Assessing the potential unintended consequences on emerging markets and developing economies (EMDEs), the G20 encouraged the Financial Stability Board (FSB) in providing policy advice to mitigate them. According to the FSB Report published in September 2013, EMDEs indicate the possibility of potential adverse implications of several regulatory reforms Basel III Capital and Liquidity Requirements, OTC derivative market reforms, policy measures for G-SIFIs, and structural reform initiatives. There are concerns about potential impact on the liquidity of EMDEs domestic sovereign bond market which varies across EMDEs on account of respective macroeconomic conditions and health of banking systems. EMDEs are particularly concerned about the Basel III liquidity standards which are expected to create implementation challenges for them due to the limited availability of high quality liquid asset and difficulties in calibrating the framework to suit practices of smaller banks and small jurisdictions.

Hence, the effective implementation of reforms in EMDEs depends on several factors like adequacy of supervisory resources, the need for intensive cross-border cooperation and information sharing especially in bank business models, and the needs and structure of the EMDEs financial system. The international financial institutions (IFIs) and the Basel Committee on Banking Supervision (BCBS) are increasingly focusing on the implementation of Basel III reforms through developing additional guidance and identifying good practices for reform implementation for EMDEs. The Basel Committee is also monitoring the timely adoption of Basel III standards, its quantitative impact on banks and the consistency of implementation among its members. The Basel Consultative Group (BCG) recommends strengthening legal and institutional arrangements in EMDEs and small economies to enable issuance of capital instruments to meet Basel capital and liquidity framework standards.

The supervisor, who is responsible for implementing the capital conservation and countercyclical buffers, must be empowered with adequate supervisory powers especially in EMDEs and small countries along with emphasis on improving their understanding of credit cycles. As the liquidity coverage ratio (LCR) is designed to improve banks' resilience to short-term liquidity shocks through holding a reserve of high quality assets (HQLA), the BCG also recommends for creation of a dedicated unit in supervisory agency to facilitate liquidity coverage ratio (LCR) implementation. For some EMDEs, the LCR may increase foreign currency risk if banks meet LCR shortfalls in domestic currency with foreign currency assets. The BCBS suggests giving greater encouragement to home supervisors to reach understanding with banks and host supervisors on how and when reserves can be made available. The BCBS also recommends allowing greater flexibility for the treatment of non-retail deposits and encourage agreement on likely resolution scenarios (in advance) in process of management of Basel liquidity framework.
As the impact of OTC derivatives reforms in EMDEs and small economies varies widely depending on financial market characteristics and stage of development, the BCBS suggests sequential implementation of reforms in non-BCBS jurisdiction and endorse an explicit reference to thresholds of proportionality. The committee advocates giving due regard to sovereign exposure risks in line of approaches preferably on a globally consistent basis. The approach needs to differentiate among types of sovereign debt held by banks, and to be tailored to country specific circumstances. The approach also considers potential unintended consequences and must be supported and informed by a robust analytical framework. The jurisdictions should require scenario-based stress tests for sovereign credit events, supported by reverse stress testing and sensitivity analyses.

To address sovereign risk build-ups, the approach must include sovereign risk capital buffers, such as incremental capital charges on sovereign exposures under Pillar 1 or concentration charges under Pillar 2. The approach must have more robust and consistent cross-jurisdictional application of the Pillar 2 Supervisory review process to address risks associated with excessive concentration. The committee also advocates on a limit on the size of sovereign debt exposures, possibly as a percentage of total assets or capital and suggests supply-side measures to promote sovereign risk diversification.

One of the major responses to the global financial crisis was the emergence of the concept of systemically important financial institutions (SIFIs). Global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs) are two find-outs to address the systemic imperfection and hence both become part of regulatory framework aimed at reducing the probability of failure of these institutions and at mitigating the negative impact in case of failure. The committee also advises host supervisors to consider bank-specific recovery and resolution plans for domestic systemically important banks (D-SIBs). There is need for close coordination between home and host supervisors on phasing in capital requirements for D-SIBs and giving more powers over branches to deter regulatory circumvention through the conversions of subsidiaries into branches.

