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Long Term Trends in the Italian Secondary Market

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Liquidity in Government Bond Markets: a general overview

The financial crisis spotlighted the need of strengthening prudential regulation in the financial sector, with a special focus on the banks, which in many cases required heavy interventions from national governments to avoid major disruptions.

The various regulatory reforms introduced after the Lehman default enhanced the solidity of every individual bank, but they also increased the cost for risk warehousing thereby affecting their market making capacity. This was reflected to a certain degree in a reduction of liquidity of government bond markets.

Assessing such an impact in a scientific manner appears extremely important, and for that we really thank CRIEP, a research centre of public economics based on Universities of Padua, Venice and Verona, that, in collaboration with the Treasury, started to run a research project on long term trends of liquidity in the Italian government bond market, exploiting the rich data base made available by MTS.

As a first step, the most relevant changes observed since 2007 have been analysed, to understand if it is possible to individuate structural breaks in the different phases of the crisis.

Liquidity in Government Bond Markets: the Italian case

Liquidity is multidimensional phenomenon that cannot be captured with one measure.

Here, given the data availability in terms of length and granularity, we have focused on one segment of our secondary market, the interdealer cash MTS market that has a prominent role in the price discovery process of Italian debt securities.

From the available data set, a very high number of liquidity measures have been analysed, some of them well known in the academic literature, some others completely new. Measures chosen were of different types: quoting based, trading based, quoting and trading based. Results provided by this analysis are very meaningful.

No doubt liquidity has somehow deteriorated since the start of the international financial crisis, but is seems that the Italian market was more negatively hit by the consequences of the financial and banking crisis started in 2007-08 than the euro debt crisis in 2010-2012. As a matter of fact, in our market there have been more liquidity structural breaks related to the financial/banking crisis and global events than those connected to the Italian credit evolution. Moreover we never recovered pre-crisis liquidity levels, even if we had periods of remarkable improvements after 2012.

Primary Dealers and *Market Making* Activity: quoting and trading patterns

Despite these trends, the activity of Primary Dealers and other MTS market makers has been pretty resilient, if we stick to the definition of market makers as entities equally engaged on both sides of the market. In a long term perspective, the symmetry between the bid side and the ask side of the bonds order book has been preserved, with only few short term deviations due to volatility peaks. Even the PSPP did not affect this equilibrium.

Some relevant changed have occurred over time on trading patterns. Especially after 2012 large order trades seem to have structurally increased, probably in an effort by dealers to minimize execution risks in a contest of structural higher volatility. In a volatile market, if you have a large order to manage, you prefer to concentrate it instead of spreading it over time, as you do not want to run the risks of sudden market moves.

The capacity of the market to cope with this new trading pattern does not seem to be homogenous on the curve. For instance this is less achievable on the 5 yr maturity that on 10 yr, as probably the latter offers more hedging opportunities.

Interestingly, the new context has increased trading activity on non-benchmark bonds. In order to minimize execution risks, it seems that dealers (and investors behind them) are more inclined to spread out their flows on several bonds, as they are more aware of the price impact of a large order on a single bond (that has increased structurally over time).

Keeping the market liquid in the new environment

It is still difficult to assess what is preventing liquidity to go back to pre-crisis levels. Of course the world of investment banks has dramatically changed over these years: incentives, business model, capital availability, market making costs and so on. Nothing looks the same as before.

At the same time we have run a small exercise that proves how market competition is still a dominant factor in driving our PDs strategies, despite all the constraints brought by new regulations.

We therefore need to safeguard the characteristics of the interdealer market, given the performance it offered over all these years that were full of troubled periods. At the same time, as the environment has changed, we are working to understand if the microstructure of the market needs some changes and what they may be.