

Investor survey of fixed income liquidity 2013

Association for Financial Markets in Europe

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About AFME

The Association for Financial Markets in Europe (AFME) is the voice of Europe's wholesale financial markets. We represent the leading global and European banks and other significant capital market players.

We believe that liquid capital markets and a well-functioning banking system are central to any successful modern economy.

AFME advocates stable, competitive, sustainable European financial markets that support economic growth and benefit society.

Focus

on market, wholesale and prudential issues

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deep policy and technical skills

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with European membership and global policymakers

Breadth

broad global and European membership

Pan-European

organisation and perspective

Global reach

via the Global Financial Markets Association (GFMA)



A message from Rick Watson, Head of Capital Markets, AFME

Open dialogue among participants is part of the life-blood of markets, and one of the most important *raison d'être* for the Association for Financial Markets in Europe. So in order to deepen the dialogue between sell-side and buy-side about key trading issues, AFME has commissioned some market research among members of the buy-side community about their fixed-income trading experience in the past couple of years, their expectations and their views on certain legislative proposals. We are pleased to present the findings in this booklet.

We engaged Cicero, a research and communications consultancy, to carry out 100 buy-side interviews, ensuring a balanced sample of European countries and types of organisation. The findings provide a useful snapshot of where the fixed-income market stands in terms of trading volumes and liquidity and also of the transition from voice to electronic trading. They also offer some interesting pointers to opportunities and potential threats in the future.

The good news, though not surprising in light of recovery from the financial crisis, is that fixed-income trading has increased in the past two years. Liquidity, though, is seen as patchy, and it is worth noting that over one-third of respondents (36%) reported a decline in liquidity, particularly in the trading of high-yield and investment-grade credit and covered bonds.

One clear message from the survey highlights the risk of further negative impact on liquidity from legislative proposals that would require disclosure of firm quotes, as in the pre-trade transparency requirements contained in the MiFID II draft regulation. Of those investors polled, 56% said they believe that compulsory disclosure of firm quotes to other market participants without the possibility to tier prices will have a negative impact on market

activity through: a decline in trading volumes, a reduction in transaction size (compromising the execution of large orders), an increase in the cost of trading, or a stop to trading altogether. It is important that political decision-makers and regulators recognise these damaging potential effects on trading and liquidity – and a corresponding increased cost of using the markets at a time when the economy is in desperate need of capital-market funding.

Another interesting finding concerns the structure of the market and the migration from voice to electronic trading. The indications from this survey are that this migration, while clearly underway, is taking place at a considerably slower pace than is often described in the press. As importantly, buy-side respondents overall believe that both electronic and voice execution are important to maintain liquidity. Also, 23% of smaller firms (as defined by AUM <€5m) expressed their preference for voice execution only.

More than a third of respondents said that electronic trading increased over the past two years, and more than a third expect a further increase over the next 12 months. But this growth is still from a relatively low base: 55% of respondents conducted no more than 40% of their trades electronically in 2012 and for a third of respondents this method of trading accounted for no more than 10% of their trades. Smaller firms seem less likely to trade electronically: 41% of smaller firms (AUM <€5m) said they conducted less than 10% of trades electronically. Buy-side firms need both electronic and voice trading.

This amounts to a more complex and nuanced picture of the fixed-income market than is sometimes portrayed in political discussions about regulatory reform. But it is nevertheless the reality of which the EU authorities need to take account when making decisions that will shape our markets for many years to come. Rules that work with the grain of the markets will produce significant benefits for those who use them and for the economy. Those that fail to do so will impede the markets from fulfilling their vital functions of serving investment in jobs and growth.

This survey was carried out in November 2012 for AFME by Cicero Research.