The BCG recommends introducing a mechanism to ensure all relevant jurisdictions are invited to core supervisory colleges and to sign a MoU before granting a banking license to a cross-border institution conditioning on sharing minimum information. Host supervisors should notify home supervisors when a banking subsidiary is important for the host's financial system and combine their efforts with other host supervisors to ensure a greater influence and voice in a college. Supervisors must sign a confidentiality agreement with home supervisors taking the lead in drafting a proposal for the college meeting agenda and distributing any documents. The BCG proposes to empower supervisors to require capital for entities in their jurisdiction and to require a restructuring of the financial group.

Source: www.bis.org
Last few years (2005:06:Q2 - 2012-13:Q4 with exception of few quarters) experienced higher food inflation - majorly on account of proximate factors like higher rural wages-induced demand of food articles, elevated input cost of agricultural production, changing consumption pattern in favor of protein items, and significant increase in minimum support prices (MSP). The higher food inflation was generalized across the basket of food items, but biased towards price rise in pulses and MFE (meat-fish-eggs). A thorough inspection of pressure points of food inflation shows that rise in demand of food items (especially of more nutritious food items factored on change in consumption preference due to income rise) and supply side constraints (structural constraints in Indian agriculture) simultaneously lead to higher demand-supply gaps and thus generates persistent pressure points for food price inflation.

While fiscal stimulus packages and expansionary monetary policy stance in the wake of the global financial crisis (GFC) contributed to raising general inflation, it did not have similar and significant impact on food inflation. Analyzing demand and supply-side factors, the paper finds that the rising rural incomes and increase in real consumption are major reasons behind higher food inflation. The average annual monthly per capita food expenditure (a measure of demand-side indicator) has risen sharply indicating a clear structural shift in food consumption pattern. The welfare schemes - like Mahatma Gandhi National Rural Employment Guarantee Scheme (MANREGA) have also driven demand level by infusing substantial amounts of liquidity and increasing purchasing power for food items. These schemes along with Pay Commission awards improved the bargaining power of rural workers and subsequently input costs in agriculture production.

On supply-side, droughts/floods along with monsoon (in terms of late activation, volume and distribution) have short-run transient impact on food inflation through affecting agricultural production. In addition to these factors, long-term structural supply-side constraints - like shift in land use to export-oriented commercial crops from food crops and environmental degradation also generates pressure points for food inflation. With growing population, supply-side constraints along with increasing demand pressures on account of rising income level, especially in rural areas (70% of total population), there are natural price pressures on food inflation at both counts and higher risk of sharp rise in inflation in case of any surprise shocks.

Given relatively inelastic demand for food particularly in rural areas factored on rise in farm wages, the aggregate demand of food items is leading to wider supply-demand gaps, and hence generates price pressures on food inflation. The country’s insufficient production is also contributing to food inflation through supply-demand mismatch. The preferential change in consumption pattern to high-value food items (like pulses, milk & milk products, and MFE) also amplifies price pressure on food inflation. Various

November 2014: Analytics of Food Inflation in India (WPS (DEPR): 10/2014)
(Thangzason Sonna, Dr. Himanshu Joshi, Alice Sebastian, Upasana Sharma)
NSSO surveys on household expenditure also reveal that rise in real rural wages are most likely to create strong demand for food items across diversified consumption basket, especially of high-value and nutritious food items.

Referring Gulati and Saini (2013) findings, the paper enlists that fiscal deficit, rising farm wages and transmission of the global food inflation simultaneously accounted for 98% of the food inflation in India in the long-run. However, the paper argues that despite progressive hikes in the MSPs of major crops, the MSPs are weak influencing factors for food inflation except temporary distressed supply condition. Extreme climatic conditions also affect agricultural production adversely and lead to pressure points on food prices. However, the past experiences show that it is not always the case when rainfall deficiencies have not always been associated with increased food inflation. This implies that deficient rainfall can have at best temporary supply-side impact on agricultural production and food inflation.

