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**Comments of the
Zentraler Kreditausschusses (ZKA)¹
on the European Commission's
Call for Evidence
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
14 September 2006**

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.

We would like to thank you for the opportunity to provide our comments on the points raised in the Call for Evidence. First of all, however, we should like to submit some general remarks on the proposed review.

General remarks

The European Commission's mandate for the current consultation process is based on Article 65(1) of the Directive on Markets in Financial Instruments (MiFID). Under said provisions, the European legislator expressed its desire to review the feasibility of a potential extension of MiFID's market transparency provisions concerning shares traded on the stock exchange to include other securities classes. We appreciate the opportunity to share our basic views on such an extension of the market transparency provisions and – during the present consultation round which is based on the aforementioned mandate – we should like to submit the following comments:

Regulatory market intervention invariably results in some kind of distortion. Hence, such intervention may only be justified if and only if:

- proof of an existing market failure is furnished;
- the respective market – left to its own devices – is incapable of establishing an optimum degree of transparency;
- there is evidence that such market failure can be remedied by means of regulatory interventions; and
- the planned action is backed by an existing, positive cost-benefit analysis.

Whilst not limited to, these points especially apply to markets such as the European bond markets, which in recent years have undergone rapid and successful development. Top-down market interventions deprive these markets of the flexibility necessary for an optimum response to the needs of its market players.

The ongoing development of the markets under observation, their promising self-regulation – offering the best safeguards for an adequate consideration of the concerns of all market players – and the European Commission's better regulation principle result in an obligation for the legislator to proceed with great care. Recital 44 (MiFID) reads: "With the two-fold aim of protecting investors and ensuring the smooth operation of securities markets, it is necessary to ensure that transparency of transactions is achieved..." Thus transparency must be seen as an interim goal on the road towards ultimate framework conditions that are conducive to efficient, fair, stable and liquid markets featuring healthy competition. Prior to its adoption, any enhancement of market transparency should therefore always be gauged against whether it will succeed in delivering these ultimate goals. Since enhanced transparency always comes at a cost, optimum transparency must invariably take precedence over maximum transparency. In line with the law of diminishing returns, from a certain point onward, the additional costs of enhanced transparency will outweigh its additional benefits. What is more, from a certain degree onwards, an isolated review of transparency would compromise the benefits thereof, since this has an adverse effect on market liquidity.

The Commission voiced the opinion that a general 1:1 transfer of MiFID's transparency provisions to transactions in other financial instruments would lack any basis; we share this view and welcome the Commission deliberations on a differentiated approach. Such an approach is warranted by the fundamental differences which exist between the markets in the various securities classes. In this regard, the transparency requirements for listed shares constitute a first level the implementation of which is about to begin. In view of the foregoing observations, we feel that the timetable for consultation envisaged under MiFID is debatable. In other words, the envisaged roadmap begs the question whether it is advantageous to conclude this timetable prior to the national implementation of MiFID's market transparency requirements, i.e. in the absence of any first findings gained from practical implementation of the new provisions on the ground. First, the impact on stock markets needs to materialise; then, this impact needs to be analysed. Such a review, however, would also have to take into account that these results cannot be directly transferred to other areas. Nevertheless, the forthcoming impact on the stock market will – more likely than not – provide pointers as regards a potential extension to include other areas. At present, preparations are underway for an implementation of the respective provisions under MiFID. This work also covers MiFID's Implementing Regulation and it has revealed a high need for clarification on the ground, - after all, Germany is not the only country where many of the implementation issues touch upon *terra incognita*. Furthermore, the European legislator obviously hoped that market transparency would have positive effects on equity trading in Europe – and these effects are still unconfirmed in practice. In view of the foregoing, we feel it would be premature to decide upon an extension of the scope of such provisions before having even tackled the first stage.

The question whether certain sets of circumstances qualify for market failure has to be investigated individually on the basis of each securities class and on the basis of each market *per se*; the second question whether such circumstances would then have to be addressed by means of voluntary action – i.e. self-regulation – or through top-down legislation, would equally merit a case-by-case decision. Every market has its own rules concerning pricing and the determination of such prices.

