EUROPEAN CENTRAL BANK
EUROSYSTEM

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Meeting of the ECB's Bond Market Contact Group – 6 February 2018
Summary of discussion

1. Bond market outlook for the year ahead

Ella Hoxha (Wellington) provided an outlook for the main bond market developments in 2018, identifying supply and demand dynamics as most likely being the main driver for bond yields, as markets would need to digest a significant increase in gross debt supply by sovereigns.

Members of the Bond Market Contact Group (BMCG) were split in their views on whether to expect a flattening or steepening of yield curves in 2018. Some argued that short-term rates in the euro area would be anchored by the ECB's forward guidance on rates, while long-term yields might move up on the back of longer-term economic growth, inflation and monetary policy expectations; others were of the view that a flattening of yield curves is a normal phenomenon in times of monetary policy normalisation. What has changed is the questioning of low terminal policy rates in the US after the latest labour market data. The ECB was considered to be facing the winner's curse, with the euro area economy becoming ever stronger and CapEx investments increasing.

Political risks were seen as a main driver for euro area yields in 2017, although much less so in 2018 as the upcoming elections in Italy as well as the coalition negotiations in Germany do not seem to raise major concerns among market participants. Some members reported an increase in investor exposure to non-core sovereign bonds after they had been flat versus their indices last year, while others still considered that markets could be somewhat complacent about the Italian election risk.

With regard to the lower purchase volumes in the asset purchase programme (APP) in January 2018, it was acknowledged that the change had had little impact on euro area sovereign bond yield spreads. Among the factors mentioned to prevent spreads from widening were (a) solid economic growth data within the euro area, (b) a turn in the rating cycle for euro area sovereigns and (c) renewed investor interest in lower-rated euro area countries since the start of the new year.

Finally, the discussion touched on the sell-off in global equity markets on 5/6 February. BMCG members were of the view that this sell-off was not entirely unexpected and was driven by technical factors rather than fundamentals. Members also identified a link to hedge funds and other investors unwinding low volatility trades.

2. Stock-taking of the first weeks under MiFID II and MiFIR

Carlos Egea (Morgan Stanley), Steve Hall (Tradeweb) and Christian Kopf (Union Investment) gave their assessment of what initial impact implementation of MiFID II and MiFIR had had on the functioning of euro area bond markets. There was a strong consensus among the presenters that the implementation had gone more smoothly than might have been feared on trading platforms as well as on trading and research desks. However, preparation for the implementation had used up a considerable amount of resources in their institutions, without any sign thus far of tangible benefits in terms of market transparency or market liquidity.

Most BMCG members were of the view that it was much too early to make a fundamental judgement on whether the new regulation had achieved its goals. However, scepticism was voiced about the feasibility of using the substantial amount of data made available, with trading desks submitting millions of reporting items a day to regulators. At the same time the effort to be more transparent was questioned. It was argued that the data is less useful for internal analysis than had been expected, owing to the t+2 time lag in data publication and the numerous exemptions granted by regulators. Some members called for less deferral and a consolidated tape similar to that in the United States, expressing optimism that a single venue to which they would report could also facilitate the usage of the data. One member observed that the domestic authorities within Europe had been inconsistent in their approach to applying exemptions.

Buy-side representatives felt that the research regulation was the most successful part of MiFID II in that it helped to clarify roles and fees. They confirmed tentative signs of a reduction of research coverage for small caps/corporates. There were also specific complaints about the lack of transparency in primary markets concerning allocation mechanism and varying approaches concerning fees.

3. Update on the green and social bond market

Martin Scheck and Nicholas Pfaff (both ICMA) reviewed the latest developments and global trends in the green and social bond market, with a particular focus on the emergence of a sovereign market for green bonds. While green and social bonds had been more of a niche market until 2016, the issuer base had become more diverse in 2017 with a shift towards euro-denominated issuance. In terms of pricing, some studies confirmed that green bond issuance could be beneficial for issuers by reducing their cost of funding across maturities. Based on smaller sample studies, green bonds trade mostly through the corresponding conventional bonds by 1-3 bps.

The presentation was followed by a lively discussion on the incentives to issue and hold green bonds. It was largely agreed that the issuer credit exposure remained the same and while there are additional costs related to the issuance of green bonds it seems that these extra costs do not outweigh the benefits and are less of a topic for issuers. Currently market demand clearly exceeds supply, taps take somewhat longer to prepare than for other bonds and investors are happy to hold the bonds. This contributes to making green bonds less volatile but also less liquid. Lowering capital requirements for holders of green bonds was seen critical, given the fact that capital requirements were normally linked to risk profiles rather than the use of proceeds. At the same time, some of the buy-side representatives noted that their portfolio management strategies need to take into account the sustainability of the business models of issuers. There was a consensus that the supply of green and social bonds would most likely not meet the strong investor demand any time soon. Some members expressed reservations with regard to the labelling of green bonds, or other similar labels, citing the potential risk that issuers might misleadingly convey the impression that their business models were particularly environmentally-friendly.

4. Benchmark reform

Jan Lundstrom (Barclays) and Richard Hopkin (AFME) provided an overview of the current state of benchmark reforms and their potential impact on euro area bond markets. They described the transition from Interbank Offered Rates (IBORs) to risk-free rates (RFR) as one of the most wide-ranging changes to financial markets given the estimated USD 370 trillion in cash and derivative products linked to IBORs.

BMCG members raised some concerns about the transition to the new regimes and highlighted the risk of liquidity gaps during the transition phase. It was acknowledged that submission-based benchmarks carried an incentive risk for reporting entities and transaction-based benchmarks do need solid volumes in order to be meaningful. There was a strong call for international collaboration on the choice of new benchmarks, including for longer tenors. A member remarked that there were already sings of divergence, with the United States choosing the Secured Overnight Funding Rate (SOFR) as RFR whereas the United Kingdom and Japan had chosen unsecured rates.