



EFFAS THE EUROPEAN FEDERATION
OF FINANCIAL ANALYSTS SOCIETIES

RESPONSE

from the EFFAS - European Bond Commission

**to the Call for Evidence from the Committee of European Securities Regulators
(CESR)**

Non-Equities Markets Transparency (Ref.: CESR/07-108)

6 March 2007

Dear Madam / Sir,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 24 members representing more than 14,000 investment professionals in the areas of Equity and Bond Research, Asset and Portfolio Management as well as Investment Advice.

The EFFAS-European Bond Commission is an autonomous body of European fixed-income analysts working under the aegis of EFFAS (the European Federation of Financial Analyst Societies). It consists of fixed-income analysts from all over Europe, consisting of bond market professionals across many business sectors, including investment management, bank treasuries, stock broking, corporate finance and even national debt management, as well as observers from numerous authorities from central Banks to regulators. The Commission can offer a unique insight into the structure, composition and current trends in European fixed income markets.

Having earlier responded to the call for evidence from the European Commission regarding 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 ("The earlier response") we intend in this submission to focus on the relationship between transparency and market failure. We will try to restrict any repetition of comments made in the earlier response to a minimum, but beg your indulgence in the instances where we find it necessary to repeat ourselves.

Without a clear definition of "market failure", or at least a set of criteria whereby to judge whether a market failure has taken place it is difficult to address whether such market failure may have been from time to time evident. Since neither the Commission, nor CESR give any clear definition of market failure, we are using what the FSA considers might be a manifestation of market failure¹ as a starting point for the purposes of this submission. Whilst we generally agree with the FSA's description of market failure as it stands, we would nevertheless argue that it omits a key type of event which would exemplify market failure: we would argue that there is clear market failure if those who owed a duty of best execution failed to find ANY prices for their clients (let alone the best obtainable price, as described in the FSA consideration).

¹ In its discussion paper DP 05/05, the FSA considers that "a market failure might manifest itself if:

- *there might be inefficiency in the price formation process*, with some participants being unable to judge at what price to place orders and whether it was appropriate to hit/lift quotes; and
- *that there might be a failure of best execution*, if those who owed a duty of best execution failed to find the best obtainable prices for their clients.

Further, such failures might be reflected in:

- *wide spreads* might indicate insufficient competition (although we [the FSA] recognised in the DP that determining the size of spread in a given bond that would indicate a market inefficiency would be very difficult);
- *a wide dispersion of prices* for very similar trades in the same instrument and around the same time (this might reflect an informational inefficiency, with some participants materially better placed than others to judge at what prices to trade);
- *low participation rates* might reflect a lack of confidence on the part of some types of investor to trade in these markets, or that some form of barrier to entry might exist; and
- *a high level of user complaints* might reflect that a market failure of some form existed."

Furthermore in our opinion such an event is a sufficient condition to indicate market failure. We would argue that an examination of this criterion for market failure may provide a limit to the optimal level of transparency for the bond markets.

The level of transparency required to avoid market failure in the bond markets is significantly lower than that required for other markets. This is because, as we have mentioned in the earlier response, any bond is simply a set of cash flows, for which both the amount and the payment date is known. In addition, for bonds with default-risk there is the question of the likelihood of the cash flow being paid, known as "credit risk". But putting questions of credit aside temporarily, the present value of a certain cash flow is easy to compute, and depends entirely on the discount rate used for that computation. That discount rate is relatively easy to observe (or interpolate) from the market, inasmuch as a so-called zero-coupon or spot curve will be relatively straightforward to deduce from the set of observable prices in the sovereign and supranational bond market, even if not ALL bonds in that market have instantaneously observable prices. The point is that since cash is fungible, and discount rates for different maturities are easily derived from observed market prices, there is no need for a credit-risk-free bond to have an observable and tradable price observable in the market for a fair-value price to be calculated. As a result the activity of price formation for a bond (as described more fully in pp16-18 of the earlier response) does not rely on the existence of a recent trading price for that bond. Indeed the bond markets, having long ago recognised 1] that most bonds trade seldom if ever, and 2] that the characteristics of bonds make all bonds exceptionally comparable in a way that for example equities or real estate are definitely not, has equally long ago settled on a basic framework for price formation which essentially relies on deriving prices for bond A (which has not traded recently if at all) by comparing its characteristics with those of bonds B and C (and if necessary bonds D, E... etc.) which have traded recently. The mechanics of such price formation may sometimes be complicated particularly when the bond is not deemed default-risk-free and the dimension of credit is involved, but it is generally acceptable for market-trading purposes: indeed other than for the set of the most liquid bonds (which is unlikely ever to include even as much as 1% of the bond issues outstanding) that is how all bond prices are formed. The proof of this pudding lies in the fact that countless models used for valuation purposes by traders or investors or even data service providers do rely on such a parametric pricing systems; and practical real-time calibration by comparing the prices advanced by such a model for specific bonds which happen to have traded with their observed trade price confirms the accuracy of such an approach. In passing, one would comment that if such models did not actually reflect reality, they would not be used: calibration is simply a confirmation of the fact that the underlying price formation does in fact take place in the manner described.

The account given above of price formation goes to the heart of the relationship between (post-trade) transparency and market failure as described by the FSA. Because most bonds do not trade regularly if at all, the reliance by market participants of all types on the price formation methodology partly described above implies that it is not the transparency of ALL bond transactions that is vital to the process, but merely the transparency of a reasonable (and relatively small) subset of bonds, upon whose observable prices a fair-value price for a much larger number of bonds can be constructed.

Furthermore, there are numerous subscribable systems available for use by market participants (though usually not by retail customers, unless they subscribe to the service) for evaluating the correct price of a bond in real-time. That market participants do not require additional transparency in order to avoid market failures as described by the FSA is clear to us. That total market transparency would not provide directly observable prices for the great majority of bonds (since these seldom if ever trade) is equally clear to us. That some additional market post-trade transparency that would be minimally onerous (since most trades are reported for regulatory and other purposes anyway) would add positively to the bond markets is also clear to us for reasons given in the earlier response, but NOT because it would help to avert market failure. Indeed as we hinted above, we feel that too much market transparency could add to the possibility of market failure, simply because in a state of limited capital available for trading operations, market makers may wish to dedicate the use of a scarce resource in an area with less transparency. This could indeed lead to a drop in liquidity, and eventually to the prospect of a market failure coming from the lack of ANY price. But, as we have previously argued in pp7-8 of the earlier response, the microstructure of the bond markets makes it somewhat unlikely that such a negative effect will ever be felt.

With regards to retail investors investing directly in bonds (as opposed to bond-based products), we would greatly welcome the publication of transaction data for trades of a size below a specified threshold, probably in the form of a daily compendium. While this will not lead to the observation of trading prices for bonds that have not traded, it may well encourage retail investors to feel confident that their position of informational asymmetry is not exploited by financial intermediaries with greater knowledge.

Finally, we would reiterate our view expressed in the earlier response that no amount of transparency of the type sought is likely to impact significantly on the more egregious abuse of bond markets within products specifically structured for retail. In most cases, such product is not directly a bond market product, but may in part be derived from such bond market product. We still feel as we mentioned in the earlier response that retail targeted interest-rate related products sold through a retail network and either unlisted or not publicly traded (or both) should be subject to greater overview. It is our opinion that such product if properly identified should be subject to a requirement whereby the sponsor of such product would be legally constrained to publish daily a price at which it would be willing to repurchase the product. This is, in our view, the only sensible way to protect the retail investor in such cases.

Yours sincerely,

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