MEF – MTS S.p.A.

THE FIXED INCOME MARKET COLLOQUIUM

INTRODUCTORY REMARKS

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1. The role of fixed income markets in the financial system

Ever since their birth, fixed income markets have always been linked to the presence of large debt issuers, both public and private.

Historically, first monarchies and kingdoms, then democratically elected governments have issued debt to help the Crown or public finances sustain large spending programs, ranging from defense (or simply wars) to public infrastructures (roads, dams, railways, etc.). The Savoy monarchy, for example, was able to finance the infrastructure costs needed to promote Italian unification only through a huge expansion of public debt.

With the development of capitalism, alongside with State entities, also large private debt issuers entered the stage. In the second half of the 19th century, railways were the typical example of investment financed by bonds issued by private companies, such as the Union Pacific railway company, which was able to link the East and the West coast of the United States.

Today, the term “fixed income” refers to a wide range of markets. The most liquid trading venues are represented by sovereign bond markets, while corporate bond markets are less liquid, with typically infrequent trading.

Given its function as a meeting point of investing and financing (public or private) needs, it is clear that fixed income markets have a public good nature.

Government bond markets, in particular, not only play a crucial role for the efficient and smooth financing of public debt, but are a key mechanism for the transmission of monetary policy.

Historically, alongside with the birth of primary markets, or places were debt underwriters and issuers meet from time to time to - respectively - buy and sell new bonds, investors soon realized that a secondary market is as important as the primary market.

The main function performed by secondary markets is to make the exit from the initial investment easy. In other words, the existence of secondary markets assures that investors can easily liquidate a bond without incurring losses.

Hence, liquidity is crucial for the well-functioning of secondary markets.

However, it is also in the issuers' interest to have a well-functioning, liquid secondary market. If this is the case, interest rates will incorporate small liquidity *premia* and public (or private) debt can refinanced at lower costs.

Governments of most advanced economies have strongly promoted the development of efficient and liquid fixed income markets, in order to help finance current deficit and the roll-over of maturing debt. This is even more important in countries like Italy, in which tax pressure has probably reached its maximum limit and public expenditure must be necessarily financed issuing new debt.

The low level of interest rates poses important challenged for fixed income markets, since this scenario is encouraging the acquisition of riskier and (potentially) less liquid assets.

Since the launch in 2015, the ECB quantitative easing (QE) program has absorbed 60 billion euros of government bonds every month for the last two years. Now most of the yield curve is below zero in Germany and France. In the first half of 2017, roughly 60% of new public debt has been issued at negative rates. This has been highly beneficial for most Euro-zone countries because has helped to reduce public deficits and stabilize debt/GDP ratio.

But when the QE begins to be phased out, at least two questions arise. First, what will happen to the stocks of bond holdings accumulated so far: will they all be held to maturity in the ECB's portfolio? Or will they – at least partially and gradually – be re-sold in the secondary markets? Second, what will be the impact on market participants? Will there be an orderly adjustment or will it inevitably cause some turbulence? What if spreads for Italy and Spain were to rebound to 2015 levels? Will we face another sovereign bond crisis?

These questions are partly linked to the key issue of the persisting high exposure towards public debt by Italian and Spanish banks. I will come back to this problem in the final part of my speech.

2. How regulation and technology will change fixed income markets

Regulation and technology will deeply affect fixed income markets in next years.

As for regulatory issues, the so called MiFID II directive, which will enter into force next year, will extend the scope of pre- and post-trade transparency obligations to most non-equity instruments, such as bonds and structured finance products.

MiFID II will bring about an overall increase in the transparency of secondary markets, which will be beneficial for the reasons discussed before. However, rules need to take into account the type of asset traded, the market microstructure, the overall market conditions in terms of liquidity, volatility, traded volumes, average size of the orders, etc.

In this respect, MiFID II new transparency regime has some degree of flexibility: various waivers are introduced (for example relating to pre-trade transparency for large-in-scale orders); pre-trade transparency requirements will be calibrated for different types of trading systems (including voice trading system for non-equity instruments); national regulators may also temporarily suspend pre-trade transparency requirements for non-equity instruments, if liquidity falls below a specified threshold.

