

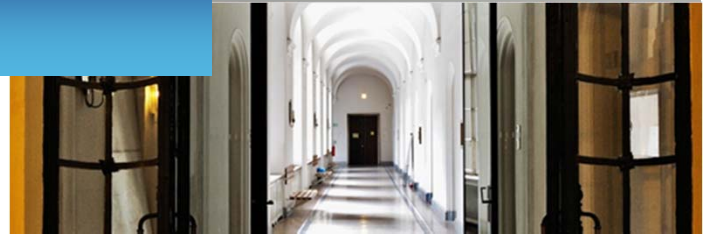
## Regulatory Reform of European Debt Markets

### Balancing the costs and benefits

BlackRock manages the investments of its clients through their pension, savings or collective investment schemes. As of 30 June 2012 we have over €175 billion of our clients' money invested in European debt.

Financial regulatory reform fundamentally impacts asset managers and investors. As a fiduciary for our clients, BlackRock supports the creation of a regulatory regime that increases transparency, protects investors, and facilitates responsible growth of capital markets, while preserving consumer choice and assessing benefits versus implementation costs. However, the Review of the Markets in Financial Instruments Directive (MiFID) in Europe could herald an unprecedented shift in how fixed income market makers would be obliged to report to regulators and to the market. Execution venues for all asset classes are being redesigned and re-categorised. The regulatory pressures on broker-dealers making markets in fixed income - from regulation and from the on-going Eurozone crisis - are significant.

This ViewPoint considers if European corporate debt markets can withstand the challenges they currently face from the current macro-economic conditions coupled with an intense period of regulatory change. Whilst end-investors would be exposed to higher frictional costs arising from regulatory change, the premium they receive for investing in debt is generally decreasing. This scenario presents significant challenges to households and individuals that are saving to ensure their financial security into retirement.



In this paper, we focus on whether the current reform of European fixed income market structure would bring added value for end-investors or if the costs of proposed reforms exceed their potential benefits. We give an overview of the characteristics of European fixed income markets and consider if these markets could actually accommodate the macro- and micro-level changes that are being proposed. In conclusion, we provide recommendations to address the public policy intentions behind the reforms whilst protecting the fixed income markets from increased liquidity pressure.

#### “Non-equity” markets are “non-equity”-like

The MiFID framework was designed for equity and “equity-like” instruments. Instruments that are not equity are labeled “non-equity” in the European Commission’s drafting. This broad category includes fixed income. Logic dictates that a comparison will be drawn in policy-makers’ minds between the category not conforming to the default, in this case non-equity to equity. It could be tempting to suggest that non-equity markets should report and be structured like equity markets, unless there is a very good reason not to do so.

### Summary of our Recommendations for the Regulation of European Fixed Income Markets

#### Appropriate market structure

We support the introduction of the Organised Trading Facility (OTF) category through the MiFID Review. To preserve liquidity provision in fixed income markets, proprietary capital should be allowed to be used in the OTF to facilitate client orders. We furthermore believe that proprietary capital should be flagged in the OTF so that investors interacting with that capital better understand the nature of the counterparty trade.

#### Calibrated and dynamic post-trade transparency

We believe that a TRACE-like model could be adapted to the specificities of European fixed income markets and applied to deliver the benefits to markets and to end-investors from more consistent post-trade transparency information.

#### Focus on post-trade transparency more valuable than pre-trade transparency information

We believe that improving the level and consistency of post-trade information would address the regulatory concerns underlying current pre-trade transparency arrangements in fixed income markets. The focus on achieving a robust and dynamic post-trade reporting system would bring benefit without disrupting the market.

#### Retail participation in fixed income through pooled products

Investing in bonds through a pooled vehicle is more beneficial than direct investment by retail clients in debt instruments. This is mainly due to the diversification benefits which reduce the effects of asymmetric returns, otherwise inherent in retail investors holding bonds.