The empirical results of the paper suggest that real rural wages have the strongest impact in driving food inflation up, followed by weighted average MSP of rice and wheat and index for agricultural inputs respectively. Though, the long-run impact of real rural wages coincides with large expansion of MGNREGA, the MGNREGA was weakly significant in pushing food inflation up in the long-run. The paper also finds identical and significant impact of real rural wages, average MSP and agricultural input cost inflation on food inflation in the short-run. The vagaries of monsoon have also contributed to food inflation occasionally, but not in the long-run.

However, the paper expresses the likelihood of price pressures on food inflation in higher economic growth environment to meet food provisioning for growing population and hence suggests for urgent need to increase agriculture growth by raising productivity through enhanced investment and improved technology. In turn, the increase in agriculture growth will reduce supply-demand gaps in the long-run and would be helpful in improving supply logistics - which consequently assuages price pressures from food inflation by securing food availability at reasonable prices in the scenario of higher economic activity in sustainable way.

Concluding, the paper found that increasing real rural wages have a strong significant impact on food inflation in the long run. The rise in MSP has significant-but-weaker-than-perceived impact on food inflation, while expenditure on protein foods has weaker impact on food inflation. In the short-run, rise in food inflation was identically explained by same set of factors (increase in rural real wages, MSP, and input price pressure).

Source: www.rbi.org.in
Changes in the behaviour of market makers as well as other liquidity providers and their impact on liquidity in fixed income markets are of particular interest to policymakers, given the relevance of these markets to monetary policy and financial stability. This report studies current trends and drivers that determine these behaviours before going on to assess their implications for market functioning and robustness.

The vast majority of bonds are traded over the counter (OTC) rather than on the central limit order books of exchanges. The dominance of the OTC market structure reflects the large number of issued bonds, which reduces the probability of finding matches in investor supply and demand for any given bond, the fixed maturity of bonds, allowing buy and hold investors to recoup their invested funds without trading in secondary markets, often resulting in ever fewer trades towards the bond's date of maturity; and the prevalence of institutional investors who require execution of large-volume transactions that could potentially have a strong price impact when trading on a fully disclosed central limit order book.

In the absence of continuous two-way markets for buyers and sellers, broker-dealers, such as banks and securities trading firms, facilitate bond transactions. They either fulfil client orders by finding matches in existing supply and demand (brokerage or agency trading) or step in as the counterparty of their clients' trades by committing their own balance sheet capacity. Primary and secondary bond markets are closely related, with many market-making firms active in both. Bond issuers generally have an incentive to improve the liquidity of their issues in secondary markets to reduce the premium that investors demand. Many jurisdictions have thus adopted primary dealer (PD) systems for central government bonds that often combine incentive schemes with market making obligations.

The business models of market-makers broadly share a number of common features, such as a sufficiently large client base to ensure access to sizeable order flow information; the balance sheet capacity to take on large principal positions; continuous access to multiple markets, including those for funding and hedging instruments; the capacity to manage inventory and other risks; and market expertise to provide competitive quotes, including during times of elevated financial market volatility. Quoted bid-ask spreads incorporate market-makers' expectations of the cost and risk associated with a change in inventory. Therefore, bid-ask spreads will tend to be narrow (and quoted quantities high) if trading positions can be offset quickly and at low cost or if the cost of funding inventory is low.

Another factor affecting quotes at the individual dealer level is the difference between the current and the desired inventory. Dealers whose positions approach the limits set by their institution's risk management framework are thus incentivised to adjust their quotes to realign their inventory. Reduced tolerance for risk at the firm level will impact the amount of capital dedicated to market-making activities.

The market structure, including the way quotes are provided, may also have a bearing on and be indicative of a market's liquidity. In the most liquid markets, two-way prices are continuously provided. Bid-ask spreads in these markets are
typically tight. Profit margins for market-making are thus thin, requiring market-makers to seek high inventory turnover. Less liquid markets, in contrast, will tend to be order-driven. In these markets, clients request quotes from market-makers and thus do not have access to firm prices on an on-going basis.

