amsterdam2016.eurofi.net

Corporate bond market liquidity

By Philipp M. Hildebrand
BlackRock , Vice Chairman

In recent years, there have been a number of indicators which point to reduced liquidity in certain financial markets, including corporate bond markets. This reflects the fact that while the outstanding volume has increased significantly, transactions have not kept up. The result of this is that the turnover has been declining, transactions costs have been increasing, and price moves can be quite extreme even when only relatively small volumes are being transacted. In the US shows investment grade bonds outstanding have grown from $2.4 tn to $6.2 tn and high yield bonds from $0.7 tn to $1.8 tn between 2006 and 2015. Turnover in the secondary market fell from 94% to 65% and 164% to 112% respectively over the same period. This is a new reality to which all financial market participants are going to have to adapt, and we cannot rely entirely on the market to make this happen by itself. This is because given the current highly compressed levels of interest rates as well as risk premia, it would be safe to say that liquidity risk is likely under-priced at the moment.

It would be safe to say that liquidity risk is likely under-priced at the moment.

That is why it is very important that financial regulation set the right incentives, in particular for investment products which are widely sold to retail investors such as mutual investment funds. Here, the European regulations basically get it right with strong liquidity management requirements such as mandatory liquidity stress tests and use of so-called swing pricing, under which the adverse price impact of redemptions from mutual funds are borne by the redeeming parties rather than by the investors who remain in the fund. This would be a good approach for other regulatory authorities to emulate. Beyond making sure that financial market participants are aware of liquidity risks and able to deal with them, there is also scope to improve market structure over the longer term in order to enhance the liquidity of corporate bond markets. There is a contrast with reforms to derivatives markets, where necessary changes to the market infrastructure were identified and addressed, while changes to bond market structure have not kept pace. In particular, policy makers have not acknowledged the need to supplement broker-dealer intermediated fixed income markets by encouraging broader market participation in structures such as all-to-all electronic trading venues.