There are certain IOSCO deliberations concerning supervisory transparency rules as regards corporate bonds markets². For convenience, please find the comments on this special area for your information as an enclosure to the present letter. On principle, in said letter we point out that we see no need for greater transparency. This is due to the fact that we cannot perceive any market failure. There are already various market-based information sources and markets' retail share is below 3%. Hence, there is hardly any perceptible potential benefit, i.e. the cost-benefit ratio clearly speaks against an extension of the transparency obligations. What is more, such an approach would appear particularly inappropriate for the combat of fraud. From our point of view, these fundamental caveats still hold true.

² IOSCO Report of May 2004 Transparency of Corporate Bond Markets

Individual remarks

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

We object to an expansion of the scope of the report to include " all classes of financial instruments" (cf. 3.1). *In lieu* of this, we suggest limiting the scope of the report to listed securities. In terms of competition, it is MiFID's declared goal to create a level playing field between the various trading venues. Any extension to include OTC securities would generate unwarranted disadvantages for alternative trading systems. Under the MiFID, the category of shares subject to transparency requirements is specified indirectly by the stock exchanges when securities are admitted to trading on regulated markets. Any further security admitted to trading results in a competitively neutral transparency obligation for all trading venues. However, if it were not viable for a particular security to be traded on a stock exchange – due to a lack of sufficient liquidity, for example – transparency obligations for alternative trading venues would no longer be competitively neutral.

Hence, it is appropriate to limit the scope to listed securities admitted to trading on a regulated market.

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

The rationale behind the classification scheme for the various securities types seems rather not transparent, since the quality criteria for subsuming securities under the various categories have been applied inconsistently. Hence, e.g. the rationale for classification of options and futures – together with interest rate swaps – as "credit derivatives" remains unclear. A distinction on the basis of credit risks and the risk of market changes would appear to be closer to actual market realities on the ground. However, for pragmatic reasons it would appear opportune to draw a fundamental distinction between cash bonds and derivatives. Cash bonds also include Pfandbriefe and other covered bonds. The list of cash bonds could also include mortgage backed securities or other asset backed securities. However, " Collateralised Debt Obligations (CDO)" – which the Commission list subsumes under the heading of asset backed securities – belong to the category of derivatives. The group of derivatives can then be further broken down into exchange-traded products on the one hand and OTC products on the other hand. As regards off-exchange derivatives trading, last but not least, a distinction needs to be drawn between standardised and non-standardised instruments.

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

At this point, we would once more like to emphasise that regulatory action shall and must only be prompted if there is demonstrable instance of market failure which is tied to the conditions contained in the general remarks. The call for evidence lists requirements such as investor protection, market efficiency and response to technical developments. These requirements can only be met in the form of optimum solutions, not in the form of maximum solutions. In the absence of market failure and as far as the cost-benefit ratio is

concerned, over time competition and market driven changes will automatically lead to a greater degree of transparency than that which could possibly be imposed by top-down regulation. Compared to State authorities, market players will always have a decisive information advantage, meaning that they will be able to take swifter, more flexible and more efficient action.

As such, information asymmetry concerning pricing cannot yet be deemed as market failure. It just goes to show that – wherever and whenever this takes place – information procurement is invariably linked to certain costs. What is more, information asymmetry may increase the willingness of some market players to provide the requisite liquidity. Therefore, one potentially adverse impact of transparency that is imposed top-down may consist in a drain on market quality and market liquidity.

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

We support the Commission's view in the Call for Evidence that the focus of the review should be confined to selected financial instruments on the list. Nevertheless, we feel that, in addition to the reasons cited by the Commission, there are arguments which require the number to be narrowed down still further.

From our point of view, only the first three securities groups listed – and not the last three groups – are relevant as far as retail and investor protection issues are concerned.

We agree that UCITS should not be included in the list of priorities. Having said this, we should also like to point out that securities trading for UCIT's, for example in bonds, is included under the scope of review. By default, higher transaction costs resulting from a more stringent transparency regime for these institutional investors will therefore also have an indirect effect on retail investors investing in UCITS. *De facto*, this has a counterproductive impact on the actual goal.

Further to our reply to question 2, we believe that non-standardised derivatives contracts should be excluded from the review since the transparency data would offer other market participants virtually no information value.