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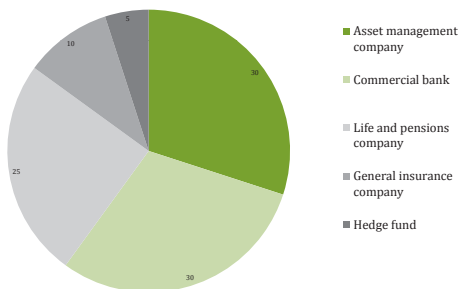
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Methodology

Breakdown of survey respondents by type of organisation and country of primary portfolio asset location

In total, 100 respondents completed the survey, conducted during 7-30 November 2012. The sample of investors, as broken down by type of organisation, country of portfolio asset location¹ and the type of fixed income products that they invest in, is illustrated below:

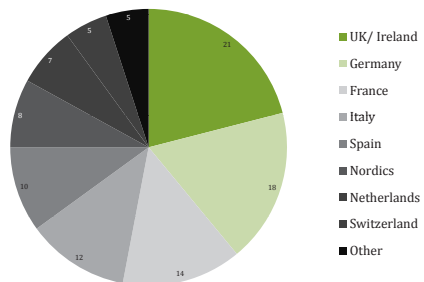
Type of organisation (%)



- 30% of respondents were from asset management companies
- 30% worked for commercial banks
- 25% worked for life and pensions companies

Country of primary portfolio asset location (%)

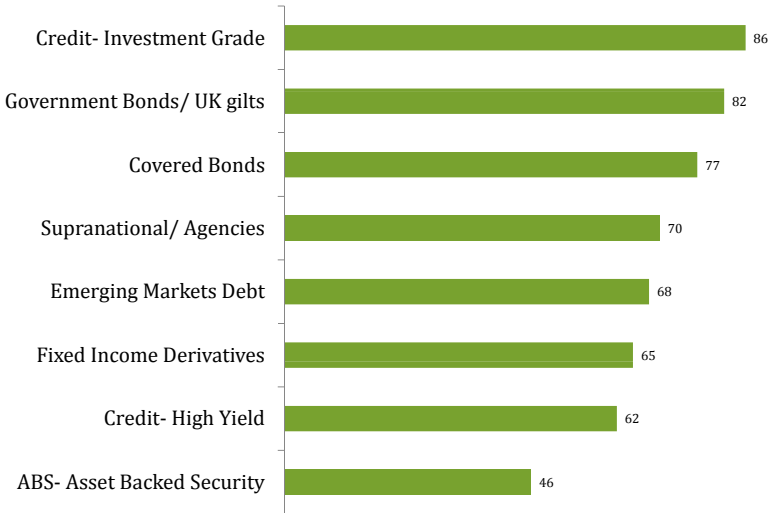
- 21% of respondents' portfolio asset location was primarily in the UK/Ireland
- 18% was primarily in Germany
- 14% was primarily in France



All respondent organisations invest in bonds and fixed income products and predominantly work on the buy-side

When asked in which bonds and fixed income products does the firm predominantly invest, respondents gave the following replies:²

Bonds & fixed income products (%)



2 Multiple responses were permitted for this question

Key findings

Market trends

- The majority of respondents said that fixed income trading has increased over the past two years;
- Liquidity has been patchy across the market;
- For those that reported a decline in liquidity, this was predominantly in the trading of credit-high yield, covered bonds and credit-investment grade.

Electronic vs voice trading

- The majority of overall trading volumes in fixed income assets are NOT executed electronically. Small firms trade a smaller share of their assets electronically;
- Over one-third of respondents said electronic trading has increased over the past two years and they expected electronic trading to increase over the next 12 months;
- Price transparency and speed of execution were the primary reasons when opting to trade electronically;
- Ticket size and liquidity were the primary reasons when opting to trade by voice.

MiFID II and voice trading

- **Commission proposal:** requirement for brokers and trading venues to publish quotes on a continuous basis upon which multiple parties can act. AFME is concerned that this may make it difficult for firms to conduct trading by voice.
- **Parliament:** requirement to force all OTC voice trading to take place under the transparency rules for investment firms. AFME is concerned that this could reduce the amount of voice trading.

