

Liquidity in the bond & credit markets

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Liquidity in the bond & credit markets

- ▶ Recent trends in market liquidity : converging views and different assessments
- ▶ Reduction in inventories: what, why and what expected impacts
- ▶ Regulatory uncertainties related to potentially conflicting objectives:
 - ▶ Bank Structure Regulation
 - ▶ Central Settlement Depositories Regulation
 - ▶ MIFID - Pre and post trade transparency requirements
 - ▶ The Fundamental Review of the Trading Book
 - ▶ The potential evolution of the regulatory treatment of Sovereign exposures
 - ▶ Capital Market Union
- ▶ Market participants (banks, issuers, investors) – what next?

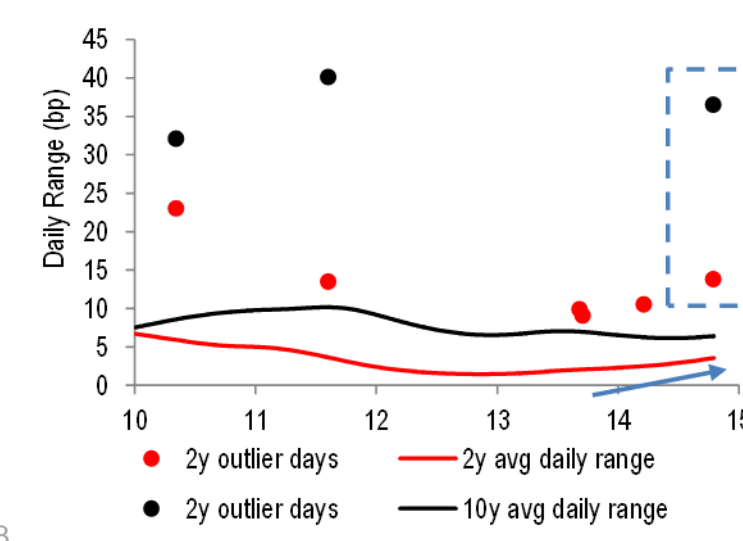
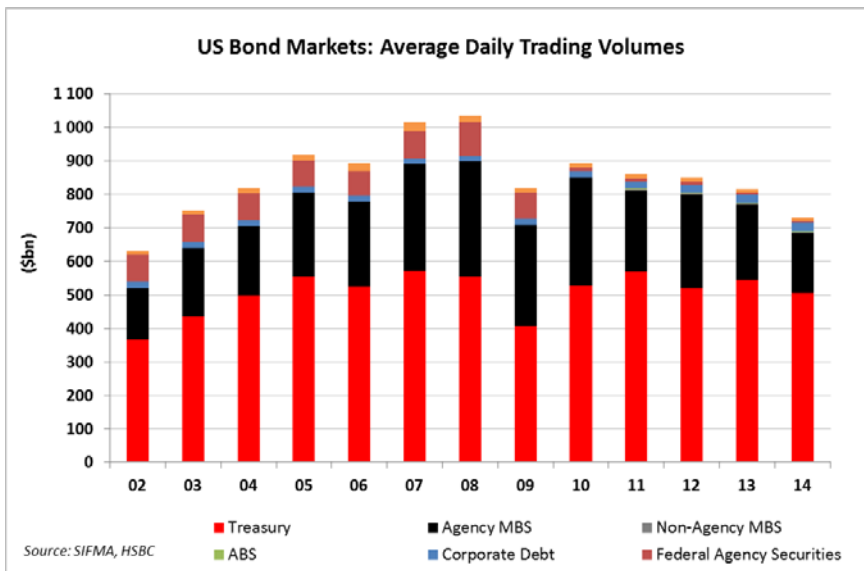
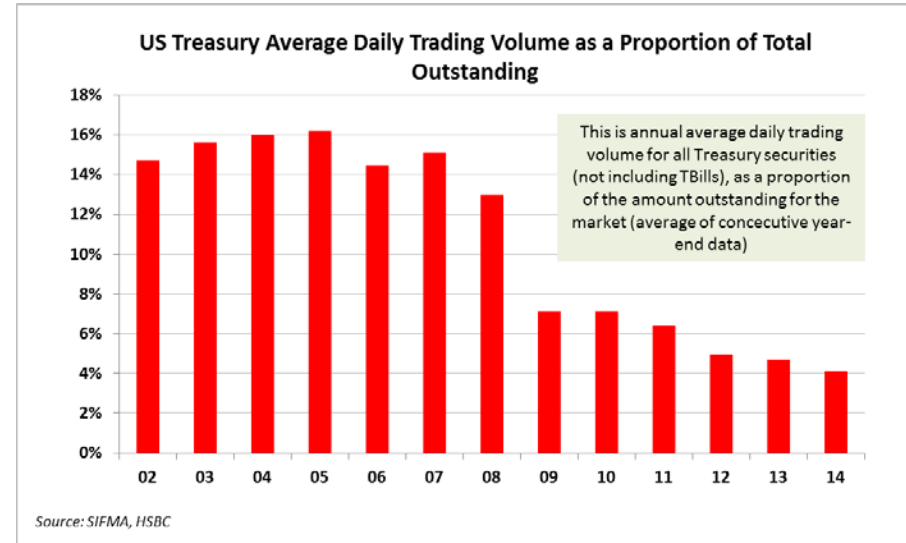
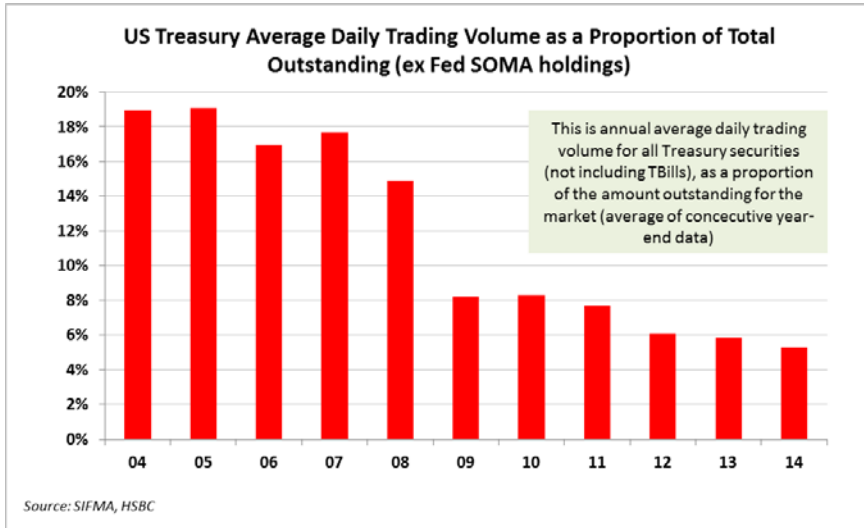
Certain / existing /
agreed