Nonetheless, MiFID II will inevitably increase compliance costs, and market making in some trading venues will be more challenging. In particular, in the secondary markets of sovereign bonds, higher market making costs may cause a decline in liquidity and a rise in volatility. However, higher transparency should attract more investors and make markets deeper and more resilient.

As for the technological innovations, fixed-income markets are affected, as other markets, by the rise of electronic trading. This innovation has led to the growth of some market practices such as algorithmic trading (AT) and high frequency trading (HFT).

There is still little research on the impact of such practices on fixed income markets, but evidences for the equity markets suggest that they could have positive impact on market quality in normal trading periods (by increasing liquidity and reducing transaction costs) and negative impact during stressed periods (by increasing volatility and amplifying negative trends).

The presence of new kind of market participants (such as algo-traders and HF-traders) is affecting the functioning of fixed income markets by changing the nature of liquidity provision and intermediation. These phenomena are affecting in particular the most liquid fixed income markets (the US Treasuries market and the main European sovereign bonds markets), while markets for corporate bonds are less affected because they are much less liquid.

Regulators have to deal with these phenomena as well as with the implications for the post-trading activity coming from blockchain and from the so called DLT technologies, as weel as from the increasing importance of new payment systems based on virtual coins (such as the Bitcoin).

It is difficult to foresee the impact of these developments on the financial industry, but it is likely that in ten years from now trading and post-trading infrastructures will be totally different from what they are today.

In a fast-changing technological environment the main risk is regulation lagging behind. To avoid this risk, as noted also by the Bank for International Settlements, regulators need to access more comprehensive data on an ongoing basis in order to fully monitor these developments. It is also crucial to establish a systematic dialogue between regulators and market participants.

3. Trade off in regulatory reforms

Post-crisis regulatory reforms aim to increase market transparency (as I said for MiFID II regulation) and to strengthen the resilience and stability of intermediaries through more stringent capital requirements (Basel IV regulation).

Both transparency and stability have a crucial role in the well-functioning of financial markets. Indeed, in the medium term, more transparent markets should be able to attract more investors, with an improvement in the overall market quality. More resilient intermediaries should be better able to absorb risks under stressed market conditions and reduce the probability of market disruptions.

But in the short run there is inevitably a trade-off between transparency and stability. Regulators have to deal with this problem in order to avoid that rules intended to improve transparency and resilience end up to be sources of instability. It seems a quite obvious remark but unintended negative consequences of regulation have already occurred recently.

Regulations that improves transparency and enhances market makers' capital requirements comes at a cost in the short run, because it implies a rise in the cost of market intermediation. Banks may reduce their trading activity and narrow the scope of their market-making activities as a result of more stringent regulatory requirements.

For example, separating commercial banking from investment banking is in principle a good idea and could foster financial stability, but it can increase market making costs and transaction cost and reduce liquidity, so that in the end the final bill is paid by investors and households.

Regulations such as the Basel III leverage ratio, higher risk-weighted capital requirements in Basel IV and, in some jurisdictions, the announcement of new regulations on specific activities (for example banks' proprietary trading) may have negative impacts on intermediaries' risk-taking capacity and may reduce their willingness to provide liquidity through the market making activity.

A final, but no less important remark, is the need to keep regulation homogenous across geographical areas. If, for example, the Dodd-Frank Act implementing regulation were to be significantly revised, European regulator should take this into account to avoid unjustified competitive advantages to US banks.

4. <u>Banks and the future of fixed income markets</u>

As I said before, one of the issue that lingers on the future of European sovereign bond market, like the sword of Damocles, is related to the end of QE.

So far Italian and Spanish banks did not profited to reduce their exposure to domestic bonds. Italian banks keep 10% of their assets invested in government bonds, while Spanish banks roughly 8%. These bonds do not absorb regulatory capital and hence are an attractive form of investments for banks, in spite of their very low yields.

Introducing capital requirements for government bonds can be dangerous for many reasons.

First, such rules *per se* are not easy to design, as the they would call for the use of agencies' ratings and we all know how controversial sovereign ratings are. On the other hand, the recourse to internal rating models for sovereign exposure seems not viable. Second, these rules would strongly penalize peripheral countries such as Italy and Spain, whose banks would be forced to quickly dismiss their investments. The large sell off would drive up bond spreads and would increase the cost of public debt financing. The disorderly unwinding of bonds investment by banks may be destabilizing for sovereign bond markets.

