NEW REGULATION

The Impact on Bond Markets – Buy Side Perspectives

BOND MARKET CONTACT GROUP
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UPCOMING REGULATION

- EMIR
  - Clearing requirements
- Mifid 2 and MIFIR
  - Market Structure (Exchange, MTF, OTF, SI)
  - Transparency requirements
- FTT
  - Financial Transaction Tax
- Capital Requirements Regulation
  - Regulatory capital
WHY DO INSTITUTIONS OWN BONDS?

- Safe haven asset in the total portfolio (but a return requirement exists)
- Dutch pension funds still adhere on average to the 60-40 percent split in real assets vs. Bonds
- 40% allocation towards bonds, but large differences in allocation between sovereign risk and credit risk
- Low yields are (already) a challenge given a 6-7% return requirement
DEALER INVENTORIES AND LCS

• L(liquidity) C(ost) S(cores) is defined by Barclays as the cost of an institutional-size round-trip transaction, expressed as a percent of the bond’s price

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\text{Liquidity Cost Score (LCS)} = \begin{cases} 
\text{OASD} \times (\text{bid spread} - \text{ask spread}) & \text{if quoted on spread} \\
(\text{ask price} - \text{bid price}) / \text{bid price} & \text{if quoted on price}
\end{cases}
\]

• Barclays concludes that dealer inventories have a significant (positive) impact on market liquidity
IMPLICATIONS OF (NEW) REGULATION

• Initial Margin – Cash & Bonds
  ➢ Bonds used as initial margin - impact on liquidity?
  ➢ Pricing influenced by ‘eligibility’

• Market Structure
  ➢ MTF, OTF, SI – only in an SI regime a dealer can trade vs. own capital. Currently low liquidity in MTF and OTF.

• Transparency
  ➢ Pre- and Post trade transparency, Liquidity threshold, Large-in-scale and Price-reference-waivers, reporting on asset encumbrance
IMPLICATIONS OF (NEW) REGULATION

• FTT
  ➢ Higher impact on instruments with short maturity, negative impact on liquidity

• Capital Requirements
  ➢ Higher cost for inventory of bonds – lower liquidity
  ➢ Sovereign risk keeps it’s low required regulatory capital
CONCLUSION & ISSUES TO DISCUSS

• Liquidity in Bond markets will be impacted negatively by new regulation

• Will we see a move from voice to electronic trading to mitigate the reduction in liquidity/volumes?

• What can we learn from the equities market? What to prevent?