Julian von Landesberger
ECB/DG-M/BMI

Some considerations on market making and trading

BMCG - Frankfurt, 1 July 2014

Overview

1. Observed recent changes in global fixed income markets

2. Possible policy initiatives

3. Issues for discussion

Feedback from BMCG survey in February

I. **Regulatory changes with persistent effects on market making**

II. **Advances in risk management techniques**

III. **Structural changes owing to technological progress**

IV. **Evolution of market conditions (low interest rate level favouring buy-and-hold)**

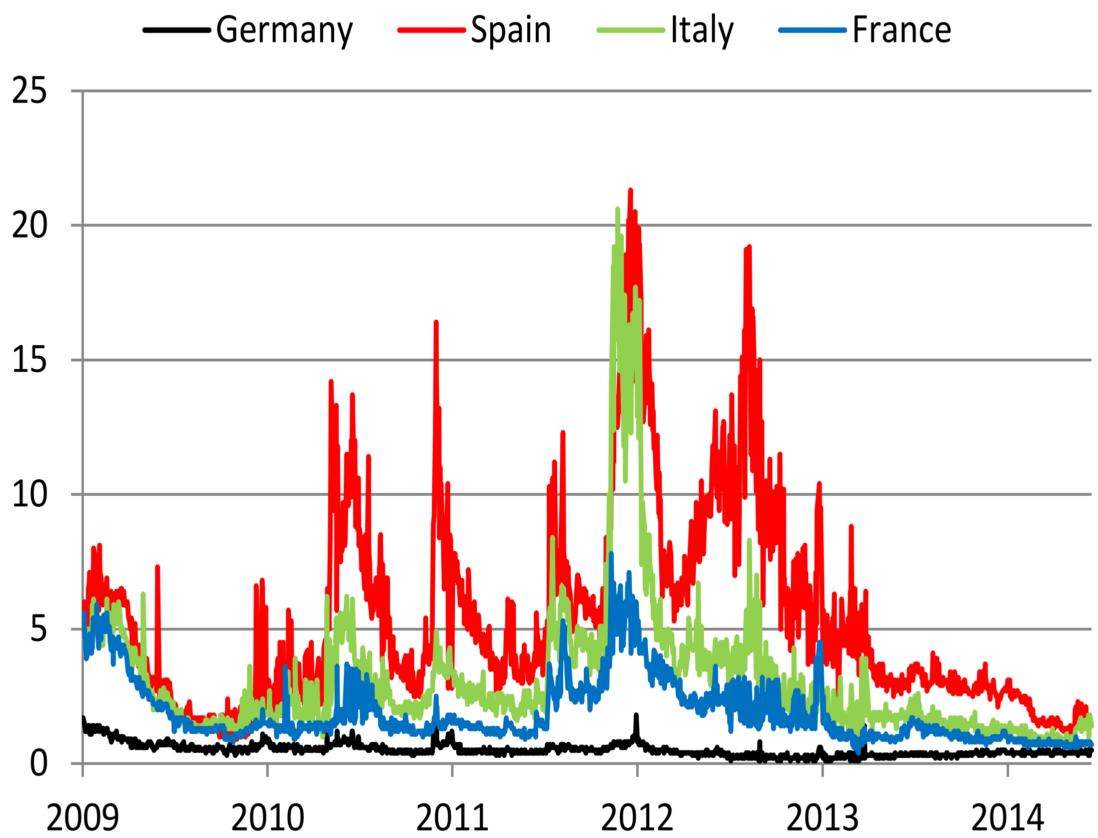
- **Reduced balance sheet capacity**
- **Stricter limits**
  - **quoting obligations can be withdrawn during stress periods**
  - **committing available balance sheet only for top-tier clients**

➡ Lower ability to absorb shocks

Market liquidity

- **Standard liquidity metrics** suggest that market liquidity in most large euro area sovereign bond markets has returned to levels comparable to before the global financial crisis.
- Market intelligence supports this assessment.

10-year benchmark, bid-ask spread in bps

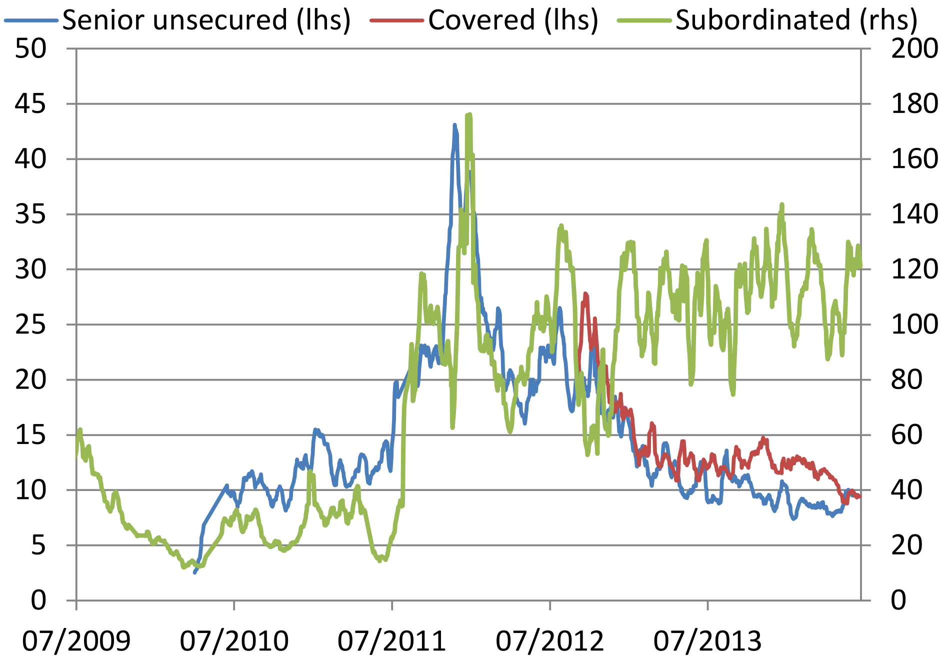


Source: Reuters/Tradeweb, ECB calculations.

