OFFSETTING FORCES

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Market Maker
WHAT ABOUT LIQUIDITY?
Decreased B2B markets

- High competition in secondary markets
- Lower trading volumes
- Limited repo and sec lending markets
- Wider bid/offer spreads
- Highly competitive primary markets
- Limited repo and sec lending markets
WHAT ABOUT LIQUIDITY?
Crisis-induced factors

- High competition in secondary markets
- Lower trading volumes
- Limited repo and sec lending markets
- Wider bid / offer spreads
- Highly competitive primary markets
- Less credit risk
- Shrunk bank treasuries
- Smaller trading books, less market risk
- Smaller trading size
- Increased volatility
WHAT ABOUT LIQUIDITY?
Regulatory factors

- Capital requirements
- Short selling restriction
- Transparency MIFID
- Risk limitations
- In preparation: - prop trading ban - financial transaction tax

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ECB BMCG, 9 April 2013
Andreas Gruber, Glenn Hadden, Karl-Heinz Riehm: Market Functioning Issues
Is Bond Market Liquidity “Back to Normal“?

- Trading volume in all German government paper has indeed recovered from its 2009 trough, but has not reached the levels of the years before the crisis yet.

- Corporate credit markets show an impressive recovery from 2009 levels. However, IG b/o levels are still significantly above pre-crisis levels. Note that dealer participation is in decline in line with decreasing balance sheet capacity.

Source: Bundesfinanzagentur. Note: Figures based on surveys among primary dealers on a) total traded volumes and b) net positions (w/o primary issue volumes).

Source: Markit IBOXX, Morgan Stanley Research

Significant recovery but pre-crisis situation not yet restored.
Volatility and Term Premium are Historically Well Correlated

Term premiums, unlike outright rate levels, are well correlated with volatility both pre- and post-crisis. An increase in term premium would likely coincide with increased volatility.

3m10y Swaption Vol vs. 3m10y Term Premiums

Data from October 1999 to February 2013
Source: Morgan Stanley Research
Illustration of $\Delta$'s in VOL Impacting Risk Management

• As yields become more volatile, portfolio risks (VAR) become larger for a given size of position.

• As system-wide capacity is risk/VAR constrained, higher vol implies diminished ability to own BTP's.

• Creates pro cyclic forced liquidation.

*Assuming 1mm/bp long position in BTP 10yr