Phantom Illiquidity

A Closer Look Reveals that the Bond Markets Are Functioning Well

By Andy Green and Gregg Gelzinis November 15, 2016

Over the past few years, countless financial sector traders[1] and executives[2] have echoed a familiar refrain: U.S. bond markets face a serious liquidity challenge. The basic argument is that financial reform measures included in the Dodd-Frank Wall Street Reform and Consumer Protection Act—particularly the provisions that require big Wall Street banks to fund themselves using less debt, or leverage, and the regulatory provision known as the Volcker Rule, which restrains these banks from making big bets in the market[3]—have forced these firms to shrink the inventory of bonds they buy as market intermediaries, or dealers. This reform-driven contraction, according to the illiquidity argument,[4] prevents the dealers from buying and selling securities on behalf of their customers—known as making markets—especially in times of stress. The argument concludes by pointing to a perception that markets are already less liquid and far choppier than before the 2007–2008 financial crisis.

The problem is, this argument is not true.

That's not to say that those making it are wrong about the importance of the bond markets. The bond markets, also called fixed-income markets, are the primary source of credit for the U.S. economy, powering borrowing by the U.S. government, corporations, and individuals.[5] A deterioration in market liquidity would increase borrowing costs, hampering economic growth. This is because investors would demand to be paid more for lending money in the markets to compensate them for the increased difficulty in turning their bonds into cash when they want.

But the evidence is clear: There simply are not, at present, broad or significant liquidity issues in the fixed-income markets. If anything, many parts of the markets are performing better than they were prior to the financial crisis. What's more, the entire theoretical foundation of the illiquidity argument is off base. Dealers do not jump into the market—known as catching the falling knife—to provide liquidity during times of market stress. As such, those suggesting that today's liquidity issues, if they existed, might get worse during a crisis are chasing a factual and theoretical phantom.

Moving in the right direction

Before tackling the illiquidity argument in more depth, it is important to consider the factual predicates that are accurate. First, since the financial crisis, dealers have drastically decreased their leverage, and their inventories are significantly smaller than before the financial crisis. Dealers increasingly utilize an agency business model that matches buyers and sellers directly without taking the security onto their books until they find a buyer.[6] But these are good things. Precrisis inventories were chock full of toxic mortgage-backed securities at highly inflated prices.[7] And precrisis leverage was highly risky, as high debt levels mean that a firm can become insolvent very quickly. The firms' inventories were so risky that firms began to dial them back even before the enactment of the Dodd-Frank Act.[8] Rather than too much financial reform, it is more likely the case that not enough has been done.[9]

Data proves that markets are doing well

Dealer deleveraging and increased use of the agency model after the financial crisis have not led to a marked deterioration in liquidity in the fixed-income markets. In testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs in April 2016, Antonio Weiss[10]—counselor to Treasury Secretary Jack Lew—and Federal Reserve Board Governor Jerome Powell[11] agreed that fixed-income markets, dominated by the markets for U.S. Treasury debt and U.S. corporate debt, are operating well and that no liquidity crisis exists. Kara Stein—commissioner of the Securities and Exchange Commission, or SEC—drew similar conclusions.[12] The data explain why.

Recent quantitative research[13] from the Federal Reserve Bank of New York looks at liquidity metrics in both the Treasury and corporate bond markets. In the securities markets, the most common trading cost metric is the bid-ask spread, which is the difference between the cost of buying and the cost of selling the security in the market. Tight bid-ask spreads indicate a market with lots of people willing to do one or the other or both—that is, it is a classic characteristic of a liquid market. Notably, the bid-ask spread in the Treasury market widened during the financial crisis but has been tight and stable for the past six years.

Other liquidity metrics such as the size of trades, how many securities are sold at any given time, and the ability to do so without moving market prices—referred to as market depth, trade size, and price impact—have shown signs of some deterioration in the Treasury market in recent years. Several market observers, including Weiss and Powell, believe that a reasonable explanation for the postcrisis changes in these alternative liquidity measurements is the transforming structure of the Treasury market. The impact[14] of technology and the increasing dominance of algorithmic—sometimes called high-frequency—trading is changing the Treasury market's structure and day-

to-day functioning. Much like in the equity, or stock, markets, when transactions are conducted at lightning-fast speeds using advanced computer systems, the size of transactions in the Treasury market tends to get smaller. These changes are not a function of regulation but of technology.

With respect to the corporate bond market, research from the Federal Reserve Bank of New York,[15] the Treasury Department, [16] and the Financial Industry Regulatory Authority—a self-regulatory group for broker-dealers[17]—finds little evidence that liquidity has deteriorated in the corporate bond market. In fact, by many metrics, the corporate bond market is more liquid now than it was before the crisis. Corporate bond issuance has been at all-time highs over the past several years. [18] Investment-grade corporate bond issuance is up 7.5 percent year-to-date in 2016.[19] Bid-ask spreads have been stable and are actually tighter than precrisis spreads. Trade size declined significantly during the crisis and still has not fully recovered, but the price impact of trades is well below precrisis levels. To put it simply, investors, especially in high-quality bonds, can trade the bonds they want to as cheaply as they ever have. As for securitizations and high-yield—sometimes called junk—bonds, regulators[20] and market participants[21] in recent years have been more concerned about a bubble from too many of these bonds, not illiquidity from too few bonds or limited trading. In short, an evidence-based approach shows that illiquidity is, at least to date, a phantom.