Proprietary traders can, in principle, also contribute to absorbing temporary market imbalances. However, market-making and proprietary trading can be differentiated along several dimensions. An assessment of the profitability of market-making is thus based not only on the P&L of the market-making units - as would be the case for proprietary trading - but also on any associated client business. Hence, banks continue to provide market-making services even in less profitable markets and, to some extent, during times of elevated financial market volatility or stress. Secondly, market-makers are typically considered not to trade on any specific informational advantages. Proprietary traders, by contrast, often seek to gain such advantages (e.g. through market research) to profit from informed trading decisions.

Despite these differences, the risk profiles associated with market-making and proprietary trading can be very similar, one reason being that market-making activities can vary widely, depending on the characteristics of the market.

Developments in repo markets provide information on changes in market-makers' funding conditions and are often closely tied to developments in trading volumes of the underlying securities. In both the United States and Europe, repo volumes surged in the run-up to the global financial crisis, before contracting markedly during the crisis. They have since stabilised at somewhat lower levels than before the crisis, with the spread between the general collateral (GC) repo rate and the overnight index swap (OIS) rate, a broad gauge of the scarcity of sovereign bonds, remaining fairly tight in most advanced economies. Despite this, some market participants have raised concerns about reduced availability of specific securities for use in repos, pointing to spikes in repo fails, and about the impact of large-scale purchases by central banks which have reduced the amount of available issues in specific market segments.

Market- and regulatory-driven trends that result in a decline in market liquidity for some instruments may thus trigger a shift in trading activity to closely related markets. One such example is the apparent shift in activity from sovereign CDS markets to bond futures in some euro area jurisdictions, coinciding with the introduction of a new regulation on short selling and credit default swaps in the European Union in November 2012; By comparison, bond futures markets in other jurisdictions have not witnessed a comparable expansion.

Market-based liquidity metrics may be less informative about the present and future capacity and willingness of dealers to make markets. To help gauge related trends, the authors assessed developments in dealer inventories and risk-taking behaviour against the feedback gathered from the Group's interviews. Aggregate data on major banks' gross and net trading securities holdings point to a steep decline in inventories during the global financial crisis for both US and European banks. Since then, positions at US banks have broadly stabilised, whereas they have continued to fall at their European peers.

Developments seem to differ also by asset class, as suggested by more detailed inventory information. A striking pattern of position changes is evident in
the United States, where dealers' net positions in corporate debt securities have fallen sharply since 2008, whereas net US Treasury positions rose during the crisis and are now net positive. Similar trends are evident among Australian banks, which have been less exposed to the global financial crisis, but have persistently raised their domestic government bond holdings since 2008 and reduced corporate bond inventories since 2010. Primary dealers in India, by contrast, have been accumulating both corporate and sovereign bond inventories, before selling off their sovereign debt securities during the mid-2013 bond market turmoil.

Especially in Europe and the United States, many interviewees underscored the view that market-makers' willingness to hold large inventory positions had decreased, particularly in less liquid instruments. Market-makers are reportedly focusing on activities that require less capital and balance sheet capacity. Some banks have migrated their balance sheets away from fixed income business lines including repo, while foreign banks without firmly entrenched franchises are scaling back or exiting these markets altogether.

Some market-makers have adopted a more selective approach to offering client services, with the total cost and revenue of client relationships coming under increased scrutiny. Likewise, assessment of the value of trades has evolved and become more granular. Rather than return on risk-weighted assets (RWA) being reported at divisional levels, this measure is now calculated per trade per client (pre-execution) by some financial institutions. Proprietary trading has reportedly diminished or assumed more marginal importance for banks in most jurisdictions, particularly in the euro area. Market players generally expect banks' proprietary trading to further decline or to be shifted to less regulated entities in response to regulatory reforms targeting these activities.

Overall, the private sector's demand for fixed income instruments continues to grow, adding to central banks' and other public sector purchases of debt securities. Expanding bond markets amid significant flows of funds to market participants that require immediacy services point to persistent and growing demand for market-making. At the same time, many market participants are adjusting their business models to mitigate the impact from reduced or more costly immediacy services in some markets. Bond issuers, in turn, have the incentive to seek ways to improve the secondary market liquidity of their issues.

