

Best practice framework - Euro area government bond markets

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Best practice framework: US

Treasury Market Practices Group

What is it?

- Group of Market Professionals
- Variety of firms & functions
- Sponsored by the Fed
- www.newyorkfed.org/tmpg

TMPG “recognises importance of maintaining integrity and efficiency of US Treasury, Agency Debt & Mortgage-Backed Securities”

“Reduce market disruptions”

Reduce “episodes of protracted settlement failure”

“Buttress overall market integrity”

What best practices does TMPG recommend?

- (1) Promoting liquidity and transparency
- (2) Maintaining a robust control environment
- (3) Managing large positions with care
- (4) Promoting efficient market clearing

“Vigorous, well-informed & assertive internal control program”

Timely clearing to avoid market congestion . In lower rate environment, a “fails charge” should apply

Promote market making, Quote to trade, not to create market distortions

“Avoid strategies that exacerbate settlement failure”

Focus on UST: Contents

Market Value & Turnover

Secondary Market Structure

Primary Market Structure

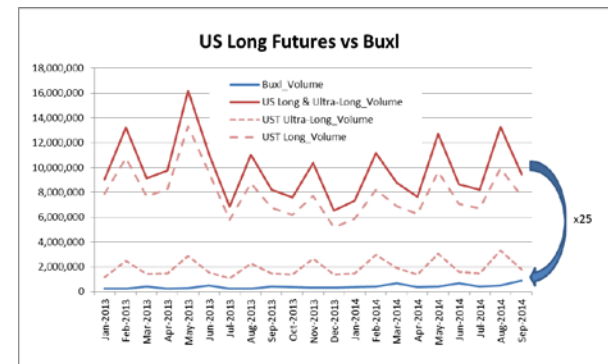
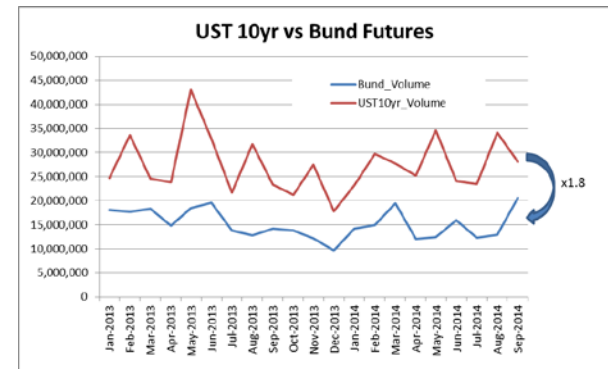
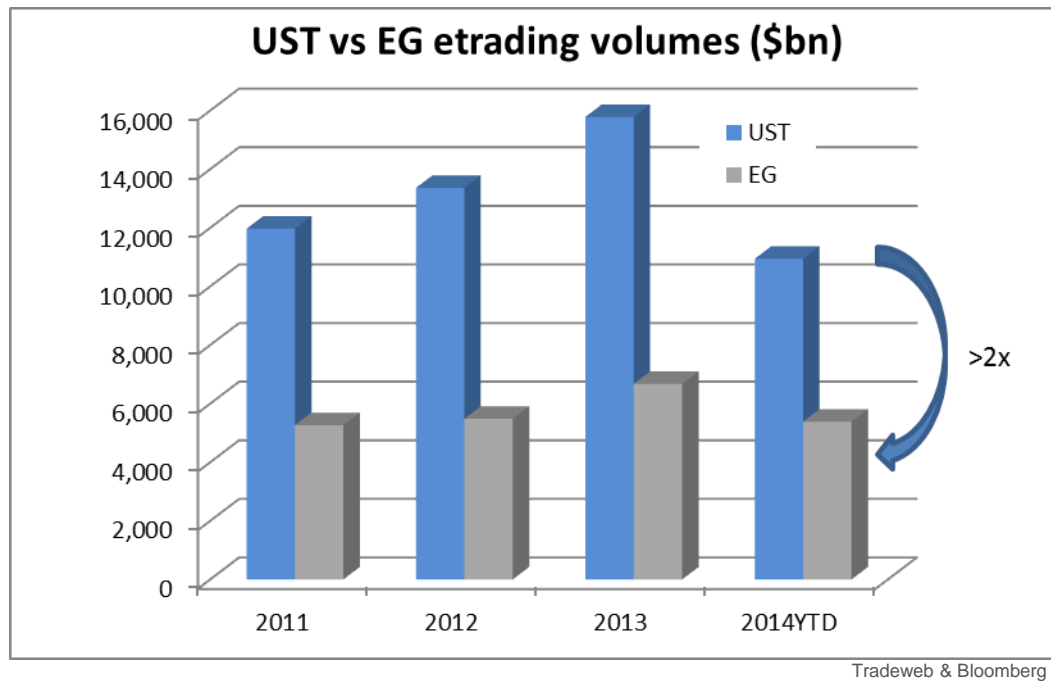
Post trade Settlement Structure

“Quotes from TMPG Apr 14”

UST Market Value & Turnover

→ US Treasury outstanding debt is smaller yet turnover is larger

	Debt outstanding	Avg Daily Turnover	Annual Debt turnover
Eurogovts ex-bills	\$7tn (€5.4tn)*	\$104bn (€80 b)^	3.7
US Govts ex-bills	\$5.9tn (€4.5tn)*	\$193 bn^	8.2



*ECB monthly bulletin: excl bills, FRNs, zeros

**Federal Reserve Bank of New York, Municipal Securities Rulemaking Board, FINRA TRACE

^ Market estimate derived from assumption that e-volume is 40%

UST Secondary Market...

