

Bond Market Contact Group

Frankfurt am Main, Wednesday, 12 October 2016, 14:30-18:30 CET

SUMMARY OF THE DISCUSSION

1. Impact of the upcoming regulations on derivatives markets and risk absorption

Francois-Xavier Boutillier (Credit Agricole CIB), Thijs Aaten (APG) and Thomas Laux (Eurex Clearing) reviewed the upcoming regulations that will have an impact on derivatives markets, in particular the European Market Infrastructure Regulation (EMIR) and the updated rules for markets in financial instruments (MiFID II).

Members discussed the impact of these regulatory measures and highlighted in particular a heavier reporting burden caused by MiFID II for European market participants, compared with the Dodd-Frank Wall Street Reform and Consumer Protection Act for US market participants. So far, the central counterparty (CCP) clearing requirements set out in EMIR have affected only the larger counterparties and have had little impact on euro area derivatives markets. However, from March 2017 these requirements will also affect small users of interest rate derivatives, imposing frequent margin requirements that can be settled in cash or in highly liquid assets. Some members expected that these costs would reduce the use of derivatives and contribute to lower diversification by smaller market participants and to a deterioration in market liquidity. Some members also expected that the phasing-in of the EMIR requirement to exchange margin for bilateral trades during 2017 would further reduce market depth in interest rate derivatives and potentially increase the speed and severity of bond markets' price adjustments.

Members also mentioned that some investors that typically do not hold cash, like insurance companies or pension funds, had reported that margin requirements had increased their collateral management burden and their need to use repo. They also mentioned that large asset managers found it increasingly difficult to maintain adequate levels of liquid collateral through repo transactions with banks during month-end periods, because new regulations reduced banks' balance sheet capacity for capital-intensive/low-margin activities such as repo financing. These factors were seen as potentially increasing market procyclicality, e.g. in a severe bond market sell-off, investors would simultaneously face CCPs' margin calls and client outflows.

2. Central banks' experience with reinvestment of QE programmes

Christoph Rieger (Commerzbank) and Franck Motte (HSBC) analysed the central banks' experience during the reinvestment of their quantitative easing (QE) programme portfolios and the lessons learned.

Some recent academic research suggested that QE programmes would work mainly through the expected amount of central bank holdings relative to the available stock. Monetary policy accommodation would be broadly unchanged in reinvestment phases with zero net bond purchases. Once central banks moved into reinvestment phases, the market dynamics would depend on how the horizon, planned purchase amounts and maturities differed from prevailing market expectations and how this had been communicated to the markets.

3. Monitoring and assessment of bond market depth and liquidity

Jan Lundstrom (Barclays) and Ingo Mainert (EFAMA) reviewed the evolution of market depth and liquidity in euro area fixed income markets.

There was broad consensus among members that regulatory measures, structural changes and risk awareness were affecting market liquidity through the following channels. First, they resulted in marginally higher transaction costs and in longer time lags for end users to be able to execute hedging actions without a meaningful market impact. Second, there was a mismatch of demand for and supply of liquidity, as banks were reducing their capacity to act as market-makers and to absorb liquidity shocks owing to their efforts to optimise their capital allocation. Other market participants were not filling the void left by the reduced role of banks as liquidity providers, thereby leading to a higher propensity of financial markets to experience sudden volatility shocks. Third, it was likely that the structural reduction in market liquidity in terms of depth, immediacy and resiliency would lead to higher liquidity premia demanded by investors in the longer term and to increasing funding costs for originators/issuers, once central banks reduced their QE activity. This notwithstanding, liquidity conditions had reportedly already deteriorated for less active counterparties (both smaller asset managers and client banks), which had contributed to some consolidation across the asset management industry. Asset managers were reportedly also adjusting their investment processes by internalising trading flows as much as possible, adopting more buy-and-hold strategies, and investing in riskier asset classes where the central banks' bond buying programmes were not active.

4. Bond market outlook and other topics of relevance

Pauli Mortensen (NBIM) reviewed the main bond market developments and the outlook.

Members discussed the muted market reaction to the Bank of Japan's policy shift to "QQE with yield curve control" and "inflation-overshooting commitment". With regard to the euro area, members discussed possible yield developments in view of market expectations and the possible effects of announcements regarding the asset purchase programme (APP) beyond March 2017.

Additionally some members regarded current bond market pricing or implied volatility levels as too complacent regarding potential risks. Such risks included the US elections, the potential for a hard "Brexit", the Italian referendum, developments in Turkey and year-end liquidity conditions.