- In the survey, the majority of respondents (63%) indicated that a choice of both electronic and voice mediums are necessary to maintain liquidity.
- 23% of smaller firms (AUM<€5m) said that they prefer voice-only trading.

MiFID II mandatory transparency

- **Commission proposal:** all quotes that investment firms agree to provide must be firm. These quotes must be disclosed to other clients and, below a certain size, are to be publicly disseminated.
- **Council draft text:** introduces an obligation for investment firms dealing in illiquid instruments to disclose quotes upon clients' requests. The obligation applies even if the investment firm does not agree to provide the quote.

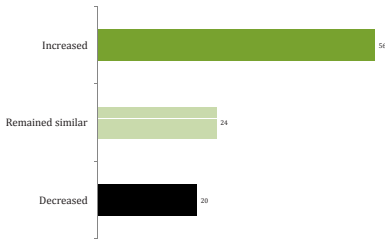
56% of investors polled said they believe that compulsory disclosure of firm quotes without the opportunity to tier prices (as proposed under the MiFID II pre-trade transparency regime) will have a negative impact on market activity through:

- A decline in trading volumes;
- A reduction in transaction size (compromising the execution of large orders);
- An increase in the cost of trading; or
- A stop to trading altogether.

Market trends

Overall the majority of respondents say that fixed income trading has increased over the past two years

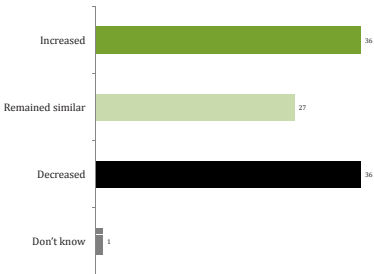
How fixed income trading has changed over the past two years (%)



- 56% of respondents said fixed income trading has increased over the past two years

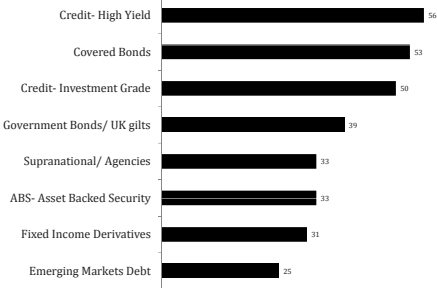
Liquidity has been patchy across the market

How liquidity has changed over the past two years (%)



- 36% of respondents saw a decline in liquidity
- These declines were predominantly in the high yield, covered bonds and credit-investment grade assets

Asset classes where liquidity has declined (%)



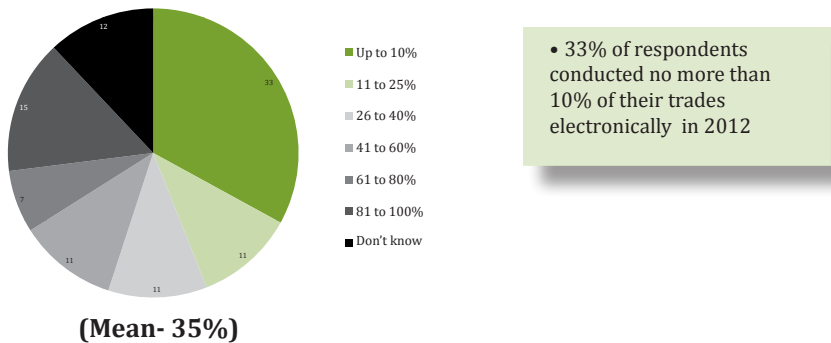
* Multiple answers allowed

Electronic versus voice trading

The majority of overall trading volumes in fixed income assets are NOT executed electronically

When asked what percentage of their organisation’s overall trading volumes in fixed income assets in Europe were executed electronically in 2012, the respondents³ said the following:

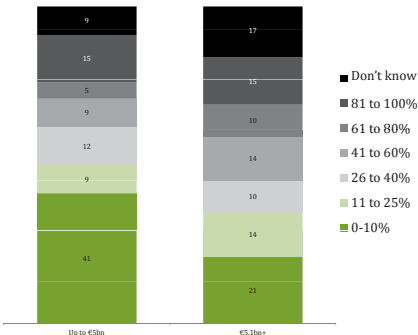
Percentage of overall trading volumes in fixed income assets (in Europe) executed electronically in 2012



Small firms trade tend to trade a smaller share of their assets electronically

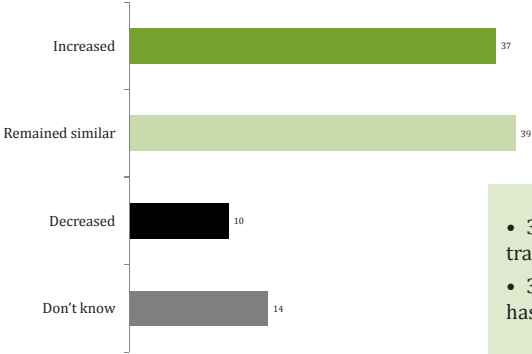
Percentage of overall trading volumes in fixed income assets (in Europe) executed electronically in 2012, broken down by firm size (as measured by assets under management, AUM)

- 41% of firms with AUM of less than €5bn conducted no more than 10% of their trades electronically in 2012
- 21% of firms with AUM exceeding €5bn conducted no more than 10% of trades electronically



Over one-third of all respondents said electronic trading has increased over the past two years

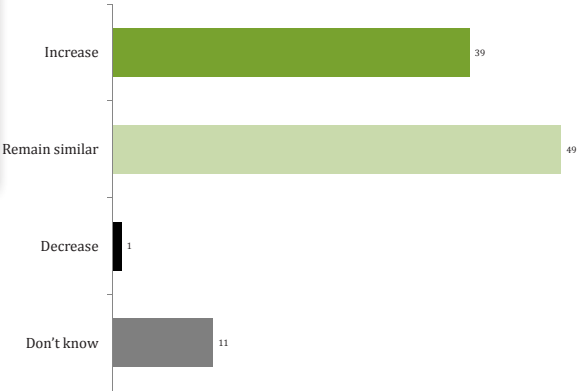
How electronic trading volumes in Europe have changed over the past two years (%)



- 37% of firms said electronic trading has increased
- 39% said electronic trading has remained similar

....and over a third of respondents expect electronic trading to increase further over the next 12 months

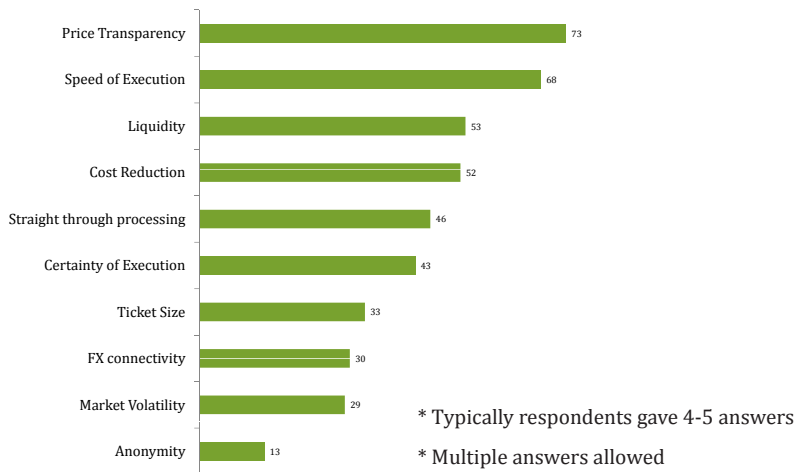
How respondents expect electronic trading to change over the next 12 months (%)