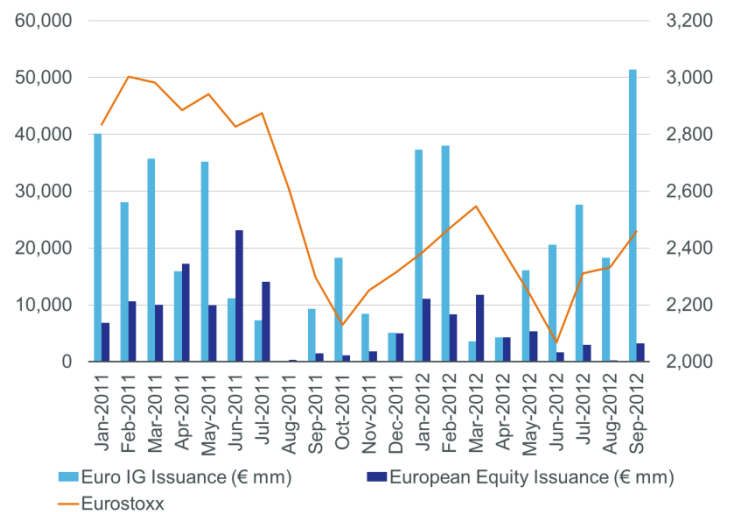
BlackRock supports a general drive to greater transparency keeping both liquidity and price in mind, across all financial instruments, since transparency facilitates the efficient transfer of capital from investors to issuers. When the cost of that transfer is priced in an economically rational way, frictional costs, such as those arising from inefficient regulation, distort the pricing equilibrium, so the greater the frictional cost, the more distorted the capital transfer mechanism from investors to issuers becomes. End-investors, like corporates, benefit most when the capital transfer mechanism is as efficient as possible, taking on the risk with which they feel comfortable, in the most transparent manner. Efficient capital transfer mechanisms furthermore create liquidity and liquidity ultimately reduces costs for end-investors as well as stimulating long-run economic growth by facilitating the financing of corporates.

Well-functioning markets strike an appropriate balance between pricing transparency requirements and, for example, the protection of trading intentions or market footprint for large orders, such as those asset managers would execute on behalf of several institutional clients (e.g., pension funds).

Fixed income and equity markets differ fundamentally in terms of the frequency and volume of issuance into the market and in terms of the resultant liquidity concentration:

- ▶ Primary market issuance in fixed income is significant but secondary market trading is thin. Contrast this with equity where the inverse situation is true – outside of infrequent IPOs, the equity market is a secondary market. Importantly, one company may issue numerous bonds with different maturities and coupons, whereas the same company will generally have one class of equity.
- ▶ Euro investment grade debt issuance decreased by 15% from the first half of 2011 to the first half of 2012 whereas in the equity market primary issuance more than halved during the same time period. Equity investors have been particularly deterred from investing in IPOs because of the large macro uncertainty that currently exists in Europe, whereas debt issuers have financing needs that require continued access to the market – see figure 1.
- ▶ This implies that while equity fits the continuous liquidity exchange trading model, fixed-income instruments typically trade over-the-counter (OTC).
- ▶ Commensurately, market-making activity in fixed income markets is vitally important. This results in a typically quote driven market with the ability for an asset manager to immediately risk transfer to a liquidity provider with inventory most often held on bank balance sheets to facilitate secondary market liquidity. Contrast this with equity, where

**Figure 1: Equity vs Fixed Income Issuance**



Source: Bloomberg, BlackRock

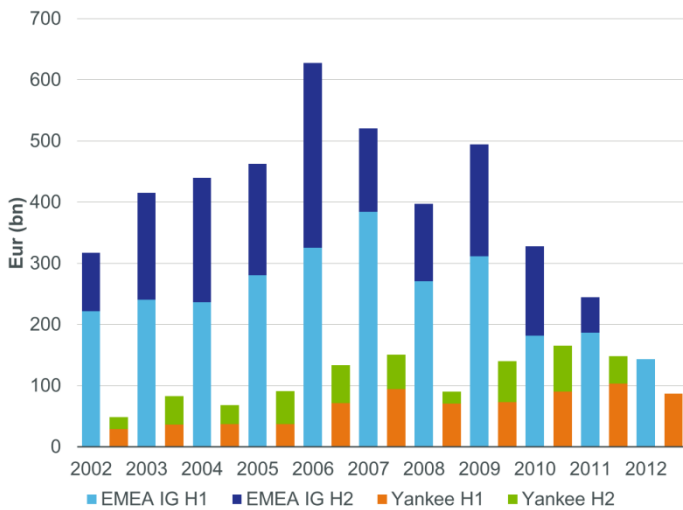
only the less liquid equities depend on quote driven market-making since equity is generally an order driven market.

