EUROPEAN CENTRAL BANK

EUROSYSTEM

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

May 2024

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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**

1 Decentralised bond trading: Requires **Dealer** to link buyer & seller

	GOVERNEMENT BOND	EQUITY MARKET
Supply	Rising (funding for climate, military etc)	Declining (-120 Bn in Q1 2024)
Transaction pattern	Few trades of large size	Many trades of small size
Intermediation	Dealer-Dealer & Dealer-Client	All to all
Trading algorithm	Quote by dealer	Limit order by investor
High Frequency Trading	No (except US-T benchmark bonds)	Yes (very active)
Clearing	Bilateral	**C**entral **C**ounter**p**arty
Fragility of Market LIQ	**HIGH (relies on Dealer Banks)**	**LOW**

SEE ESRBP OP 24

1 Dealer-run fixed income markets and robustness of liquidity

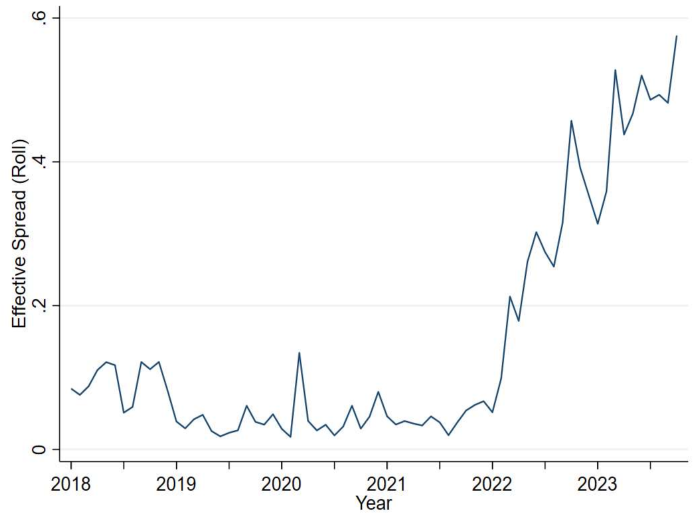
- Dealer = Market maker rather than proprietary trader; Dealer typically part of major bank
- OTC market structure with two segments:

i. **<u>Dealer-to-Client:</u>** Market for non-bank users such as Asset Managers or Hedge Funds

ii. **<u>Dealer-to-Dealer</u>** 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**

<u>Fragile liquidity in fixed income</u>



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

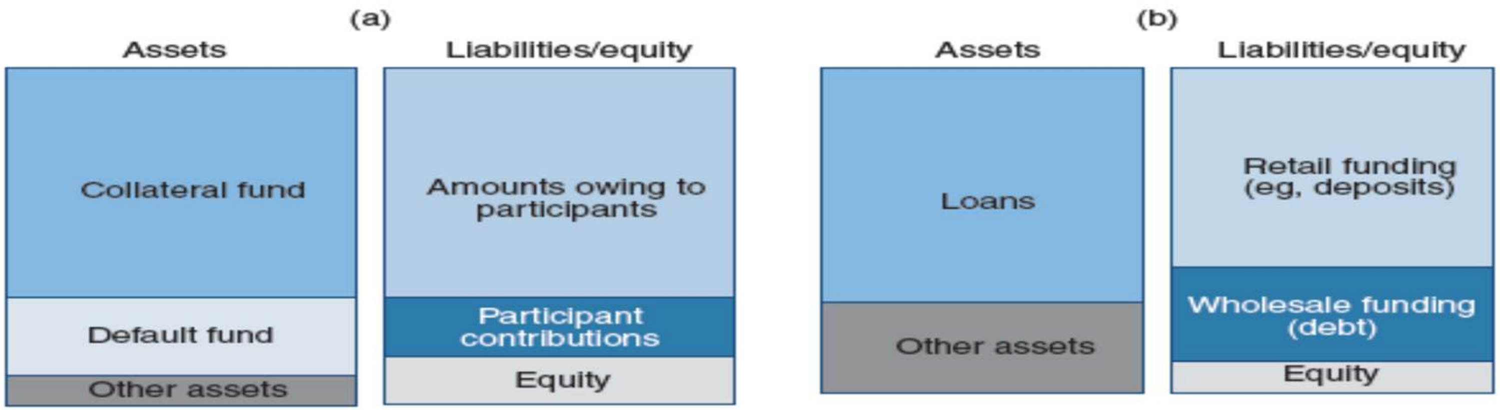
CCP's functions

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)

4 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