Deregulation, not reform, causes liquidity crises

The data show that the concerns over significant fixed-income illiquidity lack merit, even as voices in the financial sector have repeated such claims ad nauseam. In addition to the data, the supposed cause of the phantom liquidity crisis—stronger financial reform—does not hold up under scrutiny. Let's remember that the most illiquid experience in recent memory was during the 2007–2008 financial crisis, which was caused by the deregulation of the previous decade.

Moreover, some on Wall Street argue that the shift to an agency-based trading model makes markets less liquid, as dealers will not have the market-making capacity in times of stress to take securities onto their balance sheets. [22] But longstanding experience—and common sense—suggest that during large scale sell-offs in the bond market, when everyone is looking to sell, dealers are driven by the same business motives as the other market participants engaging in selling. Dealers use their inventories to make markets when there are reasonable risks to be had; they are not willing[23] to catch the falling knife.

The "taper tantrum"[24] of 2013 illustrates well how dealers behave during such a sell-off. Between May and June 2013, a sell-off began in the market for U.S. Treasury debt as the Federal Reserve announced it would begin to taper its bond-buying program.[25] Dealers reduced their holdings of Treasuries during this period and did not provide market-

making capacity during the one-sided sell-off. Interestingly, the Federal Reserve Bank of New York found that dealers with more tier one capital tended to reduce their net positions even more than dealers with lower capital ratios.[26] Put another way, the dealers with the most capacity to take on additional risk during the sell-off made a strategic risk management decision to limit their exposure. This is the exact opposite of what one would expect to see if Dodd-Frank's regulatory requirements for financial institutions were the cause of their restraint. The case also highlights the role that expected directions of monetary policy, especially in the recent extraordinary environment, have played in affecting dealers' desires to hold inventories in bonds: Bonds issued during a low-rate environment would experience a loss in value as interest rates rise.

Financial reform strengthens market in stressed conditions

If anything, periods of market turbulence such as the taper tantrum illustrate the importance of financial reform. Thanks to the passage of the Dodd-Frank Act, financial institutions are better equipped to handle stressed market conditions without allowing the situation to spiral into a crisis. They have more stable funding,[27] hold more liquid assets,[28] have higher capital cushions,[29] and are able to plan[30] for stressed market conditions. None of the recent patches of market turbulence have had a long-term effect on financial stability, which might not have been the case 10 years ago in an undercapitalized, overleveraged system where risk was not responsibly managed. When some in the financial sector make claims of fixed-income illiquidity with little evidence to back it up, the conclusion seems inescapable that it is a thinly veiled effort to unwind financial reform or ease capital requirements.

What's more, liquidity, although important to the functioning of the markets, is not itself an unlimited good. As former Federal Reserve Chairman Paul Volcker has noted, the ability to exit an investment of any size at any time may create a liquidity "illusion" that reduces market incentives to conduct effective due diligence on the quality of an investment.[31] That accountability is, however, vital to the financial markets' ability to effectively allocate capital to the real economy. Clearly, the toxic assets that played a central role in the financial crisis are case in point.

More reform, not less

So what should be done? Rather than trying to undo financial reform, regulators should stay the course and ensure strong, reliable capital and regulatory approaches. Market basics—such as transparency, anti-fraud and manipulation tools, and oversight—should be enhanced. It is good news that following the Treasury "flash rally" on October 15, 2014,[32] regulators are finally moving in such a direction in the Treasury market: In October 2016, they finalized rules to bring more transaction-level transparency

to the market.[33] More should also be done to bring transparency to Volcker Rule implementation.

Ultimately, SEC Commissioner Michael Piwowar was right when he said recently that "we all have more work to do" to understand and respond to the changes in the fixed-income markets.[34] Technology-driven approaches are here to stay in the Treasury market,[35] and they will continue to grow in the corporate bond market as well. Consolidation of large players may also be affecting trade size and behavior. Regulators need to pay close attention to these shifts over time, as well as to the accompanying potential risks.[36]

Conclusion

Financial market liquidity is important, but claims that the United States' fixed-income markets are facing a liquidity crisis are without merit. The data simply do not support the case, and even the theoretical implications of financial reform do not hold water. The Dodd-Frank Act has improved the resilience of the U.S. financial system, and it should not be weakened in response to phantom assertions. Regulators should respond to real data and enhance market functioning with transparency and accountability. Unsurprisingly, claims of a liquidity crisis get louder when bank trading profits are down. Profits have recently risen,[37] so perhaps the cries of a liquidity crisis will die down under their weight—and the reality of little evidence. Given what happened this last week, though, we suspect they will not. Let's hope the data and facts can be our best defense.

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