

The Fixed Income Market Colloquium

Market Structure and Evolution

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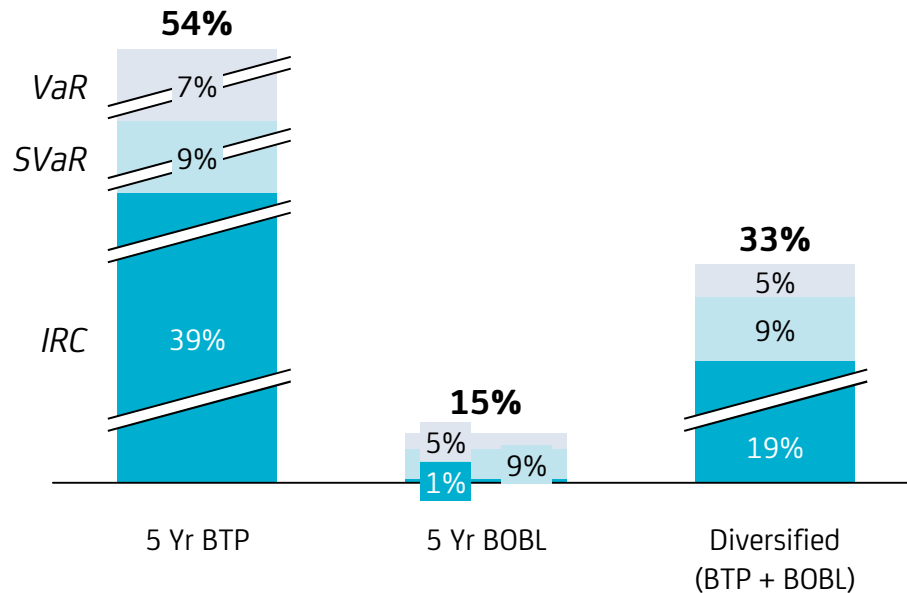
Rome, 04.07.2017

Sovereign bond crisis and country risk re-pricing generated negative spillover on the trading books

Basel 2.5 has been tough with trading book treatment, with severe consequences when positions are related to volatile assets such as peripheral bonds (due to the impact of Var, Stress Var, IRC)

- As an **example** on Italian government bonds, 1 bn of 5y standalone position absorbs about 540 mn of Regulatory Capital, which means more than 50% of the notional. Even if we mitigate via diversification with a core asset such as German Bund, the capital consumption will stay above 30%

Capital Consumption of a trading book portfolio (% of notional)*



The concurring effect of this new regulation (Q1 2012) and tensions on Italian Sovereigns (Q4 2011) generated massive increase in market volatility

Such **severe trading book treatment** of low-rated and volatile assets pushes market makers to draw liquidity, worsening the quality of the service to the “buy side”

* Source: Theoretical portfolio capital consumption based on bank's estimation

A very liquid and efficient repo market is crucial to preserve good market functionality...

- The repo market in Europe plays a **crucial role as contributor to financial stability**, since it is the only market where currently banks exchange liquidity
- There are currently about **USD 12 trillion of repo and reverse repo** transactions outstanding globally, of which nearly **USD 9 trillion is collateralized with government bonds**
- In EU, Repo markets collateralized with government bonds **represent about 32% of the outstanding government debt securities**

SIZE OF THE REPO MARKETS

Jurisdiction	Repo and reverse repo transactions against government bonds (mid-2016)		
	Amounts outstanding (in USD billions)	As a share of global total (in %)	As a share of outstanding government debt securities in jurisdiction (in %)
Euro area	2,800	32	32
United States	2,700	30	16
Japan ¹	2,200	23	21
United Kingdom	900	10	33
Canada	211	2	18
Australia	106	1	18
Mexico	79	1	21
Sweden	74	1	44
Switzerland ²	10	0.1	11
Total	8,800	100	

Source: Committee on the Global Financial System – BIS, April 2017

... but repo markets are currently operating in uncharted territory

Repo markets are deeply affected by the new Regulatory environment...

- The **Leverage Ratio** was introduced in 2015 and hit dramatically repo volumes
 - *Leveraged Investment Banks went out from Repo business because of the LR (average ratio of repo exposures to the total leverage ratio fell from 6.51% in 2014H1 to 3.95% in 2016H1, for banks with LR lower than 3%*)*
- The **LCR** makes short-term funding less attractive to banks and holding HQLA more attractive. The requirement to meet this ratio is a contributory factor in **market volatility around reporting dates** **
- The **NSFR** penalizes short-term funding, including repos of shorter maturity than one year, **particularly those under six months**. The NSFR also penalizes matched book transactions, since the negative impact of the reverse repo leg more than offsets the positive impact of the repo leg. Overall, the impact from the NSFR on short-term repo is reckoned to **be lower supply, reducing volumes and increasing the price****

