



EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

15 July 2013

Bond Market Contact Group

Frankfurt, Tuesday 9 July 2013, 15:00 – 19:00

SUMMARY OF THE DISCUSSION

1. Review of recent bond market developments

Christoph Rieger reviewed euro area bond market developments since the last BMCG meeting in April 2013. Bond markets have developed around five key themes: (1) market positioning in anticipation of the start of the Fed's tapering of its LSAP programme, which had led to a sharp increase in US Treasury (UST) real yields – particularly at the long-end of the curve – and to the unwinding of global carry trades; (2) in euro area government bonds, a shift away from a risk-on/risk-off theme into a theme of liquidity-on/liquidity-off (the recent sell-off has affected liquid assets like Italian BTPs or German bunds comparatively more, as they have been used to hedge positions in illiquid markets like Emerging markets; these have been unwound more recently, as markets have stabilised); (3) a tightening of financial conditions in the euro area, which is expected to push EONIA forwards higher over the coming months; (4) the weak performance of new bond issuance, adding a challenge to Debt Management Offices (DMOs) in jurisdictions with more fragile capital market access; and (5) the Banking Union and the asset quality review of the European banking system, which is expected to be an important driver for credit spreads in the coming months.

The discussion revealed some scepticism regarding the recent positive correlation and resilience in the performance of euro area sovereign indices, which many attributed to technical factors like their higher secondary market liquidity.

With regard to the impact of the new way of communicating a downward bias on interest rates (forward guidance) recently introduced by the ECB's Governing Council, members generally expected it to have less impact on the long-end of the yield curve in the absence of other measures. Rather, members expected the macroeconomic background to prevail as the main driving force for long-term yields.

2. Bond market liquidity

Garry Naughton and Carlos Egea analysed the liquidity microstructure of euro area government bonds and derivatives and their evolution throughout the crisis. Capital market access for non-core countries including Spain and Italy remains fragile despite the improvement since the announcement of the OMTs and the fact that both DMOs are well advanced in their 2013 issuance programmes. Some factors evidencing the fragility of capital market access in these jurisdictions are the use of syndication (implicit underwriting guarantee) and private placements, and the tailoring of auction supply to the needs of domestic banking systems, which has contributed to a significant reduction in new issuance duration over the last few years. Whereas the shift to a higher domestic share of the holdings of government debt had added to the resilience of these markets, it had also resulted in an uneven liquidity across the yield curve, with relatively low secondary market liquidity in longer-dated bonds.

On the structural side, new clearing and capital regulations, as well as the ban on certain CDS short positions, has led to an increasing usage for hedging and for active positioning and to more liquid

secondary markets for listed derivatives, with the use of CDS and OTC swaptions declining. As a result, the movements in pricing and open interest of listed derivatives are increasingly reflective and precursors of movements in the cash market.

BMCG members generally agreed with the assessment and confirmed that secondary market liquidity and market access for non-core jurisdictions remained fragile and that the relatively high redemptions of public and private sector bonds in the next two years in some euro area countries might represent a challenge. The increasing use of syndications, especially from jurisdictions regaining market access (e.g. Ireland and Portugal) was effective, but had to be dealt with caution in order to reduce the risk of a negative performance of new issues in secondary markets, which sometimes resulted from the final issued amount being revised higher and from final spreads being tightened compared to the initial guidance. The use of syndications was seen as a precursor to regaining market access: Ireland and Portugal were expected to follow the recent syndicated deals by new syndicated deals of smaller size followed by small monthly auctions as a further step into regaining full market access. Finally, the reduction in volatility since mid-2012 had contributed to the steady improvement in secondary market liquidity, as market makers had become more confident of their ability to hedge open positions within a short period of time.

3. Euro area financial integration

Karl-Heinz Riehm, Ingo Mainert and Zoeb Sachedi analysed the fragmentation of European financial markets from the perspective of an issuer, an investor and a dealer. On the bank funding side, the money market remained dislocated, leading to ECB dependence. Banks and corporates funding levels remained highly dependent on the country of residence and spreads remained elevated for peripheral issuers. From the point of view of investor positioning, there have been three phases in euro area bond markets: (i) a phase of convergence (1999 – 2007), which marked a switch from local to European benchmarks; (ii) a phase of divergence (2008 – mid 2012) resulting in a return to local benchmarks; and (iii) the current period (mid 2012 – to-date) of readjustment or customisation of benchmarks with a still prevailing important domestic focus (e.g. some investors have started to use GDP-weighted benchmarks or country weighting based on indicators of fiscal strength). Finally, from a dealer perspective, the capacity to hold inventory in peripheral bonds has declined due to the combination of the following factors: (i) changes in risk management practices; (ii) impact of rating downgrades; (iii) market volatility, which has led to liquidity fragmentation, and to (iv) lower inventories held by dealers, resulting in lower liquidity and in wider bid-offer spreads in periphery than core.

