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# Bank business models and the role of Principal Trading Firms (PTF) in liquidity provision and intermediation

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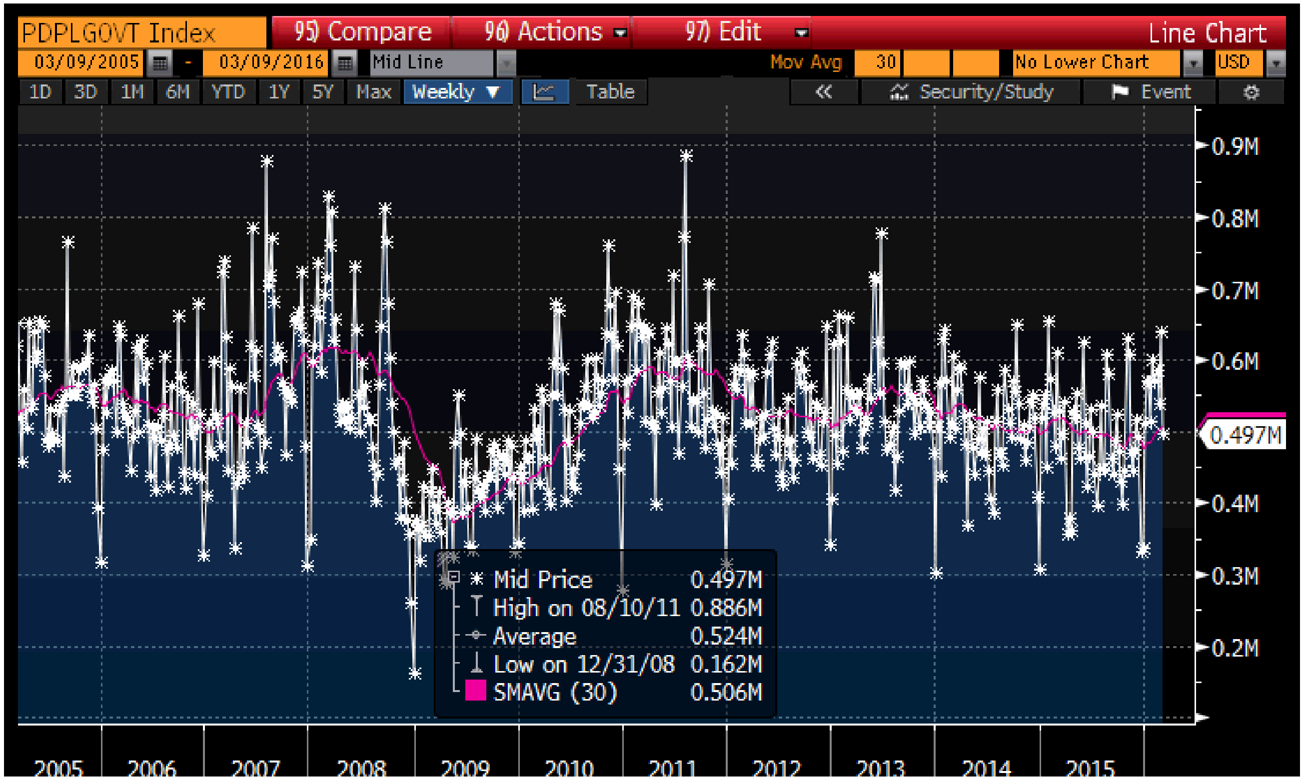
# Activity overview

## Long-term trends: US Treasury volumes broadly stable

- Primary Dealer daily average trading volumes in US Government Securities broadly stable over the last decade

