CONSOB

The fixed income market colloquium

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Introductory remarks

Ladies and gentlemen,

First I want to thank you for having assigned me this very interesting topic. Let me start now with a short historical outline, to be followed by a deeper analysis of the issue and its implications for today's financial markets.

1. The role of fixed income markets in the financial system

Ever since the birth of fixed income markets, their link with the presence of large debt issuers, both public and private, has been extremely clear.

In the past, both kings and kingdoms, and then democratically elected governments, were used to issue debt to help the Crown or public finances in sustaining large spending programs. These were generally ranging from defense plans (or simply, effective wars) to the building and management of public infrastructures (from roads to dams and railways, and so on). The Savoy monarchy, for example, showed to be increasingly able in financing the infrastructure framework and costs needed to favor Italian unification, only through a huge expansion of public debt.

All along with the development of capitalism, not only State entities, but also large private debt issuers entered the stage. In the second half of the 19th Century, railways represented the typical example of *project management* in this field, through the development of investments financed by bonds issued by private companies. We have clear examples of that in the Union Pacific railway company, which linked the East and the West coast of the United States, enhancing the myth and the significance of the frontier in the U.S.

Today, the term "fixed income" refers to a wide range of markets. Sovereign bond markets are the most liquid trading venues, while corporate bond markets are less liquid, with typically infrequent trading.

Given its function as a hub for both investing and financing (public or private) needs, it is now clear that fixed income have a kind of "public good" nature.

Government bond markets, in particular, play both a crucial role favoring the efficiency and smoothness of financing of public debt. They are also, indeed, a key mechanism for the transmission of monetary policy.

Historically, at the birth of primary markets, debt underwriters and issuers were used to meet from time to time to buy and sell new bonds. Then investors realized the role of the secondary market as important alike the primary one.

Secondary markets perform the main function to ease the exit from the initial investment assets. So, investors – when needed - can easily liquidate (sell) a bond minimizing their losses.

We fully acknowledge today that liquidity is crucial for the well-functioning of secondary markets, such as MTS, our sponsor in this very interesting conference.

In this frame, however, we are also aware that it is in the issuers' interest to have, keep and sustain a well-functioning, liquid secondary market. This is the case in which interest rates will tend to incorporate small liquidity *premia* and – therefore – there will be the opportunity for refinancing public (or private) debt at lower costs.

Today, the governments of most advanced economies do strongly promote the development of both efficient and liquid fixed income markets, in order to help finance current deficit and the roll-over maturing debt. This is even more important in countries like Italy, characterized by huge public spending, where tax pressure probably reached it maximum limit and public expenditures must be inevitably financed issuing new debt.

Today's low level of interest rates due to the policies of the European Central Bankers shows important challenges to fixed income markets. This frame is actually encouraging the acquisition of more risky and (potentially) less liquid assets.

Since its launch in 2015, the Quantitative Easing (QE) program of the ECB absorbed 60 billion euros of government bonds every month for the last two years. Now, most of the yield curve is below zero both in Germany and France. In the first half of 2017, roughly 60 per cent of new public debt has been issued at negative rates. These policies have been highly beneficial for most Euro-zone countries, helping to reduce of public deficits and the stabilization of debt/GDP ratio.

In the perspective of a next phasing out of the QE, at least two questions arise. First, what will happen to the stocks of bond holdings accumulated so far: will all they be held to maturity in the ECB's portfolio? Or will they – at least in a partial and gradual way– be sold again in the secondary markets? Second, what will be the impact on market participants? The outcome will be an orderly adjustment or some inevitable turbulence? And, again, what if spreads for Italy and Spain were to rebound to 2015 levels? Are we facing a next sovereign bond crisis?

All these questions are partly linked to the key issue of the persisting high exposure of Italian and Spanish banks towards public debt. I will furtherly develop my point of view on this issue in the final part of my speech.

2. <u>How regulation and technology will change fixed income markets</u>

Regulation and technology will deeply affect fixed income markets in next years.

As for regulatory issues, the so called MiFID II directive, will enter into force next year. , MiFID II will extend the scope of pre- and post-trade transparency obligations to most non-equity instruments, such as bonds and structured finance products.

MiFID II is expected to enhance transparency of secondary markets, and this will have general positive effects as discussed before. However, rules need to take into consideration a wider range of issues: the type of asset traded, the market microstructure, the overall market conditions in terms of liquidity, volatility, traded volumes, average size of the orders, and so on.

In this respect, MiFID II new transparency regime has of its own some degree of flexibility: various waivers are introduced (for example relating to pre-trade transparency for large-in-scale orders); pre-trade transparency requirements will be calibrated for different types of trading systems (including voice trading system for non-equity instruments); national regulators will be able to suspend - temporarily - pre-trade transparency requirements for non-equity instruments, should liquidity fall below a specified threshold.

