
AFME Briefing Note

25th June 2013

The Role of Secondary Markets and Market Making in the Long-Term Financing of the European Economy

Introduction

AFME supports the European Commission's Green Paper *Long Term Financing of the European Economy*.

We particularly welcome the emphasis given in the Green Paper to the role of capital markets in providing long-term funding for governments and companies.

Although securities markets are already an important source of long-term funding for governments and companies, their full potential remains underutilised in Europe as a genuine single market remains to be achieved and businesses have traditionally relied predominantly on bank funding. Opportunities to secure financing through the securities markets need to be further developed and capital markets channels expanded to ensure economic growth.

Derivatives enable industrial companies and governments to effectively manage risk in their operations and activities, including their financing arrangements; and they help pension funds meet their obligations to retirees. They help support economic growth by enabling banks to manage risks associated with lending to corporate and individual customers. They play a vital role in a range of industries – from international trade to residential mortgages, as well as financial services.

Further to our submission in response to the Green Paper's specific questions, the purpose of the Briefing Note is to explain the importance of capital and risk-management markets in general and market making in particular in facilitating the channelling of savings into long-term financing projects. We believe this should be a central theme in ensuring a successful delivery of the Green Paper's objectives¹. Market making activities will be critical to unleashing the full potential of European capital markets.

¹ This Briefing Note has been developed by an AFME Working Group set up to provide analysis on market making issues across a range of regulatory debates and product areas (equities, debt and derivatives markets). The Working Group comprises a mix of senior experts with business, compliance, legal and regulatory policy backgrounds, as well as representatives from the International Capital Markets Association (ICMA) and the International Swaps and Derivatives Association (ISDA).

Importance of Secondary Securities Markets in Long Term Financing

As noted in the Commission's Working Document accompanying the Green Paper: "providing liquidity is an important function of secondary markets. Liquid and well-functioning secondary markets encourage activity in primary markets too, as this enables investors to sell their investments quickly and at low costs when needed." Investing over the long-term requires the operation of strongly effective mechanisms in the form of secondary market trading strategies capable of aligning the differing requirements of investors and end-users in order to facilitate long-term funding for the economy as a whole.

A reduction in available liquidity for the relevant market affects the ability of issuers to access financing for new commercial opportunities and a range of projects requiring long-lived capital, including energy generation, communications networks, transport, hospitals, and schools, as well as investment in research and education. AFME research has shown that the adverse impact of a decline in liquidity tends to fall on less liquid instruments in particular, typically those related to small and medium enterprises (SMEs) and project finance – precisely the types of investment highlighted in the Green Paper².

Understanding Market Making and Intermediation

The fundamental role of market making

Market makers provide intermediary services that are critical to the development and orderly functioning of secondary markets. At its heart, market making is liquidity provision through the ability to promptly absorb investors' demand or supply of a financial instrument. This is also known as "immediacy" – the ability to expedite the trading interests of independent counterparties in a timely and cost-effective way. Market makers do this by quoting buy and sell prices, as well as providing on-request quotes, to ensure a two-way market.

The market making mechanism has developed over years in response to the reality that few markets have sufficient numbers of buyers and sellers with exactly matching buying and selling interests at all times. Intermediation is needed to align differing trading demands and ensure liquidity provision. Market makers play a different role to brokers, another type of intermediary service, who match buyers and sellers and generally do not take market risk onto their balance sheet. A market maker itself buys and sells assets, placing its own capital at risk and provides access to the market for buyers and sellers.

Market makers play a key role in bridging the varying requirements – including time preferences, investment mandates and risk appetites – of investors (retail and institutional) and users of capital (corporates and consumers), which are often highly diverse. Many retail investors, for example, prefer their funds to be easily accessible, while institutional investors have a wide range of maturity preferences depending on their investment mandates (for example, money market funds, intermediate vs. long term bond funds, loan funds, infrastructure funds, equity funds, emerging

²AFME (2012). *Analysis of Fixed Income Trading Activity* www.afme.eu/WorkArea/DownloadAsset.aspx?id=6821

TABB Group (2012), *MiFID II and Fixed Income Price Transparency: Panacea or Problem?* <http://www.afme.eu/Documents/Statistics-and-reports.aspx>

markets funds). Corporate borrowers also have a wide range of needs in terms of maturities (for example, bank working capital facilities, SME loans, construction build loans, infrastructure permanent financing, leveraged finance, and real estate).

