



EUROPEAN CENTRAL BANK

EUROSYSTEM

DG/MARKET OPERATIONS

14 November 2014

## **Bond Market Contact Group**

Frankfurt am Main, Tuesday, 21 October 2014, 1 p.m. to 5 p.m.

# **SUMMARY OF THE DISCUSSION**

## **1. Bond market outlook and other topics of relevance**

Franck Motte reviewed the main developments affecting bond markets since the last meeting. He also gave HSBC's outlook, according to which the economic outlook for developing countries remained weak, contributing to subdued inflation rates.

The discussion focused on the sharp bond and FX market moves of 15 October, when the yield of the 10-year US Treasury note declined by 40bps within 30 minutes before partially bouncing back. Bond Market Contact Group (BMCG) members expected episodes of sharp volatility to become more frequent in the future owing to the structural reduction in bond market liquidity and the divergent paths major central banks were expected to take in their monetary policy stances. Liquidity in secondary markets had declined significantly and members felt that this shift was structural, owing to a combination of factors: (i) dealer inventories have become lean, also as a result of the new regulation; (ii) the free float of fixed income assets has also declined significantly, with an increasing share of the outstanding amount held by buy-and-hold investors; and (iii) a wider use of electronic trading systems, which often incorporate automatic mechanisms to stop providing prices following sharp price moves, in order to protect market makers from algorithm trading. While quantitative easing and the accommodative stance of major central banks had led to a steady rise of bond prices, which allowed market makers to absorb the implications of reduced secondary market liquidity more easily, future conditions might be more challenging. In particular, the change in the Federal Reserve System's forward guidance could trigger a generalised unwinding of carry trades and lead to periods of significant spikes in volatility despite the continued loose stance of the ECB and the Bank of Japan.

The group also discussed how the purchase programmes on ABS and covered bonds (ABSPP and CBPP3) announced by the Eurosystem would affect secondary market liquidity and could lead to lower price dispersion/relative value opportunities in credit markets. Some members noted that inflation expectation indicators may be influenced by central banks' actions, which affect nominal and real yields differently. In this regard, the potential influence of central bank purchases of government bonds was deemed to be higher on nominal bonds than on inflation-linked bonds, which are more actively used by long-term investors for liability hedging.

## **2. Collateral issues of relevance for the functioning of the bond markets**

Karl-Heinz Riehm and Andreas Gruber analysed the impact of collateralisation trends on the functioning of the bond markets, including the impact of regulation and changes resulting from the crisis. João Amaro (ECB) presented the changes to the ECB's collateral framework over the last two years and their implications for market functioning and pricing. The level of fragmentation in European repo markets has improved since 2008, partially as a result of unconventional monetary policy measures. Despite this, further advances in infrastructure are required to enable a wider use of cross-border collateral and to reduce fragmentation. In this regard, the TARGET2 Securities (T2S) platform is expected to contribute to reducing fragmentation in the settlement of securities and foster a wider use of cross-border collateral throughout the euro area.

The discussion revealed that the new regulations and Eurosystem collateral eligibility requirements are the driving considerations for investment decisions and for relative pricing. In particular, regulatory developments such as the European Market Infrastructure Regulation (EMIR), the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR) and the leverage ratio requirement have resulted in an increasing demand for high-quality (AAA-rated) collateral among investors and bank treasuries, as well as more efficient and centralised management of collateral among banking groups and treasuries. The use of central counterparties (CCPs) has also become more widespread as a result of the new regulation (particularly EMIR).

A possible unintended consequence of recent trends is additional pro-cyclicality in fixed income markets. Members saw a need to define circuit breakers for periods of market stress, in a similar fashion as has been done for equity markets when trading above certain limits is temporarily halted to protect investors from disorderly market conditions. Large CCPs were seen as having an increasing systemic importance, arguably requiring more regulation and clarification of the resolution rules. Finally, the wider use of CCPs and the associated costs have reportedly increased the attractiveness of using the Eurosystem collateral framework for transformation purposes, i.e. posting the more illiquid collateral in exchange for cash.

### **3. Systemic risk**

Thijs Aaten and Alexander Düring analysed the factors affecting the pro-cyclicality and volatility of bond markets, including regulation and changes in the composition of bond market investors.

The changes in Solvency II affecting pension funds and insurance companies have possibly restricted these investors' ability to react during periods of market stress, potentially contributing to the pro-cyclicality of fixed income markets and de facto reducing the diversity of market actors or sources of liquidity. On the other hand, the share of assets held by price-insensitive investors (central banks and passive management accounts) has increased significantly to around 60% of the outstanding amount of US and euro area government bonds. This increase has two main consequences: (i) it is leading to a squeeze in nominal yields and to active investors being crowded out and pushed towards higher-yielding or less liquid assets; and (ii) broad euro area bond indices are practically non-replicable. As a result, it is likely that investors are underestimating the liquidity premia in bond markets.

### **4. Best practice framework for euro area government bond markets**

Mathieu Gaveau and Zoeb Sachedee presented the best practice frameworks for US and euro area bond markets, including the "Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets" developed by the Treasury Market Practices Group (TMPG).

Members felt that the TMPG Best Practices had contributed to promoting liquidity and transparency in US fixed income markets, leading to lower hedging costs. Having clear rules had promoted the overall market integrity of US fixed income markets and reduced episodes of protracted settlement failures. Members saw the merits of further harmonisation of fixed income market practices across the euro area, which would promote deeper and more efficient bond markets. In particular, members believed that greater harmonisation and coordination of primary market government bond issuance might be effective in improving the investor base and market liquidity in the euro area and would be relatively easy to implement. It was suggested that the BMCG could contribute to promoting greater harmonisation in euro area government bond markets, both by identifying areas where this could be particularly effective and by proposing best practices. It was agreed to explore this further in 2015.