- 39% of firms expect electronic trading to increase over the next 12 months
- 49% of firms expect electronic trading to remain similar over the next 12 months

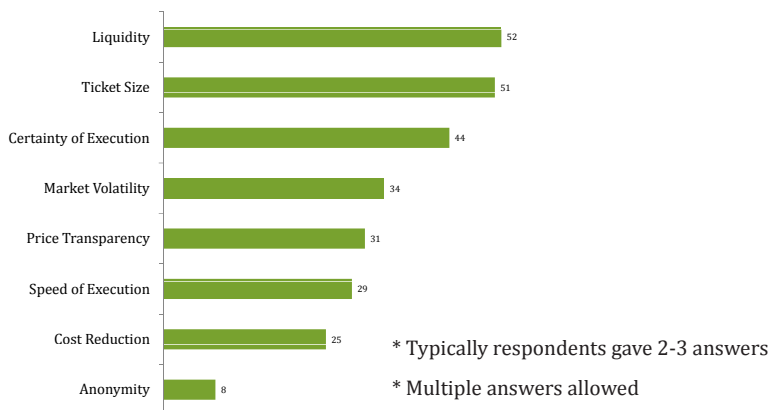
Price transparency and speed of execution were the primary reasons for the buy-side when choosing to trade electronically

Important reasons why a firm would choose to trade electronically (%)



Ticket size and liquidity were the primary reasons for the buy-side when choosing to trade by voice

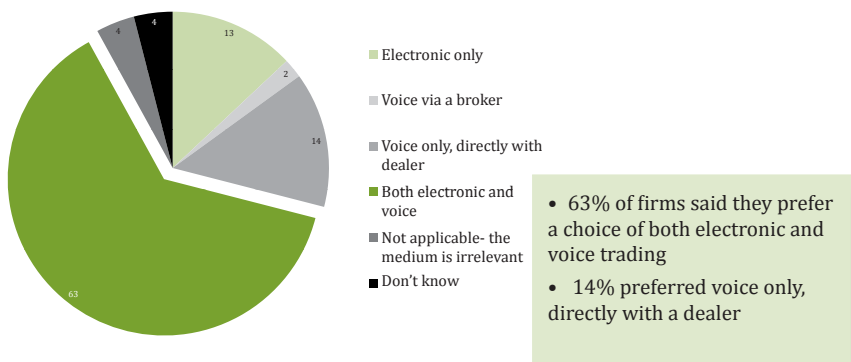
Important reasons why a firm would choose to trade by voice (%)



Overall investors believe that electronic and voice mediums are necessary to maintain liquidity

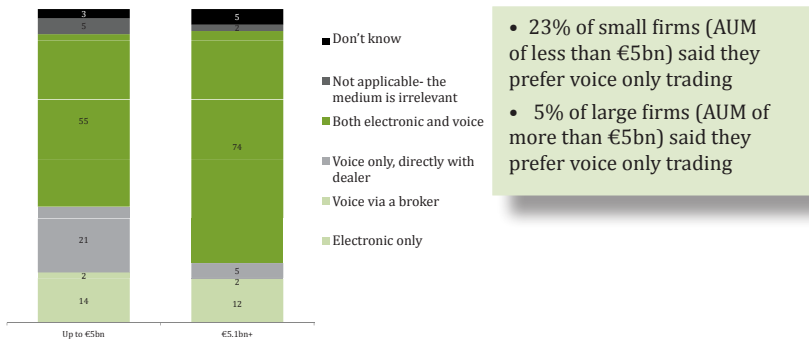
Respondents were then asked what type of medium of trade facilitation is necessary to maintain liquidity in the products that their organisation trades. Base: All (n=100)

The medium of trade facilitation that is necessary to maintain liquidity for the products in which the organisation trades (%)



Compared with large firms, more small firms expressed a preference for voice-only trading

