Session 4: Cross-Country Comparison of Drivers of Liquidity

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Liquidity in the Spanish Sovereign Debt Market

- Difficult to pin down a single metric for liquidity: a combination of factors
  - Ad hoc definition of secondary-market liquidity in Spain’s Government bond market:
    “The willingness of market makers to commit to quoting and trading an adequate volume of bonds transparently, publicly and competitively”
  - This definition helps us observe aspects of liquidity empirically, understand the determinants of liquidity and identify the benefits of a liquid market.

- Trading and turnover of Government bonds
  - We measure total turnover of bonds in electronic platforms, voice brokering and with final clients.

- Quoting in Electronic platforms
  - Bid-offer spreads are a crucial variable, but not the only one.
  - We also look at number of bonds quoted on the curve, volume quoted per bond and the number of hours quoted under those conditions – all of these show willingness to provide liquidity
  - Liquidity is a public good that should be rewarded in different ways. The Spanish Treasury evaluates liquidity provision through various indices, and rewards it with non-comp rounds and with occasional syndicated issuance.
Liquidity in the Spanish Sovereign Debt Market

- Trading turnover is the simplest metric to observe long-term trends
  - Liquidity has deteriorated since 2007
  - Annual turnover fell from 80 times to 20 times outstanding debt

- Bid-Offer quoted yields reflect medium-term liquidity tensions
  - Sharp deterioration in November 2011, with LCH increasing Italian margins
  - Substantial improvement with LTRO auctions and OMT announcement
A composite index of quoting effort

- For each bond, a Primary Dealer obtains a daily score which is a function of:
  - Quoted spread (-)
  - Volume quoted (+)
  - Time quoted (+)

- This aggregate index is a good measure of a trading desk’s willingness to provide liquidity in volatile markets.

Liquidity enables market access

- “Willingness to quote” is correlated…
  - …Positively with the average life of the Treasury’s issuance
  - …Negatively with “tails” in primary auctions (average – marginal yield)

- Causality: usually, better quoting and trading encourage and improve issuance, but a feedback loops are possible.
Liquidity in the Spanish Sovereign Debt Market: Conclusions

- Positive and negative feedback loops between liquidity and issuance
  - Better liquidity generates investor demand in longer tenors, encourages Treasuries to issue
  - Issuance in longer tenors generates the incentive for dealers to quote and trade the product

- Liquidity is a Public Good: a collective incentive to ensure it, a private incentive to free ride

- Liquidity does not emerge naturally: it is encouraged or discouraged!
  - The issuer should incentivise competitive secondary-market liquidity
    - Non-comp rounds for satisfactory quoting, none for poor quoting
    - Secondary-market evaluation informs selection of benchmark syndicates
    - Regular issuance in key tenors
  - Availability of repo financing: Central Counterparties (CCPs) contribute to the public good of liquidity and should therefore be actively supervised and regulated.
  - Recent regulation affects the ability to warehouse bonds in long or short positions. Care should be taken to balance two public goods: financial stability vs availability of liquidity
Thank you for your attention

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