The Clearing House®

Brookings Conference: Do we have a liquidity problem post-crisis?

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Market Liquidity Defined

- For a given asset, how much an investor can sell (or buy) with immediacy, without moving the price against it

Market Making Liquidity

- Liquid Market: An investor can sell large blocks, with immediacy, without moving the price
- Illiquid Market: An investor must break up a large block trade into a series of smaller trades, execute them over a period of days, with the price getting lower (sale) or higher (purchase) over the course of the execution

Funding Client Positions

- Bank or bank-affiliated broker dealer provides funding for market participants' portfolios of assets

Consequences of Illiquidity

- Increases corporates' cost of borrowing
- Lowers returns for investors as asset managers have to hold more liquid assets to fund redemptions
- Volatility in stress

Difficulty in Measuring Market Liquidity

Currently, a difficult environment to study liquidity

- Rates are historically low
- Bank loans have become relatively more expensive

Measures indicating illiquidity

- Dealer inventory
- Turnover ratios
- Block trade size
- Bifurcation
  - Liquidity clustering in largest issuances
  - Liquidity clustering in on-the-run versus off-the run
- Single name CDS markets down over 50% in five years
- Anecdotal evidence
  - Sell side
  - Buy side
  - Analysts
  - European, Asian policymakers
  - Reinhold Messner, 1978
  - Chico Marx

Measures Indicating Adequate Liquidity

- Volume of issuance
- Bid-ask spread

Mixed measures

- Price impact

To Be Determined

- Observable trade data versus unexecuted orders and dropped trades

What you see may depend on where you look

Some Touchstones

CFA Institute *Survey Report on Secondary Corporate Bond Market Liquidity*, September 2016. Respondents from the AMER and EMEA regions report that over the last five years they have observed:

(1) a decrease in the liquidity of high-yielding and investment-grade corporate bonds and no change in the liquidity of government bonds;

(2) a decrease in the number of active dealers making markets;

(3) an increase in the time taken to execute trades and a lower proportion of bonds being actively traded;

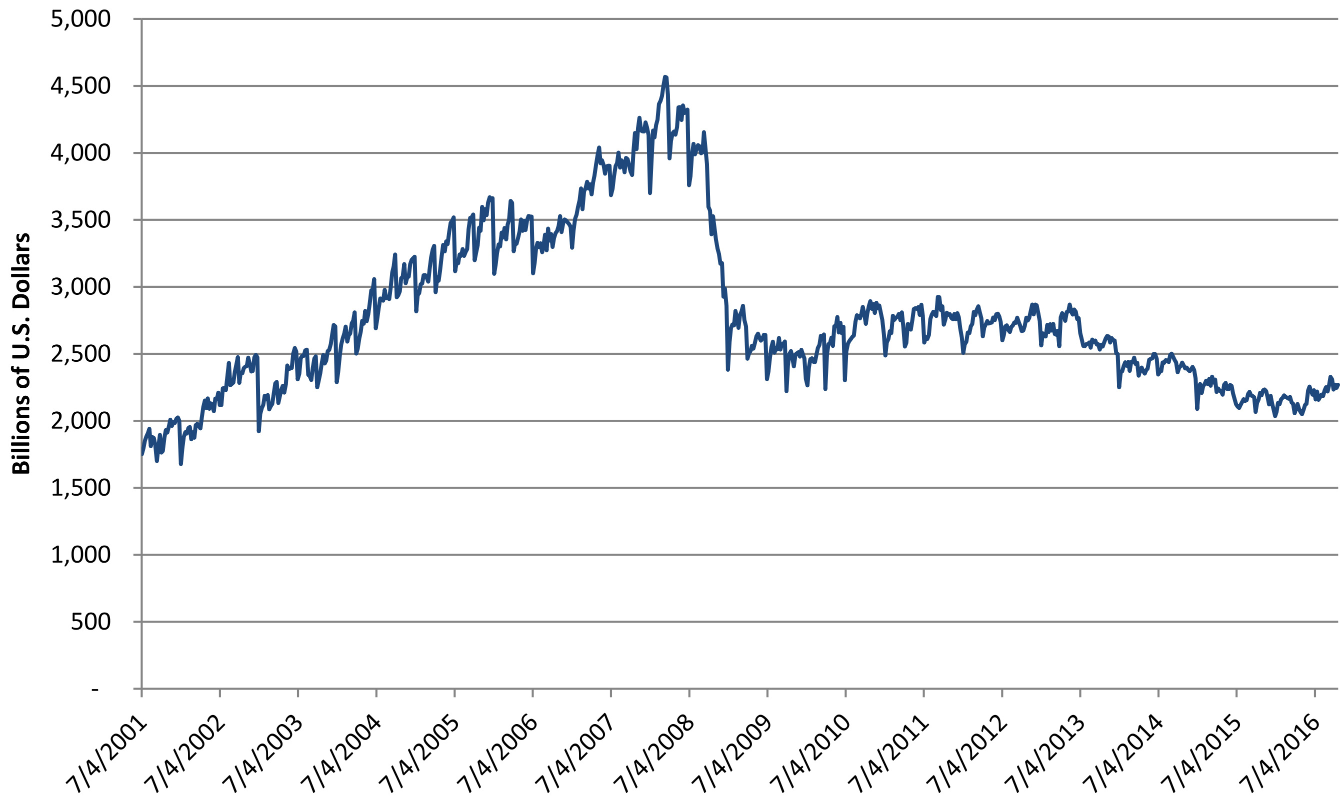
(4) a higher proportion of unfilled orders.

