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International Organization of Securities Commissions
Madrid, Spain
IOSCO Corporate Bond Market Liquidity Review

By email: CBML-feedback@iosco.org

Corporate bond markets – drivers of liquidity during COVID-19

The Australian Financial Markets Association (AFMA) is providing an Australian industry view on the International Organization of Securities Commissions (IOSCO) solicitation of views on *Corporate bond markets – drivers of liquidity during COVID-19 induced market stresses* in March 2020, for a real world insight into how corporate bond markets operate under stressed conditions.

1. Australian Corporate Bond Market Context

The IOSCO consultation is focused on the corporate bond market but given the size of the bond market in Australia, we broaden the scope of commentary to consider general conditions across all sectors. In our feedback to IOSCO AFMA wishes to contextualise the Australian feedback by noting the relatively small size of this market compared to other domestic financial markets and the importance of offshore funding as a characteristic of our market.

2. Feedback

This feedback is divided into qualitative assessments from the perspectives of Issuers, Investors, Traders, and Syndicates.

2.1. Issuers

As is common, major Issuers were dealing in markets in Australia and Europe when the COVID-19 pandemic began and initially saw issuing and trading activity come to a rapid to a halt along the curve in shorter term funding markets (Commercial Paper – CP) and longer term funding markets (Medium Term Notes – MTN).

Investors became risk averse and began to hoard cash which was invested in term deposits and cash balances. Selling pressure in longer term paper was particularly notable as investors shortened duration in their portfolios. Consequently, spreads on corporate paper widened dramatically. Dealer fees also rose reflecting the additional work that needed to be done by intermediaries.

An example was cited of a highly rated Issuer being able to get large Euro transaction away in April 2020 taking advantage of investor appetite for the Issuer's paper, although the premium to issue over previous issuance was substantial. This reflected good liquidity for highly rated issuers if they were willing to pay the premium. The European MTN market started to return after about 4 months.

Consideration was given to the IOSCO report that investors providing liquidity were typically "buy & hold", but it was difficult to discern this from an Issuer perspective. Issuers would like to see banks and intermediaries assist market functioning more with understanding Investor sentiment when market conditions become challenging and more so to understand when over time how their sentiment changes after the initial shock.

US markets also had sufficient liquidity, but issuers had to pay for it with increased spreads. Liquidity was available for highly rated Issuers and issues, but anything rated BBB and below was hard to do. Conditions in European and US markets eased after 4-5 months but the Australian market took longer.

2.2. Investors

Fund managers experienced a large amount of redemptions as the pandemic started to unfold. Market conditions for depth and liquidity were both very poor as a number of sell-side counterparties withdrew from the market. Some intermediaries did provide pricing or matching services but trying to sell anything was very challenging. Issuers that were vulnerable to the pandemic, such as airlines, were hard hit and it took a long time for investors to return to those names.

Long term effects continuing up to the present were noted. For example, the ITRAXX has widened by 20 bps. Not all counterparties are willing to trade broadly across names preferring to stick to what they see as "good names". It is questionable whether the market has learnt lessons from 2020 and would react any differently now.

2.3. Traders

From a trading perspective there are several key issues that were identified.

- The ability of banks to warehouse stock is down significantly from pre-GFC levels due to new regulations and a reduced risk-taking focus by the banks.
- In Australia, there has also been a reduction in focus on credit trading activities in the interdealer market. JLMs no longer provide the same support for transactions and are absent when liquidity is needed. It was emphasised that 2020 was a liquidity crisis not a credit crisis like the 2008 Global Financial Crisis.

- The pandemic saw many banks shut down all risk-taking activities and not just credit. Some banks did remain committed to the market, but the paucity of price makers exacerbated liquidity issues.
- Australian institutional investors and clients are growing rapidly due to compulsory superannuation and are getting to the point where their ability to enter into transactions dwarfs the portfolio holding capacity of sell side institutions.
- Regulatory intervention in allowing superannuation funds redemptions put pressure on the front end of the curve and the participation of ETF funds and index funds facing redemptions peppered the market all day with trading requests which severely damaged market sentiment. The presence of ETF funds had a big effect.

Dealers felt they had tried to facilitate (price making and transacting) as many institutional investors and clients as they could. The fixed income market lagged the price falls in equity markets, but it seemed clear that the correction in bond prices was going to be deep. As a result, dealers became discerning in deciding who they were going to make prices to and who they would not.

