes very good sense in view of the numerous questions thrown up in the course of implementing MiFID's pre- and post-trade transparency requirements. In the absence of sound empirical knowledge about the impact of pre- and post-trade transparency on the liquidity and efficiency of European share markets, it is impossible to judge whether it would be useful to introduce similar transparency requirements for the bond markets. A further consideration, in our view, is whether and, if so, to what extent findings on transparency in share trading can be applied to the corporate bond markets at all since the latter operate according to different rules, especially where price formation is concerned (see no. 6).
4. For this reason, we see no need at present for statutory or regulatory action on pre- or post-trade transparency in the corporate bond markets. As a matter of principle, however, we would like to set out our reservations about extending the concept of price transparency in this way.

B. No market need

5. There is no discernible need, in the view of the German banking industry, for pre- or post-trade transparency in the OTC bond market. We have seen no evidence that the absence of regulatory rules on transparency have given rise, or are likely to give rise, to gaps in market efficiency. This is not least because there are already various market-based sources which facilitate price transparency. According to a study by the Bond Market Association², a number of electronic bond trading platforms already offer extensive post-trade services and possibilities of pre-trade analysis. Information disseminated by the trading platforms direct or via data suppliers can be used by investors for pricing and transparency purposes. Bond indices also play an important role. Some suppliers, such as iBoxx, make their indices

² European Bond Pricing Sources and Services: Implications for Price Transparency in the European Bond Market, April 2005.

available on the internet free of charge. They publish not only the index value, which can be used as a possible benchmark, but also prices for every bond included in the index which are marked to market at least once every trading day. For this reason alone, we believe any regulatory initiative in this area this would be superfluous.

Should, against expectations, *investors* call for stricter transparency requirements at some point in the future, we do not consider that regulatory action would be the most appropriate response. A look at the German Pfandbrief market, for example, shows that self-regulation can better accommodate the changing needs of market participants. Take, for instance, the minimum standards for Jumbo Pfandbriefe or, at European level, the European Covered Bond Council, on which all market participants in the covered bond market are represented.

Irrespective of this point, we would like to draw attention to the following aspects:

I. Wholesale market

6. The wholesale bond market is largely a buy-and-hold market in which pricing is determined by interest rate and credit risk and by the lifetime of the bond. As far as interest rate risk is concerned, published swap rates function as a key market benchmark. Professional market participants have little interest in information on the volume and price of OTC bond trades (post-trade transparency).

II. Retail market

7. But even from the perspective of enhancing retail investor protection, there is no discernible need in the German market for more transparency requirements. Virtually no retail investors trade on the secondary bond market at present. They are active mainly on the primary market, which shows that buy-and-hold strategies are even more pronounced among retail investors than they are in wholesale trading.
8. We assume that the increase in retail investment in the bond market perceived by the report relates first and foremost – if, indeed, it actually exists at all – to the primary market and only to a negligible extent to the secondary market. Retail investors are already well protected on the primary market, however, particularly by rules governing prospectuses (in Germany, the German Securities Prospectus Act).
9. On the secondary market, the Federal Financial Supervisory Authority’s “Compliance Guideline” (Guideline pursuant to Section 35 (6) of the German Securities Trading Act on the details concerning Sections 31 and 32 of the Securities Trading Act) requires banks to base the price for own-account transactions on market prices. Implementation of this rule, which is based on the Investment Services Directive (93/22/EEC) is monitored in the annual review of a bank’s compliance with the Securities Trading Act.

10. Statistical evidence reveals an extremely low level of German retail investment in bonds. Holdings of domestic bonds by households in Germany account for less than 3% of the total securities holdings covered by statistics³. It must also be remembered that in Germany a significant proportion of the bond market consists of registered bonds that are issued for certain institutional investors and are transferable only to a limited extent. IOSCO should back up its hypothesis of a trend towards retail investment (cf. Section B.2 of the IOSCO report) with statistics before regulatory consequences are drawn from this unproven assumption. To our knowledge, there is no statistical evidence to suggest such a trend exists in Germany, the biggest bond market in the eurozone (30% of total issues according to ECB statistics for September 2005).

III. No connection with financial fraud

11. We also see no sign of a connection between an alleged lack of pre-and post-trade transparency in the OTC corporate bond market and financial fraud. It is the task of other regulatory regimes, such as EU rules on ad-hoc disclosure and market manipulation, as well as of effective enforcement of international accounting standards to prevent financial scandals like Parmalat. Pre- and post-trade transparency geared towards enhancing market efficiency and best execution will not be able to make any discernible contribution in this area.

IV. Cost-benefit ratio

12. The benefits of transparency requirements for OTC bond trades would thus be barely perceptible. The associated costs, in contrast, would be quite considerable. In the context of post-trade transparency, these costs would arise because every market participant in the bond market would have to ensure that all notifiable OTC bond trades in which he was involved were made public. As is shown by the current discussions on analogous OTC post-trade transparency requirements in the share market (MiFID), the system-related technical questions that have to be solved are highly complex.

13. If it were decided also to introduce mandatory pre-trade transparency requirements for some market participants, the ensuing trading risk would probably trigger a trend away from OTC bond trading among these market participants. The result would be less liquidity and wider spreads and thus a deterioration in price quality compared to the situation without pre-trade transparency.

³ According to the securities deposit statistics compiled by the Deutsche Bundesbank, 3.3% of all holdings of bonds of domestic issuers in securities deposit accounts were held by households in 2004. The following points must be borne in mind: there is no breakdown into government bonds and corporate bonds. Households also include one-person firms. The banks' own securities portfolios ("A" holdings) are not included. When adjustments are made for these factors, the market value of holdings by retail investors accounts for under 3% of all corporate bonds issued by domestic issuers. If statistics were available for industrial bonds in the narrow sense, the figure would be a fraction of this.

C. Conclusion

14. It may therefore be concluded that there is no need, in the view of the German banking industry, to introduce pre- and post-trade transparency requirements for the OTC bond market. We see no evidence of market failure in this sector. Transparency requirements would simply lead to overregulation, which, quite apart from being unnecessarily costly, could result in market participants withdrawing liquidity from the market and/or switching to other forms of non-freely tradable securitised debt instruments (e.g. borrower's note loans). This would do nothing to further a regulatory environment in the securities markets which was conducive to market efficiency or investor protection.

15. We therefore urge the Federal Financial Supervisory Authority to argue at international and European level against pursuing the idea of pre- and post-trade transparency requirements for the OTC bond market.