



EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

6 May 2013

Bond Market Contact Group

Frankfurt, Tuesday 9 April 2013, 13:00 – 17:00

SUMMARY OF THE DISCUSSION

1. Review of recent bond market developments

Michael Krautzberger provided an update on the euro area bond market developments since the last BMCG meeting in January 2013. After a temporary increase in core euro area government bond yields fuelled by i) speculation of portfolio shifts from bonds into equities and ii) concerns over tighter liquidity conditions at the start of the 3-year LTROs repayments, yields moved back to the levels prevailing in early January 2013. The general peripheral spread tightening trend initiated after President Draghi speech on 26 July 2012 had paused or stopped, although both the shape of the yield curves or bid/offer spreads were still far from their pre-crisis levels. On a more systematic basis, the market impact of the Cyprus rescue package had been rather muted, even after the first proposal to bail-in all deposits. On the foreign exchange front, the euro had appreciated strongly against the US dollar, the Japanese yen and the pound sterling, fully offsetting the loosening impact on monetary conditions from the credit spread tightening since July 2012. Finally, corporate bond issuance in capital markets remained broadly unchanged, pointing to a de facto tightening of credit conditions for non-financial corporates as they would not have compensated the reduction in bank lending by means of an increase in capital market issuance/disintermediation. Finally, an analysis of the interest rate applied to loans to SMEs showed that funding conditions for SMEs in peripheral euro area countries remained very tight.

The discussion revealed a broad agreement among members regarding the reduction in the markets' perception of systemic risk, implying that euro area sovereigns and bond price developments had become less correlated both versus other countries' developments and versus equity prices. Notwithstanding the improvement in bond market functioning, some sectors remained vulnerable. First, it may be too early to exclude that some banks in peripheral jurisdictions would now be more vulnerable to deposit outflows. Second, access to funding remained tight for SMEs in peripheral jurisdictions, including a steady increase in their financing costs. Finally, regulatory changes - particularly changes in capital requirements - have reduced banks' incentives to lend in the unsecured market, while supporting alternatives such as the purchasing of government debt instruments.

2. Market access

Antonio Ordás and Yunho Song reviewed the deterioration in the access to market funding for the Irish and Portuguese sovereigns in the period leading to their requests for macroeconomic adjustment programmes. The analysis compared the evolution of a set of market indicators and defined some triggers for the loss of a sovereign market access, which were then tested for the cases of the Italian and Spanish sovereigns in the period between 2009 to-date. The analysis concluded as follows: (i) impairments in market access for the banking sector and a deterioration in private cross-border flows precede and are good leading indicators of the loss of market access for the sovereign; (ii) the critical levels signalling a major distress in sovereign markets appear to be in the order of a 7% yield in the 10-year government bond, a spread of 450 bps versus Germany and 600 bps for 5-year CDS; (iii) there is no evident threshold for the level of the sovereign's debt/GDP or deficit/GDP that allows a

return to market access; (iv) rather, the perception of a negative feedback loop between banks and sovereigns - measured by a perceived weak domestic banking sector and low capacity of the domestic investor base to absorb sovereign bonds – is key for the sovereign's market access; and (v) announcements of structural reforms and expectations of future debt sustainability are necessary but not sufficient conditions for regaining market access.

Members concluded that the key measure determining the extent of market access for the sovereign is investors' perceptions of its capacity to refinance its stock of debt. The sovereign's refinancing capacity was deemed to strengthen in cases when the reduction of the share of sovereign debt held by foreigners was compensated by an increasing share of domestic non-bank investors' holdings. On the other hand, when domestic banks compensated for the decline in foreign holdings, this was mostly seen as only offering a temporary solution and hence did not solve vulnerabilities. Future cases of loss of market access could possibly unfold faster, also as markets have become more pro-cyclical as a consequence of some regulatory changes. In particular, higher reliance of banks on central clearing counterparties (CCPs) might increase pro-cyclicality. In this environment, members thought that the OMT provides a temporary solution to the liquidity problem by allowing to break negative market dynamics, even if it does not address the solvency problem, which obviously requires action from the sovereign. Finally, members concluded that the OMT would not be needed for those cases when a sovereign has regained market access, as in these cases yields would likely be anyway below the activation levels for OMT purchases.

