BUY SIDE ROLE IN ENSURING LIQUIDITY

BMCG MEETING 21 APRIL 2015

NORGES BANK
INVESTMENT MANAGEMENT

Active approach from buy side

What to do and challenges

- Adapt to new trading protocols offered by various new electronic platforms
- Be “willing” to show a significant amount of orders to new trading venues (OMS Blotter scraping, wish lists)
- Send multiple of bids and offers in ISIN’s where buy side has interests (support CLOB)
- Extreme version: BS become market maker
- Coordinate this effort with peers to get a critical mass for order matching
- Basically a massive change in trading behavior from buy side who traditionally take liquidity for “granted” or adjust trading to market liquidity
- WHY? Buy side need to take ownership in securing liquidity if they have a need for active management of their portfolio
- Internal trading restrictions (compliance rules/best execution requirements)
- Buy side to «agree» on the right trading protocols and trading venues (to avoid further fragmentation)
- Buy side is traditionally a price taker, not a price maker (or liquidity provider/market maker)
- Mifid II effort to promote transparency is probably against one favored trading protocol (dark pool matching), but would probably work for buy side as long as they do not become a systemic internalizer
- Level playing field, to the extent buy side are not contrained by regulation (non-regulated market makers)

Passive approach from buy side

Pros and cons

- Not in their mandate to «make» liquidity in secondary markets
- Adjust behavior to current market environment and only build positions when liquidity allows for it
- Adopt a more long term buy and hold strategy
- Build exposure in primary markets
- Harvesting illiquidity premiums is good for return (but currently these are suppressed by central bank actions)
- Investors would face huge costs, disorderly markets, if forced to terminate portfolio (mutual funds, ETF outflow etc)
- Indirect cost for a diversified investor who are invested in both bonds and equities (some return are moved from equity to bond holders because of liquidity premiums)

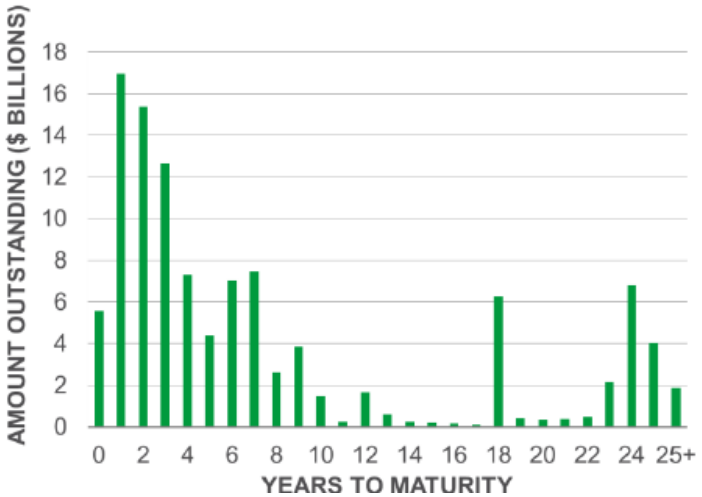
Problems with bond market structure

In short, there are just too many bonds

- BlackRock paper (9/14) reform of corporate bond market structure

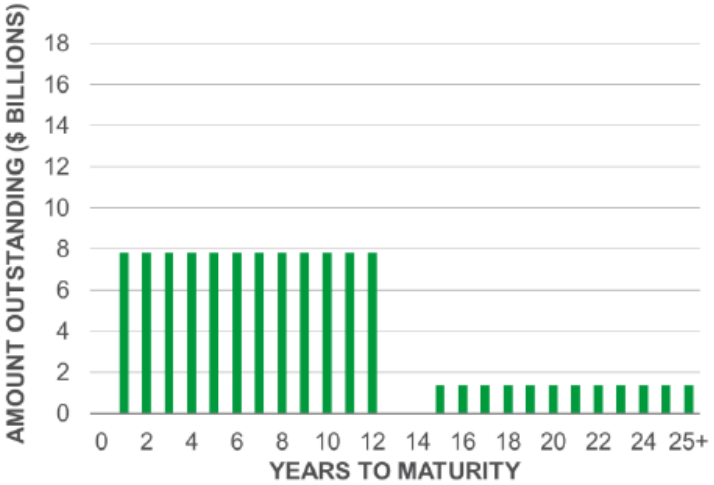
Current debt structure:

- $100bn outstanding
- 1000 securities
- 8 year average life



Debt structure under standardized format:

- $100bn outstanding
- 72 securities – largest $2bn, smallest $750mm
- 4 tranches / year for year 1-12, 2 tranches / year for longer maturities
- 8 year average life



Support standardization of bond markets

- TOP US Investment Grade bond issuers have on average 45 bonds in Barclays Index, vs a single common equity.
- Standardization would increase matching opportunities
- Suggestions (Blackrock paper received no enthusiasm from market)
  - Issuers need custom issuance to match assets
  - Ratings Agencies don’t like too big reinvestment risk
  - Banks would lose fees and put further pressure on their market maker capabilities
- Diversified investors ultimately loose return from de-standardized market and issuers face higher funding costs

Items for discussion

- To what extend can/will an active buy side be a solution for the lack of liquidity we now experience?
- Will market making shift to non-regulated extraterritorial market makers? Is that contributing to solving the lack of liquidity?
- Is the reduction in market making capacity of the sell side temporary? Or will sell side, after becoming compliant with new regulation, start to increase market making activities?
- How procyclical are markets? Is this not a bigger problem than the illiquidity itself?
- Are we trying to solve a non solvable problem? ‘There is no such thing as liquidity of investment for the community as a whole’