Future/ Uncertain /
Potential outcomes

Recent trends in market liquidity : converging views and different assessments (1/3)

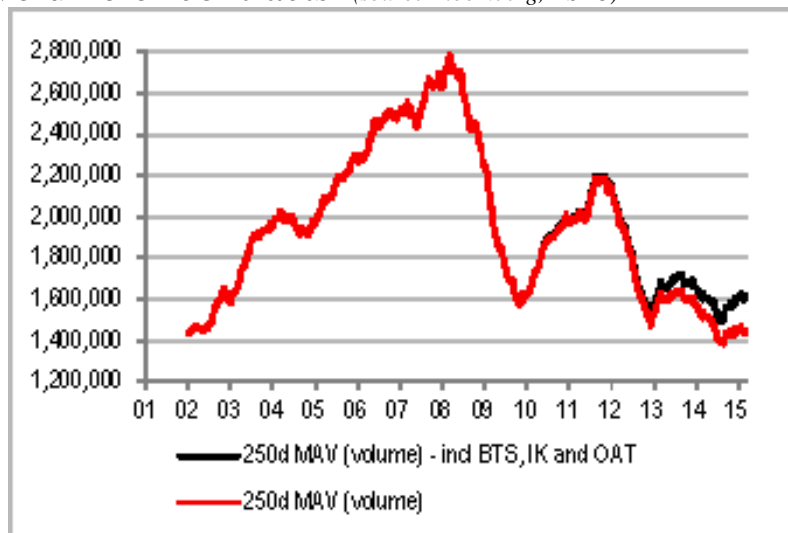
- ▶ Recent trends in market liquidity : Converging views
- ▶ Growing and significant concerns on secondary fixed income markets



