



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Some considerations on market making and trading

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1. Observed recent changes in global fixed income markets
2. Possible policy initiatives
3. Issues for discussion

- 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)**



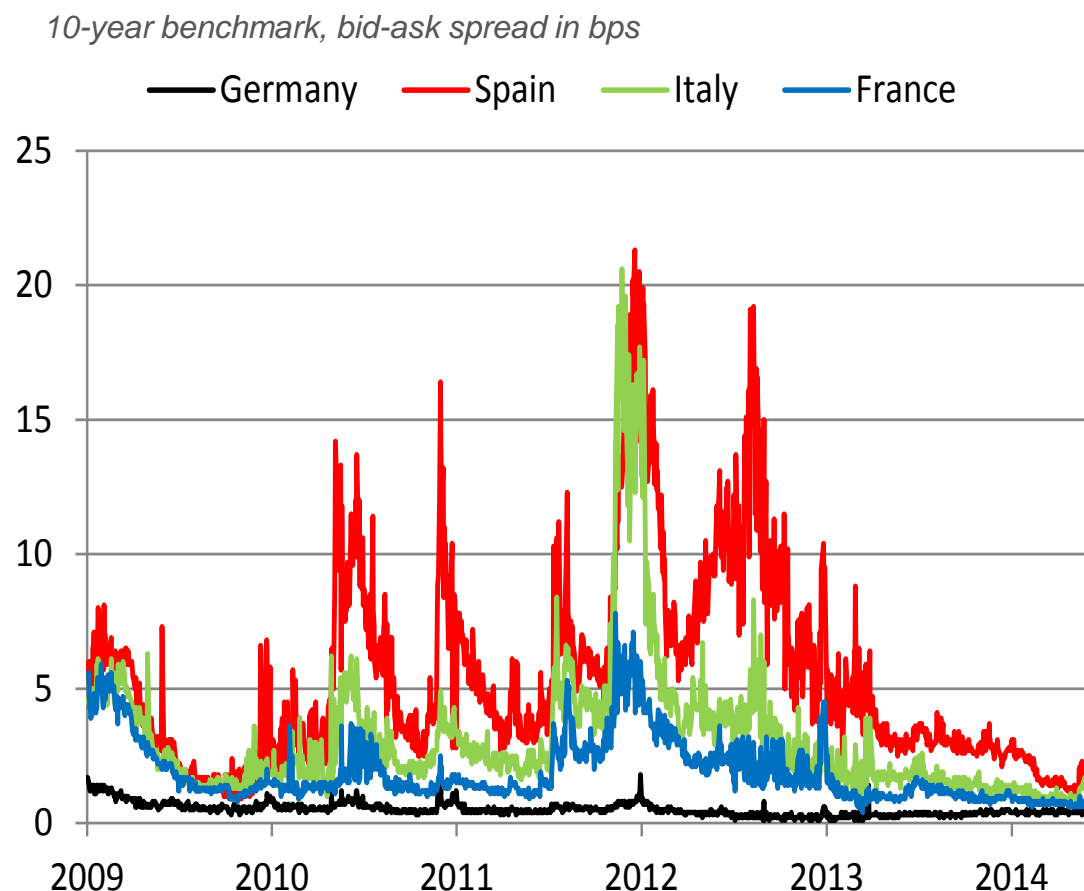
- Reduced balance sheet capacity**
- Stricter limits**

- quoting obligations can be withdrawn during stress periods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.

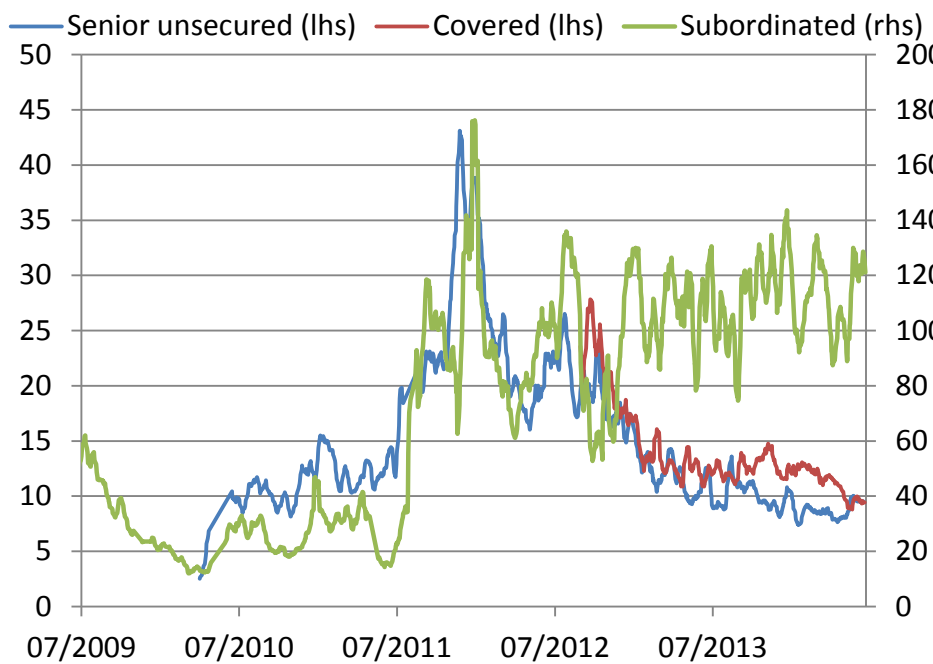


Source: Reuters/Tradeweb, ECB calculations.

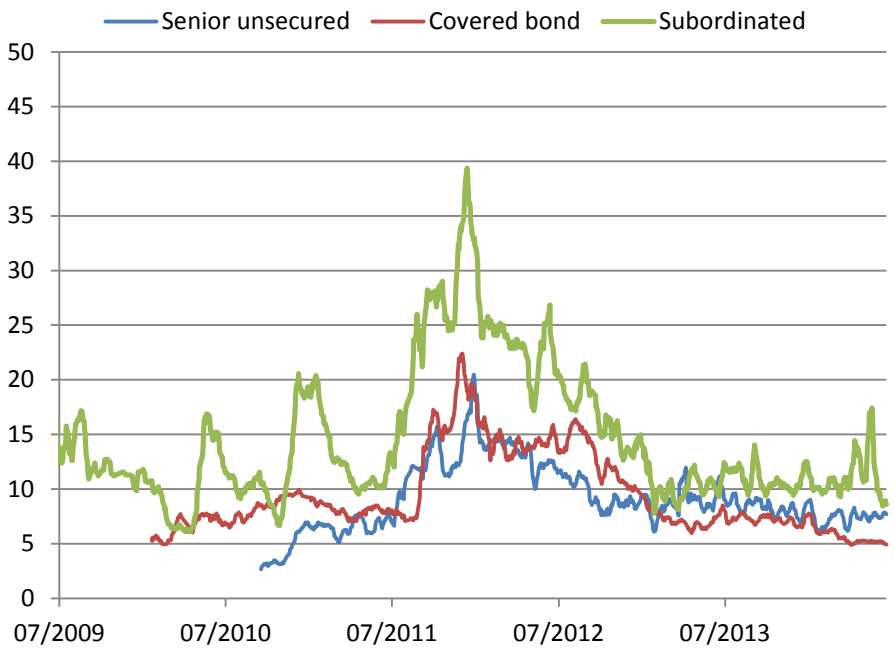
Market liquidity II

- **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.

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]**

- 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?**

Thank you for your attention