Liquidity of the Secondary Corporate Bond Market

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The Occasion for this Meeting

• The role of Dealers in the secondary bond market is threatened.
• They are projecting that the market itself is suffering: “liquidity is drying up” they warn us.
• They are promoting the idea that a rollback of financial reforms is needed to permit them to once again play their valuable role.
Markets are changing in response to technological change as well as regulatory reform. Advancing technology is creating new opportunities and new challenges.

What are these technological advances and new opportunities?
- Electronic trading is how most people see the change.
- In reality there are a variety of improved computing and communications tools in the hands of investors that enable investors to meet up via a number of new channels, leaving the old dealer model as an anachronism.
- Improved access to interest rate, credit and FX derivative markets that augment the secondary corporate bond market in important ways.

How does that affect how we interpret symptoms in the market?
There are a slew of popular liquidity indicators, such as average transaction size.

When technology context is stable, this might correlate with effective liquidity.

But when technology is changing, declining trade size does NOT betoken declining liquidity.

New technologies allow the same demand to be broken up and serviced through a higher quantity of smaller transactions.
Key liquidity benchmarks, such as “immediacy”, are motivated by overly simplistic investor needs focused on a single trade that needs to get done.

- Investors have a portfolio of trading opportunities, and get a portfolio of results. The investor needs tools and a strategy that work over time and under various circumstances. Available tools substitute for dealer immediacy.
- No simple “immediacy” metric usefully captures what may be lost or gained to the investor from changing circumstances in the marketplace.

And, too often the frame of reference is limited to the services available on the bond market itself.

- It makes no sense to evaluate changing liquidity in the bond market without also evaluating changing access to complementary derivatives.
Declining Dealer Inventories: That’s Not a Bug, It’s a Feature
Forward, Not Backwards

- Subsidizing dealer inventory with a taxpayer backstop was stupid,
  - even when the dealer model was the most effective way to intermediate bonds.
- Meanwhile, new options for intermediation have been arriving.
- Be attentive to the new.
  - Actions are needed to enable the new.
  - Actions are needed to prevent abuses of the new technology, witness the October 2014 ‘flash crash’ in U.S. Treasuries.