Market making services help investors bridge a range of gaps encountered in different market conditions, such as risk gaps, inventory gaps and time gaps. They contribute to allocating capital to the most efficient investments within the economy and providing mechanisms for saving, risk pooling and management.

Market makers also contribute to significantly reducing transactions costs in the economy –by for example minimising the costs for borrowers in relation to the number of investors and end-users that would otherwise have to be approached and to the variety of terms that they would demand.

Market makers can also provide tailor-made products to their customers. For example, end-users use derivatives for hedging. In order to ensure prudent risk management, customers demand hedging instruments that very closely match their risk or cash-flow profile. Market-makers provide such instruments and then manage their risk on a portfolio or cross-asset class basis (e.g. taking positions in more standardised instruments available in the wholesale markets).

Key attributes of the market making service and business model

A market maker will absorb an investor's need for immediate demand or supply of an asset or financial instrument and charge a premium for the service provided. Clients can obtain quotes from several market makers for a particular asset or transaction which helps them to achieve better cost efficiencies. In addition to the Over-The-Counter (OTC) markets, investors can access directly/indirectly the liquidity provided by market makers on regulated trading venues.

The market making revenue generation model could be likened to running a store. Shops earn revenue by taking on risk³ in the form of stock held in inventory in order to provide a ready source of products for buyers. This also provides an available market to sellers for their goods. The business model depends upon the intermediation between customers rather than on seeking to realise profits due to variations in price over time.

One outcome of market makers' activities is to promote market efficiency by narrowing spreads. The bid-offer spread is the difference between the price someone is willing to buy at versus the price someone is willing to sell at. Market makers make a profit from the difference between the buying prices and the selling prices applied to transactions.

The "tightness" of the bid-offer spread in the market is an important measure of liquidity. In highly liquid markets spreads can be narrow, reflecting the availability of many willing buyers and sellers. Less liquid markets will feature wider spreads, reflecting compensation for absorbing additional risk. Competing market makers are willing to bear this risk in the expectation – not always realised – that their risk management capabilities and ability to assess future client demand will help them achieve a reasonable return on their activities. This is why, from a regulatory perspective, market makers have strong risk management processes and controls in place.

³ The risks involved refer to the possibility that the goods cannot be sold at profitable prices due to a lack of customer demand or a decline in their value.

To perform their role, market makers must manage the inventories of positions they take in order to stay within their risk tolerance levels. Partly this will be done through sensible judgements around potential supply and demand for a particular instrument; partly it will be done through the hedging of positions arising as a result of market making. For this reason, market making activities need to be viewed holistically (on a portfolio basis and across different asset classes) and not on a trade-by-trade approach.

Market makers must often manage their inventory in anticipation of a client order. Done effectively, inventory management allows market makers to accommodate clients' trades quickly and at reasonable prices. Removing the possibility of hedging the risks associated with the acquisition of instruments in advance of client orders would undermine responsible risk management practices and discourage liquidity provision. A sound hedging environment also encourages market makers to take on responsible risks, therefore enhancing investors' ability to manage their own risk in a cost-effective manner.

The extent to which market-makers are obliged to assume risk as a result of their daily activities is closely controlled through limits and other measures and must be supported by adequate capital backing against the possibility of losses.

EU legislators have recognised that market making activities play a crucial role in providing liquidity to markets and that imposing undue requirements on such activities could severely inhibit their ability to serve this function. This is, for example, reflected in the exemptions included for marking making in the Level 1 text of the Short Selling Regulation, discussed in the Regulatory Environment section of this Briefing Note.

OTC markets and other bilateral platforms are very important to the fulfilment of the Green Paper's objectives. They currently cover much of the trading in bonds, loans, mortgage related securities, currencies, commodities and a share of derivatives, which do not lend themselves to venue trading. The OTC space enables market participants to find counterparties for non-standard, bespoke, large, illiquid or "technical" (non-price forming) transactions. Market making is the engine supporting these markets generally catering for the least liquid trades. Because of their non-standard nature or the infrequent and ad-hoc basis upon which they are carried out, such transactions should not be subject to all of the same obligations that apply to more standardised, systematically offered transactions.