→ ...is deeper, larger, 24hr, more liquid, lower hedging costs, greater certainty to offload positions

On-The-Runs

- **Highly transparent & non-ambiguous benchmarks:** 2, 3, 5, 7, 10, 30 year -> EU: some confusion, no harmonisation
- Trade on price in 32nds -> Reduction in arbitrage?
- Volumes across OTRs & OffTRs are roughly similar
- Fewer concentrated points breeds liquidity and creates deeper markets across the curve

Off-The-Runs

- All other UST coupons are “Off-The-Runs”
- Trade as a spread to OTRs -> Benefit to liquidity in non-benchmarks?

Futures

- Efficient hedge for both OTRs and OffTRs alike: CTD 2y, 5y, 7y, 16y, 26y -> Europe: limited hedging NL, BE,...
- Liquidity on each point is deep especially at long end -> Lacking in Europe; visibly so in times of stress
- US 10yr note future volume is ~2x Bund futures; UST long futures volumes are ~25x Buxl futures
- Futures complement liquidity in cash market -> Europe: DE exchange futures & basis substitute cash markets

Brokers

- Efficient hedge for all trading -> Europe: don't consider brokers for hedging DE
- Volume distributed ~equally across 2 major platforms
- High frequency unofficial market makers also access cash broker markets
- Technology more sophisticated through broader use of algos (for example); possible due to concentrated points of liquidity

UST Primary Market...

→ ...has greater transparency, lower risks and lower running costs

One issuer

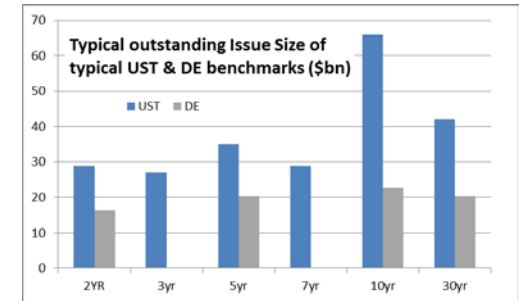
- One auction system
 - One issuance calendar
- Reduces complexity
 - Reduces technology costs

Issuance Practice

- Issuance concentrated on fewer instruments
- Promotes deeper liquidity

Primary Dealer Targets

- No market share targets
- Promotes real interest
 - Lowers probability of post auction price swings as dealers race to flatten positions

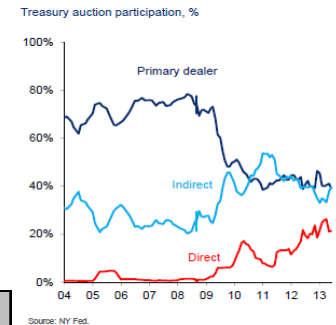


Client Orders

- Client orders entered into main auction system either:
 - directly by client (e.g. central banks)
 - indirectly via dealers on behalf of clients
- Dealers can also enter orders directly

- No separate system required by dealers
- Less opportunity for discounts
- Minimises over-bidding
- Less scope for pre-auction adverse price movements
- Greater transparency

	Indirect	Direct	Dealer
Average 12-month 10year UST participation	45%	17%	37%



UST Post-Trade Settlement Structure...

→ ...less settlement risk, less complex, greater certainty to cover short positions

One Settlement System

- Facilitates possibility of T+1

Compare Europe:

- *Multiple domestic depositaries that are not incentivised to enable freer movement of collateral*

Fails

- TMPG introduced a charge of 300bp preserving the integrity of the market
- Furthermore, Fed can lend bonds to banks

Compare Europe

- *No common penalty system*
- *Compare Europe: ECB leaves banks to control liquidity*

Max Post Trade Settlement Size

- Compulsory break-up of trades to maximum \$50MM clips

Compare Europe

- *Asset Managers & Hedge Funds reluctant*

Discussion Items

→ Possible to consider a European “TMPG”?

- UST best practice framework is more difficult to implement in Europe given greater restrictions but **not unachievable**
- Possible & achievable aspects to consider to improve liquidity, transparency and efficiency in European bond markets:

Centralisation

- Centralising information and statistics e.g. auction calendar

Issuance

- Reviewing auction procedures to minimise over-bidding & discounting

Settlement

- Maximising post-trade settlement size
- Implementing a harmonised fails charge

- ECB could create a “TMPG-Like” Group *or* the scope of the current ECB Bond Contact Group could be extended?

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