Robust growth in primary bond markets over the past years has pushed the amount of outstanding debt securities to record levels. Accommodative monetary policies to support the economic recovery have driven down interest rates to unprecedented levels, with unconventional policies directly targeting the medium to long end of the yield curve and contributing to the compression of term premia and credit spreads. Given persistent demand for debt securities, funding conditions in corporate bond markets have improved considerably. Corporate bond issuance has thus surged in many emerging market economies, while also growing rapidly for non-financial corporates in many advanced economies. The outstanding debt of advanced economy financial institutions, by contrast, has contracted in many jurisdictions amid widespread efforts to deleverage balance sheets.

Unprecedentedly low bond yields have incentivised risk-taking by some investors. Given the thin secondary market liquidity in most corporate bond markets, particularly for high-yield instruments, bond funds that promise daily liquidity on a best
endeavours basis, have attracted significant inflows from both institutional and retail investors.

Despite the significant expansion of primary bond markets, there are signs that assets under management by the private sector are increasingly concentrated in a few large market players. One implication of further concentration would be that investment decisions of these market players could have a greater impact on market liquidity conditions going forward.

Asset managers are reportedly adapting their investment strategies to account for reduced market-making capacity. While this would tend to mitigate the effects of rising demand for immediacy services, the associated costs may be difficult to bear for smaller firms, thus reinforcing market concentration. Some investors, in particular the larger investment fund managers, are becoming increasingly important to market-makers as a regular source of bonds. Yet, there is scant evidence that market participants facing fewer regulatory constraints are seeking to replace traditional market-makers, as they typically lack the customer franchise and balance sheet capacity to take on more active market-making roles.

Market participants with medium- or long-term investment horizons, such as pension funds, life insurance companies and reserve managers, tend to be less sensitive to changes in liquidity conditions. Yet, once the current environment of monetary accommodation is changing, more prudent investment policies in the aftermath of the global financial crisis may encourage a structural shift towards investing in less risky and more short-term instruments, possibly accentuating the impact of reduced risk-taking by dealers. Greater use of fair value accounting under IFRS, for example, may limit the scope for taking long-term or illiquid assets on balance sheet, particularly during times of elevated market volatility. Likewise, higher risk charges may disincentivise allocations to corporate bonds.

Rising funding needs and, at times, volatile market conditions have induced debt management offices and other fiscal agents to adjust their issuance procedures, aiming to align them with the needs of a broad and diverse investor base. Measures to more directly improve secondary market liquidity are also gaining importance, creating spillovers also for the ability of market-makers to provide their services in other, related markets. One such measure is the increased reopening of issues (“taps”), raising the outstanding amounts of existing securities rather than issuing new ones. In addition, some debt management offices and fiscal agents are seeking to improve the liquidity of their securities by smoothing temporary supply and demand imbalances. One such example is the provision of securities lending facilities for dealers.

The use of electronic trading platforms in bond markets has been growing in both advanced and emerging markets. Existing electronic platforms tend to be used only for a limited range of typically standardised and often smaller size transactions for which a sufficiently large number of orders can be matched on a regular basis. For the vast majority of corporate bonds in particular, scattered order flow would tend to work against the use of electronic platforms. Large trades by institutional investors with a potentially large impact on prices also seem less suitable for trading on platforms and typically require dealer intermediation. Transparency requirements, in addition, may limit the willingness of investors and dealers alike to execute trades electronically if doing so might reveal their trading strategies and portfolio positions. Large investors are reportedly starting to explore trading strategies that split transactions into smaller
amounts to optimise trading performance on electronic platforms. Trading platforms that do not disclose the participants’ identity may face specific difficulties in supporting market liquidity during periods of financial market stress.

Market participants that could, in principle, provide liquidity in addition to traditional market-makers have, so far, focused their trading activities on the most liquid fixed income instruments. Traditional market-makers may also be inclined to protect their share of client order flow by preventing key customers from shifting their transactions to electronic platforms or offering their own proprietary solutions. This would imply less market liquidity, on average, on existing platforms. Some electronic trading platforms are exploring ways to support market participants, including non-dealers, in providing market-making services.

