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Dear Mr. Rowe,

Trading transparency in the UK secondary bond markets (DP05/5)

The International Swaps and Derivatives Association appreciates the opportunity to comment on Financial Services Authority Discussion Paper 05/5, "Trading transparency in the UK secondary bond markets." Although the paper primarily addresses cash markets and not derivatives activity, ISDA is concerned with the subject for two reasons. First, the paper states explicitly that the FSA might "consider extending [their] review to cover derivatives at a later stage" (Paragraph 1.4). Second, there is, as the paper acknowledges at several points, an extensive interrelationship between risk shifting in the form of derivatives and capital raising in the form of bond and equity markets. Bond traders use derivatives to lay off their cash exposures and derivatives traders make use of fixed income markets to hedge their swap portfolios.

ISDA believes that mandated transparency requirements would not help and might harm the efficiency of derivatives and cash market activity, but agrees with the FSA on two major points. First, ISDA agrees that, before imposing a regulatory solution, it is essential to demonstrate that a market failure has occurred. In that regard, ISDA concurs with The Bond Market Association that so far there has been no evidence of market failure. Even if such evidence were found, however, it would not be sufficient to warrant a regulatory solution: It is also necessary to demonstrate that the mandated solution is likely to lead to an improvement over the current state. ISDA therefore commends the FSA for its intention to limit regulatory intervention to cases that are justified by a cost-benefit analysis.

ISDA also agrees with the FSA in emphasizing optimal instead of absolute levels of transparency. Transparency is not an end in itself, but a means to the end of market efficiency. Various market structures have evolved, some highly transparent and some hardly transparent at all, for the purposes of capital raising and risk shifting; each market structure reflects the optimal level of transparency and other attributes appropriate to a particular market segment. To bring

the two points together, ISDA suggests that mandating high transparency for all markets, especially in markets that rely heavily on private information, could lead to less efficient markets and to reduced availability of essential forms of financial intermediation.

Questions posed by FSA 05/5

The FSA posed a series of questions, which are assembled in Annex 4 of Discussion Paper 05/5. For most of the questions, most notably those regarding the existence of market failure and considerations of best execution, ISDA concurs with The Bond Markets Association’s thorough response. Further, ISDA has received no inputs from member firms suggesting that inefficiencies in fixed income markets have caused problems for the conduct of derivatives activities.

In addition, ISDA would like to comment on three questions, one on transparency in general and two that touch on derivatives activity.

On the basis of the discussion in section 6, what practical issues do you think are important for regulators to consider in formulating policy in relation to transparency in bond markets?

ISDA opposes any type of “one-size-fits-all” model of transparency, and believes that each type of financial intermediation requires its own optimal level of transparency. Financial intermediation consists of a vast array of institutions and markets, which have evolved in response to market demands for capital raising and risk shifting services in various environments. Considered from the point of view of transparency, financial markets span a continuum from highly transparent to hardly transparent. The continuum is shown in the following table.

	Low transparency (Private information)			High transparency (Public information)	
Capital raising	Bank lending	Loan sales	Securitisation		Securities underwriting
		Loan syndication	Private placement	OTC securities markets	Securities exchanges
Risk shifting	Insurance	Swaps and other OTC derivatives	ATS?		Futures exchanges

At the right end of the continuum are the high transparency markets. For capital raising, these include the public securities underwriting process and the securities exchanges; for risk shifting,

they include the futures exchanges. A securities exchange, for example, provides *pre-trade transparency* by collecting all orders in a public order book, which can be viewed by all users of the market. In addition, it provides post-trade transparency by providing information on done transactions. In such markets, transparency is a desirable characteristic that users seek out and choose.

At the low transparency end lie two traditional forms of financial intermediation. For capital raising, there is bank lending; for risk shifting, there is insurance. Compared with exchanges, the amount of information made public is minimal, and the regulatory regimes of low transparency institutions generally encourage an atmosphere of confidentiality.

There are also points on the continuum in between the two poles. Moving away from high transparency in capital raising are the over-the-counter securities markets. In capital raising, securitization, loan syndication, loan sales, and private placements occupy the middle ground between high and low transparency; in risk shifting, swaps and other OTC derivatives hold the middle. Such activities operate in a more open manner than traditional loans and insurance, but do not attempt to match the openness of the exchanges.

The primary factor differentiating the high transparency from the low transparency markets is information. The high end of the continuum is characterized primarily by public information, that is, by borrowers and lenders or by traders relying for the most part on information equally available to all. Firms raising capital on such markets tend to be those who can make their case for funding to the public. Further, liquidity tends to be focused on the organized exchanges, in some cases by means of standardized contracts and terms, which make more of the traded instruments substitutable for each other. Finally, practices that increase transparency enhance the public nature of the information, that is, they attempt to minimize to the extent possible differences between information available to various transactors.

