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# Report on CESR's Wholesale day

CESR's wholesale day took place in CESR's offices in Paris on 20 February 2006. CESR's Chairman, Mr Arthur Docteurs Van Leeuwen, chaired the meeting. . A wide range of industry representatives, including EuroMTS, Bloomberg, Reuters, S&P, Moody's and other market participants identified by the relevant European associations together with academics from London Business School and the Centre of European Policy Studies, participated in the discussions. Also present were representatives from CEBS, CEIOPS, the ECB and the Commission. A list of participants is provided in the attached Annex. This note highlights the main conclusions of the discussion by market participants.

The aim of this roundtable was to identify current major trends in wholesale markets and to assess whether any regulatory or supervisory implications existed. The discussions helped CESR to prepare its contribution to the Financial Stability Table of the European Financial Committee and generally speaking its future activities. The conclusions drawn from the meeting were included in the CESR/CEBS/CEIOPS contribution to the Economic and Financial Committee (EFC) on the functioning of the Bond Markets.

The wholesale day was organised in three sessions:

Session 1: primary market operations

Session 2: secondary market operations:

- trading venues,
- bond price formation,
- risk analysis.

Session 3: The impact of public regulation on market choices and conclusions.

Each session was introduced by two or three brief presentations given by invited participants. The following conclusions were drawn from the discussions and the presentations.

**On Primary markets:**

European bond markets have undergone rapid changes in the past few years, including the development of Pan-EU electronic secondary market trading platforms. Increasing standardisation of market conventions leading up to Economic and Monetary Union (EMU) greatly improved the comparability of bond issues.

Around half of all bonds listed in the European Union (EU) are listed in Luxembourg or London. European investment banks hold strong positions as book runners in the European bond primary market, particularly in euro-denominated supranational bonds, government agency bonds, covered bonds and corporate bonds.

In the Eurobond market where private placements take place, smaller spreads are observed in comparison to public offerings. Private placements are more attractive to issuers because an issuer with a strong credit quality can better tap the market at the time of its choice. Private placements seem to be quicker methods to raise capital instead of alternative distribution channels. EU governments have increasingly turned to private intermediaries to help them place their debt issues.

The importance of credit rating agencies in recent years has increased. This is considered to be beneficial for the market functioning, even though not a substitute for adequate disclosure. The commercial success of most debt instrument issues largely depends on the rating granted. A rating has become a pre-requisite for seeking external financing in the securities markets, especially when issuers do not have an established presence in the debt markets.

There are concerns on International Financial Reporting Standards (IFRS) which seem to result in EU issuers seeking listings in non EU exchanges or in the "unregulated" EU markets in order to avoid the application of IFRS. The same applies to non-EU issuers, who are facing uncertainty on whether and when the European Commission is going to consider US, Canadian and Japanese GAAP equivalent for the purposes of the Transparency Directive.

**On Secondary markets:**

With regard to **trading venues,** it is observed that most EU bonds are listed on an EU stock exchange. However the vast majority of them are traded off-exchange. The off-exchange trading of the European fixed income securities is performed either via electronic trading or via voice brokers. Both use D2D (dealer to dealer) and/or D2C (dealer to customer) systems.

The electronic trading platforms are the dominant trading venues in government bond trading in the EU. However a far from negligible portion of the government bond market is still intermediated by voice brokers. Some of the electronic trading systems have devoted segments that support the electronic execution of corporate bond transactions and less liquid debt securities, such as asset-backed and mortgage-backed securities. However, voice brokerage continues to be largely predominant in the corporate bond markets.

As regards trading platforms, there seems to be enough variety of electronic trading venues. However, the characteristics of the different microstructures of these platforms should be adequately considered and relations with the post-trading infrastructures should also be assessed.

According to a recent CEPS study[1], the total turnover of bond trades in the EU is estimated to be 29 trillion euros per annum out of which one third (9.7 trillion euros) is traded on-exchange. Of the latter figure, 683.4 billion euros is estimated to be the annual turnover of the electronic order book transactions; i.e. around 7 per cent of the total amount traded on European exchanges per annum.

The available over the counter (OTC) trading information is not fully consolidated, although some information providers consolidate quotes from a range of dealers on a bond-by-bond basis. Different data sets provided by different information services, in most cases at a cost, can result in access to a broad range of data being costly for smaller institutional investors and prohibitive for retail investors.