Generally, there was a step back in risk taking appetite in the interbank market that started with the short end. Trying to get a handle on fair value further out the curve is challenging even in a normal market, so trying to find fair value when markets were dislocated was almost impossible. Price making and hedging services were difficult to provide in these circumstance and this was reflected in pricing.

It took some time for traders and clients to step back into larger transactions. The size of the take up (orders) in some large deals was reduced substantially and JLMs had to deal with many more clients in smaller parcels. This made price discovery when launching a deal very difficult.

2.4. Syndicates

The impact on Syndicates was a combination of everything that happened in the market. It was difficult to meet Issuer and Investor expectations and bring deals to the market when there was:

- a lack of transparency in pricing,
- little appetite to provide price support for new transactions,
- a lack of liquidity in secondary trading,
- a rising number of redemptions; and
- a lack of certainty.

Primary and secondary fixed income market were functional and market conditions were reasonably good in early February 2020. Two months later in April conditions were difficult.

The adverse market conditions were not isolated to one sector, asset class or market. These dynamics affected all global bond markets. As the saying goes “confidence breeds confidence” and markets were relieved that central banks provided that confidence by indicating that they were going to be there to help stabilise markets.

This gave the market confidence that things would get better and that the market would become functional again albeit at a price.

The widening of credit spreads in secondary trading elevated new issue premiums. The widening of credit spreads in offshore markets fed through to the local market. The market difficulties were not just limited to the corporate bond market. Australian Government Securities (AGS) and semi-government securities were also affected.

3. Official Market Support Evaluation

Consideration was given to the question of market support that the Reserve Bank of Australia (RBA) and financial sector regulators provided to the Australian market Australia.

As part of the comprehensive policy response to the effects of the pandemic, the RBA established the Term Funding Facility (TFF) to offer low-cost three-year funding to authorised deposit-taking institutions (ADIs aka banks). The facility closed to new drawdowns on 30 June 2021. One of the main objectives of the TFF was to encourage ADIs to support businesses during a difficult period, ADIs could access additional low-cost funding if they expanded their lending to businesses. This lending was not available to institutional investors. While, the RBA implemented quantitative easing to support fixed income markets this started with AGS and semi-government securities and then followed out to support to other asset classes.

It was felt that the TFF had generally influenced pricing down because corporate spreads stayed wide. This low pricing still affects pricing in the MTN market. The objective of encouraging bank lending to the SME sector from the TFF and commercially unattractive tightened covenants meant in practice it was generally not available to large corporates.

Support for corporate bonds came last in the queue. This occurred through the move by the RBA to broaden the range of corporate debt securities by reference to their investment grade credit rating that are repo eligible as collateral for domestic market operations in early May 2020. This helped to reinvigorate the entire market. A major airport infrastructure Issuer raised A$850 million following this development. The transaction was expensive for them, but it demonstrated that the buy-side and the sell-side were able to meet and agree on a price. The issue was taken up by Australian investors demonstrating that money was available but had to find the right price level.

Generally, it was felt that the interventions and support shown by the official sector reached a point where the market found its feet and financial issuance returned quickly. A review by the RBA of how the TFF funds were utilised and effect on the market would be desirable.

4. Market Reopening

The market needed a “champion” to reopen the market and a big-name retailer provided this in mid May 2020 when they issued 3 and 10 year securities. As soon as that deal was priced, it set the tone for the rest of the market. This was then followed by a major dealer which reopened the financial sector space with a transaction. The prices on these deals were more expensive than before COVID-19 period but they demonstrated what could be achieved.

The Australian market has insufficient transparency due to a lack of trade reporting infrastructure. A lack of transparency affects investor confidence. The US market was able to see volumes going through which gave insights to pricing, volumes, liquidity, and depth. However, the small size of the Australian corporate bond market continues to complicate increasing transparency through reporting as a significant number of bonds trade very irregularly, as the last trade sets the mid-price but if the bond last traded is a few weeks old that price or mid is not relevant. It was suggested that an "All to All" platform might help to provide more transparency. The platform could offer transactions in small amounts where price makers could make two-way prices. The price makers could transact with each other and investors which would provide transparency and beget liquidity.

The cost of running a credit business is high because of regulatory capital and compliance costs. The costs of holding bonds is expensive due to capital holding costs. Regulatory restraints have only increased since the GFC. As a result, price makers are not putting the same resources into credit trading as they used to.

Finally, it was felt that current market conditions are once again difficult, and this will provide a further reference point based on different economic conditions by which to compare and assess corporate bond market liquidity.

Please contact Mark McCarthy either on 02 9776 7998 or by email at mmccarthy@afma.com.au in regard to this letter.

Yours sincerely

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