

Discussion of
Corporate Bond Market Transparency:
Liquidity Concentration, Informational Efficiency, and Competition

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Background - U.S. Corporate bond market

OTC market for corporate bonds used to be opaque.

Increase in price transparency phased in over time.

TRACE system introduced transparency (last transaction)
Started with largest high quality bonds, others added later

First question:

Result: lower transaction costs
(various papers)

More interesting question: Why? (and in which subset of the market)

Economically more interesting

Policy implications (welfare improving?)

Many other markets...

Hypotheses - possible routes for transparency to improve pricing

1) Liquidity concentration

- Transparency shows which markets have more liquidity, and then liquidity begets liquidity.

2) Informational efficiency

- More information is embedded in the price
(less adverse selection - narrower spread)

3) Greater competition

- Traders have more information and can get a better price

What would I think? Competition model with cost to acquiring information.

Summary of Results: Possible paths for transparency to reduce transaction costs

- 1) Transparency *reduces* liquidity concentration
(Doesn't hurt less liquid bonds - although least liquid excluded from the study)
- 2) Transparency doesn't affect informed trade
- 3) Transparency does increase competition, but competition not significantly related to reduced transaction costs

Dissapointing results, but I don't think that this is the end of the story...

Comments

Transparency measure is the percent of trades in a bond that were transparent. (Unclear why some trades are/aren't transparent.) How about using time series? (Is such data available?)

TRACE was phased in, so the effects should appear in different bonds at different times.

Even if we can't see pre-TRACE trades, we may see effects as pool of TRACE bonds increases.

(Side comment: possible announcement effect?)

Also, should it be the percentage of trades that are transparent, or the number of trades that are transparent? (E.g., for info efficiency, both types of trades will matter, but the transparent ones more so. Imagine a regression with market impact...)

Liquidity concentration is measured relative to similar bonds, and cost of trade measured. However, more liquid bonds have less volume (!)
In fact, some would use volume (or # of trades) as the measure of liquidity.

Given liquidity measure, again, absolute liquidity or relative to similar bonds?

PIN measure pretty weak. Better ways of measuring informational efficiency?
(Thus, negative result not too bad...)

Competition:

"Percent of customer bond volume reported by low cost dealers"

Why do low/high cost dealers exist in equilibrium?

Is it just a proxy for which bonds each dealer trades? (in which case, the low cost dealers are simply those that cover liquid bonds)

Conclusion,

Exactly the right question to be asking, but I wouldn't be discouraged yet by the results.....