- ▶ Institutional investors (typically pension funds, insurance companies, sovereign wealth funds and other official institutions) tend to invest fixed income for the long term with a buy and hold approach. Fixed income appeals to these more risk-averse investors since bonds offer a specific yield to maturity. Equity, by contrast, is often used as a tradable portion of a portfolio with investors seeking higher returns than with bonds.
- ▶ The fixed income market is primarily a wholesale market. Direct retail participation in bond markets is low. Where retail participation in bond markets is said to exist it is usually through a high degree of intermediation by banks that package, structure and/or re-sell debt instruments to retail investors, since the fixed income market is per se an institutional market.

In light of these significant differences in market characteristics between equity and debt, regulatory solutions for the equity market are only appropriate for instruments that most closely share equity-like liquidity characteristics. We make suggestions in the conclusion to strike the balance between debt market specificities and the wider public policy goals of increasing transparency.

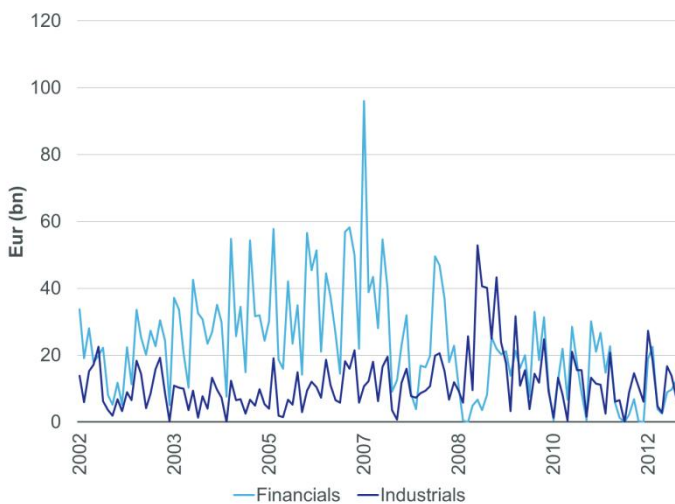
### Market conditions - a snapshot of the European corporate debt markets today

Supply of primary market debt issuance in Europe is currently below the 10 year average with a decreasing volume trend - see figure 2.

**Figure 2: European IG Issuance**


Source: BlackRock, JP Morgan

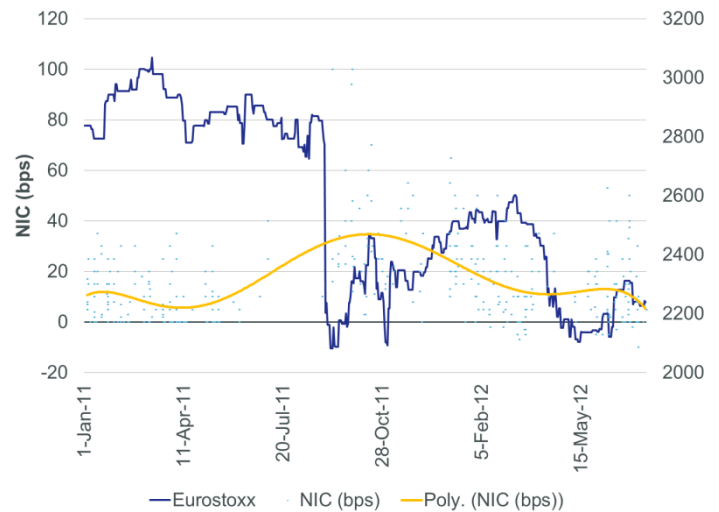
Since the onset of the financial and Eurozone crisis, there has been a significant drop off of European financial issuance from highs in 2007 due to bank balance sheet de-levering and limited (and expensive) access to the market – see figure 3.

**Figure 3: Financials vs Industrials IG Issuance**


Source: JP Morgan

In addition, with sustained volatility in European markets, issuers have increasingly been accessing the US dollar markets to fulfill their funding needs.

Generally, New Issue Concessions (NIC) – the discount in the price of a security offered in a new issue or a secondary distribution – is a function of market volatility and demand, generally rising as market volatility increases. However, currently we observe that NICs are tightening despite volatility in Eurostoxx due to inflows into investment grade (IG) asset classes – see figure 4.

**Figure 4: NIC vs Eurostoxx**


Source: BlackRock

Going forward, we expect financial issuance to remain low as banks continue to de-lever balance sheets with some of the de-leveraging being due to the lack of “pass through issuance” where financials borrow from primary markets and lend to corporates. When stability returns to European markets we would anticipate a slight increase in industrial issuance volume as they replace their bank funding with corporate bonds.