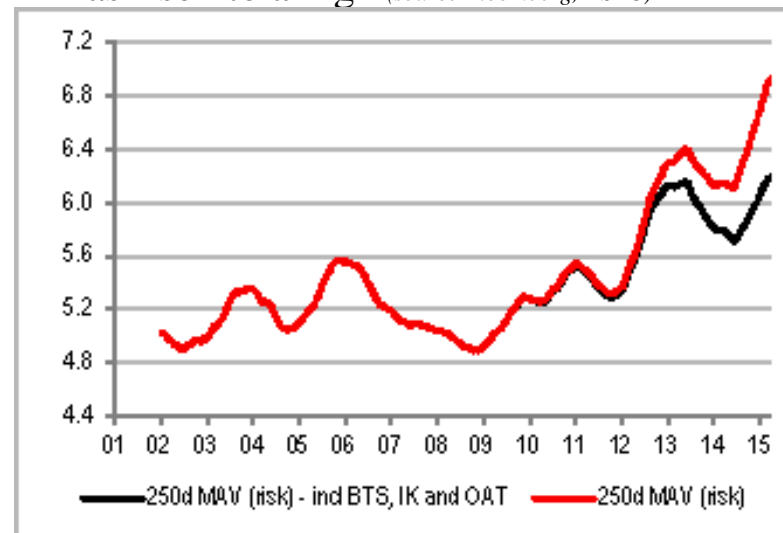
Recent trends in market liquidity : converging views and different assessments (2/3)

▶ Converging views : Material concerns on market liquidity

Turnover for the German futures is at the low since 2002
volume of contracts *(source Bloomberg, HSBC)*



The contract weighted bond risk (i.e. dv01) of the
has risen to a high *(source Bloomberg, HSBC)*



- ▶ O Wyman / Morgan Stanley (March 2015) – “New rules have driven a severe reduction in sell-side balance sheet and banks liquidity provision, (...) We think the liquidity of the secondary fixed income markets is likely to get materially worse.”
- ▶ BIS I Fender and U Lewrick (March 2015) – “We see signs that market liquidity is increasingly concentrating in the most liquid securities, while conditions are deteriorating in the less liquid ones (“liquidity bifurcation”)”.
- ▶ Dame Clara Furse, BoE, (Feb 2015) – “some measures of liquidity risk premia appear compressed; the compensation that investors require for bearing liquidity risk in some corporate bond markets has actually fallen to below its long-term average. Fragile liquidity conditions in these markets render them vulnerable to sharp correction.

Recent trends in market liquidity : converging views and different assessments (3/3)

- ▶ Recent trends in market liquidity : different assessments and focuses
- ▶ The BIS study considers that bid/ask spreads of the USD and EUR Sovereign debts have broadly returned to levels comparable to those prevailing before the crisis (cf appendix 1)...
- ▶ Whereas Barclays considers that transactions costs, incl bid/ask have materially evolved:

Transaction costs, today versus the pre-crisis period

	1/31/2007		1/31/2015		Change	
	LCS (%)	Bid-Offer	LCS	Bid-Offer	LCS	Bid-Offer
US Credit Corporate	0.531	8.5 bp	0.951	13.2 bp	+79%	+55%
US High Yield Corporate	1.276	1.28 pts	1.550	1.56 pts	+21%	+21%

Source: Barclays Research

- ▶ and market participants have faced a material reduction of the repo market:

According to IOSCO (*Securities Markets Risk Outlook 2014-15*), end of 2007, gross amounts outstanding reached roughly \$10 trillion in each of the US and Eurozone repo markets. After the crisis the use of repos declined, and repos outstanding were expected to total only \$3.1 trillion in 2014.

The last ICMA European repo market survey (published in Feb 2015) showed a further reduction by 4.8% in H2 2014, mainly explained by the leverage ratio and the LCR.