Bank of England *Financial Stability Report*, July 2016: "Over the past year, government and corporate bond markets, including in the United Kingdom, have shown signs of reduced liquidity, and activity in repo markets has fallen materially." These changes "probably, in part, reflect post-crisis regulations as firms adjust their risk management and business models."

GCF Treasury repo imbalance

Frequent violations of covered interest rate parity

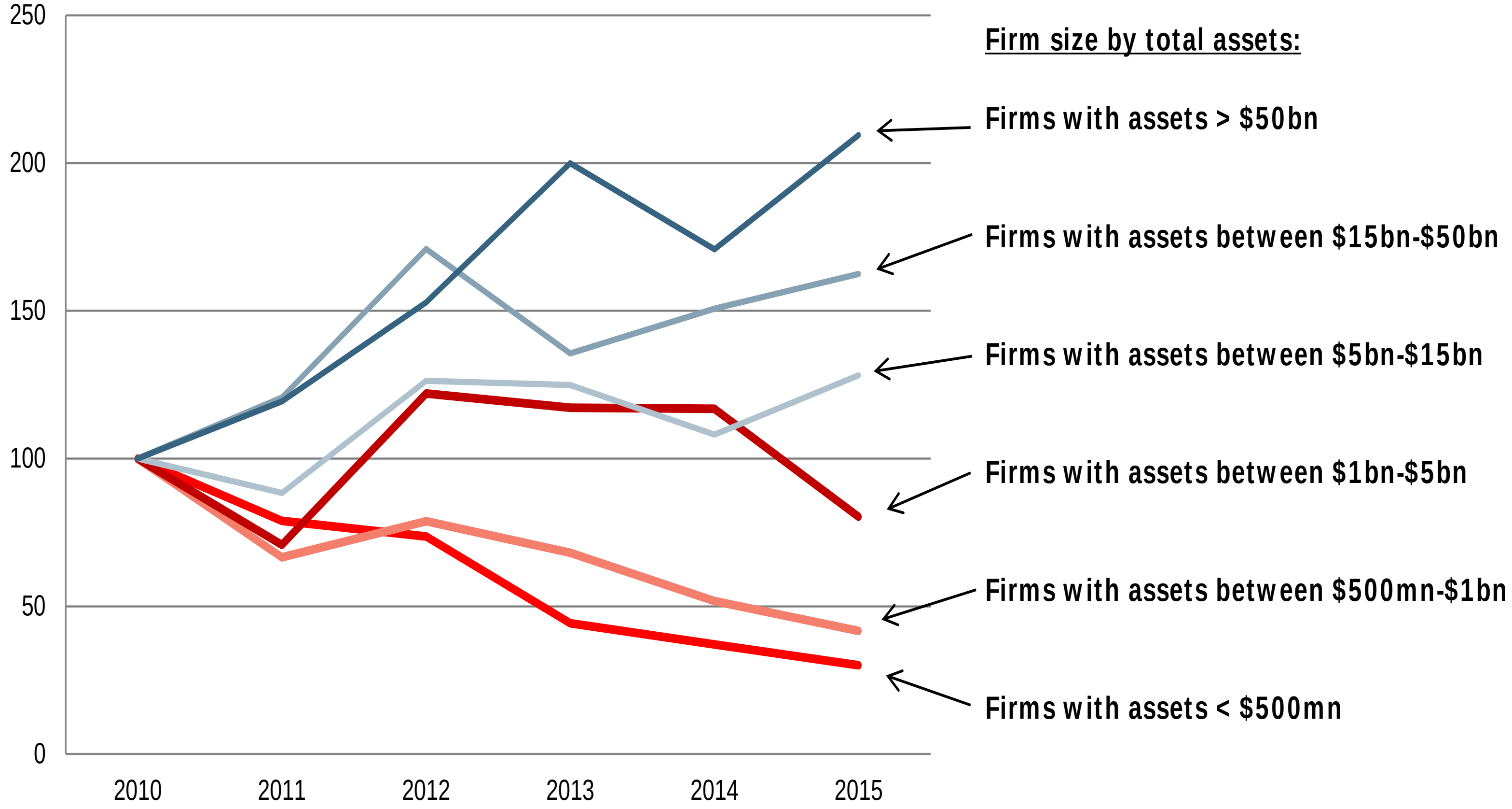
Primary Dealers' Outstanding Repos



Source: Federal Reserve Bank of New York.

Since 2010, access to corporate debt markets has fallen for small and midsize firms

Total value of corporate debt issued, by firm size (excluding financials); indexed to 2010



Note: Excludes issuance by financials and issuance of preferreds, medium-term notes and tranche size < $50mn

Source: Dealogic, Capital IQ, Goldman Sachs Global Investment Research.

Why Would Market Liquidity Be Reduced?

- Crisis learning: scaling back of risk
- Regulation

Regulations diminishing balance sheet availability

- U.S. SLR
- GSIB surcharge
- LCR
- Pending:
  - NSFR (Not Suitable for Repo)
  - CCAR + GSIB

Effects of Regulation

- Higher cost of holding inventory
- Higher cost of hedging inventory
- Higher cost of funding transactions

Do electronic, faster markets solve the problem?

Policy Choices at this Stage

- Continue study, particularly as rates rise and Central Banks' balance sheets unwind
- Take action to restore market liquidity
- Regulate buy side on assumption of illiquidity
- Take action to further reduce market liquidity
  - NSFR
  - GSIB into CCAR
  - FRTB

Why do we regulate non-bank affiliates of banks?

Cost Benefit Analysis

Evidence that U.S. Banks Do not Have Sufficient Capital and Liquidity to Support Markets Businesses