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Speech by Robert Ophèle, AMF Chairman - IOSCO/OECD Virtual Conference on Corporate Bond Markets - 24 June 2022

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Enhancing the liquidity of the Corporate Bond market is necessary but tricky we should tackle both sides, supply and demand, of the liquidity conundrum.

When we look back at the March 2020 episode on financial markets, we could be inclined to remember only the sharp drop in equity valuation and the dash for cash with the large outflows recorded by the private paper MMFs. To some extent, the corporate bond market has remained under the radar despite the fact that they are much more important than MMFs for the financing of our economies.

Such an assessment would be wrong. During the first two weeks of March, the primary market for corporate bonds almost froze and while the secondary market remained overall active, many bonds were no longer quoted and valued; ETFs looked to be the best proxy in order to get a complete valuation of some bond portfolios.

However, central bank intervention had such a very decisive impact on the corporate bond market that we might have missed the few occasions when it took place. Actually, immediately after their announcement, issuance resumed sharply; for example, during the four months from April to July, bond issuance by EU non-financial corporations amounted to

more than twice their usual amounts and the full year issuance was finally up by more than 50% versus the usual annual figure.

A deep dive in the March 2020 episode in order to understand what are the drivers and the obstacles to corporate bond market liquidity was all the more needed since relying on central bank intervention in order to stabilize the market could in no way be taken for granted. This is especially the case in the current economic environment where inflationary pressures have triggered a complete change in central banks' monetary stances. Actually, it is fair to say that here we have all the ingredients for a difficult time for corporate bond markets:

- an increase in risk-free rates derived from rising inflation and the new monetary policy stance,
- an increase in credit spreads, linked to a likely severe economic downturn, with the ITRAXX Crossover index back at its end of March 2020 level,
- a tightening of access to bank loans for corporates,
- and a discontinuance of corporate bond net purchases by central banks, with possibly a shrinking of their portfolio when they decide to not reinvest the amortizations. In order to assess the possible consequences of such a policy change, we should bear in mind that there are currently almost 400 billion euro of corporate bonds on the books of the Eurosystem (i.e. around 25% of the outstanding amount of bonds issued by Euro Area non-financial corporates).

Actually, for the very first time in many years, the net issuance of bonds by Euro Area corporates during the first four months of the year has been in negative territory.

An in-depth understanding of the drivers of corporate bond liquidity would appear therefore highly relevant.

You have many insights and many questions raised on these issues in the IOSCO report and they will be discussed later today during the conference. I will concentrate this introductory speech this morning on two topics only: the growing role of open-end funds which are seen as driving the bulk of the demand for liquidity and possible ways of enhancing the liquidity supply in the corporate bond market.

The fund industry has become an important investor in the bond market and more specifically in the corporate bond market. In most cases it is through open-ended funds providing daily liquidity to the holders.

For example, in the Euro Zone, open-end funds have multiplied by 2.5 their holding of corporate bonds in the course of the last ten years; they currently hold more than 25% of the outstanding amount of bonds issued by Euro Area non-financial corporations; an amount, similar to the holding of the Eurosystem.

While institutional investors are mainly long term investors with a buy-and-hold strategy, open-end funds could be subject to large outflows with holders rebalancing their portfolio more rapidly than investors directly holding the bonds. To some extent, open-ended funds could be more concerned by secondary bond market liquidity issues than other market participants, either by adding/exerting additional selling pressure in this market at time of stress or by being directly affected by a sudden onset/bout of market illiquidity.

To be more specific, some Authorities consider that open-ended funds have emerged as a significant source of systemic risk over the last years, with a possible amplifying effect of their intermediation which, in one way or another, could lead to faster asset sales than if investors held the assets directly. This would be due to the fact that open-ended funds:

- offer the promise of higher liquidity of units than the underlying assets;
- they incorporate pro-cyclical incentives in their valuation methods, which in the event of a crisis, could generate a first-mover advantage and trigger runs;
- their managers are inclined to lower their holdings of liquid assets in a buoyant market and quickly increase them significantly in times of crisis.

I nevertheless do think that we should not overstate these risks. They could be addressed by an appropriate use of liquidity management tools and regulatory overreaction would be highly counterproductive, resulting in a push for banking re-intermediation, a shift in favour of asset management without fund intermediation through managed accounts or simply, the drying up of one of the channels for financing the economy... or all three happening at once.

