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

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

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

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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?

Source: BIS

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

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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