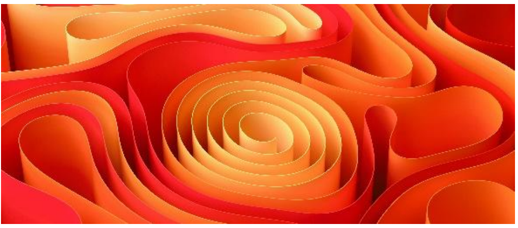
Pills

Regulatory/Supervisory Pills | N.146 October 2025



TOPICS:

Market risk

SOURCE

European Central Bank

ECB: Constraints on Intermediary Banks Can Undermine Functioning Government Bond Markets

- This ECB blog examines **the increasing importance and emerging constraints on intermediary banks** - particularly primary dealers - **in the euro area government bond markets**, highlighting implications for market liquidity, pricing efficiency, and monetary policy transmission.
- **Primary dealers** play a pivotal role by facilitating both the **issuance and secondary trading of sovereign bonds**. They absorb bonds temporarily on their balance sheets, easing market frictions and ensuring liquidity. However, their ability to intermediate is being tested. The withdrawal of central banks from bond purchases and a sharp rise in bond issuance, especially in response to fiscal expansion for defence and infrastructure, have increased reliance on private sector investors. This trend, coupled with the rising participation of leveraged hedge funds, places growing pressure on dealers' balance sheets - particularly through repo market activity.
- While current intermediation capacity appears robust, with dealers showing confidence in absorbing additional supply, **signs of strain are emerging**. Survey data and quantitative metrics (e.g., leverage ratio buffers and capacity utilisation) suggest dealers are moderately constrained.
- Moreover, constraints become more visible during periods of stress, such as quarter-ends, around government bond auctions and under high market volatility. These pressures manifest in temporary reductions in repo activity and bond inventory, leading to intraday or multi-day "auction cycles" with inverted V-shaped yield patterns.
- Foreign banks and hedge funds have partially alleviated pressure, but their procyclical nature raises concerns about stability during market shocks. To **enhance structural resilience**, the ECB advocates expanding central clearing, enabling netting of positions, and improving access to granular market data. These measures aim to safeguard liquidity and ensure stable financing conditions essential to broader financial stability and effective monetary policy transmission.