Equities markets

In the case of equities markets, the very wide range of trading sizes – from "micro" trades to "block" orders – and strategies continues to be a major factor affecting the way these markets operate and driving the demand for intermediary services. Shares in large companies with high levels of capitalisation may be traded in small volumes many thousands of times per day. On the other hand, shares in mid- or small-size companies may trade far more infrequently. Institutional investors may also seek to trade blocks of shares to raise or lower their stake in a company without affecting market prices or revealing their intentions to competitors. Market makers can often handle such trades with lower price impact than an exchange and deliver optimal pricing and execution; pre-trade transparency waivers are sometimes needed to achieve this.

The Green Paper refers to the need for more equity financing in Europe, noting that the cost of equity capital remains high in Europe. We fully concur with this assessment and the emphasis given to mid-cap firms. The secondary market can play an important role in providing incentives for investment into such stocks. Mid-cap shares tend to be less liquid given the perceived higher risk they carry. The

services provided by market makers will be important in aggregating liquidity and therefore increasing the willingness to invest in these stocks.

Debt markets⁴

Debt markets are very different from equities. Governments and companies will often issue many different types of bonds, with varying interest rates and maturities. While certain government bonds may trade in relatively liquid environments, the vast majority of debt instruments trade sporadically and very often in large sizes. The high degree of complexity and heterogeneity makes the market maker model indispensable in allowing investors to trade instruments and restructure their debt portfolios.

Market makers provide liquidity through a process where clients, either electronically or by phone, request a quote. The market maker then uses its distribution network to find the other side of the trade, or if unable to locate a buyer, may take the debt into inventory pending the location of a willing buyer. To achieve this, the market maker needs flexibility and discretion to manage its inventory over time and a capacity to manage risk on its balance sheet in accordance with appropriate risk limits and subject to available capital.

As the Green Paper notes, there is significant potential to improve SME and mid-cap firms' access to bond markets for funding. Inevitably, liquidity in these markets will be constrained as the markets evolve and deepen over a number of years. This means that issuers will need to pay a premium in order to compensate investors for the risk that they may not be able to find a seller for the securities if they wish to exit their position in the future. The provision of liquidity in the secondary market by market makers will therefore be crucial to expanding the range of funding options for businesses in the primary markets.

The effective management of market makers' inventories is critical to the way bond markets operate. If the regulatory environment forces market makers to increase their transaction costs, price adversely, restrict their client base or pull away from the market entirely in an attempt to avoid risk, liquidity will be quickly drained from these markets. The negative price impacts suffered by investors seeking immediacy would be more pronounced and the corresponding volatility in prices would be larger and more persistent. The less liquid issuances would be particularly affected – notably SME debt.

Client facilitation, especially in less liquid markets, is essential to a proper functioning of European bond markets. It is challenging to match buyers and sellers in these intermittent markets, particularly at the same time and size. The fixed-income market structure is based on a quote-driven bilateral system. AFME analysis has indicated that 70% of government bonds trade less than 400 times per month and 64% of corporate bonds trade less than 20 times per month⁵.

Derivatives markets

Market making is also essential for derivatives markets, and in particular OTC derivatives which are characterised by customised, relatively in large-in-scale and illiquid transactions. It is challenging to match buyers and sellers in these markets at the same price, size and point in time.

⁴ By debt markets we mean all securities markets other than equities: namely bonds, notes, certificates, covered bonds, securitisation.

⁵AFME (2012). *Analysis of Fixed Income Trading Activity* www.afme.eu/WorkArea/DownloadAsset.aspx?id=6821

Unlike futures, liquidity in OTC derivatives markets is fragmented, with a large number of products trading very infrequently, but in large sizes when traded. The average notional size of an exchange traded derivative transaction is \$100,000 and the average notional size of an OTC derivative transaction is \$126m (Source: BIS, WFE, FIA, ICAP/Tri Optima). Liquidity and trade sizes vary considerably depending on the specific type of product and the terms thereof. For instance, only 13 single name CDS trade more than 20 times per day (1% of the market).⁶

As noted in a Staff Report by the Federal Reserve Bank of New York: [If market making in OTC derivatives is hampered], “end-users would have limited ability to obtain derivatives that are customised to their specific needs. As a result, businesses and investors would be unable to offset certain types of business risks caused by fluctuations in currency prices, interest rates, default risk, and energy prices, among many other sources of financial risk that they may wish to control.”