In principle, these problems could be mitigated through a very smooth and gradual introduction of the rules, so that banks have time enough to orderly adjust their balance sheets. Yet, these same rumors that regulators are seriously thinking to introduce capital requirements for government bonds would drive up spreads and bank may record losses on their bond portfolios that could erode most of their regulatory capital.

Finally, even if the regulation were gradually introduced, it would probably overlap with QE ending and hence of the combination of these two effects would destabilizing for the markets.

We may have something similar to that we have seen for the bail-in directive: a regulation that in principle is designed to make intermediaries more stable and resilient may end up increasing the instability of the overall financial system.

However, Italian banks have already been strongly penalized for their exposure to government bonds in recent stress test exercises by EBA and ECB in 2014 and 2016. Because government bonds have been applied significant haircuts in stress tests exercise, Italian banks have displayed lower capital ratios in adverse scenarios than other European banks.

This is even more controversial if we take into account the fact the fact large banks in Germany, France and UK have big exposure to illiquid assets valued using internal pricing models (so called “level 2” and “level 3” assets) - mostly OTC derivatives and structured bonds - that have not been fully taken into account in stress test exercise. Since these assets are worth more than twelve times the TIER 1 capital of German and French banks, even a small haircut could erode a large portion of the capital of such banks in stress tests exercise.

I hope that future stress tests and SSM supervisory actions will take these elements fully into account. One possibility, as I said in other occasions, is that stress test exercises are not made public. They would just be one of the different elements that SSM takes into account to fix target capital ratios for each single bank.

5. Conclusions

Let me close my remarks with some general considerations on the future of the Italian financial industry in light of two recent structural developments.

As we all know, the merge between LSE and Deutsche Boerse has been eventually dismissed. This couples with the decision of UK to leave the EU.

These two developments represent a unique opportunity to strengthen the Italian financial industry and to try to bring back in Milan some of the market infrastructures now located in London and in other Euro-area countries.

In the case of bond markets, this opportunity need to be reaped not only to strengthen the Italian financial industry but also to simplify an extremely complex and fragmented market structure.

Let me give you a quick snapshot of how it currently works.

Italian government bonds are traded on platforms managed by MTS SpA, an Italian company controlled by Borsa Italiana Spa, who is in turn owned by LSE Group Plc. Central counterparty services on MTS are offered by two companies who have an interoperability agreement and are located in different countries (an Italian one, Cassa di Compensazione e Garanzia SpA, owned by Borsa Italiana SpA, and a French one, LCH Sa, controlled through a majority stake by LSE Group). Another Italian company, owned by Borsa Italian SpA, offers custody and settlement services (Monte Titoli SpA). Finally, foreign government bonds are traded on a platform managed by EuroMTS Ltd, a company located in London and controlled through a majority stake by MTS SpA. Some central counterparty services on EuroMTS are offered by LCH Ltd, a UK company controlled by LSE Group.

On top of this, I want to recall that derivatives on Italian BTPs are traded on Deutsche Borse AG, whose central counterparty is Eurex AG. This creates significant complexities for traders and market makers who want to arbitrage or cover their positions in Italian government bonds with derivatives, because using two different central counterparties (one for cash markets and another for derivative markets) is more expensive in terms of margins and collateral.

Given these fragmentations and complexities, I see an opportunity to bring back in Italy all or most of the trading and post-trading infrastructures related to government bond markets, possibly including derivatives on BTPs, leveraging on the role and reputation that MTS has been able to build over the last years as a market leader in providing trading services.

This challenge is actually linked to a battle that will be fought on a larger scale, which is related to the possibility to attract into the Euro area the OTC derivatives clearing business which is now almost entirely done in London (mostly by LCH Ltd). I think the Italian central counterparty that offer its services both to MTS and MTA (the equity market) should put in place any possible effort to be a candidate to attract part of the OTC derivatives business, at least those done by Italian banks. Italian banks, on their side, should do their best to convince their foreign counterparties to clear OTC contracts on Italian infrastructures.

These are big opportunities but also enormous challenges. Only by a tremendous, timely and coordinate effort by government, regulators and the industry itself, Italy can hope to attract some of the business that will sooner or later will leave London.