With regard to **price formation**, in the OTC markets the bond price formation is decentralised and mostly set by dealers who hold inventories. Price discovery mechanisms are not continuous as in the equity markets. The liquid segments of the bond markets (e.g. government bonds, investment grade bonds) are tightly priced because the issues are of larger sizes, bonds are usually tradable via electronic trading platforms, issues are more standardised, there is more competition and committing capital is less costly for the dealers.

In illiquid bond markets, dealers are prepared to service their clients' base by making a market for the bonds, but they are reluctant to expose their quotes to their competitors, as this may result in their competitors attempting to exploit this information in the D2D market. In these markets, bonds

[1] J.P. Kasey, K. Lannoo, "Europe's hidden capital markets", Belgium 2005.

are more expensive to trade as they have smaller issue sizes and fewer dealers are willing to trade and commit their capital. In the liquid segments of the market it is easier to find firm quotes; in the illiquid segments of the market it is more common for quotes to be indicative.

No case has been made (particularly from the sell side) to expand the pre-trade transparency regime to financial instruments other than shares. More open (light case) is the debate for post-trade transparency.

Finally, with regard to risk, there seems to be uncertainty about the valuation of illiquid assets and credit derivatives. In addition, there seems to be a trend to increased leverage due to Leveraged Buy-Out (LBO) activities. Leveraged Buy-Outs are effective instruments to disperse the risk in the market. However, the anticipation by current managers could lead to a considerable shift towards more leverage and therefore more risk for bondholders. Some concern was expressed on the nature and appropriateness of information provided to clients during private placements.

According to participants, hedge funds do not currently represent an immediate source of systemic risks. However, the issue is serious enough to be closely monitored. CESR's concerns include investor protection issues (e.g. fitness and properness of the manager, quality and independence of valuation of assets, transparency and disclosure, prevention of fraud, conflict of interest) and financial stability issues (e.g. the possible impact of a big hedge fund or a group of hedge funds collapsing, the level of leverage used and the impacts to counterparties). The split between professional and retail unit holders still represents a critical issue.

### On the impact of public regulation on market choices

The growth in the private equity market presents a number of issues that warrant consideration. Such as the effect that continued growth in the private equity market relative to the public market may have on the efficiency of the overall capital markets; whether the leverage and the illiquidity inherent in private equity structures may increase the risks to financial stability; and whether market standards, including those related to transparency and disclosure of overall activities, remain appropriate given the increasing, albeit indirect, interest of retail investors.

For some products, given the existing low level of disclosure and lack of documentation and standardisation of covenants, the case has been made for self-regulatory initiatives. CESR will monitor the progresses made in this respect.

### Conclusion

Wholesale markets seem to be functioning properly and CESR will continue to monitor these activities with periodic meetings with market participants.

ANNEX

CESR Wholesale Day
Paris, 20th February 2006
Participants

| Association/Entity | Name of Participant |
|---|---|
| CESR Chairman | Arthur Docters van Leeuwen |
| CESR | Carlo Comporti |
| CESR | Alexandra Berketi |
| EuroMTS | Gianluca Garbi |
| FESE | Hubert Grignon Dumoulin |
| FESE | Gonzalo Gómez Retuerto |
| Bloomberg | Doug Kemp |
| Reuters | Martin Oakley |
| Bond Market Association | Craig Abouchar |
| Bond Market Association | Christophe Rivoire |
| ICMA | Robert Gray |
| ICMA | Nigel Denison |
| FBE | Grant Ashton |
| FBE | Marc Henry |
| European Savings Banks Group | Lars Röh |
| European Securitisation Forum | Philippe Z. Tromp |
| European Association of Co-operative Banks | Olivier Motte |
| ISDA | David Pasquier |
| ISDA | Atilla Ilkson |
| Moody's Cooporation | Frederic Drevon |
| Standard & Poor's | Blaise Ganguin |
| EFAMA | Volker Marnet-Islinger |
| EFAMA | Alex Wear |
| Dawnay, Day Olympia Ltd | Ian Morley |
| ADI Gestion | Christophe Lepitre |
| AMTE | Jean-Paul Rigaud |
| CEPS | Karel Lannoo |
| CEPS | Jean-Pierre Casey |
| London Business School | Richard Portes |
| CEBS | Thomas Dietz |
| CEIOPS | Sandra Wesseling |
| European Commission | Marion Dewar |
| European Central Bank | Olli Castren |