Furthermore, the Report states that [businesses and investors] “often rely on OTC derivatives to hedge those risks for which there is no close match available on organised exchanges, and to satisfy hedge accounting standards. Remaining unhedged can be costly. For example, if unable to hedge effectively, project managers may choose to avoid certain projects whose uncertain cash flows have a high net present value for their shareholders out of fear that losses resulting from unhedged risks could be misperceived by their shareholders or superiors as a reflection of poor project selection or management. A failure to hedge can also increase the probability of bankruptcy, or at least financial distress, which brings additional costs, such as legal fees or high frictional costs for raising new capital when distressed.”⁷

The Regulatory Environment

As discussed in the Green Paper, new prudential rules will require banks to hold many times more and higher quality capital than previously, and this will constrain their capacity to provide direct financing and hedging. Liquidity requirements will change the way banks do business. Derivatives markets are being transformed by the implementation of G20 rules impacting hedging possibilities as well. Meanwhile, we can shortly expect the finalisation of bank resolution legislation to ensure banks can be resolved without damaging financial stability and without recourse to public money.

We briefly discuss below some of the regulatory developments that we feel are at odds with bolstering the role of capital markets in addressing Europe’s long-term financing needs.

Financial Transactions Tax

The impact of the proposed European financial transactions tax on financial markets is a source of deep concern to the vast majority of participants, including from outside the financial sector. Although technically limited to the eleven Member States taking part in the enhanced cooperation process, the proposed tax will in fact apply to an unprecedented number of transactions in the rest of Europe and beyond. As currently formulated, the tax will increase the cost of raising capital for Europe’s businesses and governments, as well as having a negative impact on hedging transactions undertaken

⁶<http://www2.isda.org/attachment/NDAXMw==/MiFIDMiFIRandtransparency20120214.pdf>

⁷<http://www2.isda.org/attachment/NTQ1MA==/Credit%20and%20Rates%20SDR%20Liquidity%20Data%20Study%20January%202013.pdf>

⁷Federal Reserve Bank of New York Staff Reports (2010), *Policy Perspectives on OTC Derivatives Market Infrastructure*http://www.newyorkfed.org/research/staff_reports/sr424.pdf

in order to manage risk. Worst of all it will significantly impact the returns of long term investors such as insurance companies and pension funds.

The FTT proposal does not recognise the importance of intermediation in its design and contains no exemptions for market making activity. The tax will introduce significant economic constraints on intermediaries, resulting in additional costs for the investors wishing to buy and sell and the issuers wishing to raise finance.

The “gross basis” application of the FTT will lead to a “cascade effect” which significantly increases the impact of the tax. By contrast, most taxes operate on a net basis (e.g. VAT, corporation and income). Taxing on a gross basis creates the potential for multiple layers of tax in a chain of transactions. For example the sale and purchase of equity, bonds or derivatives within the FTT zone would be charged at multiple stages of the chain of intermediation, clearing and settlement.

Analysis recently put forward by Oxera shows that imposing the tax on market-making will reduce liquidity, increase trading costs for buyers and reduce asset prices⁸.

Follow up to Liikanen Group recommendations

Proposals to mandatorily require banks to segregate their trading activities from other banking business would have a profound negative impact on market making activities and secondary market liquidity.

Structural separation of market making activity from deposit taking through a carve out of trading activities from universal banks would threaten the ability of capital markets to assist in meeting European financing needs. There is no guarantee that the reduced role of universal banks in capital markets will be compensated in the short and medium term by a higher capacity of viable stand alone entities. This would also reduce competition and exacerbate the problem of too-big-to-fail by increasing concentration of investment banking activities into fewer bigger players.

Mandatory structural separation may result in some banks withdrawing from market making activities on EU markets, for EU market participants, in EU securities and other financial instruments. The gap would be filled by other potentially unregulated entities that do not have to comply with similar restrictions. The result would be a balkanized funding structure that would rely primarily on domestic capital formation and concentrate risks within local banking systems. This outcome would be inconsistent with the objectives of the Green Paper.

As expressed by the Swedish National Debt Office (SNDO) in its submission to the High Level Expert Group (November 2012): “If burdened by the higher capital requirements that will face a specialised trading bank, banks may well respond by increasing margins or by abandoning market making altogether. Banks may also have incentives to curtail market making activity in government bonds to avoid exceeding the thresholds for separation, instead focusing that part of the balance sheet on

⁸Oxera (2013), *Analysis of the European Commission staff working document on the proposed Financial Transactions Tax* <http://www.afme.eu/Documents/Statistics-and-reports.aspx>

activities with higher margins. This will hurt liquidity and market depth. This will be costly for governments, who will face higher funding costs.”⁹

Short Selling Regulation (SSR)

The interpretation of market making for the purposes of an exemption from the Level 1 short selling rules is posing unanticipated challenges to market participants. The exemption is a fundamental provision of the Regulation, conceived to reflect and accommodate the important role of market makers as discussed throughout this document.

