

Addressing the Liquidity Challenge

Michael Krautzberger

ECB Bond Market Contact Group

Frankfurt am Main, 1 July 2014

The challenge – deteriorating liquidity in the corporate bond market

Challenged secondary market liquidity in the corporate bond market has been a topic of increasing concern to both institutional and retail investors for the past several years

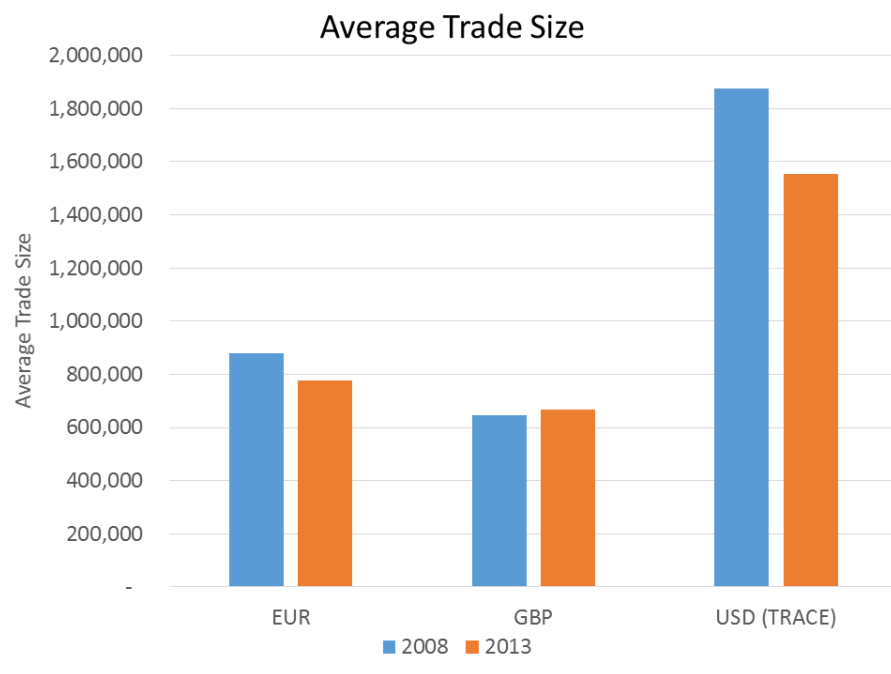
COST OF DOING BUSINESS

Average High Grade Bid-Offer Spreads, 2013–2014



Sources: MarketAxess and BlackRock Investment Institute, May 2014.

Note: The bid-offer spreads for U.S., euro and sterling high grade corporate bonds are one-year averages and represented as a percentage of price.

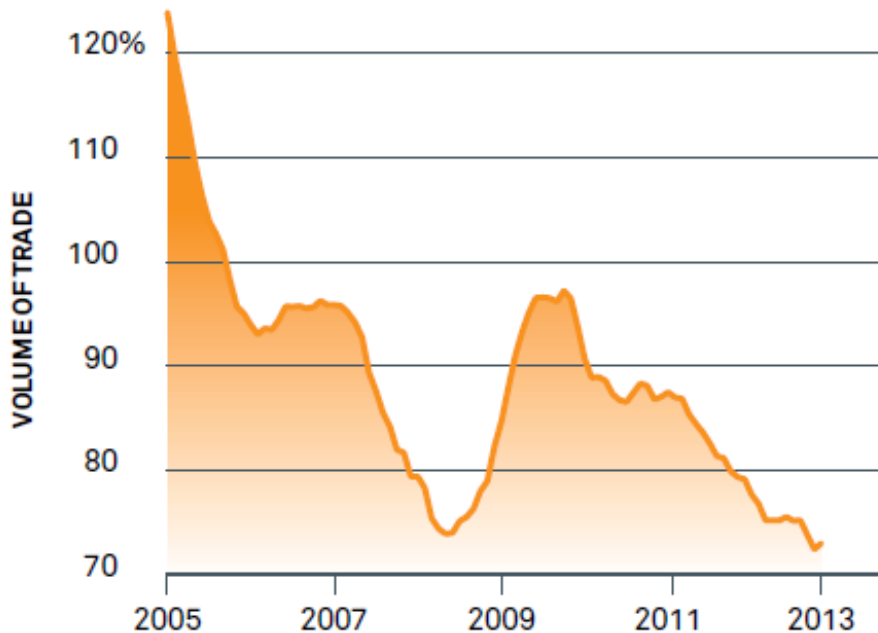


Source: MarketAxess estimates

Secondary market liquidity has deteriorated as the corporate bond market's size has grown in recent years, driven by record issuance