However, for now due to the low levels of primary market issuance caused mainly by the challenges posed by the Eurozone crisis and re-capitalisation of banks, European corporate debt markets are under strain and are possibly even less “equity-like” than they have ever been.

### Regulatory change - details are important

Under the MiFID II proposals, the public policy goal is to encourage all trading onto regulated trading venues, with consistent level of pre- and post-trade price transparency required of each venue.

Currently, MiFID imposes harmonised pre-and post-trade transparency requirements only on equity shares admitted to trading on regulated markets. The European Commission proposes to introduce pre- and post-trade transparency requirements for other instruments as well, including fixed income and across all trading venues. The Commission acknowledges the different structure of markets in non-equity instruments compared with those in equities, so it has proposed to tailor the exact transparency regime to the instruments in question, which is welcome.

- ▶ Pre-trade transparency requirements – disclosure of the bid and offer price: regulators will be able to use a waiver for specific type of instruments based on market model, liquidity or other relevant criteria. They will also be able to apply a set of different waivers to exempt some transactions from the transparency requirements.
- ▶ Post-trade transparency: the proposed provisions set the possibility for deferred publication in certain cases, depending on the size or type of transactions. The details of the relevant transparency regime will be crafted by the European Securities and Markets Authority (ESMA) following political agreement of MiFID, currently anticipated for end-2012 or early 2013.
- ▶ Market participation and liquidity provision: since fixed income is an inventory-based market that relies on banks to facilitate secondary market liquidity with their own capital, the proposed MiFID rules regarding systematic internalisers<sup>1</sup> are additionally important.

### Greater transparency is desirable, in theory

The European Commission believes that the absence of harmonised transparency requirements in non-equity markets leads to lower market efficiency and higher risks “than would otherwise be the case”. By extending equity-like pre- and post-trade transparency requirements to fixed income markets the Commission expects this additional transparency to the market could encourage greater retail participation in fixed income. The Commission justifies the requirement to publish two-way quotes in fixed income by emphasising the need for a level playing-field with other trading venues, supporting market-wide price discovery, and to protect retail investors.

However noble the public policy objective, when the theory meets the practice, a number of serious unintended consequences for market efficiency and liquidity could result in diminished returns and investment possibilities for Europe’s end-investors.

Theory suggests that transparency may reduce adverse selection, and that in turn will reduce bid-ask spreads on average. Greater transparency may also reduce search costs for investors. When investors search more, this increases competition among dealers, which narrows spreads.

On the other hand, greater transparency could reduce the supply of liquidity. Once a liquidity supplier has purchased securities, he usually endeavours to re-sell at least part of the purchase, to manage inventory. If his competitors have observed this initial trade, however, they may be tempted to react opportunistically. Knowing he needs liquidity and is willing to pay for it, they will adjust their prices. Thus after large trades in transparent markets, liquidity suppliers trying to unwind inventory can be in a weak bargaining position. This will increase the margin, or widen the bid/ask spread, they will require from investors to offer liquidity risk in the first place and ultimately impact the returns end-investors receive on their savings.

Whereas an appropriate level of transparency is beneficial for investment, conversely, incompatible “equity-like” levels of transparency applied to fixed income markets could reduce information acquisition and revelation in the market place, with the following consequences:

- ▶ From the issuer’s perspective, smaller, lower rated bond issuers would have to pay a greater yield to raise capital via bond issuances in a less liquid market and may not be able to issue bonds at levels that are economically viable to them. Overall it is likely that the cost of raising capital would rise.
- ▶ A poorly calibrated pre-trade transparency regime would particularly impact smaller less liquid bonds, such as those corporate issues trading on the secondary market. It would also discourage market makers from providing liquidity or holding inventory in such issues. This would, in turn, depress investor demand or would lead to investors requiring a higher risk premium to compensate for the reduced liquidity.
- ▶ From the end-investor perspective, for investors mandated to hold bonds as part of their investment strategy, the tendency will be to invest predominantly in only sufficiently liquid bonds, to minimise market impact and trading costs. Many investment mandates are already restricted to a limited universe of the strongest sovereigns and the largest corporates.

The adverse market activity will reduce the ability of investment managers to diversify their portfolios, impede the ability of companies to finance their future growth and hinder some governments’ ability to finance their debt, to the detriment of the wider European economy as a whole.

