

AN EXAMINATION OF TRANSPARENCY IN EUROPEAN BOND MARKETS

This Issue Brief examines the existing level of transparency in bond markets, and the potential for increased transparency in Europe. In many ways, these policy proposals are consistent with forthcoming provisions in the Markets in Financial Instruments Directive (MiFID) to extend pre-trade and post-trade transparency requirements beyond markets for equity shares.

OVERVIEW

Thus far in Europe, only Italy has extended pre-trade and post-trade transparency requirements to bonds, and we consider the Italian experience to discover potential costs and benefits to increased transparency. The American implementation of the TRACE system for public reporting of transactions in fixed-income securities is reviewed to inform the potential advantages and disadvantages of similar transparency requirements in other developed markets. A survey of academic literature provides further insights as to the effects of greater transparency on market liquidity and trading costs.

We believe that investors would benefit from access to timely information related to price and size of past trades. We also believe that the legitimate concerns of dealers in the market can be accommodated while still advancing transparency.

Accordingly, CFA Institute recommends a phased-in post-trade transparency requirement for bond transactions in the European Union. Post-trade transparency provisions should be calibrated to enable delayed reporting of very large transactions. Authorities should set minimum standards over the content and format of post-trade data in order to ensure high-quality, consistent information; ultimately, investors should have access to a reliable, consolidated picture of bond market activity. We further believe that technological advances have facilitated growing investor preferences for electronic trading platforms which lessen the immediate need for mandates for increased pre-trade transparency.



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SUMMARY POLICY CONSIDERATIONS:

Buyers and sellers in bond markets typically have unequal access to information about prices and market conditions, especially when buyers and sellers meet away from an exchange. This asymmetry potentially provides protection to dealers who provide liquidity to markets, shielding their positions from opportunistic traders who would use that information.

Unlike equity markets, dealers play a significant role in bond markets. The sheer number of debt securities, the large sizes in which they trade, and, away from government bonds, the relative infrequency of transactions and low secondary market liquidity all mean that bond trading takes place primarily over-the-counter.

Dealers act as intermediaries, maintaining an inventory to trade bilaterally with customers before adjusting their exposures in the inter-dealer market. Investors must rely on indicative quotes provided by dealers, which can often be wide of the mark of executed prices.

Investors stand to benefit from enhanced transparency and expected declines in trading costs as the information advantage of dealers is negated. Rather than assign arbitrary indicative prices, dealers will increasingly compete on the basis of price.

Implement post-trade transparency requirements in European bond markets.

› **Calibrate transparency requirements to take account of the size and liquidity of the issue.** The information to be reported, and the timeliness with which that information is reported, should take account of the size of the trade relative to the size of the issue, and the level of recent trading in that issue. Accounting for the relative size of a trade to determine disclosure requirements will address some fears that dealer positions would be needlessly exposed to the market, potentially sacrificing liquidity.

- › **Implement new requirements gradually.** Market participants will need time to adjust their trading processes to any new requirements, and reporting infrastructures will need time to develop. A phased-in approach would mitigate the risk of a temporary liquidity shock.
- › **Develop standards over content, format, and distribution of post-trade data.** Investors need access to accurate and consistent information on transactions in fixed-income securities to facilitate the investment decision-making process. Consistent standards over trade reporting are necessary to facilitate the consolidation of post-trade data to provide investors with an aggregate view of bond market transactions. Investors should have access to post-trade data on reasonable commercial terms through approved publication arrangements.

Adopt a “wait and see” approach on pre-trade transparency

- › **A single pre-trade transparency requirement for OTC transactions would be impractical.** A requirement to quote prices on thousands of issues in an illiquid market would likely result in fewer dealers making markets, reduced liquidity, and greater costs to investors, particularly while OTC remains the dominant method of trade execution.
- › **Pre-trade transparency for on-exchange transactions should take account of existing electronic bond trading platforms.** As electronic trading platforms continue to develop, authorities should take account of the type of transparency these platforms provide and their use to investors when determining the scope of any pre-trade transparency requirements for on-exchange transactions.



