

Bond Market Contact Group

Frankfurt am Main, Tuesday, 7 April 2016, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Francesco Garzarelli (Goldman Sachs) reviewed the main bond market developments and the outlook.

During the discussion, members of the Bond Market Contact Group (BMCG) reported changes in investor positioning and some frontloading in anticipation of the increase in the pace of monthly purchases under the ECB's expanded asset purchase programme (APP) to EUR 80 billion and the start of the corporate sector purchase programme (CSPP), also resulting in a broad-based compression of the intra-euro area government bond spread over the last month. The announcement of the CSPP had mitigated some concerns about bond scarcity, although members expected the public sector purchase programme (PSPP) to contribute to most of the additional EUR 20 billion of monthly purchases, with CSPP purchases expected to range between EUR 3 and 5 billion per month. The implementation of the APP continued to run smoothly, although there were emerging signs of deterioration of secondary market liquidity across all APP asset classes. Going forward, some members anticipated broader repo specialness for German government bonds. The favourable funding conditions of the new series of targeted longer-term financing operations (TLTRO II) were expected to result in a decline in covered bond issuance and increasing challenges to the implementation of the third covered bond purchase programme (CBPP3) going forward.

Some BMCG members noted that euro area corporate bond market liquidity had improved over the past month, benefitting from an increase in corporate bond supply and more divergent investor views on the long-term impact of the CSPP on corporate bond yields and their relative value compared with other asset classes. This notwithstanding, most members considered the recent rebound in corporate bond supply to be a temporary factor, largely reflecting the fact that some of the planned issuance for the first quarter of 2016 was postponed owing to the volatility of credit markets up to mid-February. Some members expected that the supply of corporate bonds to the CSPP would be rather inelastic – as opposed to the higher responsiveness of covered bond issuance to the CBPP3 – given the low corporate funding needs reported in corporates' annual funding plans and the improving conditions for funding alternatives. Members anticipated that most of the CSPP purchases would be conducted in the primary market owing to low secondary market liquidity associated with a large hold-to-maturity investor base.

Members recommended that the detailed technical parameters of the CSPP should be made public sufficiently in advance of the actual CSPP purchases.

2. Impact of the low or negative interest rate environment

Peter Hegge (Allianz) and Zoeb Sachedi (Citi) analysed the impact of the low/negative interest rate environment on banks and insurance companies. A protracted low interest rate environment limited the growth in the net interest income of banks (which would represent 55-60% of profits for a typical euro area bank) and was a source of risk for insurance companies, with the potential to accelerate changes in the structure of the industry.

There was a broad consensus among BMCG members that persistently low interest rates were challenging for the net interest income of banks, as their liability base was less flexible and adjusted more slowly to the lower interest rate environment than did their asset/investment side. In addition, the impact of low interest rates on the net interest income of banks and insurance companies also depended on the applicable regulatory environments and on the individual product mix. Some members argued that these factors limited the possibilities for adjustments of the business models and their timing, with the potential to lead to excessive risk taking or leverage to compensate for the declines in net interest income.

3. Bank business models and the role of Principal Trading Firms (PTFs) in liquidity provision and intermediation

Chris Pulman (Morgan Stanley) and Jan Lundström (Barclays) analysed the role of PTFs and the implications for banks' business models and for bond market liquidity.

Their analysis pointed to a limited presence of PTFs thus far in euro area fixed income cash markets, owing to the specificities of the electronic European government bond market (see the Summary of the discussion for the BMCG meeting held on 19 January 2016), which contrasted with their increasing role in bond futures and foreign exchange markets. The different degree of presence of PTFs in futures versus cash bond markets introduced a risk of market dislocations during periods of large intra-day volatility. Some BMCG members felt that dealers would need to change their business models over the longer term in order to reprice liquidity and hedge the impact of macroeconomic risks in their multi-asset portfolio.

4. Money market benchmarks and the ongoing reform process

Guido Ravoet and Alberto López (European Money Markets Institute (EMMI)) provided an update on the status of the ongoing Euribor reform aimed at anchoring the benchmark in transactions. The EMMI had reached out to multiple stakeholders and market associations regarding the planned Euribor reform, including via a public consultation in October 2015. The EMMI informed members about its plans to publish the feedback it received from its October 2015 consultation in the coming days and that it was considering postponing for several months the initially planned date of changeover to the new methodology in order to enable a more in-depth pre-live verification process.

Members of the BMCG took note of the planned changes and timeline, stressing the importance of continuity in the most frequently referenced maturities and ensuring the legal validity of the upgrade of the benchmark, given that many contracts – including derivatives – used Euribor rates as an underlying reference. Members emphasised the importance of having some form of coordination with the authorities working on the Libor reform and warned that differences in contract specifications (e.g. between Libor and Euribor) might create distortions for some asset classes such as cross-currency basis swaps. Finally, members took note of the EMMI's ongoing work towards the development of a new pan-European repo benchmark and some members recommended an inclusive benchmark that would take all transactions cleared by central counterparty clearing houses as initial inputs for the computation.