Market rules and practices

Q 2-03. How do market rules and practices affect the development of the government securities market?

Sovereign debt is an important market asset with a critical role in the construction of many portfolios. The rules that govern markets, therefore, will have an impact on the use and the demand for sovereign debt instruments as they do with all market assets. Market rules may fall under several broad categories including rules concerning securities exchanges, investor protection, contracts, institutions, and taxes.

Perhaps more important than the "other laws" are the rules that govern access to the Government securities market, i.e., the bar that likely exists as to what entities are eligible to be book-entry custodians and to have access to the electronic network through which trades are made. The central bank rules that apply to daylight overdrafts could also be a serious constraint.

Q 2-03.01. Do debt-trading practices differ from those of other assets?

Bonds markets differ from equity markets. Bond markets often do not have a centralized exchange or trading system. Rather, in developed bond markets (such as in the United States, Japan and Western Europe), bonds are traded in decentralized, dealer-based, over-the-counter (OTC) markets. In such a market, market liquidity is provided by dealers and other market participants committing risk capital to trading activity.

In the bond market, when an investor buys or sells a bond, the counterparty to the trade is usually a bank or securities firm acting as a dealer. In some cases, when a dealer buys a bond, the dealer carries the bond "in inventory." The dealer's position is then subject to risks of price fluctuation. In other cases, the dealer immediately resells the bond to another investor.

Bond markets can also differ from stock markets in that, in some markets, investors sometimes do not pay brokerage commissions to dealers with whom they buy or sell bonds. Rather, the dealers earn revenue by means of the spread, or difference, between the price at which the dealer buys a bond from one investor—the "bid" price—and the price at which he or she sells the same bond to another investor—the "ask" or "offer" price. The bid-offer spread represents the total transaction cost associated with transferring a bond from one investor to another.

The rules governing sovereign debt should reflect the needs and practices of the bond market in order to support trade in such securities.

Q 2-03.02. Why are secondary markets of importance?

The existence of a market in which sovereign debt can be traded as any other security gives benefit to sovereign debt as an investment. This expands the demand for sovereign debt beyond the passive "buy and hold" market. In most countries, government securities trade in the secondary market along with all other securities and are, therefore, subject to secondary market regulation.

Since government securities are often defined as "exempt securities," that is, exempt from registration requirements, it is important to make sure that this status does not undermine the integrity of the secondary market.

Q 2-03.03. What additional rules are needed for secondary markets?

Effective secondary market regulation is necessary to support a viable secondary market. It should include (i) regulation of market intermediaries, (ii) market conduct regulation (including trading rules) and market surveillance and (iii) transparency requirements, which will vary according to the choice of market structure.

Q 2-03.04. What oversight is needed for participants in secondary markets?

The capacity of market participants to fulfill contract obligations or to serve as the agent of other participants is critical to the healthy functioning of secondary markets. Capacity is often measured by the ability of the entity to withstand adverse market conditions by use of the firm's own assets and balance sheet and not by reliance on external financial resources. For this reason, oversight often focuses on capital rules, margin requirements, risk controls, and trading-practice regulations.

The question of capital requirements and adequate reserves is a highly technical issue that has been addressed repeatedly by regulating organizations. Details are beyond this outline.[1] Capital requirements must take into account liquidity, price, and credit risk for assets in the firm's own portfolio, as well as for assets managed on behalf of third parties. Leverage requirements, if imposed, must take account of differing definitions of leverage.

[1] As an example of the complexity of the issue, consider the question of uniformity of requirements. Lack of uniformity in capital requirements within the same class of securities market participants, such as brokers or dealers, can increase both systemic and credit risk for individual market participants. In contrast, non-uniformity of capital requirements across different classes of market participants can be an important factor in creating incentives for self-regulation. If members of securities depository and settlement corporations are required to hold higher levels of capital than non-members, the members will have greater incentives to monitor those financial institutions with lower capital requirements.

Capital rules, margin requirements, risk controls, and trading-practice regulations applied to intermediaries are likely to grow in importance with technological advances.