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

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

As far as government bonds and corporate bonds are concerned, we endorse the findings from the 2006 studies presented by the Centre for Economic Policy Research (CEPR). These studies come to the conclusion that market forces create a high degree of competition and engender swift technological evolution which – provided this is required by market players – also ensures pre- and post-trade transparency. At the same time, these

studies issue a warning against potentially erratic market developments resulting from top-down transparency regulations and their potentially harmful impact on market liquidity. Although there is a study of corporate bonds which reports an allegedly positive impact of greater post-trade transparency, it also makes clear that as yet no proof or reliable data have been put forward showing the probability of this positive impact or its possible extent. In addition, the study clarifies that any regulatory intervention – regardless of its motivation and the reliability of previous analyses – invariably incurs the risk of being mispremised and that it may have unwanted and negative implications. Hence, we feel it would be advantageous to bank on market driven solutions.

Also the area of Pfandbrief and covered bond markets feature functioning market forces. Along with a high degree of liquidity, the European covered bond market is marked by strong dynamism. Electronic trading platforms play a major role in this. Here, again, we have an area where regulatory top-down transparency provisions may result in market distortion. This market caters to the needs of market participants in a self-organised and consistent manner. The European Covered Bond Council (ECBC) – the membership of which is comprised not only of issuers but also of investment banks, rating agencies, trading platforms and other market players – offers a pan-European forum for the development of market driven solutions whenever and wherever needed.

As far as derivative financial instruments are concerned (e.g. interest rate swaps and credit default swaps (CDS)), we should like to point out that these lend themselves to a certain degree of standardisation. By now, first electronic trading approaches for these swaps have emerged. This development is market driven and it strongly hinges on a sufficient degree of instrument liquidity. Contrary to this, to date, collateralised debt obligations (CDOs) have not seen the emergence of any form of electronic trading. Here, the market is very illiquid which is due to the fact that the product is not geared towards being traded in the secondary market. If needs be, the customer may address the issuer who then usually makes a further placement. The trading price can differ significantly from a fair price based on objective standards. This is due to the fact that such an illiquid market is exclusively determined by the rules of supply and demand. Along with the fact that this clearly reduces the information value added that is offered by any post-trade transparency data, we should also bear in mind that such obligations may squeeze the only provider of liquidity out of the market. The foregoing examples illustrate the point that while markets with a sufficient degree of liquidity are perfectly capable of achieving an optimum level of transparency in an autonomous manner, additional transparency requirements may – by having an adverse effect on liquidity – prevent these desired developments from emerging in the market in question. At the same time, additional transparency requirements may even have adverse effects on markets with low liquidity

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

Since item a) does not list any specific problems, deliberations on this matter are limited to an abstract nature. State intervention may resolve potential problems, in principle. Yet, this presupposes that the legislator is capable of drawing upon information which the market is either unaware of or upon which the market cannot act. In the present context it

appears unlikely that the legislator will be in a better position to judge the optimum degree of transparency than market players themselves.

According to a study by the Bond Market Association³, many bond trading platforms already provide ample scope for pre-and post-trade transparency.

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?

Equity trading takes place on systems that are different to the trade in non-equity securities. Hence, a cost-saving adjustment and extension of existing transparency systems to cover also equity trading is not possible. At the same time, it needs to be taken into account that the trading volume of non-equity financial instruments by far exceeds the share trading volume. For instance, there are some market participants who actively trade several thousand bonds. This is further compounded by derivatives, where the lack of standardisation would lead to a plethora of contracts, the sheer number of which would no longer be manageable.

b. render mandatory transparency unnecessary?

According to said Bond Market Association study (cf. 5b), EU markets offer a high degree of publications in the field of government bond markets – both, in terms of pre-trade and post-trade transparency. The study points out that corporate bonds are accompanied by a constantly rising level of transparency.

The progressive development of electronic trade is particularly pronounced in markets that feature trading of standardised securities (e.g. covered bonds, interest rate swaps and credit default swaps); this is a further reason which speaks against mandatory transparency obligations. Said development also results in improved liquidity. Trade volumes are rising whilst the bid-ask-spreads are declining⁴.

Market driven developments can remedy erratic developments caused by excessive transparency. For instance, in 1997, a decision was taken to no longer reveal the identity of the party requesting a quote. This had a positive impact on the liquidity of the Italian MTS system⁵.

