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What is the difference between transparency and price integrity?

Does size really matter?

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When Keeping It Old School Goes Wrong: Debating Transparency in Fixed Income Markets

It's like a jungle sometimes it makes me wonder

Despite the rise of the internet, smart phones and Pokemon Go, most fixed income markets have done an excellent job of shunning technology and remaining true to their unstructured, OTC origins. Like the last uncontacted tribes in the Amazon, fixed income market participants have avoided the trappings of modern tools to preserve a naturalistic market environment where trading and valuations are based on superstition, intuition, and guess work instead of high quality data.

I'm just a bond trader, your world confuses me

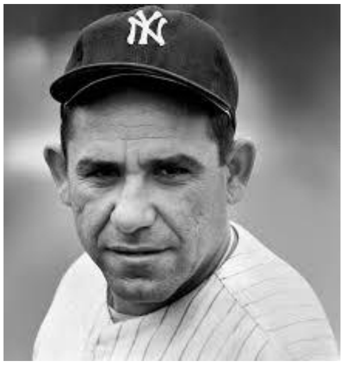
The preservationists maintain their stance based on a myth about market structure: Transparency around pricing and execution impairs markets by collapsing bid/offer which eliminates the commercial incentive to trade. Don't believe in this ghost story? Look no further than the floor of the NYSE or the futures pits in Chicago. What were once thriving markets dependent on human interactions are now sterilized environments where computers talk to computers and markets move in micro-seconds. This fundamental fear is hiding something that most fixed income market participants do not dare speak. Lack of market transparency has historically been very good business.....for some.

All you need in markets is ignorance and confidence
A dearth of pricing and execution information in any financial market creates a very interesting environment. Calculations for value, risk and transaction costs are derived subjectively. Therefore, nobody knows the true value of what they are trading, the risk that they hold or what it costs to trade. Some business models thrive in the cover of darkness provided in this environment. For example, most veteran sell side traders will tell you, their biggest year for compensation was due to "mark to market" gains in their positions. Mark to market is perceived value, not actualized value, but in the absence of adequate market transparency, perception is enough if you have the right amount of confidence. The environmental benefits are not exclusive to the sell side. Funds that trade certain fixed income products have no way of measuring the quality of their execution because trading costs are implied and not formally articulated. Proving best execution is done through qualitative means and is far less quantitative than you would expect.

Losing my religion

Due to central bank monetary policy, some unstructured fixed income markets like corporate bonds, have experienced rapid and prolonged growth over the past 8 years. Increase in market size has been accompanied with an expansion in market breadth (number of different bonds). Ultimately, this combination has brought an unprecedented amount of ambiguity when valuing and trading bonds. Those that remain devoted to transparency prevention in the corporate bond market are now faced with a serious dilemma. Can the traditional, unstructured OTC model support a market that is now almost $9Trillion in size (up from $2Trillion in 2002)? Preservationists seem to think so: US Banks Push for a Delay in Reporting Corporate Bond Trades – Financial Times April 2015

In theory there is no difference between theory and practice. In practice there is.



The goal of transparency is to provide equal access to information for all market participants. In theory, transparency should improve market performance by creating greater efficiency, but in practice, unfettered access to certain information creates an environment that allows opportunists to profiteer off the actions of others.

Complaints and fears about mandated transparency are warranted but eliminating or preventing transparency also requires examination. In theory, limited transparency should encourage robust market making activity due to the commercial opportunity available in an inefficient environment. In practice, lack of transparency is the root cause of some of the largest systemic issues in unstructured

What we have here is a failure (to see pricing information)

OTC markets. These problems are often articulated quite clearly when there is a closer examination of market practices by outsiders:

Inability to properly calculate risk

Big Banks' Risk Does Not Compute – Bloomberg May 2016

*"Mathematicians Jon Danielsson and Chen Zhou have examined **how much data would be required to get reliable estimates of either value-at-risk or expected shortfall**, even in a world where the future is like the past. Suppose you wanted a reasonably accurate reading of expected shortfall -- say, an estimate likely to fall within 5 percent of actual losses. For the complex portfolios of large financial institutions, this **would require decades of price history on hundreds or thousands of different assets -- something that simply doesn't exist for many of those assets** (many firms don't even stay in business that long, for example). **With less data the result would be illusory, offering no meaningful sense of the risk present at all**."*

Inability to examine market phenomenon, like liquidity shortages

Now We Have Two Answers to the ECB Corporate Liquidity Question – Bloomberg Aug 2016

"Now the ECB is in full throes of the CSPP, which began June 8, and disclosed information about its holdings on July 18, we have data to test out these liquidity fears.

***Firstly, a big caveat is in order**. **There's no standard and objective measure of bond-market liquidity since bonds are predominately traded over the counter** (OTC), unlike stocks. **As a result, market benchmarks to gauge a snapshot of liquidity conditions** — roughly defined as market participants' ability to buy and sell bonds, on a given stable trading day, without triggering a material shift in their price — **are imperfect and subject to debate**."*

Corporate Bond Liquidity Redux – Liberty Street Economics February 2016

*"As discussed in our earlier post, **we don't have access to quote data for corporate bonds, which trade over the counter. We therefore estimate "realized" bid-ask spreads** by comparing—for a given bond—prices when a customer buys from a dealer (at the dealer's offer price) to prices when a customer sells to a dealer (at the dealer's bid price)"*

Inability to trade against the best prevailing price

How to Lose $667 Million in Bond Trades Without Trying – Bloomberg September 2015

*"**In most of the deals the investors simply did not know that the lower prices existed because they rely on human traders to tell them the value of bonds** at any given moment before they make a trade."*

Jobu. Look I go to you. I stick up for you. You no help me now.

What makes unstructured fixed income markets “unstructured” is not a lack of transparency. The missing ingredient to improving these markets is price integrity, which is different from transparency. While transparency is focused on the level of information visibility, price integrity is entirely focused on the quality of pricing data. For any financial product, price integrity is generated when there is a standardized price formation process, however, just having a process is not adequate. The soundness and objectivity of the price formation process has an impact on the overall level of market integrity. A clear illustration of this point is visible when we compare the difference between the method the US government uses to auction their securities (demand curve) and the method for fixing LIBOR (no comment).

Once price integrity begins to take form in fixed income markets, participants can start using high quality pricing data to calculate value, risk and transaction costs. Eventually, we may even laugh about the good old days when “real” traders used their gut and intuition instead of real-time and historical data. Until then, remember it is very bad to steal Jobu’s rum and keep your fingers crossed.