Reduction in banks' inventories: why, what and expected impacts

► *Why:*

- i) Low yield environment : no carry
- ii) Based on a simplified portfolio made of European Govies and swaps, HSBC computed that the required capital had been multiplied by more than 7 since 2010 (introduction of the stress VaR, IRC, CVA VaR, increase of the level of capital required and LR). G-SIBs add on, Stress tests, floors also increase the required capital.
- iii) Additional pressure coming from the implementation of the Volcker rule in the US and expected identical effect from the French banking law (and BSR).

- *What:* according to O Wyman, flow rates consumed ~40% of industry capital but generated only 5-10% of PBT, Over the next 3 years:

We expect banks to shrink balance sheet further Share of 2014 balance sheet and expected reduction

	Changes in balance sheet 2010-14	Further potential reduction
Rates & repo	~ -30%	-15% to -25%
FX, EM, & Commodities	~ -25%	-5% to 0%
Credit & Securitised	~ -30%	-5% to -15%
Equities	~ 0%	-5% to 0%
Total	~ -20%	-10% to -15%

Source: Oliver Wyman proprietary data and analysis

► *Expected impacts:*

- Inventories held by other market participants (AuM in daily redeemable funds are up 76% since 2008)
- Liquidity provision expected to concentrate on the more liquid instruments
- Banks expected to segment their clients and offer their balance sheet capacity to their key clients.
- Reduction of the number of large in scale transactions and of the average size of transactions.
- OTC Derivatives trade compressions...

Regulatory uncertainties related to potentially conflicting objectives

	Rates & Repo	Credit	Comments
Bank Structure Regulation			Prohibition of prop trading and potential separation of trading activities - Pressure on inventories / huge costs if market making is separated / potential detrimental costs if hedging efficiency is broken / potential exemption of Sovereign bonds.
Central Settlement Depositories Regulation			Improve post trade efficiency : harmonization of CSD rules but potential detrimental effects on the repo market if rules on mandatory buy-in are adopted as specified in the ESMA consultation.
MIFID - Pre and post trade transparency requirements			Adequate calibration needed (specification of a liquid instrument, LIS and SST levels, reporting and publication timeline). Level playing field and ET impact.
The Fundamental Review of the Trading Book			Adequate calibration needed – the netting benefit will depend notably on the desk structure, the level of cross-asset class diversification will be constrained by regulators, expected shortfall will replace VaR and SVaR, liquidity horizon by risk factor categories up to 250 days for illiquid risk factors, mandatory calculation of standardised capital charges, likely to be used as a floor or surcharge to the models-based-approach...
NSFR			\$300-500bn additional stable funding required for derivatives ; 10-15% increase in derivatives funding costs.
Leverage ratio			the allocated capital might have to increase well above the required capital driven by risks, showing a multiplier of 11,1 since 2010 if LR was set at 6%.
Potential evolution of the regulatory treatment of Sovereign exposures			Potential evolution of CRR and Solvency II aimed at reducing the favourable treatment of sovereign exposures (low or 0 weight, haircuts for collat, large exposures, LCR and NSFR, 0% risk factor in Solvency II).
Capital Market Union			Resilient market liquidity is key to successful market-based finance: expected positive measures.

Market participants (banks, issuers, investors) – what next?

❑ At the Industry Level

On Derivatives:

Standardised CSAs

SIMM (Standard Initial Margin Model)

Automatic collapsing of Trades, Trioptima, reset, novations etc ..

On Bonds:

reduce the lag between trade date and settlement date (T+3 to t+2)

change the way we operate in the repo market, security lending and exchanging bonds

Create alternative platforms in order to source liquidity (e.g. HSBC Credit Place).

❑ At the Sell side level

Banks with strong Capital:

Manage RWAs and RoRWAs more strictly

Reduce unprofitable balance sheet usage

Tactically increase market share and margins

Banks with weak Capital:

Raise Capital

Stop some activities

Do what the banks with strong capital are doing

❑ At the issuer level

Signing and changing CSAs and docs to reduce the costs

Managing more closely their credit exposure with banks (assignments, regular restructuring)

Standardize their issues / restructure their debts

❑ At the buy side level

Impact and reaction different according to the liquidity horizon (daily NAV funds and ETFs have different needs than Hedge funds, Reserve management / Central Banks, Pension funds and Insurers).