- Underlying stock of securities has expanded significantly however

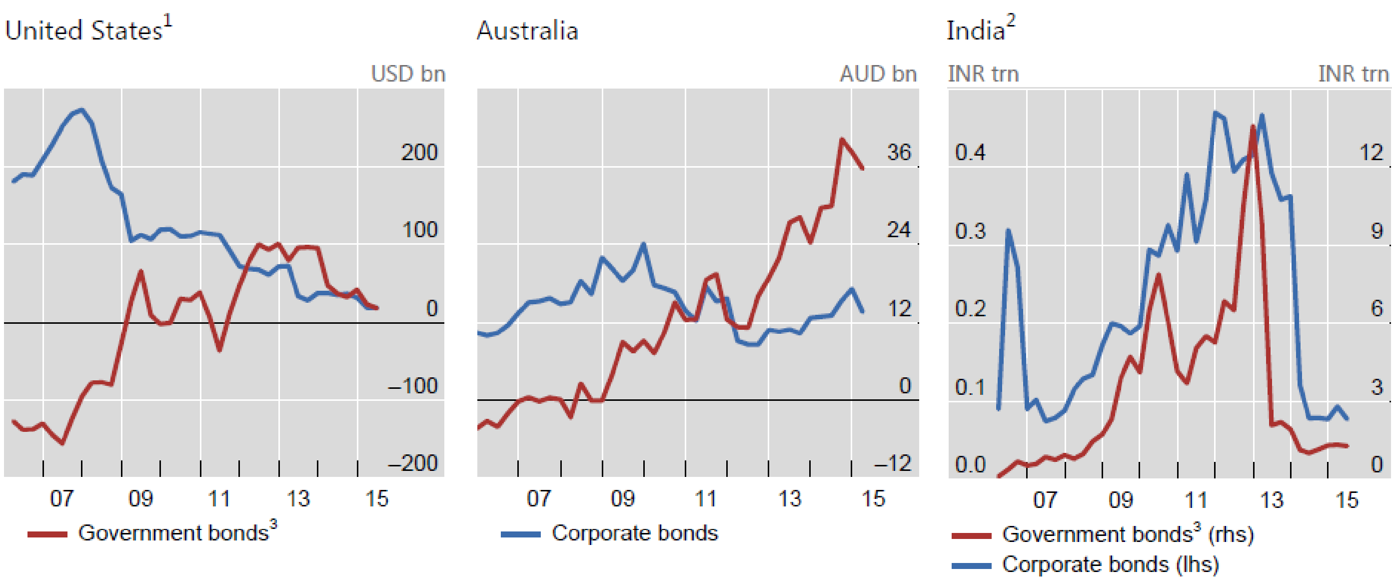



Source: Federal Reserve Bank of New York, Bloomberg

# Smaller net positions ....

## Broker/Dealer net positions

- Broker/Dealers net positions generally decreasing across the Fixed Income spectrum
- Consistent trend in DM and EM - **net** Government bond holdings in Australia have increased