Market participants in most advanced economies and several emerging markets emphasised that risk tolerance has declined in recent years, either altogether or more selectively for certain financial instruments. The aggregate VaR of US dealers declined markedly after the global financial crisis; a trend that is common among many major banks in advanced economies and often closely tied to broader deleveraging efforts. By contrast, risk-taking by dealers in countries such as India has picked up considerably since the crisis. This is because, in the first place, the risk premium required for activities with an uncertain income seems to have been revised up. This reassessment has resulted in a reconsideration of how both capital and funding costs are allocated internally, increasing the cost of taking market risk.

Secondly, dealer feedback indicates that risk measures have become more sensitive to changes in volatility because they now tend to give more weight to recent observations. Risk measures will thus rise more quickly when market volatility picks up, and market-makers may be forced to reduce their exposures more aggressively than in the past.

Since the onset of the global financial crisis, some hedging strategies have become more difficult to implement, as liquidity in the underlying derivatives markets has deteriorated. This has further reduced market-makers’ risk tolerance as they enter into positions that are difficult to hedge. Furthermore, the wind-down of dealers’ in-house proprietary trading desks and reduced risk-taking at the system level are limiting their options for redistributing risks, further reducing their willingness to build up large inventories of less liquid assets.

The downsizing of proprietary trading desks has been one element of advanced economy banks’ deleveraging efforts since the financial crisis. The same pressure has also led some market-makers to enhance their pre-execution due diligence to ensure that the pricing of transactions reflects the internal costs of allocating capital and providing the desired return on equity.

Based on these lessons from the recent financial crisis, a variety of international and national regulatory reforms have been initiated to improve the robustness of the financial system. The totality of current regulatory changes is likely to affect market-makers’ balance sheets and P&L accounts in a rather complex fashion, which implies that their overall effect is hard to assess. Abstracting from the beneficial effects of regulation, many market participants expect the cost of market-making to rise, with less liquid assets expected to be affected most, potentially reinforcing the observed trend towards liquidity bifurcation. The leverage ratio tends to be seen by market participants as the most important possible constraint for market-makers.
in many jurisdictions and across fixed income instruments.

For corporate bonds, many market participants also point to increased regulatory capital charges adding to inventory costs. The additional impact of these requirements on banks’ total capital charges may however be modest, with many banks having already adjusted their business models to the new regulations. The ineligibility of less liquid corporate bonds for the liquidity coverage ratio, in turn, is expected to further reduce the willingness of banks to warehouse these assets.

It is unclear, at this stage, to what extent on-going regulatory reforms will accentuate the impact of the market-driven adjustments. The perceived shift in liquidity risks to investors, as market-makers reduce their risk-taking, could imply a redistribution of risks towards those market participants that, at least in principle, are better suited to manage these risks.

The market implications of current trends in market-making and proprietary trading are likely to differ across jurisdictions and asset classes. For a number of jurisdictions, the observed adjustments in market-makers’ business models point to a reassessment of the risk-return trade-off, suggesting a reduced and more differentiated provision of market-making services across clients and asset classes. At the same time, rising net issuance of debt securities and increased holdings by market participants that require immediacy services indicate persistent or even growing demand for market-making in debt markets. Market participants have, at least selectively, started to adjust their trading strategies to perceived structural supply and demand side forces. Advancements in fixed-income market infrastructures, in turn, are increasingly focusing on pooling liquidity to facilitate trading amid reduced liquidity provision by traditional market-makers.

Diverging trends for market-making supply and demand imply, all else being equal, upward pressure on trading costs, reduced market liquidity on average and, ultimately, higher costs of financing in primary bond markets. Feedback from market participants suggests that, in many markets, the compressed liquidity premia observed before the global financial crisis may not have been sustainable. That said, there is no conclusive evidence of a widespread rise in trading costs so far. There are a number of reasons for that. First, competition limits the extent to which market-makers can pass through costs to clients. Second, interview results underscore that market-makers have become more cost efficient in providing immediacy services, leveraging on advancements in electronic trading and in the processing of trades. Finally, changes in the cost of trading are inherently difficult to track. Market-based liquidity indicators typically provide a gauge only of the cost of trading limited amounts and are usually available only for the more liquid markets.