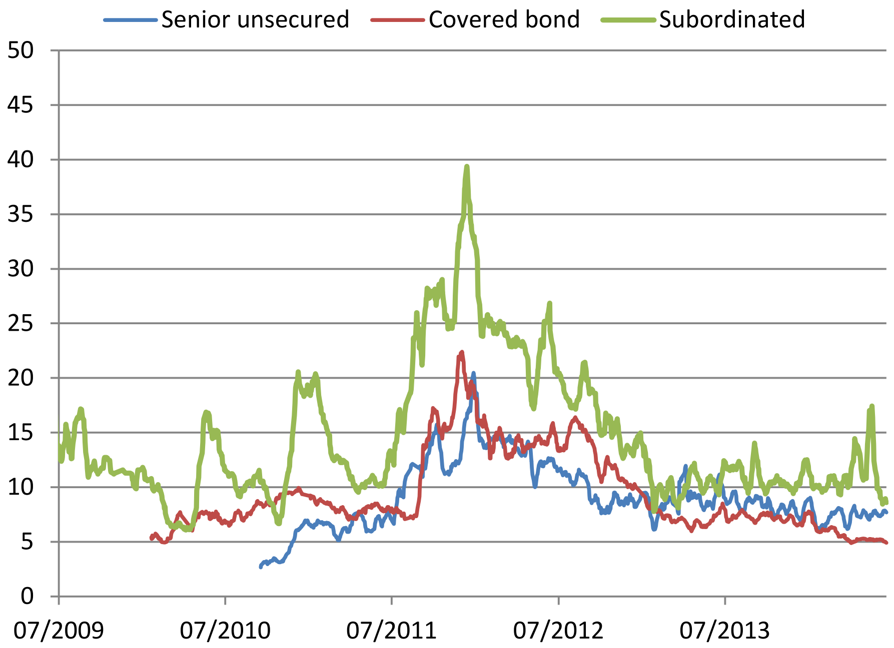
Market liquidity II

- **Liquidity bifurcations in credit markets** resulting in a concentration of market liquidity in the most liquid instruments and deteriorating in the less liquid ones.
- Supported by market participants' feedback
- Less liquid bonds generally tend to be also riskier bonds.

Intesa San Paolo (6-8 years), bid-ask spread in bps



BNP (4-6 year), bid-ask spread in bps



Source: Reuters/Tradeweb, ECB calculations.

EUROPEAN CENTRAL BANK ©
www.ecb.europa.eu

Three key questions from a central bank perspective

- Impact of changes in fixed income market-making on **monetary policy transmission and monetary conditions:** In how far is the relationship between key policy interest rates and actual funding conditions of the real economy dependent on market functioning
  - Strength of portfolio rebalancing mechanism (weaker)
  - Monetary policy announcements and impact on bond prices (stronger)

- Is the liquidity risk that is being transferred to issuers and investors by recent developments in market-making correctly priced? How can central banks foster an appropriate pricing of this liquidity risk?

- Will these sectors be able to handle the liquidity risk or are structural adjustments needed? How can this adjustment be supported?

Observed recent changes in global fixed income markets

- **Changes in market-making practices**
- fewer but larger market makers;
- tiering of liquidity provision;
- a shift from inventory based to brokerage based (match-making) trading/exchange-like trading;
- a rise of non-traditional market makers, such as hedge funds.

- **Changes in the “demand” for market-making services**
- usage of a more limited number of counterparties by asset managers
- more buy-and-hold positions with less relative value trades
- opportunistic timing of trades
- sourcing bonds in the primary market, potentially increasing concentration risk
- use of routing software to break down large orders in smaller tradable ones

- **Changes in debt issuance practices**
- Sovereign issuers may need to offer primary dealers larger concessions
- PD requirements may need to be recalibrated owing to new regulatory constraints
- More direct placements to by-pass the PD needs
- Corporate issuers to standardised bond issuances, larger benchmark issues and benefit from the available liquidity pockets.

Possible policy initiatives to support market liquidity?

- **Exit fees on fixed-income investment funds**

  - US retail investors have pumped more than USD 1tn into bond funds since early 2009.
  - Reduced market-making capacity of dealers
  - Prospect of a massive disorganized flight out of the funds should interest rates rise sharply
  - News reports mention Fed discussed topic
  - Alternatives: Redemption gates ?

- **Reduce risk of liquidity illusion by promoting transparency on the market-making capacity**

  - MIFID2 and MIFIR request mandatory price transparency
  - Possibly more important is to have quantity transparency owing to liquidity illusion
  - Increased information on dealer positioning in Tradeweb and Bloomberg

  - **[to be completed after London meeting]**

Issues for discussion

1. **How to distinguish liquidity bifurcation from credit fragmentation? How could it be most effectively addressed?**

2. **Which structural measures on behalf of issuers (e.g. DMOs) and investors could support market-making?**

   - Enhancement of market-making arrangements
   - Wider use of issuance calendars and greater standardisation of bond issues
   - More robust infrastructures (e.g. multi-dealer platforms)
   - Withdrawal of “same day liquidity” promise

3. **Would you see scope for initiatives supporting liquidity in repo markets? What form should such initiatives take and who should initiate them?**

EUROPEAN CENTRAL BANK
www.ecb.europa.eu

Thank you for your attention