## ECB Bond Market Contact Group

### Impact of the regulatory environment on market making

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#### • The role of a primary dealer is to

- Act in principal facing issuers and investors: no natural match between offer and demand (issuer, maturity, coupon, volume and price) on thousands of instruments
- Provide liquidity at any time and for any sizes
- Warehouse the risks and manage inventories (being long of some bonds and short of others).

#### • What is liquidity and what drives liquidity?

- Criteria relate to spreads, depth (size of transactions that can be absorbed without affecting prices), immediacy (speed with which orders can be executed) and resiliency (prices return to "the initial level")
- Drivers are a competitive market structure, low fragmentation, transaction costs, heterogeneity of market participants and quality of infrastructure.
- The market makers on Euro Govies day to day operations are and will be impacted by :
  - higher costs of inventories (higher RWAs + a LR being the primary biting constraint rather than a backstop)
  - constraints on inventories in relation with the Volcker like measures
  - market fragmentation
  - and **increased uncertainty** on the likelihood to be able to hedge quickly a large position in the market.

#### The impact on the costs of inventories of capital adequacy rules

Sovereign, Supra and Agencies: from a 0 risk weight in Basel 2 to material RWAs due to the IRC and the stress VaR



—IR VaR (1day) —Outright —sum long EAD —Peripherals pvbp —RWA

#### The impact of the leverage ratio on the costs of inventories

<ul> <li>The LR impacts :</li> <li>The inventories of bonds (no exemption for HQLAs)</li> </ul>	<ul> <li>Let's assume a theoric/simplified primary dealer with</li> <li>10bn net long bond = 10bn leverage exposure</li> <li>10bn net short bond = 10bn reverse repo = 10bn leverage exposure</li> <li>⇒ Total leverage exposure = 20bn - 600m T1 ( 3% * leverage</li> </ul>				
<ul> <li>The reverse repos</li> <li>The stock of derivatives used for hedging</li> <li>The settlement accounts.</li> </ul>	With an assumption of 50% cost income ratio, 30% tax and expected ROE of 10%: The activity is expected to generate 60m profit or 170m operating income.				

- Based on the €855 bn programme of Eurozone Sovereign issuance in 2014, a primary dealer with a 5% market share would have to buy c. €1 bn on a weekly basis (with 42 active weeks in the year):
  - whereas there is a strong incentive to sell the more liquid assets at each computation date, in order for a bank to reach the targeted level of LR.
  - There is greater uncertainty on the ability to quickly sell a position in the market (herd behaviour)
  - Seasonality effects around computation dates can be expected.

#### Uncertainties on inventories linked to banking structures reforms

- Prohibition of proprietary trading generates questions around expected or « normal » size of inventories by supervisors.
- Uncertainties relating to the interpretation of the rules by internal audit and supervisors are also putting a downward pressure on bond inventories:
  - how to support/document the expected near term demand of clients
  - how to analyse and/or set thresholds notably in terms of clients revenues / PnL attribution
  - how to ensure that macro and dynamical hedges are properly taken into account....

# Market fragmentation as a result of the uncertainties around the DFA , the FBO and other similar approaches

- The CFTC July 2013 interpretative guidance led the US groups to set up non guaranteed affiliates in Europe,
- ... While the FBO requirements "trap" capital and liquidity in the US...
- ... And the FBE scope of the Volcker rule requires foreign groups to rethink their organisation and booking model.
- At the same time, the uncertainties relating to the proper interpretation of mandatory execution rules led to reduced volumes of transactions both off and on SEFs and to a temporary segregation/fragmentation of the IRS markets (with different prices on and off SEF).
- EMIR reporting rules create also an incentive to create local subsidiaries, notably in Asia.
- Third country regime in European regulations aim at ensuring a proper dialogue with the US authorities, recognition, equivalence or substitute compliance but also increase uncertainty and market fragmentation.
- TTIP won't include financial services?
- All these reforms were initiated following a common analysis of the G8-G20: where is global convergence?

- The Euro area (EA17) government debt to GDP ratio stood at 66.4 % in 2007 and is 92.7 % in Q3 2013.
- Whereas it can arguably be stated that liquidity was mispriced before the implementation of the IRC and the stress VaR, the impacts of the LR, additional market fragmentation and banking structure reforms are still to be seen.
- This is notwithstanding any tax on financial transactions or further bank levy on assets or derivatives.
- How markets participants can adapt?
  - Dynamic allocation of capital?
  - Smaller sizes of transactions, more concentration on multilateral platforms, more velocity, more volatility?
  - Need for actors who would be ready and able to accept a temporary lack of liquidity and volatility, ie adaptation of accountinf and prudential rules,
  - Accept some concentration and less competitive markets
  - Repricing of liquidity ie accept higher liquidity premiums.

How to manage transition?

Whereas Euro Sovereign issuers have still large needs of new money, there is a strong incentive to sell the more liquid assets, in particular just before the computation date, in order for a bank to reach the targeted level of LR before the start of the disclosure requirements.

	Relative Change in Leverage Exposure from changes in capital and assets												
		Relative Change in Assets											
		-50%	-40%	-30%	-20%	-10%	0%	10%	20%	30%	40%	50%	
ange in Capital	0.0%	100%	67%	43%	25%	11%	0%	-9%	-17%	-23%	-29%	-33%	
	0.5%	101%	68%	44%	26%	12%	0%	-9%	-16%	-23%	-28%	-33%	
	1.0%	102%	68%	44%	26%	12%	1%	-8%	-16%	-22%	-28%	-33%	
	1.5%	103%	69%	45%	27%	13%	1%	-8%	-15%	-22%	-28%	-32%	
	2.0%	104%	70%	46%	28%	13%	2%	-7%	-15%	-22%	-27%	-32%	
	2.5%	105%	71%	46%	28%	14%	2%	-7%	-15%	-21%	-27%	-32%	
	3.0%	106%	72%	47%	29%	14%	3%	-6%	-14%	-21%	-26%	-31%	
	3.5%	107%	73%	48%	29%	15%	4%	-6%	-14%	-20%	-26%	-31%	
	4.0%	108%	73%	49%	30%	16%	4%	-5%	-13%	-20%	-26%	-31%	
	4.5%	109%	74%	49%	31%	16%	4%	-5%	-13%	-20%	-25%	-30%	
	5.0%	110%	75%	50%	31%	17%	5%	-5%	-13%	-19%	-25%	-30%	
С <mark>н</mark>	5.5%	111%	76%	51%	32%	17%	6%	-4%	-12%	-19%	-25%	-30%	
Relative	6.0%	112%	77%	51%	33%	18%	6%	-4%	-12%	-18%	-24%	-29%	
	6.5%	113%	78%	52%	33%	18%	7%	-3%	-11%	-18%	-24%	-29%	
	7.0%	114%	78%	53%	34%	19%	7%	-3%	-11%	-18%	-24%	-29%	
	7.5%	115%	79%	54%	34%	19%	8%	-2%	-10%	-17%	-23%	-28%	
	8.0%	116%	80%	54%	35%	20%	8%	-2%	-10%	-17%	-23%	-28%	
	8.5%	117%	81%	55%	36%	21%	8%	-1%	-10%	-17%	-23%	-28%	
	9.0%	118%	82%	56%	36%	21%	9%	-1%	-9%	-16%	-22%	-27%	
	9.5%	119%	83%	56%	37%	22%	9%	0%	-9%	-16%	-22%	-27%	
	10.0%	120%	83%	57%	38%	22%	10%	0%	-8%	-15%	-21%	-27%	

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