Whiter than white?

A new formula for bond-market transparency—as recommended by dentists

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WHO remembers the Belgian dentist, the legendary buyer (so market lore has it) of tax-efficient Eurobonds. Buttonwood can reveal that this dull but largely inoffensive creature is alive and well, and said to be attending the same Brussels dinner parties as Charlie McCreevy, the European Union's commissioner for the internal market. Not only that, but the dentist seems to have found the opportunity to bend the commissioner's ear.

To some, the subject of the small talk will be as enticing as root-canal work: the transparency, or lack of it, in European bond markets. Earlier this month Mr McCreevy published his plans for implementing “level 2” of MiFID, the Markets in Financial Instruments Directive. MiFID, which dates from April 2004, tries to improve the competitive framework of Europe's securities markets. Level 2 is the consultation process in which various committees, the European Council and the European Parliament, chew over how the directive will be implemented, what instruments and market entities it will cover, and how much will be decreed in Brussels and how much left to the discretion of member states.

The lobbying by interested parties has been intense, and nowhere more so than in determining how MiFID might affect Europe's bond market, which by volume is second only to that for dollar-denominated bonds. Mr McCreevy's draft doesn't say much about bonds specifically. It focuses mainly on equity markets, competition (among exchanges and other providers of trading and post-trade services) and how to ensure "best execution" of trades in clients' interests. Still, transparency requirements of some kind will surely be imposed on the bond market too. The question is: how detailed might these be? Will dealers have to report prices before and after they trade (known as pre-trade and post-trade transparency)? To what extent will dealers be allowed to "internalise" trades, matching buy and sell orders for different customers in-house without going to the market for bids?

Those who favour the status quo ask whether anyone actually suffers because the bond market is an over-the-counter business in which prices are discovered by osmosis, via indicative prices on screens, rather than from the publication of hard data. They argue too that forced transparency could make dealers reluctant to make markets: poor liquidity, they say, would cost customers more than opaque pricing does. Those on the other side say that if bond dealers are reluctant to divulge the prices at which they deal then they must be up to no good.

It would be helpful to draw on lots of studies of the effect of transparency on bond markets' liquidity and efficiency. Unfortunately, very few studies have been done, says Bruno Biais, professor of finance at Toulouse University. Mr Biais, though, is working on one now, commissioned by various associations on the buy and sell sides, on European corporate bond markets. A second study, on sovereign bond markets, is in hand.

Experience in America, where post-trade transparency for corporate bonds was introduced in stages from July 2002, does provide some sort of guide. The Trade Reporting and Compliance Engine (TRACE), operated by the self-regulating National Association of Securities Dealers, now gives details of every trade in the 29,000 existing American corporate bonds, with a 15-minute delay.

Empirical studies suggest that TRACE has narrowed the bid/offer spread on liquid bonds by around 50%, to six or seven basis points (hundredths of a percentage point). For less liquid bonds the results are not as clear. TRACE may even have reduced trading in these bonds, perhaps because marketmakers are more reluctant to take risk, given the added pressure to reduce their spreads.

Mr Biais warns against taking the American market as a proxy for Europe. He thinks there may be better price discovery in euro bonds anyway, given that there is wider competition among dealers. (The sterling market, however, could certainly do with a dose of transparency. Spreads in sterling corporate bonds, where three dealers have 50% of the volume, are around 40-50 basis points compared with ten or so for the euro equivalent.)

Positive Biais

Mr Biais has been looking at the tick data collected by the International Capital Market Association and thinks they would be good enough to be the European equivalent of TRACE data. He suggests that the process could be self-financing if investors paid for the data rather than getting them free.

With the effect of transparency still open to debate, the lobby for the status quo has not given up. Most dealers tend to believe it is to their advantage to keep things as they are, so that they can make prices that aren't measured against official data—although in the past forcing better practice on dealers has tended to increase volumes and hence the size of their business. Some dealers argue that they need their knowledge advantage in order to make markets, especially in less liquid bonds: they want a reward for taking the risk of being stuck with unwanted bonds on their books. "Who are these retail investors that McCreevy wants to protect anyway?" rails one market professional. Bond investors are mostly either big institutions or rich individuals (including the odd dentist), not widows and orphans.

A gathering in Luxembourg last week of EFFAS, the European Federation of Financial Analysts Societies, broadly concluded that more transparency would be "a good thing". Some discussants reckoned they would give their right arm to know, even long after the event, the price at which a highly structured bond, such as a collateralised debt obligation (CDO) had traded. Banks and fund managers could value their trading and investment portfolios with greater accuracy.

Consumer groups looking at MiFID have been more concerned about disclosure of commissions. Intermediaries will have to reveal commissions from third parties for channelling orders their way. Fund managers and others will have to give evidence that they chose the deal, from those offered, in the best interests of the client.

Managing conflicts of interest is what acting for clients in complex financial markets is all about. Mr McCreevy is right to be sceptical that financial intermediaries will always put their clients first, unless there is a risk of being found out. However, tampering with the way bond markets work could have unintended consequences. One result of the EU's Prospectus Directive, which since last July has governed “retail” securities in denominations of less than €50,000, is that few low-denomination bonds have been issued since. Transparency forced on to bond trading by new regulation, without careful assessment of the impact, could drive dealing elsewhere, for instance into new-fangled instruments or investment vehicles that are comfortably less transparent. That would be bad for the single European market, and bad for dentists.

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