A number of factors may contribute to raising the probability of an adverse impact of large and self-reinforcing order imbalances on liquidity conditions. These include, but are not limited to an overestimation of liquidity by market participants (“liquidity illusion”); the order flow being concentrated within only a few market participants; market participants following similar investment strategies; and market players relying on funding strategies that are vulnerable to changes in market conditions.

Policy implications can be categorised in terms of supporting initiatives to raise the probability of achieving more robust liquidity conditions, and possible backstops to address deteriorating
liquidity conditions and market vulnerabilities arising under adverse scenarios. Promoting transparency on the degree of market-making capacity in individual financial markets can help reduce the risk of liquidity illusion by supporting market participants in pricing liquidity risks. Industry bodies and relevant authorities could consider collecting and disseminating more detailed information on market-makers’ inventories and risk taking to monitor risks and support other market participants in assessing liquidity conditions. Another aspect is the need to assess structural developments and how they affect the capacity and willingness of financial intermediaries to make markets.

Market participants need to ensure that their risk management frameworks account for the shift in liquidity risks that may result from a reduction in the supply and an increase in the price of immediacy services by traditional market-makers. The relevant authorities can support such measures by monitoring whether institutional investors’ liquidity buffers and redemption schemes adequately reflect the liquidity risks of the underlying investments and by addressing any vulnerabilities they identify. All market participants should also be in a position to assess the impact of significant liquidity shocks on their balance sheet and funding position, and assess the capability of their operational frameworks to manage risks in times of market turmoil.

On-going regulatory reforms to raise the loss absorption capacity of banks and to incentivise prudent funding structures will tend to also broadly support more robust market-making. Additionally, significant public funding needs and global interest rates returning from their exceptionally low levels provide strong incentives for sovereign issuers to limit the liquidity premia on their debt securities. One option to consider is establishing or expanding existing incentive schemes for market-makers to enhance secondary market liquidity in sovereign bond markets.

Initiatives aimed at supporting the robustness of these markets thus directly benefit bond market liquidity more broadly, facilitating the management of inventory risks. One set of measures here could focus on reducing counterparty risks.

Backstop measures to support market liquidity have been provided to different degrees across jurisdictions during the recent crisis, reflecting the different nature of shocks, demand and supply patterns, and market setups. Overall, possible backstops can be grouped into three broad categories. The first category includes central bank liquidity provision to underpin bank funding and help market-makers finance their inventories, thus indirectly supporting bond market liquidity. The second is more structural in nature, comprising measures such as securities lending facilities (SLFs) that can help address bouts of excess demand for specific securities. The third and most controversial category of measures encompasses direct interventions in key markets to address dysfunctions or imminent risks of a market freeze.

Central bank operations to strengthen bank funding positions can support the banking sector’s market-making capacity by helping market-makers finance their inventory. Likewise, liquidity insurance facilities, as established by some central banks, can backstop market liquidity by providing banks recourse to central bank funding. Adjustments to central bank collateral frameworks, such as broadening the scope of eligible collateral assets, can provide further support to market liquidity if market-makers (and other market
participants) face imminent funding constraints. A key condition for all of these responses is that central banks have the appropriate risk assessment and management capabilities to manage associated risks.

The second category of measures is more structural in nature in that it involves backstops that are not necessarily part of central banks’ operating frameworks. The design of lending terms would need to balance two factors: terms should be unattractive under normal market conditions to mitigate any distortion in private sector trading and they should be sufficiently favourable under stressed conditions to be effective.

A possible question for policymakers is if they would consider more direct measures - such as outright purchases and sales of securities - to support market functioning as a further line of defence for markets that are judged critical to financial stability or when the transmission of monetary policy is severely impeded. Any such intervention would need to be designed to support only those markets viable in the longer term, absent public sector action, and targeted at facilitating the reopening of private market activity. Backstopping market liquidity directly risks structurally distorting economic incentives for market participants and, as a result, could aggravate liquidity illusion. Intervening in markets over an extended period of time could also result in market functioning becoming overly dependent on such backstops, posing significant exit problems.

Source: www.bis.org