Liquidity of the Secondary Corporate Bond Market

John Parsons, MIT Sloan School of Management

Panel of Industry Experts, International Organization of Securities Commissions (IOSCO)

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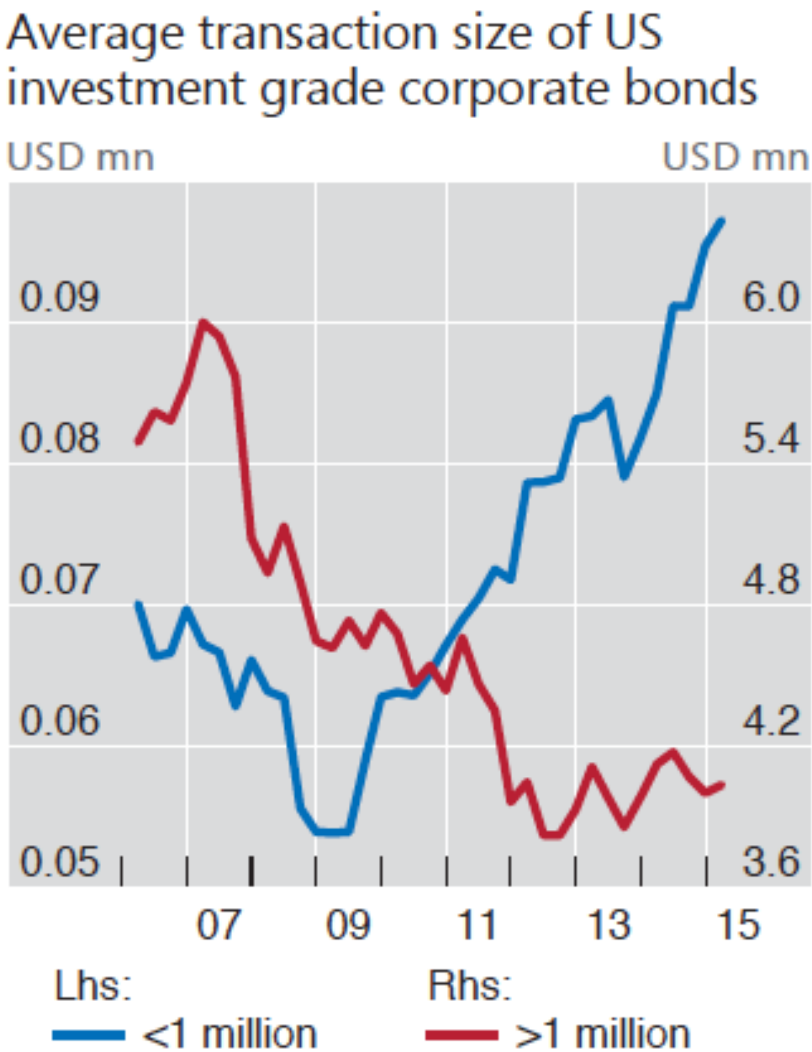
The Occasion for this Meeting

- **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.**

What’s Missing

- **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?**

Misdiagnosing Causality in Time Series of Familiar Benchmarks

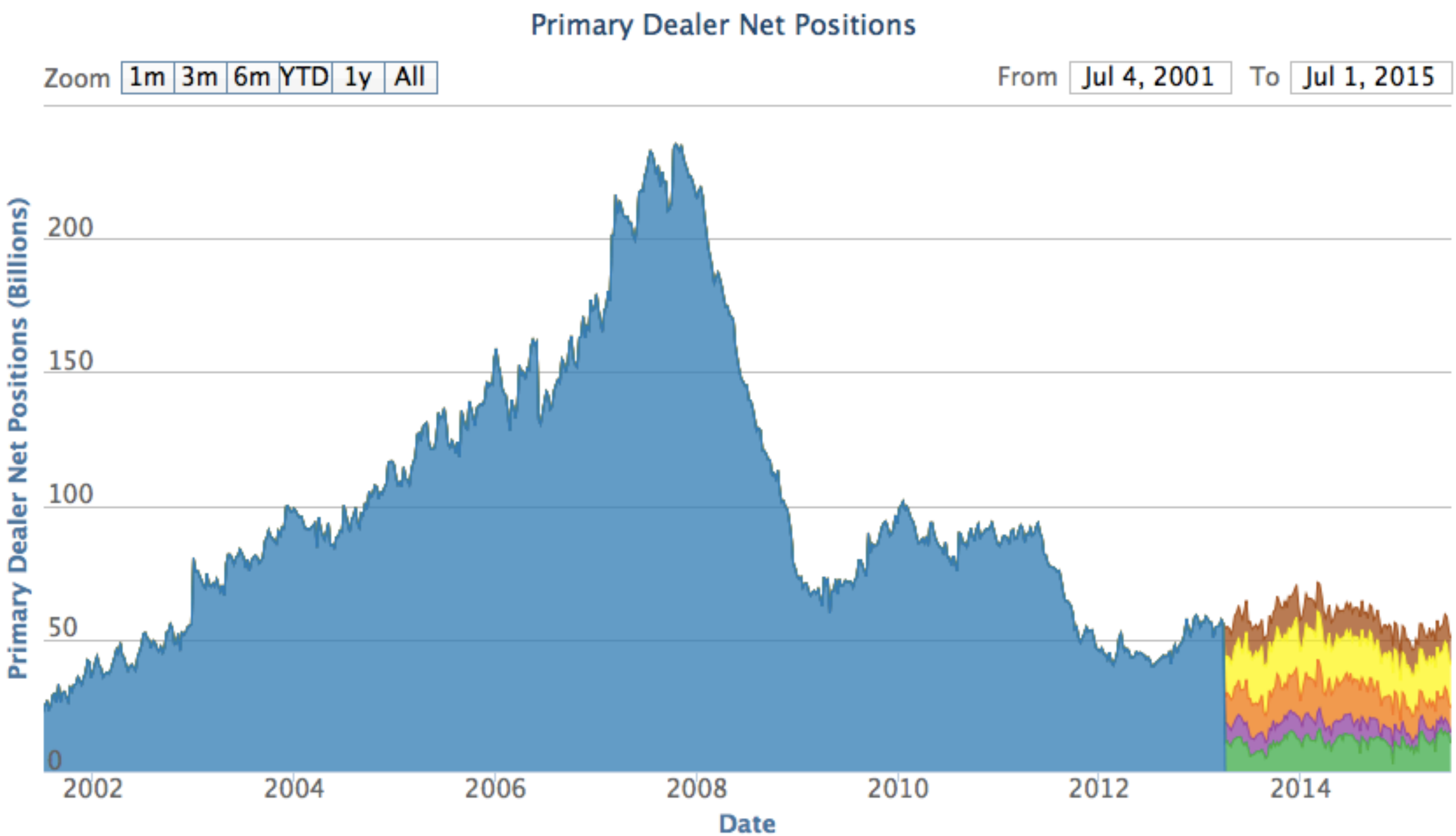


- There are a slew of popular liquidity indicators, such as average transaction size.
- When technology context is stable, this might correlate with effective liquidity.
- But when technology is changing, declining trade size does NOT betoken declining liquidity.
- New technologies allow the same demand to be broken up and serviced through a higher quantity of smaller transactions.

Misestimating Delivered Liquidity With Stale Models of Investors

- **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.