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USC Marshall School of Business Study Makes Case for Greater Transparency, New Model for U.S. Bond Markets.

Greater transparency and the adoption of trading procedures similar to those of the nation's equity markets could save U.S. corporate and municipal bond customers billions a year in transaction fees, according to a new study of bond market practices and transaction costs.

Lawrence Harris, who is Fred V. Keenan Chair of Finance and Business Economics at the USC Marshall School of Business, tabulated millions of bond transactions completed between Dec. 15, 2014 and March 31, 2015 for a study titled Transaction Costs, Trade Throughs, and Riskless Principal Trading in Corporate Bond Markets. What he discovered was that the benefits of electronic bond trading largely accrue to bond dealers who often take little or no risk in exchange for the mark-ups and commissions they charge their customers. Public investors, meanwhile, generally do not have the information they need to trade at the best-available prices. And unlike commissions, they do not even know the mark-ups they pay to dealers to trade.

According to the data, customers incur an average transaction cost of 85 basis points for retail-size trades (under $100,000 in par value) and 52 basis points for larger trades. "These costs are many times larger than costs for similar-sized trades in equity markets," writes Harris. "Electronic trading has substantially lowered investor transaction costs in equities, but it has provided little benefit to most bond investors."

U.S. bond investors, Harris says, "would benefit if the 850 most actively traded bonds for which dealers provide near continuous electronic quotes were traded in market structures more similar to those in the equity markets. If the public could see national best bids and offers before trading, as they can for equities, dealers would have a strong incentive to offer better pricing. A rule that simply requires brokers to disclose their mark-up rates before a trade also would improve the markets."

The study shows that public investors in U.S. bonds presently pay $26B per year to trade. Greater pre-trade price transparency could save them 20% or more, or about $5B per year according to Harris.

The results of the study and Harris' recommendations are a wake-up call for regulators and may influence how bond markets are structured in the future, says James G. Ellis, dean, USC Marshall School of Business.

"This study's findings and recommendations will inform the growing debate on the future of bond markets in the United States," Ellis said. "Clearly, greater transparency must also be the standard in our bond markets, just as it is now in our equity markets."

The full study is available for download here.

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