Bond Market Development, Liquidity and Stability

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Deep and Liquid Financial Markets Enhance Financial Stability

- Liquid capital markets help distribute financial risks to those market participants most able and willing to bear them. They enable investors to raise funds, manage investment portfolios and hedge against unexpected events. An important example is the growth in Asian domestic government bond markets and their role in mitigating the impact of the global financial crisis.

- The U.S. Treasury's recent review of the regulatory framework for the banking sector found that the cumulative effect of a number of regulations and the implementation of Dodd- Frank may be limiting market liquidity.

- Treasury's review also found that maintaining strong, vibrant markets at all times, particularly during periods of market stress, is necessary to support economic growth, avoid systemic risk, and therefore minimize the risk of a taxpayer-funded bailout.

- In Asia, the focus on financial stability may have slowed the development of domestic bond markets, particularly for Repo markets, hedging instruments and basic securitizations.

Increased Regulation Reduced Liquidity in Financial Markets

Some Observed Impacts of Increased Regulation

- Reduction in dealer inventory of certain debt instruments
- Withdrawal of market-makers in some products and markets
- Contraction of Repo markets
- Increase in the time needed to execute trades
- Lower transaction sizes
- Reduction in size of trades that move markets
- Lower turnover ratios
- Unusual market/liquidity events
- Increased reliance on electronic trading
- Increased demand for safe assets/short supply

Banks Have Restructured Balance Sheets Since the Crisis

	Year-End 2006	Year-End 2014
Loans	66%	54%
Cash, Treasury, Agency Securities	16%	34%
Other Assets	18%	16%

Global Bond Market Trends and Flows and the Effect of Regulation on Liquidity, Joyce Chang J.P Morgan, CFA Institute

Balance Sheet Realignment May Have Restricted Credit

There is evidence that the reduction in loans has effected the real economy. A Chamber of Commerce survey found a strong and growing concern for the ability of businesses to access credit and to manage cash flow and liquidity due to existing and pending regulations.

Businesses reported taking unanticipated steps to address increased costs or a lack of access to financial services at the expense of customers or expansion.

- 43% of the companies surveyed said that maintaining cash flow and liquidity are their chief concern.
- 50% said that increased bank capital charges have increased their costs and challenges.
- 79% have seen their business affected by changes in the financial services markets.
- 29% have increased prices for customers and consumers as a result of changes to the financial services market.
- 76% believe that the regulations on the financial services sector will not help their company's outlook over the next two to three years.

Treasury Recommendations For Improving Market Liquidity

- Adjustments to the Supplementary Leverage Ratio (SLR) and enhanced Supplementary Leverage Ratio (eSLR). Exceptions from the denominator of total exposure should include: (1) cash on deposit with central banks; (2) U.S. Treasury securities; and (3) initial margin for centrally cleared derivatives.

- Treasury recommends significant changes to the Volcker Rule, including changes to the statute, regulations and supervision. Undue compliance burdens must be eliminated in order to eliminate unnecessary impact on market liquidity. Treasury supports in principle the Volcker Rule's limitations on proprietary trading and does not recommend its repeal.

- Banks with $10 billion or less in assets should not be subject to the Volcker Rule. Treasury also recommends that the proprietary trading restrictions of the rule not apply to banks with greater than $10 billion in assets unless they exceed a threshold amount of trading assets and liabilities.

Treasury Recommendations For Improving Market Liquidity

- The covered funds provisions of the rule require modification to decrease unnecessary burdens, including by refining the definition of a covered fund. This change can greatly assist in the formation of venture and other capital that is critical to fund economic growth opportunities.

- Treasury advocates simplifying the definition of proprietary trading and allowing banks to more easily hedge their risks and conduct market-making activities.

- Given the fragmentation of responsibility for implementing the Volcker Rule across five agencies, these agencies should ensure that their guidance and enforcement of the rule is consistent and coordinated.

- Treasury has identified various ways of reducing the complexity of the Volcker Rule to decrease regulatory compliance burdens. Treasury's recommendations respond to the concern that undue constraints on market making present risks to market liquidity, particularly during times of stress.