The libertarian point of view

Why regulate transparency?

Why not leave it to market forces to supply the amount of transparency the market needs?

The economist point of view

If markets perfect and competitive, equilibrium is Pareto optimal, regulation can only worsen things

Otherwise, spontaneous market outcome (in particular concerning supply of transparency) need not be optimal

I will discuss this in the case of OTC derivative and corporate bond markets, which are very important markets for banks

Are these markets (or the market for these markets) perfect and competitive? Are participants atomistic? Is information symmetric? Do we expect market equilibrium to be Pareto optimal? Is there scope for regulation?

Market concentration& market power

What is the market share of the largest 10 players (investment banks) in the CDS market? Hard to tell since the market is not transparent. Likely $\geq$ 50%

€-denominated corporate bonds: 5 largest players have 40% of the market.

£-denominated corporate bonds: 3 largest players have 40% of the market

(Biais & Declerck, 2007)

Such large players not likely to be competitive

Adverse selection

BBB corporate bonds: information content of trade

€ denominated: 4 bp (significantly >0)

£ denominated: 6 bp (also significant)

After trade conducted, no ex-post transparency

It takes > 5 days for info content of trade to be impounded in market prices

(Biais & Declerck, 2007)

These empirical results suggest significant information asymmetry in the market

Inefficient outcome

Market power + adverse selection

$\Rightarrow$ transactions cost for investors

$\Rightarrow$ Larger cost of funds for firms

Opaque markets

$\Rightarrow$ Informative signals not provided to economy

Increased transparency could improve things, will markets spontaneously provide it?

Opaque market not contestable

If I offer a transparent platform, will the dealers post competitive quotes there?

I guess not ;-)

What will happen to those (less informed) who do?

Customers also ask dealers for quotes

$\Rightarrow$ hit transparent market quotes only if better than those of informed dealers

$\Rightarrow$ adverse selection

$\Rightarrow$ breakdown of transparent market made by competing uninformed

$\Rightarrow$ large (informed) players keep market power

Mandatory transparency

Reduces informational advantage of large dealers (others can observe at which prices they traded)

$\Rightarrow$ Increases competition, reduces spreads & dealer profits

TRACE, 2002: mandatory post-trade transparency in corporate bond markets

Empirical findings: TRACE reduced spreads … and corporate bond dealers profits (by $ 1million per year, before crisis)

Catch me if you can

Just after TRACE, rise of new markets: syndicated bank loans, CDS : exempt from post-trade transparency requirement (TRACE not single or even main cause for this development, but …)

Severe weakness of transparency regulation (or any regulation): spurs development of new markets or institutions that avoid regulation, and may be even more toxic than the original ones

Should we stop regulating? Rather monitor market reaction and close regulatory loopholes