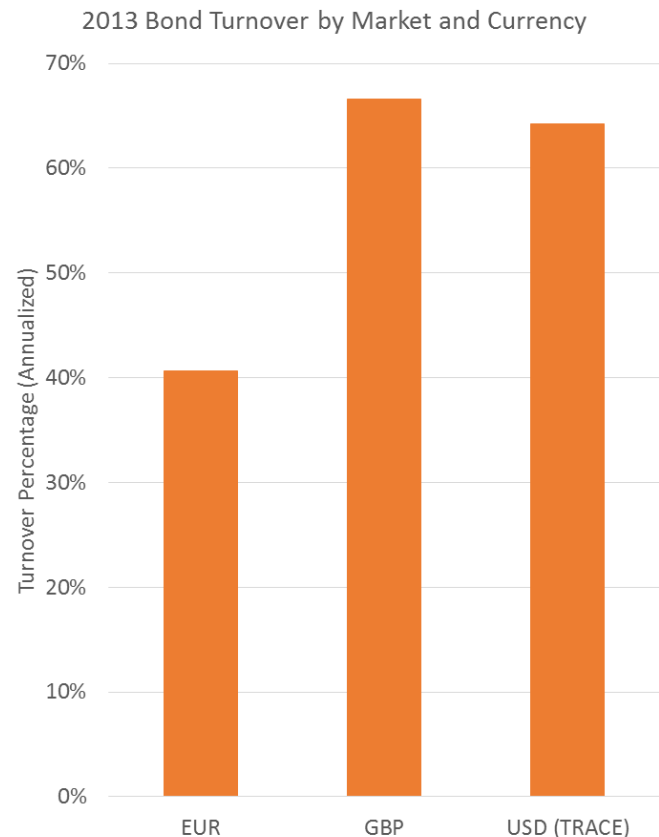
IS THIS A BULL MARKET?

US IG Bond Volume as % of Outstanding Debt, 2005–2013



Source: MarketAxess, March 2013.

Note: Line represents 12-month rolling value of trade as share of outstanding debt.



Several market changes can contribute to an environment of improved liquidity

There is no “silver bullet” which will cure the liquidity challenge

However, there are four drivers which, in concert, have the potential to substantially improve liquidity

- ▶ Standardization of new issue activity
- ▶ Broadening of trading to an All-to-All environment, uncovering latent liquidity
- ▶ Adoption of new eTrading protocols, reducing reliance on scarce dealer capital
- ▶ Behavior changes by market participants that recognize the fundamentally changed landscape

Of the above drivers, electronic trading venues have seen the most activity to date

- ▶ Broader eTrading activity will be an important driver
- ▶ However, without a concurrent change in the underlying market structure, will simply transfer voice activity, rather than truly broaden liquidity

Addressing the challenge

Numerous efforts aimed at addressing the challenge of deteriorating liquidity are being explored by market participants

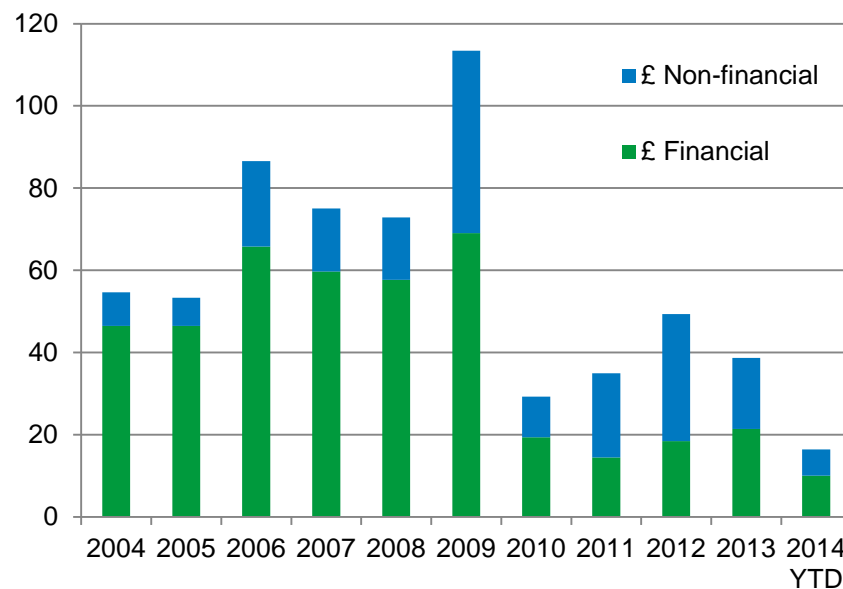
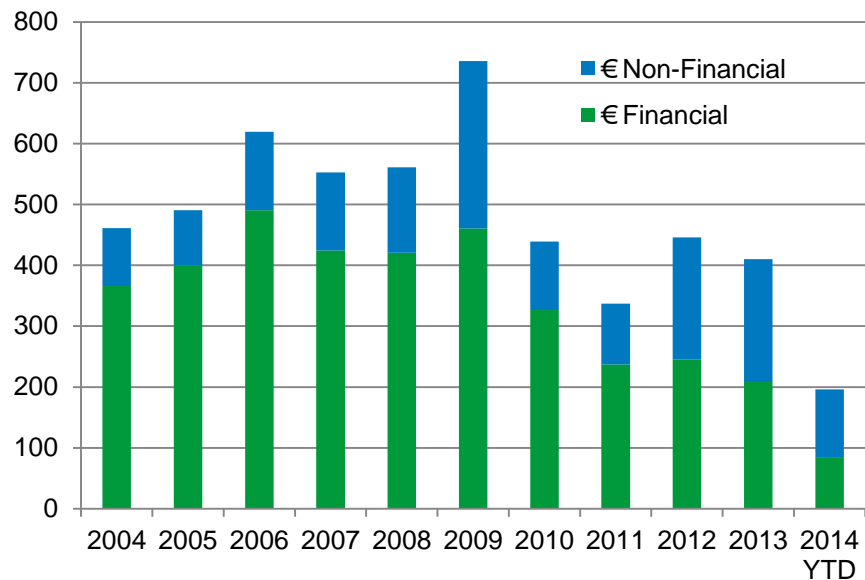
Most are focused on new trading venues – client-to-client trading, exchange-like venues with a central order book