Nonetheless, MiFID II will inevitably increase compliance costs and market making in some trading venues will be more challenging as well. In particular, in the secondary markets of sovereign bonds, higher market making costs will be able to cause both a decline in liquidity and a rise in volatility. In any case, higher transparency should attract more investors and make markets deeper and more resilient.

With reference to technological innovations, fixed-income markets are today even more affected, as other markets, by the rise of electronic trading. This innovation brought the increase of some market practices such as algorithmic trading (AT) and high frequency trading (HFT).

There is still little research to determine the impact of these such practices on fixed income markets, but evidences from the equity markets suggest that their impact could be positive in normal trading periods (by increasing liquidity and reducing transaction costs) and negative on market quality during stressed periods (by increasing volatility and amplifying negative trends).

The presence of new kind of market participants (such as algo-traders and HF-traders) is permanently affecting the functioning of fixed income markets through the change of the nature of liquidity provisions and intermediation. These new features are affecting - in particular - the most liquid fixed income markets (US Treasuries market and main European sovereign bonds markets), while markets for corporate bonds tend to be less affected for their less liquidity.

Today, regulators have to deal with these new features as well as with the new implications for the post-trading activity, from Blockchain and from the so called DLT technologies, as well as from the increasing importance of new payment systems based on virtual coins (such as the Bitcoin).

However, it is difficult to predict the impact of these developments on the financial industry. It is quite likely, however, that in 10 years from now trading and post-trading infrastructures will be totally different from their today's features.

In an increasingly fast-changing technological environment the main risk for regulators is to lag behind financial innovation. To avoid this risk, as noted also by the Bank for International Settlements, regulators need to access more comprehensive data on an ongoing basis as well as to be able to fully monitor these developments. It is also crucial to establish a systematic, continuous dialogue between regulators and market participants.

3. Trade off in regulatory reforms

It is true that post-crisis regulatory reforms aim to increase market transparency (as I said about MiFID II regulation) and to strengthen both resilience and stability of intermediaries through more stricter (more rigorous) capital requirements (the reference is Basel IV regulation).

Both transparency and stability do have a crucial role in the ordered functioning and development of financial markets. In the medium term, indeed, more transparent markets should be able in perspective to attract more investors. This should lead to an improvement in the overall market quality. More resilient intermediaries should be therefore still better able to absorb risks under stressed market conditions as well as to lower the case for of market disruptions.

In the short run we must acknowledge there is an inevitable trade-off between transparency and stability. Regulators have to deal with this potential conflict in order to avoid that rules conceived to improve transparency and resilience could end up to be theirselves sources of instability. Should this seem a quite obvious remark, it is necessary to remember that unexpected negative consequences of regulation showed themselves in recent times, too.

Regulation for the improvement of transparency and enhancement of market makers' capital requirements has a cost in the short run, because it implies also increasing costs for market intermediation. Banks may therefore reduce their trading activity and narrow the scope of their market-making activities as a result of more stringent regulatory requirements.

Here is an example. Separating commercial banking from investment banking is generally a principle that has to be pursued. It could foster financial stability, but it can altogether increase market making costs and transaction cost and then it can also reduce liquidity, so that in the end the final bill is shared by investors and households.

Regulations such as the Basel III leverage ratio, higher risk-weighted capital requirements in Basel IV and, in some jurisdictions, the announcement of new regulations on specific activities (for example, banks' proprietary trading) could have negative impacts on intermediaries' risk-taking capacity and reduce altogether their willingness to provide liquidity through the market making activity.

A final, but no less important remark, is the need to keep regulation homogenous, to harmonize it, across geographical areas. If, for example, the Dodd-Frank Act implementing regulation were to be significantly revised in the near future, European regulators should take this into account to avoid unjustified competitive advantages to US banks.

4. Banks and the future of fixed income markets

As I previously said, one of the main issue lingering on the future of European sovereign bond market, like the sword of Damocles, is related to the end of QE.

So far, Italian and Spanish banks did not profited of the QE opportunity to reduce their exposure to domestic bonds. Italian banks keep 10 per cent of their assets still invested in government bonds, while with Spanish banks the level is roughly 8per cent These bonds do not absorb regulatory capital. Hence they are an attractive form of investments for banks, in spite of their very low yields.

The proposal arising from time to time of introducing capital requirements for government bonds can reveal itself dangerous for many reasons.