3. Market functioning issues

Andreas Gruber, Glenn Hadden and Karl-Heinz Riehm presented the most important factors contributing to the changes in market functioning since the financial crisis. Several offsetting forces including regulation and demand for high-quality assets appear to reduce the capacity for market makers to take on credit risk and hence to generate market liquidity. The implied loss of shock absorption capacity can lead to increasing market volatility. Episodes leading to an increase in implied volatility result in negative feedback loops (forced selling by market makers to reduce their VaR, amplify the spike in volatility/need for more forced selling), as no segment of the market is currently able to underwrite/own the asset when volatility increases. In this environment, episodes of uncertainties on the capability of sovereigns to refinance might become more frequent.

During the discussion, some members expressed concerns over the reduction in the number of market makers and the resulting reduction in market depth/liquidity. On the other hand, it was noted that the number of primary dealers has increased considerably. The latter was generally regarded as a temporary phenomenon resulting from both the widening in bid/offer spreads (which might have attracted new entrants like medium-sized re-capitalised commercial banks looking for business opportunities) and political considerations such as having a primary dealership status.

4. Future demand of high-quality liquid assets

Christoph Rieger analysed the structural changes in market practices, central bank operations and regulation, which will shape the future demand for euro area government bonds and high quality assets in general. Using a broad definition of high-quality liquid assets, supply for high-quality liquid assets in the euro area is currently still exceeding demand for various reasons. First, in contrast to other central banks, the Eurosystem's net demand for government bonds could be negative in coming years, requiring SMP countries to attract more private investors. Second, broad regulatory definitions of quality assets should encourage investors to move down the credit curve as tensions subside, reinforcing the peripheral spread tightening trend initiated last summer. However, the demand for AAA-rated assets like government and covered bonds will rise at a faster pace than the rate of supply, due both to market practices and to regulatory changes. The latter will shift the demand/supply balance into a relative shortage and scarcity scares should keep swap spreads structurally more elevated.

Members agreed to the conclusions of the analysis and confirmed that regulatory changes and market practices will result over time in increasing demand for high-quality assets from banks, insurance companies and pension funds and reinforce the declining yield trend for such assets. These two trends are also adding pressure on investors' capacity to generate positive returns, with many investors moving into less liquid/low volatility assets like infrastructure loans and mid-cap loans.

5. Impact of recent regulatory changes & other structural issues

Thijs Aaten and Sander Schol analysed the most recent regulatory changes with a particular focus on: (i) the pre trade/post trade transparency requirements of MIFID II; and (ii) the comments published in the BIS website on the second consultative document "Revisions to the Basel Securitisation Framework". Members thought that regulatory and supervisory bodies should strengthen their cooperation, in order to appropriately gauge and steer the overall impact of the proposed changes on market functioning and on the overall economy. Whereas the individual impact of each regulatory measure might be manageable, the joint implementation of all of them was seen as potentially leading to unintended negative consequences on market functioning and on markets' resilience to withstand future shocks. Furthermore, the low interest rate environment and the scarcity of high-quality bonds were expected to further reduce liquidity and to exacerbate volatility in the future.

With regard to MIFID's pre trade/post trade transparency requirements, members agreed that transparency in the terms of trading was generally positive for strengthening market confidence and for the robustness of the system. However, the limits to transparency should be carefully assessed and the delay for the publication adequately calibrated given the positive relationship between dealer inventories and secondary market liquidity. For instance, any measures which would lead to a reduction in market makers' inventory would negatively affect liquidity and increase volatility/market pro-cyclicality.

6. The Financial Transactions Tax (FTT)

Florian Walch (ECB) presented the current proposal for a Council Directive introducing a Financial Transaction Tax (FTT) in the 11 EU countries in the FTT-area and analysed its market impact.

Members expressed strong concerns regarding the FTT in its current form and warned of its adverse effects on (i) the intermediation role of the banking system, (ii) market functioning and (iii) liquidity. The European repo market would be particularly affected, with some analysis conducted by ICMA estimating that the FTT would lead to a contraction in the repo market by at least two thirds. The reduction in repo volume would also negatively affect bond market functioning, given the importance of the repo market for hedging new issuance and for providing liquidity in the secondary market. Regarding possible amendments to the current proposed text, members believed that its adverse impact could be mitigated by the following modifications: (1) exempting repos; (2) linking the tax rate to the maturity of the transaction; (3) modifying the scope of implementation from its current residence and issuance principles; and (4) exempting market making.

7. Other items

The next meeting would be held in Frankfurt on 9 July 2013.