

## Recommendation for quotation performance measurement systems in the Government bond market

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This paper contains a recommendation of the members of the European Primary Dealers Association<sup>1</sup> (EPDA) to the European Debt Management Offices for the construction of their quotation performance measurement systems.

### Convergence between systems

A certain rapport between the different European quotation measurement systems is desirable. Among the different quotation reports from the issuers, it can be challenging to keep an overview and adjust quotes in a timely manner. Nevertheless, each DMO should of course have its own compliance requirements, based on the unique characteristics of its market. Ideally, the levels where compliance is reached would be different for each market, but the calculation methods would resemble.

### Recommended characteristics for a quotation measurement system

- The system should be both transparent and simple to use and understand. It should allow the dealer to adjust his quotation behavior promptly if required.
- The system should lead to spreads that are supported by the market and that are tenable in the long run. Long run tenable spreads reflect market characteristics such as liquidity. They encourage competition, but not to a level that is incompatible with the characteristics of the specific market. Therefore, next to measures that have the effect of encouraging spreads to be tight and competitive, measures to prevent a race to the bottom should be taken. Long run tenable spreads support *real* liquidity, and therefore are a useful reference for price formation all across the market.
- A way to reach long run tenable spreads is to adopt a mechanism which is able to seamlessly accommodate different market circumstances.
- In normal circumstances a firm prescribed spread should apply, which is established by the DMO in consultation with the PDs. This could also be expressed in terms of establishing a floor. If the PD quotes within the firm floor, the quote should automatically be judged compliant. A balanced firm prescribed spread should take into account current (post Lehman) market circumstances.
- In other (exceptional) circumstances the prescribed spread should be market based; i.e. measured relative to peer performance. Peer performance could be measured as the average of the quotes of the PDs on a given bond, measured over a confined number of hours per day. Compliance limits could be set depending on the characteristics of the specific market. Quotes should be tradable in a certain prescribed size in order to be compliant.

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<sup>1</sup> The European Primary Dealers Association's (EPDA) Executive Members are: Banca IMI, Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Calyon, Citigroup, Commerzbank, Crédit Suisse, Deutsche Bank, Goldman Sachs, HSBC, ING, J.P.Morgan, Morgan Stanley, Natixis, Nomura, Royal Bank of Scotland, Société Générale, UBS & Unicredit.

- In case there is a mechanism in place that formally distinguishes between normal or exceptional circumstances, it is important for the decision procedure to be automatic (without further consultations with market participants) and market based. If the average quoted spread (of the PDs that quoted the bond) of a given bond on a given day is outside the prescribed firm spread, then it should automatically be judged according to the exceptional circumstances methodology. If the average spread falls within the firm spread it should be judged according to the normal circumstances methodology.
- A quotation measurement system should allow for flexibility on the side of the dealer. It should allow for both under- and overcompliance scores on a given bond on a given day, averaging out performance across the curve and across a certain time frame (e.g. the course of a calendar month). Once a PD's quotes are compliant and fall within the firm prescribed spread, these quotes should not be ranked versus the quotes of other PDs. The number of mandated quoting hours per day should be limited within reason; e.g. not more than 5 or 6 hours.
- Examples of quotation regimes that encompass (important elements of) the above recommendations include, but are not confined to, the systems of France and the Netherlands.

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