Technological progress, globalisation and the introduction of constantly new financial instruments lead to swift developments on the markets under observation. As a result, the flexibility and speed with which these markets can respond to changes are vital for their success. Any additional regulatory framework conditions reduce markets' adaptation capacity and distort their competitive capabilities.

³ European Bond Pricing Sources and services: Implications for Price Transparency in the European Bond Market, April 2005.

⁴ Andersen & Baertelsen (2004), "Liquidity and Transparency in the Danish Government Bond Market"

⁵ Scalia & Vaca (1997), "Does Market Transparency matter?".

In our view, the pre-existing, constantly growing level of market transparency which is being offered through various providers (e.g. Onvista, iBoxx and other sources of information), renders mandatory pre-and post-trading transparency redundant.

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?

Protection of the entity which provides liquidity is essential for a functioning market. Compared to equity trading, banks generally assume an even far greater risk when trading bonds. Therefore, bond trading incurs an even greater need to protect banks than is already the case. Otherwise, this will lead to a risk exposure for the individual bank which, in the final analysis, may also compound systemic risks. Furthermore, since other market players may exploit this risk exposure to their own benefit, more likely than not, additional transparency will reduce the willingness and the capability to enter into those risks. In the final analysis, this would weaken the effectiveness of the overall market as a whole.

Whilst an undertaking usually only issues one share, the same undertaking may issue a large number of bonds – featuring different terms to maturity, risk profiles, interest rates and options (e.g. convertibility). The same – albeit to an even stronger extent – applies to derivative instruments. In view of the foregoing, any regulatory change of transparency requirements needs to match the specific market requirements at hand. Therefore, we have strong difficulties in comprehending the rationale behind more stringent transparency requirements as regards non-liquid securities, where trading takes place only on the basis of very long time intervals. In the year 2003, out of the approximately 70,000 bonds covered by the US TRACE system, more than 47,000⁶ of these bonds only saw one-off trading, at most. In such markets, the information value added by providing data on the last trading price is negligible – if not to say misleading.

There is a large number of securities (e.g. high-interest bonds, complex, structured products) which only have at most one liquidity provider, who sets the prices. Additional transparency requirements could bring these markets to a standstill.

The development of a structured financial product is a complex task and therefore constitutes intellectual capital. Depending on the information which needs to be published, additional transparency creates the danger of an unwanted disclosure of characteristics of these financial products. Such a lack of intellectual property protection can therefore turn into a drain on innovation.

When it comes to bonds, in an attempt to generate steady flows of payments, especially retail investors but also institutional investors (e.g. insurance companies or pension funds) frequently adopt a buy and hold strategy. The Commission's putative benefit incurred by

⁶ Edwards, A., L. Harris and M. Piowar (2004), "Corporate Bond Market Transparency and Transaction Costs".

greater transparency during the term to maturity can therefore, at best, only be observed indirectly.

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 produce any relevant data if necessary?

Latest surveys of German market participants report the share of retail transactions in the overall business volume for cash bonds to be at approximately 0.05%.

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

There are some academic papers which prove that an increased level of transparency does not necessarily lead to more efficient markets; instead, it is pointed out that quite the opposite can be the case. Hence, market efficiency is not a direct function of market transparency and the relation between these two is by no means of an exclusively positive nature. By way of example, suffice it to mention the following publications: Allen, Hawkins und Sato (2001), " Electronic Trading and its implications for financial systems" and O'Hara (1995), " Market Microstructure Theory" .

The academic literature distinguishes between two different types of information deficits: Uncertainty with regard to future developments and a lack of knowledge concerning facts that lend themselves to objective verification. In essence, the issue of uncertainty cannot be addressed by greater transparency. Where there is a lack of knowledge, such lack of knowledge can be further broken down into a knowledge deficit concerning benefits, prices and quality. The negative consequences of information asymmetries are known: adverse selection or moral hazard. These are generally subsumed under the heading of a knowledge deficit concerning quality. Mandatory transparency requirements, however, merely address the information asymmetry concerning prices. Its impact on potentially existing market failure is therefore, at best, of an extremely indirect nature. As a (German) reference we should like to mention: Fritsch, Wein, Ewers (2005), " Marktversagen und Wirtschaftspolitik" .

