SUERF Webinar on US Treasury Clearing and bond market resilience: Introduction

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Introduction

- Bond trading is inherently fragile because bonds are not traded on exchanges, but "Over the Counter" in opaque bilateral transactions

- Recently rising pressure: Stress in US (2020 / Covid) and UK (2022 / mini-budget)
  - Supply up: Government bond issuance has grown tremendously ("Treasury tsunami")
  - Demand down: Quantitative tightening
  - Intermediation capacity also declining

- **This presentation:**
  - Background on bond trading and clearing
  - Main themes for discussion today
## Decentralised bond trading: Requires Dealer to link buyer & seller

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<thead>
<tr>
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<th>GOVERNMENT BOND</th>
<th>EQUITY MARKET</th>
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<tbody>
<tr>
<td>Supply</td>
<td>Rising (funding for climate, military etc)</td>
<td>Declining (-120 Bn in Q1 2024)</td>
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<tr>
<td>Transaction pattern</td>
<td>Few trades of large size</td>
<td>Many trades of small size</td>
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<td>Intermediation</td>
<td>Dealer-Dealer &amp; Dealer-Client</td>
<td>All to all</td>
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<tr>
<td>Trading algorithm</td>
<td>Quote by dealer</td>
<td>Limit order by investor</td>
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<tr>
<td>High Frequency Trading</td>
<td>No (except US-T benchmark bonds)</td>
<td>Yes (very active)</td>
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<td>Clearing</td>
<td>Bilateral</td>
<td>Central Counterparty</td>
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<td>Fragility of Market LIQ</td>
<td>HIGH (relies on Dealer Banks)</td>
<td>LOW</td>
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SEE ESRBP OP 24
1 Dealer-run fixed income markets and robustness of liquidity

- Dealer = Market maker rather than proprietary trader; Dealer typically part of major bank
- OTC market structure with two segments:
  i. **Dealer-to-Client**: Market for non-bank users such as Asset Managers or Hedge Funds
  ii. **Dealer-to-Dealer** for rebalancing of exposures to achieve low inventory
- GFC reforms: Dealers facing higher capital & liquidity requirements, e.g. leverage ratio
- Low rates, electronic trading and growth of trading firms: **Further pressure on Dealer Banks**

Source: Boudiaf et al, ESRB WP 147
2. **Liquidity in fixed income markets under stress: Policy options**

- **Bank Dealers:** Adjust Leverage Ratio to reduce balance sheet burden e.g. for repos
- **Market structure:** “All to all” trading to increase resilience
- **Market infrastructure:** Central clearing of cash bonds and repos to further stabilise intermediation
- **Transparency:** Publish comprehensive data on transactions
- **Central Banks:** NBFI access to central bank operations (BoE’s “Grand bargain”) and design of “Market Maker of last Resort” (Fed)
CCPs: A unique and vital element in Financial Market Infrastructure

CCP’s functions

A CCP steps into e.g. derivatives trades between two banks
- It processes payments and collateral of Clearing members
- It guarantees counterparty performance
- It uses comprehensive netting (-> reduces required) LIQ

Unique structure of CCP balance sheet

CCP’s balance sheet (a) differs significantly from a bank (b)
A CCP does not use leverage or provide liquidity to its clearing members
=> Risk-bearing capacity not driven by capital …
.... but rather by pool of margins paid in and cash in default fund

Source: Manning and Hughes (2016)
Main themes for today: Fostering fixed-income liquidity

1) Transformation of **systemic risk** — now driven by **liquidity pressure** ("dash for cash")

2) Market LIQ as central variable in QT environment: Produced by Dealer banks where MLIQ and funding LIQ interact

3) Which **policy action** by central banks and supervisors could help increase robustness of trading conditions in bond market?

4) Growth in CCPs — **CCPs as new TBTF entities** — How to ensure their soundness?

5) **US vs EU**: Differences and similarities in pressure points and reforms