Enhance risk management and improve liquidity sourcing.

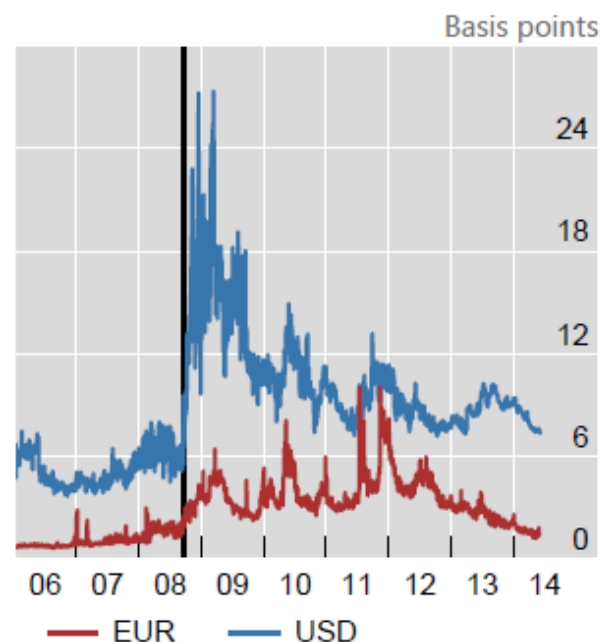
Get prepared to deal with temporary (or longer) lack of liquidity

Appendix 1 – extract from “shifting tides – market liquidity and market making in fixed income instruments”, BIS Quarterly Review, March 2015.

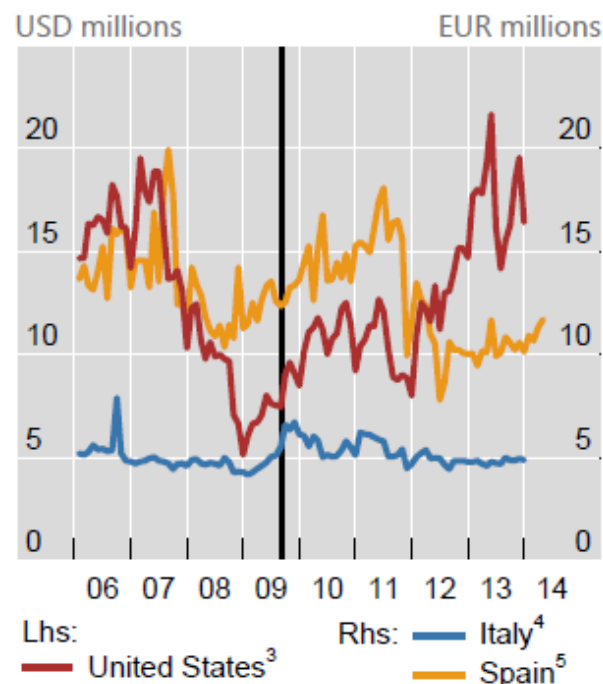
Post-crisis recovery in sovereign bond market liquidity

Graph 1

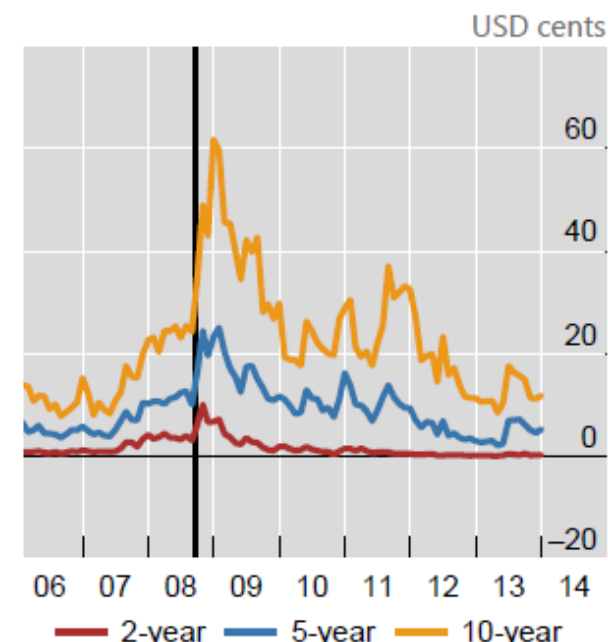
Sovereign bond bid-ask spreads by currency¹



