

Transactions costs: What can we do?

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Outline

- Transactions taxes
- Barriers to market access
- Transparency
- DMA
- Frictions of middlemen
- The call auction

Part I

Transactions taxes

Do no harm

- The task of financial sector policy is to drive down transactions costs
- When a government introduces a transactions tax, it is directly doing the wrong thing
- Instead of building an expressway, the government is building speedbumps.
- First principles of public finance: The only correct tax bases are : income and value added.

Part II

Barriers to market access

Is every possible participant in a market?

- All kinds of financial firms – banks, insurance companies, pension funds
- Are they all participating in markets on the scale that is normally expected of them?
- Particularly in a small country, you can't afford to immobilise any of them.
- Non-financial firms and individuals: Is every person and every firm able to trade in every market?
- Enlarging market access is an easy path to strengthen liquidity.

Part III

Transparency

Transparency about underlyings

- A key insight of the field of market microstructure is: illiquidity is bred by asymmetric information
- If some people have more information than others, spreads widen
- This has a direct policy implication: Escalate rules about transparency so as to obtain low impact cost.
- For stocks and corporate bonds: Transparency about the firm
- For currencies and government bonds: Transparency about the government and the country (i.e. the statistical system).

Transparency of the market

- The exchange should produce a good subset of the LOB in realtime that financial firms can access
- On a daily basis, the exchange should release high quality intra-day data (at the end of day) which will foster analysis by financial firms - thus improving their knowledge and confidence.

Part IV

DMA

The new world of algorithmic trading

DMA DMA stands for 'direct market access' – it is the computer protocols required for tightly wiring a computer system at a financial firm into the exchange

Algorithmic trading Financial firms who use DMA to build computer systems that process market data and put orders back into the market.

NYSE - roughly two-thirds of orders are now coming over DMA.

The importance of DMA

- The algorithms continuously place orders based on quantitative strategies.
- They are very good at formulaic arbitrage strategies
- They tend to not lose their heads when markets move - they make liquidity more resilient

What does it take to foster DMA?

- Exchange must release high quality data for financial firms to do research
- Exchange must publicly release documents required for financial firms to build their own algorithmic trading systems.

Part V

Frictions of middlemen

Total t.c. is what matters

- Impact cost is very important
- But it looms large only after all other frictions have been controlled
- These include brokerage fees, payments to custodial firm, payments to depository, etc.
- What matters to customers is the total t.c. - not just the IC.
- Blistering competition and economies of scale are the way to fight these.

Aggressively grow the market

- Remove entry barriers in exchange membership
- Remove restrictions against foreign securities firms
- Remove restrictions (if any) on creating branch offices or placing exchange terminals anywhere
- Remove restrictions against Internet trading
- Remove restrictions against banks / hedge funds / whoever obtaining a direct exchange membership so as to cut the intermediary out of the loop.

Litmus test

1. A foreign hedge fund
2. Comes to Sri Lanka, hooks up directly to the exchange
3. Obtains high quality data, builds an algorithmic trading system,
4. Uses DMA to hook it up into the exchange.
5. Is able to bring capital in and out of the country as it likes, while hedging currency risk if it likes.

Is this feasible?

Part VI

The call auction

Call auction

- The LOB market involves continuous trading
- A call auction runs from (say) 9:30 to 10:00
- Only at 10 AM do transactions take place
- All transactions are matched at a single price - there is no IC
- From 9:30 to 10:00, the computer is collecting orders, showing the supply and demand curves, and showing the notional price at which the matching would take place.

The tradeoff

- The call auction gives up continuous trading in return for zero impact cost.
- It is very useful for the official opening and closing of the day
- It gives futures arbitrageurs a locked-in execution at the official closing price, and thus fosters arbitrage.

Thank you.