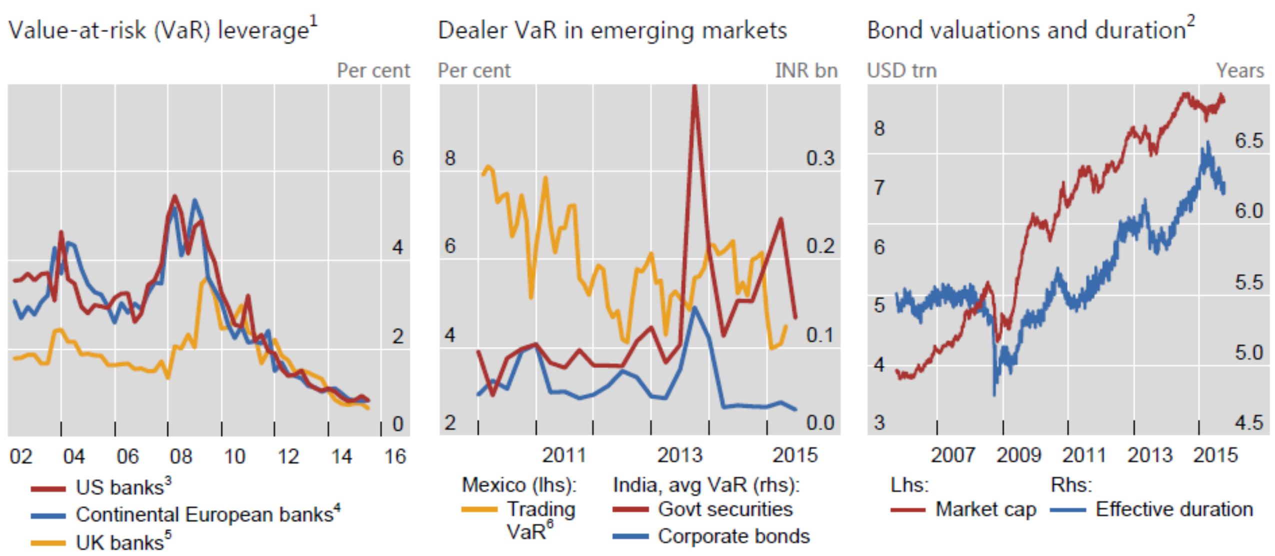

[1] Includes all US primary dealers. [2] Sample of 10 primary dealers and banks. [3] Domestic central government bonds.

Source: BIS Study Group member contributions based on national data (BIS CGFS Papers No 55 – Fixed income market liquidity)

# ... and lower VaR

## Dealer deleveraging and de-risking

- Significant  and highly correlated decreases in VaR leverage across DM
- Consistent trend despite increase in bond valuations and duration




[1] Annualised total trading VaR (99% confidence) divided by total equities, weighted by banks' total assets. [2] Based on the Merrill Lynch global corporate bond index. [3] Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Lehman Brothers (to Q2 2008), Morgan Stanley. [4] BNP Paribas, Deutsche Bank, Société Générale, UBS. [5] Barclays, Royal Bank of Scotland, HSBC. [6] In percent of banks' net capital.

Source: BIS, Bloomberg, Merrill Lynch

# Balance sheet velocity: degree of freedom?

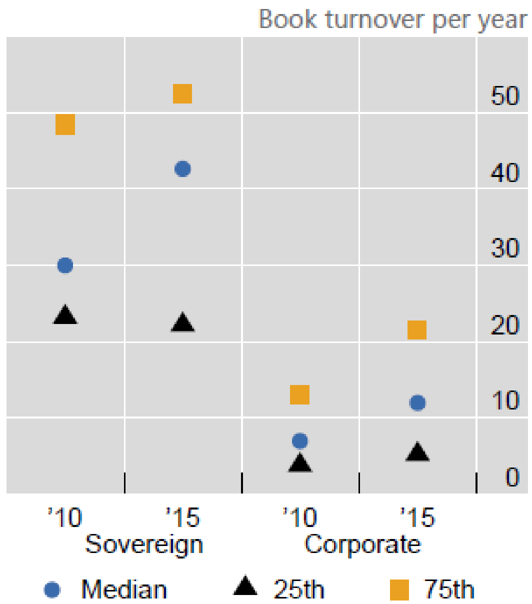
## Increase in estimated balance sheet velocity

- Increase in Balance sheet velocity has allowed trading volumes to stay broadly stable despite lower balance sheet usage

- Liquidity bifurcation? Asset managers' holding period has increased, stable overall volatility pointing to higher balance sheet velocity in liquid on-the-run instruments?

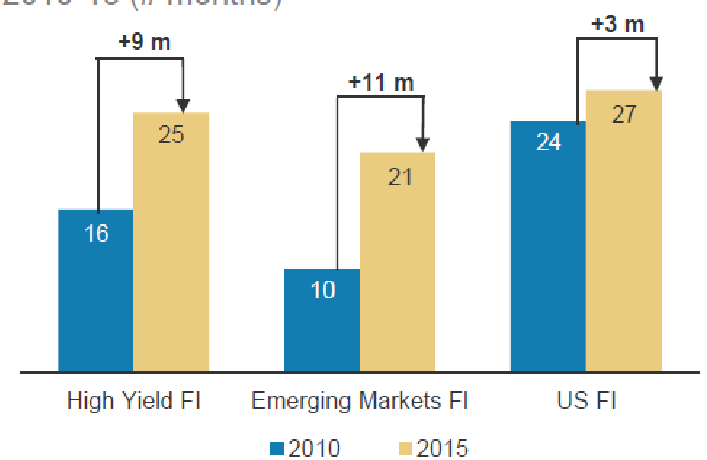
- Limits to how much further balance sheet velocity can increase?