<sup>1</sup> An investment firm which, on an organised, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF (Source: FSA Handbook)

## Recommendations

In view of these observations, we make the following recommendations:

### Recommendation 1 – Appropriate market structure

We support the introduction of a new trade execution category in the MiFID Review – the Organised Trading Facility (OTF). The OTF would, we believe, effectively capture OTC trading in regulation and apply a comparable standard of disclosure and reporting to other trading venues thereby improving information to the market. To preserve liquidity provision in fixed income markets, proprietary capital should be allowed to be used in the OTF to facilitate client orders. We furthermore believe that proprietary capital should be flagged in the OTF so that investors interacting with that capital better understand the nature of the counterparty trade.

### Recommendation 2 – Calibrated and dynamic post-trade transparency

The MiFID Review presents an opportunity to address regulatory concerns around opacity in European fixed income markets. The investor experience of TRACE – the FINRA-regulated Transaction Reporting and Compliance Engine launched in the US in 2002 – has been generally positive. Importantly, TRACE was phased in over time, allowing the market to adapt to the reporting requirements and thereby the liquidity impact of its introduction was limited. The reporting window has subsequently narrowed over time. While some may point to shortcomings with the reporting engine, we believe that these can be addressed.

We recommend adapting a TRACE-like model to the specificities of European fixed income markets and applying this solution to deliver the benefits to markets and to end-investors from more consistent post-trade transparency information.

#### What is TRACE?

TRACE was launched in 2002 by FINRA to increase transparency in US fixed income securities. At that time, dealers were required to report all secondary OTC market transactions in domestic public and private corporate bonds to TRACE. Government bond (US Treasury) markets were subsequently considered sufficiently transparent that TRACE reporting would not benefit the market and have since been excluded from reporting requirements. Dissemination from TRACE to the public also started July 2002. Over a period of about two years, FINRA gradually expanded the dissemination rules such that data on all publicly traded corporate bonds were made available. FINRA initially gave 75 minutes for dealers to report into TRACE then gradually tightened the reporting window down to where it stands today at 15 minutes. The vast majority of trades are reported in near real time. TRACE reporting and dissemination for Agency bonds (e.g., Fannie Mae, Freddie Mac and FHLB) began March 2010 and works similar to investment grade corporates.

### Recommendation 3 – Focus on post-trade transparency more valuable than pre-trade transparency information for markets and end-investors

Pre-trade transparency is currently available to market participants (i.e. streamed prices, RFQ platforms, order books such as LSE or Bond Match) although it is up to each investor or institution to make use of it and offer the best execution services to the clients. The concerns regarding the impact of a non-harmonised, non-equity like, pre-trade reporting that have been expressed by policy makers are, we believe, largely unfounded.

We believe that improving the level and consistency of post-trade information would address the regulatory concerns underlying current pre-trade transparency arrangements in fixed income markets. The focus on achieving a robust and dynamic post-trade reporting system would bring benefits for systemic risk reduction without disrupting the market, especially during the current period where a liquidity challenge already exists.

### Recommendation 4 – Retail participation in fixed income through pooled products

We support initiatives to facilitate further retail investment in debt since the risk profile of fixed income is an important building block of any investment portfolio. However, there are several reasons why retail participants investing directly in individual bond securities rather than owning a bond fund would be sub-optimal from the end-investor perspective:

- ▶ Bond markets are not as widely followed by retail investors as, say, equity markets. Therefore there is a lack of coverage and lack of sufficient information to make informed decisions on a security level.
- ▶ Proper diversification is difficult to achieve as many issues have large minimum trading sizes and may be out of reach for retail investors.
- ▶ Efficient execution is not guaranteed as small trade sizes can have bid-ask spreads that negate many of the benefits from holding the security especially in the low yielding environment. Also, liquidity is not guaranteed during the times of stress in the market.

Many of these risks are mitigated when investing in bonds through a pooled vehicle. First, pool vehicles are typically managed by professional investment managers who more closely follow the bond markets. In addition, due to the increased size of the transactions at the fund level, diversification can be more easily achieved and execution is relatively more efficient. There are already many well established pooled vehicles structures available for retail participation.

BlackRock welcomes the opportunity to explore these issues further. We support constructive engagement with policy makers to find the balance between fulfilling stated public policy

objectives and ensuring that the already precarious liquidity situation in European corporate debt markets is not exacerbated by untimely or inappropriate regulatory reform. The

recommendations in this ViewPoint are intended to address policy issues while also delivering a positive outcome for end-investors.

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