Some considerations on market making and trading
Overview

1. Observed recent changes in global fixed income markets
2. Possible policy initiatives
3. Issues for discussion
Feedback from BMCG survey in February

I. Regulatory changes with persistent effects on market making

II. Advances in risk management techniques

III. Structural changes owing to technological progress

IV. Evolution of market conditions (low interest rate level favouring buy-and-hold)

- Reduced balance sheet capacity
- Stricter limits
  - quoting obligations can be withdrawn during stress periods
  - committing available balance sheet only for top-tier clients

Lower ability to absorb shocks
Market liquidity

- **Standard liquidity metrics** suggest that market liquidity in most large euro area sovereign bond markets has returned to levels comparable to before the global financial crisis.
- Market intelligence supports this assessment.

![Graph](10-year benchmark, bid-ask spread in bps)

Source: Reuters/Tradeweb, ECB calculations.
Market liquidity II

- **Liquidity bifurcations in credit markets** resulting in a concentration of market liquidity in the most liquid instruments and deteriorating in the less liquid ones.
- Supported by market participants’ feedback
- Less liquid bonds generally tend to be also riskier bonds.

*Intesa San Paolo (6-8 years), bid-ask spread in bps*

*BNP (4-6 year), bid-ask spread in bps*

Source: Reuters/Tradeweb, ECB calculations.
Three key questions from a central bank perspective

• Impact of changes in fixed income market-making on **monetary policy transmission and monetary conditions**: In how far is the relationship between key policy interest rates and actual funding conditions of the real economy dependent on market functioning
  – Strength of portfolio rebalancing mechanism (weaker)
  – Monetary policy announcements and impact on bond prices (stronger)

• Is the liquidity risk that is being transferred to issuers and investors by recent developments in market-making correctly priced? How can central banks foster an appropriate pricing of this liquidity risk?

• Will these sectors be able to handle the liquidity risk or are structural adjustments needed? How can this adjustment be supported?
Observed recent changes in global fixed income markets

- **Changes in market-making practices**
  - fewer but larger market makers;
  - tiering of liquidity provision;
  - a shift from inventory based to brokerage based (match-making) trading/exchange-like trading;
  - a rise of non-traditional market makers, such as hedge funds.

- **Changes in the “demand” for market-making services**
  - usage of a more limited number of counterparties by asset managers
  - more buy-and-hold positions with less relative value trades
  - opportunistic timing of trades
  - sourcing bonds in the primary market, potentially increasing concentration risk
  - use of routing software to break down large orders in smaller tradable ones

- **Changes in debt issuance practices**
  - Sovereign issuers may need to offer primary dealers larger concessions
  - PD requirements may need to be recalibrated owing to new regulatory constraints
  - More direct placements to by-pass the PD needs
  - Corporate issuers to standardised bond issuances, larger benchmark issues and benefit from the available liquidity pockets.
Possible policy initiatives to support market liquidity?

• Exit fees on fixed-income investment funds
  • US retail investors have pumped more than USD 1tn into bond funds since early 2009.
  • Reduced market-making capacity of dealers
  • Prospect of a massive disorganized flight out of the funds should interest rates rise sharply
  • News reports mention Fed discussed topic
  • Alternatives: Redemption gates?

• Reduce risk of liquidity illusion by promoting transparency on the market-making capacity
  • MIFID2 and MIFIR request mandatory price transparency
  • Possibly more important is to have quantity transparency owing to liquidity illusion
  • Increased information on dealer positioning in Tradeweb and Bloomberg
  • [to be completed after London meeting]
Issues for discussion

1. How to distinguish liquidity bifurcation from credit fragmentation? How could it be most effectively addressed?

2. Which structural measures on behalf of issuers (e.g. DMOs) and investors could support market-making?
   - Enhancement of market-making arrangements
   - Wider use of issuance calendars and greater standardisation of bond issues
   - More robust infrastructures (e.g. multi-dealer platforms)
   - Withdrawal of “same day liquidity” promise

3. Would you see scope for initiatives supporting liquidity in repo markets? What form should such initiatives take and who should initiate them?
Thank you for your attention