Investors stand to benefit from enhanced transparency and expected declines in trading costs

SUMMARY OF FINDINGS:

Market Structure

- › The European bond market has more than 150,000 debt securities, as compared to approximately 6,000 shares trading on regulated markets in Europe. Whereas a firm's equity structure may be limited to one or two classes of shares, it is common for a firm's debt structure to include layers of debt issues.
- › Whereas equity shares typically trade hundreds of times a day, there are few trades each day in corporate bonds, on average. The size of trades in bonds tends to be tenfold higher compared to equities for both institutional and retail investors.
- › Bonds tend to be traded off-exchange on a bilateral basis, and the bond market is a quote-driven market. Investors typically solicit quotes for bond transactions from multiple dealers, as compared to the equity market where investors can observe trade information in near real-time from multiple market participants whose orders they can trade against directly.
- › Liquidity in the bond market is provided almost exclusively by dealers, who may transact as principal or agent.

Costs and Benefits to Transparency

- › Potential benefits of enhanced transparency include alleviation of information asymmetries that may currently discourage market participation; increased ability of investors to assess best execution; and increased market efficiency and price discovery.
- › Potential disadvantages of enhanced transparency include risk aversion by dealers whose positions might be costly to hedge; false investor assurance when investors perceive liquid markets but experience thin markets with prices that offer limited execution size or that widen from indicative quotes when placed under stress; and the potential for dealers to pass through compliance costs from transparency mandates to end-investors.

The Italian Bond Market Experience

- › Italy is the largest European bond market and one of only a few countries to extend transparency measures beyond equity shares to the trading of bonds.
- › Electronic trading platforms have found acceptance in Italy. Borsa Italiana oversees three electronic platforms that cover European corporate bond trading. Because post-trade transparency reporting requirements are similar across all potential venues, there does not appear to be preference among participants for one venue or another.

The American Experience with TRACE

- › The Trade Reporting and Compliance Engine (TRACE) was introduced in 2002 to enhance post-trade transparency in the U.S. corporate debt market.
- › TRACE has been expanded beyond investment-grade, high-yield, and convertible debt to now include asset-backed securities, mortgage-backed securities, U.S. government agency debt, and primary transactions in corporate debt.
- › Introduction of TRACE did not cause concentration in dealers active in U.S. debt markets, nor does analysis suggest that dealers have been reluctant to provide liquidity since implementation of TRACE.

Analysis of Benefits of Transparency By Academia

- › Consideration of potential costs and benefits of enhanced transparency has been the subject of numerous academic studies. The results from academia may be fairly characterized as mixed, with mostly positive benefits ascribed to implementation of TRACE in the U.S.
- › Conclusions by academics as to negative effects of increased transparency in European markets tend to revolve around the potential for decreased liquidity as dealers leave the market rather than confront increased risks and hedging costs.

Development of Electronic Platforms Enhances Transparency

- › Many electronic trading platforms are emerging that allow for trading of European corporate credits. Although use of these platforms is growing, it is still a fragmented market, and electronic trading of corporate debt trails far behind volumes of government bonds traded electronically.
- › Electronic trading platforms offer market participants pre-trade transparency (as well as post-trade transparency) independent of regulatory requirements.

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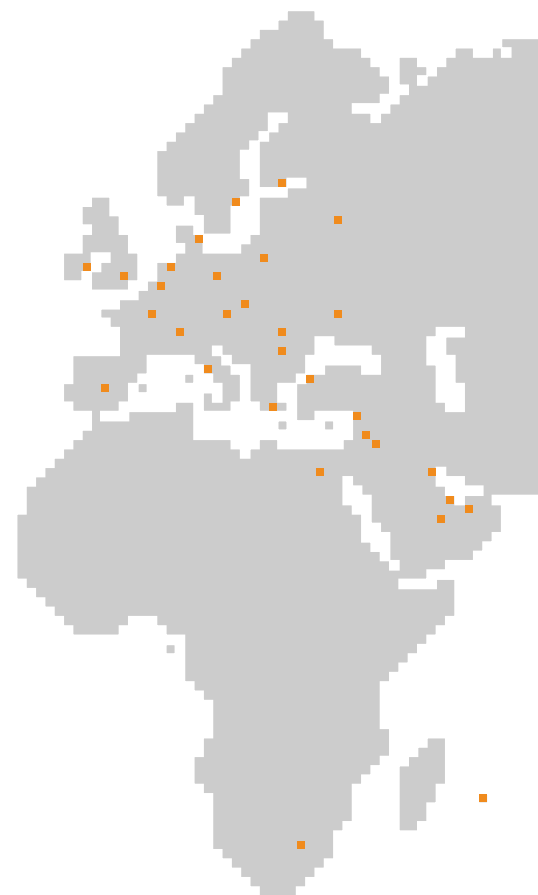
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