Regarding liquidity management tools, they appear to be particularly necessary for corporate bond funds since the liquidity of these bonds is obviously rather fragile. While these liquidity management tools are primarily trending towards an equal treatment of investors, they have also stabilizing features. Depending on the circumstances, the fund manager needs to be ready to:

- Charge the cost of liquidity to investors leaving (or entering) the fund when the markets for the underlying assets are rather illiquid and thus see their bid-ask spreads widen; they should use tools such as swing pricing or anti-dilution levy mechanisms;

- And, in exceptional circumstances:
 - When redemption demand become difficult to manage or goes over a certain threshold, activate gates to ensure that outflows are spread over time and avoid panic selling of assets;
 - Split the fund by isolating those assets that become impossible to value in a side-pocket (provided these assets are a small portion of the fund and the inability to value them is expected to last);
 - Suspend outflows (or inflows) if a significant portion of the fund's assets becomes impossible to value or if the inability to value a small portion is likely to be very temporary.

Actually, when valuation is difficult or indeed impossible, this is because the assets have become highly illiquid and it is precisely under these circumstances that investors decide to exit the fund, sometimes in large numbers. Measures that avoid creating a first mover advantage, because withdrawals can only be honoured with the fund's most liquid assets, can prevent investors from becoming artificially motivated to exit and, if the crisis is particularly severe, they can reduce (via gates) or even halt (via suspension) withdrawals.

As long as these tools are available and activated in a timely manner by asset managers – and here, there could be a need for regulatory guidance – the liquidity risks are not greater than those resulting from direct holding and, from a financial stability perspective, fund intermediation is rather/somewhat preferable: funds can diversify the liquidity risk of individual investors; gates can act as specific type of shock absorber and, in any case, the monitoring of risks by public Authorities is made easier by fund intermediation. By reducing selling pressure artificially, demand for liquidity, of corporate open-ended funds would only incentivize investors to shift to direct holding of the bonds or to ETFs.

So, in short, corporate bond open-ended funds are not by construction bond market illiquidity amplifiers.

It does not mean the liquidity of these markets should not be enhanced, by improving the supply of liquidity. While the idea of alleviating the prudential supervisory framework – more specifically the leverage ratio – in order to incentivize the development of market-making activities by banks is unanimously considered inappropriate by public authorities, some technical measures are worth exploring and are mentioned in the IOSCO Report. One key avenue to explore would be to increase transparency requirements and develop, on this basis, all-to-all trading in some limit order book electronic venues. Mobilizing the buy-side as possible liquidity providers could indeed be a welcome complement to the usual RFQ dealer trading model.

With this in mind, finding the adequate level of transparency is obviously key and, as is often the case, we end up with the usual chicken and egg scenario: if the market is illiquid you can advocate that there is a need to be less transparent in order to allow market-makers to manage their book and hedge their risk; however if you are less transparent you will not attract liquidity. Furthermore, we have contradictory requests coming from the very same market participants who, simultaneously, consider the very same bonds should be considered illiquid from a transparency requirement perspective but highly liquid from a prudential regulation perspective.

From a transparency perspective, it is fair to say that in Europe, be it the UK or the EU, bond market transparency is rather low when compared to the US. The transparency requirements are very slight and they are not centralized in a consolidated tape.

It is nevertheless all the more opportune to revisit this issue now that wholesale market reviews are being carried out both in the UK and in the EU with the MiFIR review.

More specifically the revision of MiFIR aims at simplifying the existing system by defining the transparency rules on only two pre-defined criteria: the issuance amount and the size of the transactions. Deferrals, price and volume, would be calibrated according to these two criteria.

Since the bond market is also quite fragmented and still essentially OTC, the MiFIR review also aims at organizing the creation of a post-trade consolidated tape, which should allow all market participants, and in particular investors, to have a comprehensive view of the market (which only few currently have) and narrow the asymmetry of information. I understand that there is huge appetite for developing this corporate bond consolidated tape. In that respect the project recently announced involving three of the largest bond platforms to explore a joint proposal for a consolidated tape looks quite promising.

But let us be frank, there is no silver bullet for making radical and rapid enhancements to corporate bond market liquidity. Only combining efforts both on the demand and on the supply sides could to some extent reduce risks of liquidity crisis. Let's do our best collectively in order to make progress in this field.

This is precisely the purpose of the following roundtables.

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