First, such rules *per se* are not easy to design; they would call for the use of agencies' ratings and all we know how controversial the esteems of these sovereign ratings could be. On the other hand, the resort to internal rating models for sovereign exposure seems not a viable solution. Second, these rules promise to be strongly penalizing for peripheral countries - such as Italy and Spain - whose banks would be forced to a quick dismissal of their investments. Such a large sell off could drive up bond spreads and therefore increase the cost of public debt financing. A disorderly unwinding of bonds investment by banks would be surely destabilizing for sovereign bond markets.

These problems could be mitigated, instead, through a very smooth and gradual introduction of the rules, so that banks have time enough to orderly adjust their balance sheets. It has to be acknowledged that these same rumors that regulators are seriously thinking to introduce capital requirements for government bonds menace to drive up spreads so that banks may record losses on their bond portfolios that could erode most of their regulatory capital.

Finally, even if such a regulation were to be gradually introduced, it would probably overlap with QE ending and hence the combination of these two effects could be destabilizing for the markets.

The effect could be something similar to the "unexpected" experience already seen in the case of the bail-in directive: a regulation designed, in principle , to make single intermediaries more stable and resilient may determine increasing instability for the overall financial system.

It is true that Italian banks have already been strongly penalized for their exposure to government bonds in recent stress test exercises by EBA and ECB in 2014 and 2016. Due to the fact that government bonds have been applied significant haircuts in stress tests exercise, Italian banks have consequently displayed lower capital ratios in adverse scenarios with respect to other European banks.

This is even more controversial if we take into account a further element. Larger banks in Germany, France and UK have in their *portfolios* big exposure in illiquid asset valued using internal pricing models (so called "level 2" and "level 3" assets) - mostly OTC derivatives and structured bonds. These assets have not been fully taken into account in stress test exercise. Since these assets account for more than twelve times the TIER 1 capital of German and French banks, even a small haircut could erode a large portion of the capital of such banks in stress tests exercise.

I hope that future stress tests and SSM supervisory actions could take these elements fully into account. An alternative possibility is, as I already said, not to make public stress test exercises. They would just be this way one of the different elements that SSM takes into account to fix target capital ratios for each single bank.

5. Conclusions

Let me close my remarks with some general considerations on the future of the Italian financial industry in light of two recent structural developments.

As we all know, the merge between LSE and Deutsche Borse has been eventually dismissed. This couples with the decision of UK to leave the EU.

These two developments represent a unique opportunity to strengthen the Italian financial industry and to try to bring back in Milan some of the market infrastructures now located in London and in other Euro-area countries.

In the case of bond markets, this opportunity need to be reaped not only to strengthen the Italian financial industry but also to simplify an extremely complex and fragmented market structure.

Let me give you a quick snapshot of how it currently works.

Italian government bonds are traded on platforms managed by MTS SpA, an Italian company controlled by Borsa Italiana Spa, who is in turn owned by LSE Group Plc. Central counterparty services on MTS are offered by two companies who have an interoperability agreement and are located in different countries (an Italian one, Cassa di Compensazione e Garanzia SpA, owned by Borsa Italiana SpA, and a French one, LCH Sa, controlled through a majority stake by LSE Group). Another Italian company, owned by Borsa Italian SpA, offers custody and settlement services (Monte Titoli SpA). Finally, foreign government bonds are traded on a platform managed by EuroMTS Ltd, a company located in London and controlled through a majority stake by MTS SpA. Some central counterparty services on EuroMTS are offered by LCH Ltd, a UK company controlled by LSE Group.

On top of this, I want to recall that derivatives on Italian BTPs are traded on Deutsche Borse AG, whose central counterparty is Eurex AG. This creates significant complexities for traders and market makers who want to arbitrage or cover their positions in Italian government bonds with derivatives, because using two different central counterparties (one for cash markets and another for derivative markets) is more expensive in terms of margins and collateral.

Given these fragmentations and complexities, I see an opportunity to bring back in Italy all or most of the trading and post-trading infrastructures related to government bond markets, possibly including derivatives on BTPs, leveraging on the role and reputation that MTS has been able to build over the last years as a market leader in providing trading services.

This challenge is actually linked to a battle that will be fought on a larger scale, which is related to the possibility to attract into the Euro area the OTC derivatives clearing business which is now almost entirely done in London (mostly by LCH Ltd). I think the Italian central counterparty that offer its services both to MTS and MTA (the equity market) should put in place any possible effort to be a candidate to attract part of the OTC derivatives business, at least those done by Italian banks. Italian banks, on their side, should do their best to convince their foreign counterparties to clear OTC contracts on Italian infrastructures.

But the excess of regulation and taxation could penalize European financial markets relative to the US markets.

It is necessary to work together with the market in order to reduce the increasing costs of regulation.

These are big opportunities but also enormous challenges. Only by a tremendous, timely and coordinate effort by government, regulators and the industry itself, Italy can attract some of the business that will sooner or later will leave London.