NEW REGULATION

The Impact on Bond Markets – Buy Side Perspectives

BOND MARKET CONTACT GROUP

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tomorrow is today

UPCOMING REGULATION

- EMIR
  - Clearing requirements
- Mifid 2 and MIFIR
  - Market Structure (Exchange, MTF, OTF, SI)
  - Transparency requirements
- FTT
  - Financial Transaction Tax
- Capital Requirements Regulation
  - Regulatory capital

WHY DO INSTITIONS OWN BONDS ?

- Safe haven asset in the total portfolio (but a return requirement exists)
- Dutch pension funds still adhere on average to the 60-40 percent split in real assets vs. Bonds
- 40% allocation towards bonds, but large differences in allocation between sovereign risk and credit risk
- Low yields are (already) a challenge given a 6-7% return requirement

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DEALER INVENTORIES AND LCS

- L(iquidity) C(ost) S(cores) is defined by Barclays as the cost of an institutional-size round-trip transaction, expressed as a percent of the bond's price

$$\text{Liquidity Cost Score (LCS)} = \begin{cases} \text{OASD} \times (\text{bid spread} - \text{ask spread}) & \text{if quoted on spread} \\ (\text{ask price} - \text{bid price}) / \text{bid price} & \text{if quoted on price} \end{cases}$$

- Barclays concludes that dealer inventories have a significant (positive) impact on market liquidity

IMPLICATIONS OF (NEW) REGULATION

- Initial Margin – Cash & Bonds
  - Bonds used as initial margin - impact on liquidity ?
  - Pricing influenced by ‘eligibility’
- Market Structure
  - MTF, OTF, SI – only in an SI regime a dealer can trade vs. own capital. Currently low liquidity in MTF and OTF.
- Transparency
  - Pre- and Post trade transparency, Liquidity threshold, Large-in-scale and Price-reference-waivers, reporting on asset encumbrance

IMPLICATIONS OF (NEW) REGULATION

- FTT
  - Higher impact on instruments with short maturity, negative impact on liquidity
- Capital Requirements
  - Higher cost for inventory of bonds – lower liquidity
  - Sovereign risk keeps it's low required regulatory capital

CONCLUSION & ISSUES TO DISCUSS

- Liquidity in Bond markets will be impacted negatively by new regulation
- Will we see a move from voice to electronic trading to mitigate the reduction in liquidity/volumes?
- What can we learn form the equities market ? What to prevent ?