Giving the Bond Market More 'Colour' Through Transparency

Most business people assume regulation increases the cost of doing business. It usually does, but not in the case of making the bond market more transparent—with a net positive result for the investor, large or small. New research by finance professor Kumar Venkataraman of SMU Cox and co-authors reveals how recent market regulation benefits investors in the bond market. Their results have been widely cited across regulatory bodies and financial trade associations globally, and have significantly impacted the global dialogue on bond markets and greater access for investors of all persuasions.

Background

Uniquely, this is one of the first studies on bond market transparency, in this case meaning information on what the last traded prices were. Bond markets around the world have been virtually opaque, which is 'very surprising' according to Venkataraman since they comprise a major component of financial markets. He states that "equity markets have been transparent for decades now." In order to achieve greater transparency, the National Association of Securities Dealers (NASD) began publicly reporting transactions of approximately 500 corporate bonds through its Trade Reporting and Compliance Engine (TRACE) on July 1, 2002. After the initial subset of bonds, the trade price for a majority of corporate bonds are now reported via TRACE, providing information on approximately 22,000 transactions representing $18 billion in volume as of a February 2006 Securities and Exchange Commissioner's speech.

The authors write, "The initiation of TRACE transaction reporting provides a potentially powerful experiment for assessing whether transparency is important to market quality." And so, the authors set about to determine what effect the implementation of TRACE, i.e., bond market regulation, has had on the market. The Securities and Exchange Commission (SEC) as well as the NASD have studies which analyze these effects, but none carries the weight of independence as this study. Another distinctive feature of this research is that other studies looked at the effects of TRACE in the year after the regulation was implemented rather than around the initiation of transaction reporting, thus their results would underestimate the real impact of TRACE. In order to accomplish this mathematical feat, the authors had to re-create data using sophisticated econometric models as they lacked the detailed data the SEC had, for example. By studying the period around TRACE initiation, they were able to document a liquidity effect that could not be captured otherwise.

Findings & Implications

The study focused on institutional players as they comprise the lion's share of the market—mainly insurance companies with their large holdings. Initially, the authors posited that since institutional players were more sophisticated investors, the results on transactions costs (one proxy of TRACE's effectiveness) would yield minimal insights. Significantly, transactions cost reductions were great—a 50% (six to seven basis points) reduction, which translates into roughly over a billion dollars a year. "In this equation, the bond dealers have lost, but the investor has gained. There's a net wealth transfer from the sell-side institutions (broker-dealers) to buy-side institutions that manage money for investors. Ultimately, whether through one's 401(k) or through direct exposure to bond markets through retail holdings, it means roughly 50% of transaction costs are now eliminated; perhaps even more so for retail investors who were receiving worse execution than institutions before TRACE, "Venkataraman remarked. "If you aggregate eight basis points over time with compounding, that sum becomes quite significant to the investor." Annually, investors could achieve trading cost reductions of $372 million according to the UK's Financial Services Authority calculations. Venkataraman notes that in the numerous studies on equity market transparency, none have such dramatic reductions to transaction costs due to increased transparency, mainly because equity markets were quite transparent to begin with. In contrast, bond markets were very opaque before TRACE introduction.

Another noteworthy effect of the regulation is the *liquidity externality* (knock-on effect) which results in a 20% reduction in trading costs for non-regulated bonds. The result of increased information about prices, or greater transparency, gives a boost to other traded bonds not required to report. Venkataraman relays the implications, "The introduction of TRACE has increased competition in dealer markets. We document that large dealers have reduced their market share and small dealers are able to compete more effectively. Previously, the smaller dealer had less information on order flow; thus the smaller dealer was more risk-adverse and quoted inferior prices because he/she didn't know what was really going on." Now, everybody has access to every transaction price. This has reduced the mark ups that dealers charge and promoted greater competition. That price competition benefits the end investor—both retail and institutional. Since the implementation of TRACE, the US corporate bond market is now more actively traded, which provides an indication of the increased liquidity in the market. Increased liquidity offers investors a better chance at being able to buy and sell their holdings as needed with a smaller price concession.

Impact Abroad
The findings of this study have implications beyond the US bond market. Other major financial market regulators have taken note of the findings from the US experiment. Both the United Kingdom*, a leading global financial center, and the European Union (EU), are in the discovery process as to what type of regulation may be needed for their bond markets of the future. The Markets in Financial Instruments Directive (MiFID) will introduce a comprehensive pan-EU transparency regime for traded shares initially, and then perhaps, after further analysis due November 2007, extend the regulation to bonds.

The UK and EU regulatory efforts are aimed at strengthening capital markets because of rising investment in bond funds and for pension funds with the need to moderate risk exposure due to changing demographics. These objectives also apply to the US. EU regulators acknowledge the benefits of TRACE as providing a comprehensive picture of trading, increasing competition, and reducing trading costs. Additionally, the authors' research has been cited in a series of studies about transparency in the European bond market published by the Centre for Economic Policy Research (CEPR), a cross market group of associations, in May 2006.

This research has achieved powerful recognition and made a significant contribution to US, UK, and EU bond markets—with great impact for the investors that are served by them. Essentially, their results confirm the 'colour'—the enhanced ability of investors to make better informed decisions—provided by transparency.

"Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds" by Hendrik Bessembinder, William Maxwell, and Kumar Venkataraman is forthcoming in *Journal of Financial Economics*.

* The authors' research was cited and analyzed in a discussion paper by the United Kingdom's Financial Services Authority of May 2005.

Summary by Jennifer Warren.