A Discussion on:

Corporate Bond Market Transparency and Transaction Costs

by Amy K. Edwards, Laurence E. Harris
and Michael S. Piwowar

Presented by: Lance Uggla

May 2005

markit

What does this paper tell us?

It shows, on average, being or not being TRACE transparent is about the 18th most statistically significant variable and the TRACE impact is small and relatively not that statistically significant as shown in Table 5

After: Credit Quality Proxies
Bond Complexity Measures
Bond Desirability Views
Issuer characteristics

However, it does show that the TRACE transparency effect is measurable

Corporate Bond Market Transparency and Transaction Costs

A few generally accepted views in the marketplace …

- Transparency increases volume
- Volume affords tighter Bid/Offer levels
- Many variables effect Bid/Offer more than transparency

Can TRACE really save investors $ 1,000,000,000?

- What happens when bonds move into TRACE and why?
- Does the analysis of this paper really support this conclusion?

….. time to be Devil’s Advocate!

Tale of 2 Theories: Part 1

Theory 1:

- Bid/Offer narrows on these bonds
- All other bonds Bids/Offers stay the same

Conclusion:

If all bonds were TRACE, you save $ 1 bln through Bid/Offer narrowing and TRACE is a good thing.

….. this is the contention of this paper!

Tale of 2 Theories: Part 2

Theory 2:

- Bid/Offer narrows on these bonds
- Bid/Offer widens on other bonds

Conclusion:

Liquidity moves to NEW TRACE bonds at the expense of both non-TRACE and existing TRACE bonds. The saving, if any, may not be this large.

….. which Theory does this paper really support?

Which Theory is supported?

The time-varying analysis (Table 6/7) sees:

- Spreads narrow by 0-5 bps on bonds moving into TRACE
- Spreads widen by 5-10 bps on bonds previously in TRACE
- Spreads widen by 5-20 bps on bonds never in TRACE

….. what's a possible explanation? …..

Explanations for the “Time Varying Analysis”

Possibility 1:

The overall Bid/Offer spread increase was due to higher credit market volatility in Q2/Q4 then Q1 2003, confirming that higher volatility will widen Bid/Offer spreads

“or”

Possibility 2:

Theory 2 is true and TRACE is simply shifting relative liquidity

….. what’s the evidence? …..

Evidence of Market Volatility

We looked at BBB Generic credit spread volatility data for:

Q1 2003: = 3.2 bps
Q2 – Q4 2003: = 1.6 bps

This would seem to refute Theory 1 and support that TRACE is simply shifting relative liquidity and savings are truly not $ 1,000,000,000

Corporate Bond Market Transparency and Transaction Costs

Some Layman's points if time permits …

- Transparency does tighten Bid/Offer spreads and will increase volume. Proof exists in several asset classes, historically governments, swaps, FX, etc

- Transparency supported by terminals: Markit Portal, Market Axess, Bloomberg, Reuters, etc will increase volumes and support tighter Bid/Offers

- The most active, large issues supported by TRACE will outperform all others. Not all bonds will trade as actively as Top 100.

- Bonds that suffer rising transaction costs because they may have a higher coupon, a small issuer size but are the same credit, may well be the best buy for retail investors, regardless of the transaction costs