* Source: Committee on the Global Financial System – BIS, April 2017

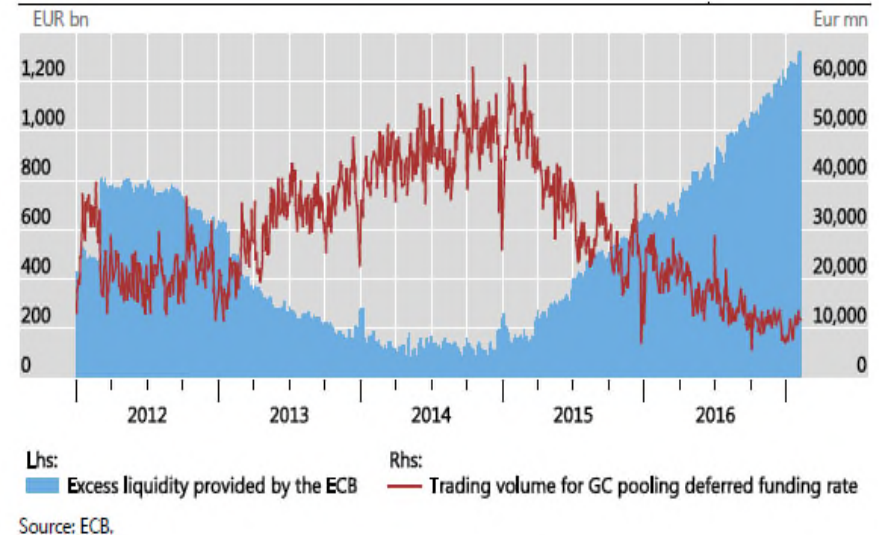
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** "Ructions in the repo market – monetary easing or regulatory squeezing?", Speech by Yves Mersch, Member of the Executive Board of the ECB, at the GFF summit, Luxembourg, 26 January 2017

...at the same time, they are strongly influenced by current ECB monetary policy

Excess liquidity provided by the ECB and repo trading volume

Graph 10



"Banks and other market participants report a **decrease in market making activities** and **collateral scarcity in repo-markets**. The perception of a challenging environment can therefore not be denied*" Yves Mersch, Member of the Executive Board of the ECB

Main takeaways: the secondary market is facing strong challenges ...

The repo market is already changing ...

- **Without a very liquid repo market** and related possibility to easily cover short/long positions, **creating a liquid and efficient bond market would become hardly achievable**
- Due to an extremely tough regulatory framework, the bond market is trading in lower size per ticket. Few years ago it was very easy to trade **clips of 500mn, while today** such a size can easily move the market creating price dislocation in the curve
- As counter action, the “buy side” is **self-imposing limitation of positions per ISIN** code to reduce the embedded “liquidation risk” in the books
- **MIFID regulation is pushing for increased transparency** and for an order driven market. However, **fixed income markets are characterized by frequent issuance activity**, usually with a regular calendar than cannot be fine tuned to better suit market conditions. **Market makers play a crucial role** in this respect, helping to absorb new supply even during volatile market conditions
- Bottom line, the new regulatory framework and consequent change of behaviour of market participants are leading to a more fragile secondary market.

... a hybrid market structure should be the response !

... paving the way for an hybrid market

- In the next future, market infrastructure should accommodate a sort of **hybrid market**, both “**Quote-driven**” and “**Order-driven**”. In the **trading platforms such as MTS**, market makers should quote larger size but with wider spreads while the “Buy side” could input “orders” in bid or offer, which can be matched
- It is crucial to have a robust and **effective secondary market to ensure the placement of government bonds** in the primary market, while the industry has to do its best to facilitate liquidity bundling in the most efficient market infrastructure. Simple aggregators are not a solution
- **Market makers will continue to play a key role in pricing the yield curve, smoothing out relative value and stabilizing the market**, putting a sort of cap and floor to avoid price distortions in case of sharp price actions due to big trading size

SIZE OF THE REPO MARKETS

Adjustments in banks' repo activity

Changes in the share of repo exposures by tightness of the leverage ratio

Annex Table 6

		Banks classified by leverage ratio score in H1 2014		Banks classified by latest leverage ratio score
		H1 2014	H1 2016	H1 2016 H1
LR <= 3%	avg	6.51	3.95	1.06
	std	8.76	5.24	2.12
	max	30.55	15.27	4.23
	repo share ¹	6.81	6.33	0.02
	count ²	13	13	4
3% < LR <= 5%	avg	6.20	5.53	5.32
	std	6.43	6.20	5.57
	max	30.06	27.53	27.53
	repo share	72.60	74.04	49.98
	count	78	78	63
5% < LR < 7%	avg	3.19	3.18	3.92
	std	5.54	5.40	6.19
	max	33.39	27.38	27.38
	repo share	19.32	17.97	41.12
	count	59	59	72
LR >= 7%	avg	3.44	3.22	3.49
	std	7.92	9.31	8.67
	max	43.33	55.20	55.20
	repo share	1.28	1.67	8.88
	count	37	37	48

Source: Basel Committee on Banking Supervision and CGFS calculations. ¹ Repo exposures by category as a share of all banks' repo exposures. ² Number of banks in the category.