- ▶ Several dealers have developed proprietary electronic trading platforms

To date, little focus on the impact of new issue practices on market structure

- ▶ New issue activity is critically important to the structure of bond market, far more so than in equities

Corporate Bond New Issue Volume (bn)



New issue practices have contributed to a market structure that is inherently illiquid

Companies tend to issue bonds whenever financing needs arise or opportunities present themselves

By staggering issuance schedules and diversifying maturities, companies can minimize risks of refinancing and higher rates when credit markets are expensive (or closed)

As a result, trading is fragmented across thousands of bonds of varying maturities

Issuer	Bonds in Barclays Euro Index	Share of Amount Outstanding	Total Euro bonds Outstanding
Rabobank	20	49%	218
BNP	22	24%	1011
VW	22	50%	86
GE	22	58%	63
Intesa	16	13%	755
Credit Agricole	15	15%	1047
HSBC	15	49%	275
ING	15	29%	558
BFCM	16	28%	230
Telefonica	13	65%	30

More standardized issuance – a tool to enhance liquidity, transparency, and access

Standardization would reduce the number of individual bonds - via steps such as issuing similar amounts and maturities at regular intervals and re-opening benchmark issues to meet ongoing financing needs

Standardized terms would improve the ability to quote and trade bonds

Standardized issuance would;

- ▶ Enhance secondary market transparency and encourage liquidity
- ▶ Greater transparency and access for retail investors
- ▶ Lower new issue concessions, lower volatility, and more reliable market access for issuers

Adjacent markets such as government bonds, credit default swaps, and agency & supranational bonds have all experienced standardization in the preceding two decades

What is corporate bond standardization?

Guiding principles

Enhance liquidity in OTC corporate bond markets via 3 inter-dependent components of new market structure

- ▶ Issuance of standardized corporate bonds
- ▶ Increased use of standardized index products, such as ETFS and others
- ▶ Increased use of standardized hedging tools, including cleared interest rate swaps and credit default swap indices

Concentrate liquidity by reducing the vast number of unique securities

- ▶ Facilitate larger benchmark issues and ultimately reduce the number and size of relatively illiquid securities
- ▶ Increase in securities eligible as high quality collateral
- ▶ Applicable to both small and large, frequent and infrequent issuers

Increase reliability of market access for issuers

- ▶ More regular, predictable, reliable market access
- ▶ Dampen volatility

Lower costs

- ▶ Financing and issuance costs for corporate borrowers
- ▶ Transaction costs for investors

Increase price transparency

- ▶ Easier for regulators to monitor credit market conditions
- ▶ Facilitates greater retail market participation
- ▶ Enable corporate bonds to act as primary credit risk benchmark, instead of CDS

More standardized issuance – a tool to enhance liquidity, transparency, and access

For discussion:

- ▶ How much concentration is optimal. Should a corporate have more bond lines than a sovereign?
- ▶ Can more concentrated liquidity be attractive for market makers?
- ▶ Will such a standardization be tougher in Europe?
- ▶ Will increased issue sizes lead to more concerns about refinancing risk in times of stress? Can call options improve this?

BLACKROCK[®]