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

The literature shows that an extension of transparency obligations does not always generate effects that are exclusively positive; instead, this may also have an adverse impact on the market structure. These negative effects result, for instance, in a limitation of market liquidity, changes to the market structure and in competitive restraints. The 2006 CEPR study on government bonds provided an outline of various problems which may result from mandatory transparency; empirically speaking, some of these concerns have already come true. Consequently, this study comes to the conclusion that – if and when it is modelled on MiFID – a transparency regime for the market in government bonds would have to be considered with great caution (cf. page 6). It would be more

advantageous for the markets " to let them evolve further... under the influences of rapid technical change and changes on the market structures themselves (e.g., consolidation of the European banking system)" (cf. p. 6).

In their own calculations, Casey and Lannoo (2005) come to the conclusion that in 2004, only 2.35% of transactions were being conducted via electronic order books of stock exchanges or alternative electronic trading platforms (the baseline being the aggregate value of all bond transactions within the EU). For the sake of simplicity and since the institutional sector reports hardly any sales figures through such systems, said ratio can be deemed to designate the ratio of retail investors. Hence, the sheer difference in magnitude between OTC trade and floor trading already illustrates the dangers that might result from top down regulation of market structures that exclusively seek to improve the standing of an extremely small group, without taking appropriate account of the needs of the majority group of market players. This issue is further compounded, since the relation between an increased level of transparency and benefits for retail investors appears rather spurious indeed.

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

As has already been pointed out above (cf. question 7), we see fundamental differences between the pricing mechanisms that apply to equity markets and those which can be found in markets in non-equity securities. This makes any transfer of the findings obtained in the field of stock trading more complex. Market structures in bond trading and in derivative transactions are fundamentally different from those which apply to equity trading. For instance, whilst stock trading in the field of retail is primarily located on the secondary market, the secondary market plays but a minor role for retail business in the bond area.

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?

Ever since the introduction of the US TRACE system took place, spreads have gone down in bond trading. There are several reasons which induce us to issue a warning against any direct transfer of this observation to the European markets: Firstly, it appears unclear whether this phenomenon is truly caused by the TRACE system itself, the reason being that over the same period, even in the absence of TRACE, European markets witnessed a similar development. On the other hand, circumstances accompanying the introduction of TRACE need to be taken into account. In the US, the secondary market features far greater intransparency than is the case in Europe today. Hence, it remains questionable whether the effects can be transferred.

As regards trade reporting, TRACE features fundamental differences to MiFID's requirements (15 minute deadline, more comprehensive reporting scope, post-trade

transparency which is related to the compliance obligations of the issuing bank, double reporting obligation (both sides are covered by the reporting obligation) and much more). This makes any comparison with the provisions that are currently being discussed in Europe difficult.

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?

Since we hold the view that market transparency measures are neither helpful nor necessary, we feel that this question may be not applicable. Basically, however, any forthcoming provisions regulating the securities markets should take account of the European market structures.

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 feel that there are no problems which would justify regulatory intervention. Should future developments of market participants' transparency needs or a further decline in IT costs incur any changes as to what can be deemed as the optimum level of transparency, a sufficient degree of market transparency will be generated through market driven developments and vendor offerings,.

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?

With regard to the option of self-regulation it should be made clear that this does not relate to a uniform self-regulation of each and any trading platform for one or several securities classes, but, instead, that it relates to an individual regulation of the individual trading channels. This is the only way in which the transparency requested by all parties participating in the respective trading route may be created resulting in competition between different transparency regimes that ultimately benefit user interests.

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?**

Concerning all markets that have been listed above, we endorse the "no change" option. This option partly also includes the second option of self-regulation, since there are numerous market participants who have already ensured an appropriate degree of market transparency on a voluntary basis.

Contact:

Zentraler Kreditausschuss

c/o National Association of German Cooperative Banks/

Bundesverband der deutschen

Volksbanken und Raiffeisenbanken e.V. (BVR)

Diedrich Lange

Schellingstraße 4

10785 Berlin

Phone: +49 30 2021-1610

E-Mail: dr.lange@bvr.de

Enclosure