At the low transparency end, by contrast, the primary form of information is private information. Lesser-known borrowers, new ventures, and those with special financing and risk shifting needs are examples of transactors at the low transparency end. The lenders and dealers in such markets attempt to profit from investing in information about such borrowers, and the transactions tend to be conducted confidentially. Further, the nature of such markets makes them illiquid, and it is only by earning a return on investment in private information that the lenders will have the incentive to provide services in such markets. Attempting to mandate transparency in such markets would exacerbate their inherent illiquidity by taking away the incentive to operate there.

Swaps and other over-the-counter derivatives do not belong with insurance at the low transparency pole of the risk-shifting continuum, but they do lie more on the low than on the high transparency side. Because counterparty credit risk assessment and management are an integral part of the OTC derivatives markets, dealers expect to earn a return on the private counterparty information in which they invest. But in addition they form a bridge to more liquid and to more transparent markets in that the risks taken on in swaps transactions are often passed on to those markets on the higher transparency end of the spectrum. Indeed, OTC derivatives traders rely so heavily on the price discovery information provided by exchange-traded derivatives that OTC activity slows to a trickle during times when the futures markets are closed. Imposing futures-style transparency on OTC derivatives could upset the optimal balance of transparency in the market by reducing the return to credit intermediation by swap dealers and

thereby increase the cost and reduce the availability of risk shifting products to those clients for whom higher transparency products (such as futures) are less feasible.

All the points on the continuum represent responses to market demands at some point. Even those highly regulated market forms, such as securities and futures exchanges, arose originally not as the result of regulatory fiat but from the demand of market participants for specific forms of financial intermediation. Regulatory intervention that ignores the essential differences between the markets and the nature of the services they provide could reduce the options available to users of financial services.

How does the inter-relationship between trading in the cash and derivatives markets affect the consideration of [transparency] issues?

It is sometimes argued that, as derivatives activity grows and markets mature, regulation of derivatives should be made consistent with regulation of the underlying cash market. ISDA believe such arguments ignore the essential differences between cash instruments and derivatives, but full consideration of such issues is beyond the scope of this comment. Instead, we focus on the relationship between cash markets and derivatives as it relates to transparency.

Just as OTC derivatives rely on price discovery information generated by exchange-traded derivatives markets, cash markets rely increasingly on information generated by OTC derivatives activity. In fixed income markets, for example, the maturity and high liquidity of interest rate swaps has led to swap rates achieving par with, if not surpassing, treasury bond rates as benchmarks for medium- and long-term rates. Although most new fixed-rate issues are still priced at a spread over treasuries, it is common practice to rely on swap markets for secondary market trading (“price off treasuries, trade off swaps”). Interest rate swaps have enhanced transparency in fixed income market by increasing the amount and quality of pricing information available to fixed income participants.

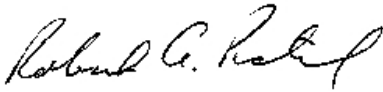
Credit derivatives provide a more dramatic example of increased transparency for underlying cash markets, and we concur with TBMA’s comments on the effect of CDS on price formation. Prior to the existence of CDS, credit pricing information in bond markets was limited and difficult to disentangle from liquidity pricing; asset swaps were the primary source of information. Credit pricing information for loans was even more limited, due largely to the private information considerations discussed above. As CDS have grown to cover more underlying credits and have achieved greater liquidity, there is now a benchmark against which to evaluate the pricing of credit risk. Somewhat paradoxically, the lack of formal transparency in the CDS markets has made possible a higher degree of transparency in underlying bond and loan markets.

ISDA believes that the inter-relationships described above demonstrate how important it is to avoid mandating levels of transparency that are inappropriate to the structure of a given market segment. The existing inter-relationships developed in response to many market demands, including demand for transparency, and it is likely to be counterproductive to attempt to second-guess the market by restructuring it to provide information that the market did not ask for.

Would greater transparency in the bond markets bring any wider benefits, for example in aiding the pricing of bond portfolios and credit derivatives?

ISDA is skeptical that regulatory mandates of greater transparency would improve the functioning of fixed income markets or derivatives activity. That is not to say, however, that ISDA opposes all initiatives that would increase market transparency. First, ISDA supports moves toward electronic trading, which will inevitably increase transparency, although ISDA has not so far taken a position on what form electronic trading should take. Second, ISDA notes that several initiatives—Markit, Creditex, GFI, and CreditTrade among others—actively seek to increase the quality and quantity of information available to credit derivatives participants. ISDA believes that the evidence so far supports the conclusion that the market supplies the appropriate level of transparency to market participants.

Yours Sincerely



Robert Pickel
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