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Informed trading in parallel bond markets[☆]



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ABSTRACT

European government bond market segmentation has not been extensively investigated. I contribute to this scant literature by studying the market microstructure of the Italian government bond market, the largest one in the eurozone. Using a sequential trade model, I analyze the probability of informed trading (PIN) in the parallel trading of the same bond on two secondary electronic platforms: the inter-dealer MTS and the dealer-to-customer BondVision; an aspect that has never been investigated before. I find that the PIN is significantly lower in the dealer-to-customer segment than in the inter-dealer one.

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1. Introduction

In recent years, the organization of securities trading has notably changed. Trading no longer takes place in a physical location, direct dealing between dealers keeps diminishing, while more and more transactions are executed via electronic trading platforms. This is happening to a greater extent in the fixed income markets. The advent of electronic trading has dramatically affected the functioning of fixed income markets, mainly reducing the costs of transacting and obtaining information, making the execution of transactions quicker and automating the settlement procedures.

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Government bonds have traditionally been the dominant segment of the euro area bond market (Biais, Declerck, Dow, Portes, and von Thadden, 2006). According to Persaud (2006), in the United States, electronic government bond trading represents 98 percent of all *on-the-run* volumes, whereas in Europe, it amounts to 75% (80% according to The Bond Market Association and 70% according to Celent Communications, Casey and Lannoo, 2005).¹

In the last decade, there has been an increasing number of researchers analyzing the functioning of the European electronic government bond market. I contribute to this growing literature studying the market microstructure of the long-term secondary Italian government bonds. In terms of the composition of the government debt instruments, around 70% are long-term government bonds (Lojsch, Vives, and Michal, 2011). With an outstanding amount of roughly € 1.6 trillion in 2011, the Italian government bond market is the third largest in the world after the U.S. and Japan and the largest one in the eurozone, followed by Germany and France.

In particular, I analyze the parallel trading of ten-year government bonds on two electronic trading platforms – an inter-dealer platform – MTS – and a dealer-to-customer one – BondVision. I investigate whether the probability of informed trading (PIN) is related to the different transparency requirements of these two platforms.

The PIN is considered an appropriate measure of asymmetric information also in the context of the bond market. Even if the type of private information in the government bond market is diverse from that in the stock market, many studies have shown its existence also in this setting. Indeed, the presence of heterogeneous information in this framework can be thought of as a different skill to interpret the same publicly available information (Green, 2004) or as dealers' private access to customers order flows (Lyons, 2001). In fact, if private information is defined as in Ito, Lyons, and Melvin (1998), i.e., as anything that is not common knowledge and that is price relevant, there is likely private information also in the bond market. Some dealers may have private information in the more traditional meaning of the word (i.e., privately observing their client's order flow they infer valuable information to forecast future prices). Others will trade only on the basis of their subjective evaluations and different abilities in interpreting past economic data or in understanding the current state of the economy (Brandt and Kavajecz, 2004).

The literature on government bonds has been focused only on the more liquid inter-dealer section of the market, almost ignoring the dealer-to-customer segment. Other papers on parallel bond trading include Drudi and Massa (2005) and Dunne, Hau, and Moore (2008). Drudi and Massa (2005) analyze the behavior of investors simultaneously operating on the primary and secondary market, providing evidence of price manipulation in the more transparent secondary market when the less transparent primary market is open.² Dunne, Hau, and Moore (2008) consider the interaction between the inter-dealer and the dealer-to-customer segments of the European sovereign bond market, developing a model to understand the quote dynamics in both segments, as well as their interrelationship.

However, government bonds have traditionally been divided into an inter-dealer segment and a dealer-to-customer segment. The main contribution of this paper is to investigate the parallel trading on these two secondary electronic platforms. I examine on which platform, characterized by different transparency requirements, the PIN is higher, filling a gap in the market microstructure literature on the European government bond market.

The term transparency refers to pre-trade transparency (i.e., information about quotes and/or orders), post-trade transparency (i.e., information about prices and volumes), and anonymity (i.e., information on pre- and/or post-traders' identity). Under full transparency, all relevant pre- and post-trade information is publicly and timely transmitted to all market participants.

MTS provides extensive pre-trade transparency, making the order book available to all market participants; however, the trader identities are not displayed, foreseeing pre-trade anonymity. Transaction prices and volumes are instantaneously reported to all market participants providing full

¹ A possible explanation for this discrepancy is the concern over liquidity that European market participants could have, since only one specific platform (MTS) dominates, whereas in the U.S. there are variety of different trading platforms.

² The authors consider the period before 1997, when market makers were not anonymous.

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