BMCG members largely agreed with the assessment and concluded that euro area bond markets remained fragmented, although the 3-year LTROs and the OMTs had contributed to stabilising the markets. In particular, the 3-year LTROs had contributed to allow the system to absorb the temporary excess supply resulting from portfolio re-allocation of foreign accounts in late 2011-mid 2012. The recent decline in TARGET2 balances and in particular the repayments from banks in core jurisdictions was interpreted as a sign of stabilisation, as these banks were no longer localising their balance sheets and hence no longer seemed to believe that redenomination risk could materialise in the short term. Notwithstanding the tentative signs of stabilisation, fragmentation was not likely to disappear in the short-term, with recent regulation (such as the introduction of the incremental risk charge (IRC) by the Basel Committee in 2012 for banks' trading desks and the Liquidity Coverage Ratio (LCR)) adding to country differentiation and impacting on the transmission of monetary policy. In this regard, several options were discussed for potential central bank policies that could contribute to reducing the effects of fragmentation, including (i) cutting the key policy rates to zero and reducing the width of the corridor; (ii) providing more specific forward guidance, i.e. specifying the horizon of the guidance; (iii) being prepared to use the OMTs actively; (iv) creating a special 3-year LTRO similar to BoE's Funding for Lending Scheme where cheaper funding would be provided to banks for e.g. 5-7 years conditional on (new) lending to the real economy and possibly combined with a first-loss central government guarantee; or (v) actions to prevent excessive volatility by intervening in financial markets at times of demand/supply imbalances.

4. The fallout from too big to fail & the Bank Recovery and Bank Resolution directive

Pär Torstensson (ECB) presented the main aspects of the draft directive of the European Parliament and of the Council establishing the framework for the recovery and bank resolution (BRRD) of credit institutions and investment firms in three stages: preparatory and preventative, early intervention, and resolution. Jonathan Burrows analysed the draft directive from the investor perspective. In the view of some participants, the proposed directive, albeit very important, had not introduced many new elements, but had rather captured best practices in euro area bank resolution regimes and was seen as reducing systemic risks. Several positive aspects were noted, including a clear roadmap to tackle potential bank crises, clarity of bondholder treatment in the event of resolution (liability cascade) and some flexibility for the treatment of systemic banks. However, other aspects remained unanswered or were unclear, in the view of some of the participants, such as the timing for its application, the treatment of cases which may occur prior to the application of the bail-in tool in January 2018, the ranking of deposits and of the EIB above senior debt holders, and the reasons for making bail-ins compulsory and for putting caps on the access to resolution funds.

BMCG members took the view that the new rules for dealing with crises were likely to lead to more differentiated cost and access of issuers to senior unsecured funding and reinforce the status of covered bonds as an attractive investment. Going forward, the comparatively weaker credit names were unlikely to have market access to senior unsecured issuance. The reduced access to diversified funding sources and the 8% rule¹ could contribute to the ongoing trend of bank deleveraging.

5. Impact of recent regulatory changes from an insurance company perspective

Laurent Clamagirand analysed the latest regulatory developments affecting insurance companies and their implications in their strategic and tactical asset allocation on fixed income assets. The analysis included Solvency II, the impact of the new IFRS accounting rules, the implications of EMIR for bond strategies, the regulatory developments related to securitisation and the implications of a PSI for investments in bank debt. In its current format, Solvency II had the potential to dissuade insurance companies from entering into certain long-term investments beyond 5-year tenors, due to incremental capital charges. Furthermore, insurance reserves will be discounted at the swap rate, introducing undue volatility to Solvency II ratios. Regarding securitisation, the main hurdles for an important role of this instrument in the euro area stem from (i) the current and future regulatory treatment, and in particular high capital charges; (ii) often insufficient transparency, and (iii) in some cases caution of investors regarding the underlying assets and their performance.

¹ The draft BRRD directive establishes that the resolution fund can absorb losses or recapitalise an institution only after a minimum of 8% of the total liabilities have been bailed in.