Average transaction size



Price impact coefficients for US Treasuries²



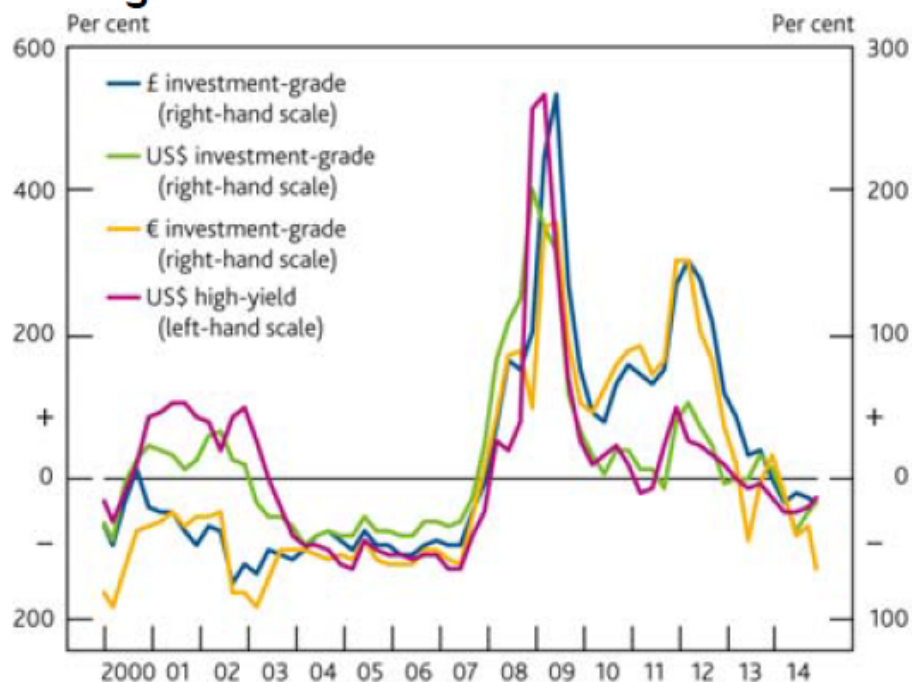
The black vertical lines correspond to 15 September 2008 (the date of the Lehman Brothers bankruptcy).

¹ Based on Markit iBoxx indices; includes domestic and foreign sovereign bonds denominated in US dollars and euros, respectively. ² Estimated price change per \$1 billion net order flow; monthly averages. ³ Average transaction size for 10-year US Treasury note. ⁴ Average transaction size on MTS Cash, an inter-dealer market and the most important wholesale secondary market for Italian government bonds. ⁵ Average transaction size for Spanish public debt.

Sources: CGFS Study Group member contributions based on national data; Markit iBoxx; BIS calculations.

Appendix 2 - Extract from Dame Clara Furse speech, External Member of the Financial Policy Committee, Bank of England, 11 Feb 2015

Chart 2: Deviations of estimated corporate bond liquidity risk premia from historical averages^{(a)(b)(c)(d)}



Sources: Bloomberg, BofA Merrill Lynch Global Research, Thomson Reuters Datastream and Bank calculations.

(a) Implied liquidity premia are estimated using a Merton model as in Leland, H and Toft, K (1996), 'Optimal capital structure, endogenous bankruptcy, and the term structure of credit spreads', *Journal of Finance*, Vol. 51, pages 987-1,019, to decompose corporate bond spreads.

(b) Quarterly averages of deviations of implied liquidity risk premia from sample averages.

(c) Sample averages are from 1999 Q4 for € investment-grade and 1997 Q1 for £ investment-grade, US\$ investment-grade and US\$ high-yield.

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