The first key problem with the Level 3 Guidelines published by ESMA in February 2013 is the prohibition on making use of the market making exemption in respect of certain instruments (and associated hedging of such instruments) which do not themselves create positions in relevant companies or sovereign debt for the purposes of the SSR disclosure regime – for example corporate debt and convertible bonds and rights.

The second key problem is the narrow interpretation of the “market making activities” definition with regard to the trading venue requirement. Based on this interpretation, the exemption can only be used by market makers when carrying on market making activity in relation to a financial instrument that is traded on or admitted to trading on a trading venue – therefore the exemption cannot be used in relation to trading in OTC derivatives transactions. A considerable amount of activity where liquidity is provided (in particular for some sovereign debt and most sovereign CDS instruments) occurs away from trading venues as these venues may not provide enough liquidity, depth or customised offer to support all trading needs in large, bespoke and illiquid transactions.

In its 3 June 2013 report on the SSR review, ESMA considers that the reasons for providing a market maker exemption apply whether the market maker is dealing in an OTC product or a venue-traded one. Based on the legal advice we have received, we do not believe that market making activities under the Level 1 text of the SSR require a link between the trading venue of which the relevant party is a member and the financial instrument in which it transacts¹⁰.

MiFID 2 / MiFIR

MiFID is the key piece of legislation governing the functioning of secondary markets. The MiFID 2 / MiFIR debate has the potential to enhance investor protection and market confidence, but if wrongly pursued could lead to an increase in spreads and trading costs through constraints in the provision of market making services.

There are significant severe constraints under consideration for the proposed Organised Trading Facility (OTF) category. The deployment of own capital and the ability to conduct matched principal trading in an OTF is critical for the facilitation of investor business in equity, debt and derivatives markets. The key function of the OTF operator’s own capital will be to ensure client execution when there is no simultaneous two-way end-user market. Without own capital deployment, client order

⁹ Swedish National Debt Office (2012), *Response to High-level Expert Group on reforming the structure of the EU banking sector* http://ec.europa.eu/internal_market/consultations/2012/hleg-banking/public-authorities/swedish-national-debt-office_en.pdf

¹⁰Some Member States (Denmark, Germany, France, Sweden and the UK) have given notice to ESMA on non-compliance with certain elements of the ESMA Guidelines (19 June 2013).

execution on an OTF will be more difficult and more costly. A more balanced approach would be to allow for operator capital deployment when requested by the investor to ensure best execution and introduce conflicts of interest and client facilitation rules to mitigate any concerns about neutrality.

AFME is also concerned by proposals in the MiFID 2 / MiFIR debate to force instruments traded in the OTC space to trade according to non-intermediated models or platforms not designed for such trading. The OTC space covers the largest, least liquid trades – precisely the ones most in need of the support provided by market makers with a high degree of flexibility to absorb their more customised nature. We believe that a curtailment of OTC trading is likely to translate into an overall loss of market liquidity, rather than a direct shift in liquidity from certain trading categories onto others.

Conclusions

Properly functioning financial markets will be instrumental in the fulfilment of the Green Paper's stated aim to channel funding to address Europe's long term capital needs. A functioning and liquid secondary securities market as well as access to customised risk management via derivatives is dependent on market makers.

Although diverse and combining many concepts in nature, the range of market making activities form an integral part of the market ecosystem and the intermediation chain leading to the allocation of capital from those who have it to those who need it or to the transfer of risk from those who are not specialised in hedging to those who are better prepared to manage risk (e.g. an export company hedging foreign exchange risk with a bank). We support an appropriate regulatory framework for market making activities that provides confidence to regulators and market participants and encourages liquidity and responsible risk management as well as investment in the real economy.

Further information

Mr. Pablo Portugal

Association for Financial Markets in Europe, Tel: +32 (0) 2401 8723, pablo.portugal@afme.eu

4th Floor

Square de Meeûs 38-40

1000 Brussels

Association for Financial Markets in Europe

St Michael's House

1 George Yard

London EC3V 9DH

Tel: + 44 (0)20 7743 9300

www.afme.eu