The medium of trade facilitation that is necessary to maintain liquidity for the products in which the organisations trades (%)



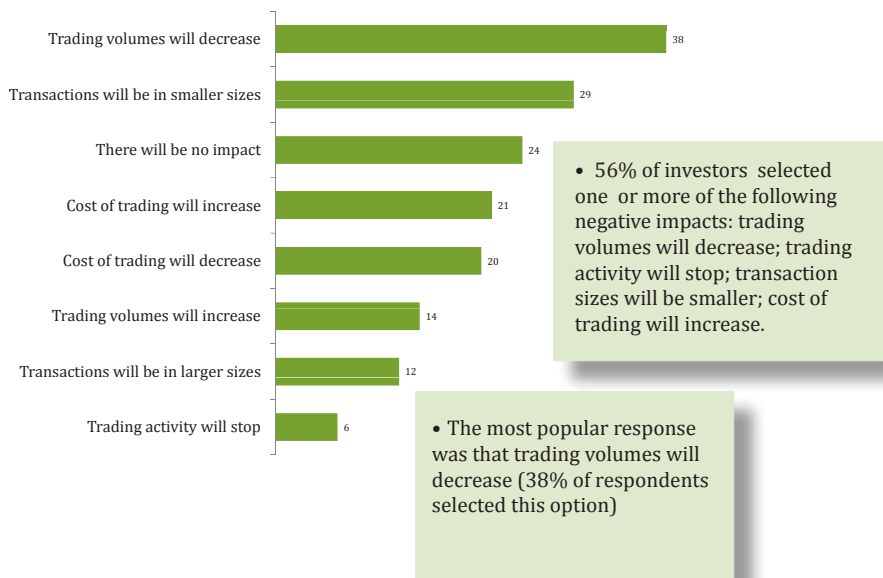
Impact of MiFID II

Commission proposal: all quotes that investment firms agree to provide must be firm. These quotes must be disclosed to other clients and, below a certain size, are to be publicly disseminated.

Council draft text: introduces an obligation for investment firms dealing in illiquid instruments to disclose quotes upon clients' requests. The obligation applies even if the investment firm does not agree to provide the quote.

Our survey suggests that compulsory disclosure of firm quotes to other market participants will have a negative impact on trading activity

How compulsory disclosure of firm quotes to other market participants will impact trading activity (%)



* Multiple answers allowed

Investor quotes

"The key is not to do a cut and paste job from the equity market. I would be very disappointed if they tried to do that. We can inspire ourselves from the equity market but do not have to copy it. Pre-trade transparency will not be more efficient. The Fixed Order Book is a good idea, it is transparent and anonymous, and it is from the buy side. People are willing to show the price on that platform, but they need to be given that choice. Remember there are not the same volumes on the equity and fixed income markets, so do not treat them the same."

Asset Management company, France

"I think it is very good how they handle it in America with their trade system, where they show the price-transparency very clearly. Depending on the market volumes they obtain, at a certain volume the price gets published. This is completely different in Europe and in Germany, where it results in problems with the audit at end of year, because the price doesn't get published. So in America they have this central organ especially in regards to OTC-business. So there should be a central price publishing register for the OTC-trades. That is better for the course-price-transparency and certainly advantageous towards the auditors as well."

Life & Pensions company, Germany

"It all relates to the volumes that we can get done. Over-regulation is a concern because we are in danger of demonising bankers and driving liquidity providers out of the picture. Where will we get liquidity? Will there be a buy-to-buy side? I think there will be in the fullness of time. Will we become liquidity providers ourselves? These are all questions to consider."

UK Asset management company

"Basically we are against the MIFID 2 pre-trade transparency proposals. We believe they harm liquidity provision through discounting in an active market making situation - this leads to a less liquid product (in the bond market), increasing the cost for borrowers to borrow as there will be a demand for increasing returns to compensate for the increased risk."

Life & Pensions company,
UK

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