Estimated trading book turnover




Source: BIS

Average asset holding period[1] for asset managers, 2010-15 (# months)



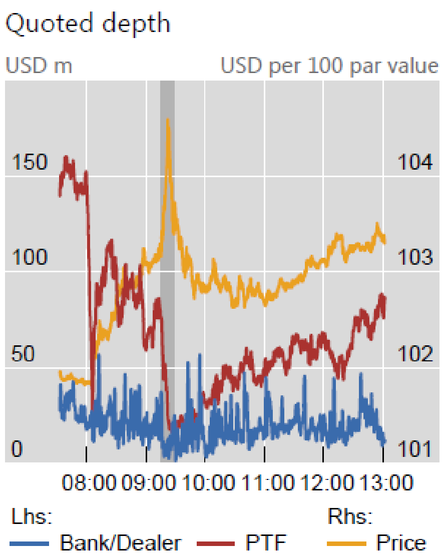

1. Holding period is calculated as 1 / turnover-ratio, and the average is absolute for all of the funds in the asset class hat have been open from 2010 to 2015.

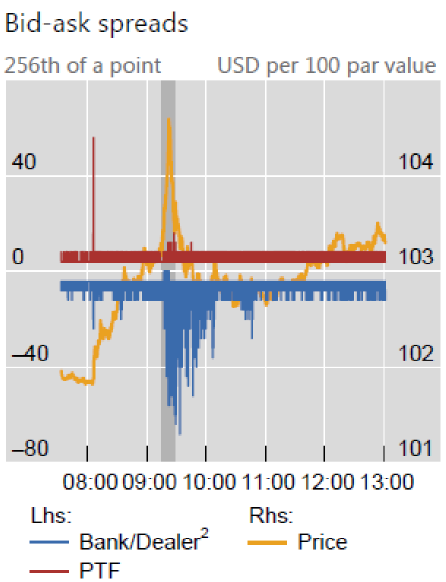
Source: Morningstar, Oliver Wyman, Morgan Stanley

# Broker / Dealer vs. PTF comparison – nature of liquidity provision

**US Treasury "Flash Crash" 15 October 2014: reaction functions of Dealers and Principal Trading Firms (PTFs)**

- Broker / Dealer quoted depth stable, adjustment to market conditions via increased bid/offer spreads
- PTFs bid/offer spreads stable, adjustment to market conditions via reduced quoted depth




Source: BIS, US authorities Joint Staff Report (2015)

# Bank / Dealer vs. PTF Comparisons

## Conclusions

- Bank / Dealer: Prudential regulation and Capital requirements driving cost of Financial Resources and liquidity provision
- PTF: lower (prudential) regulatory burden - market participation in many cases a function of CCP / Exchange rules (e.g. Capital base requirement a percentage of IM)
- Execution & intermediation services vs. Clearing services - cost dynamics likely to lead to different outcomes in different service areas
- Underlying product structure important factor in driving market structure
- Nature of liquidity provision
- Liquidity bifurcation within asset classes

# Bank / Dealer vs. PTF Comparisons

## Discussion points

1. Potential liquidity bifurcation from greater PTF involvement in EGB markets;
2. Possibilities for regulatory initiatives to bolster liquidity resilience;
3. How should banks' reaction functions change on days in which PTFs are stopped out and cease trading? Should this also be considered by investors?
4. Do banks need to change their business models to incorporate the increasing role of PTFs?

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