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Bond Market Contact Group

Frankfurt am Main, Tuesday, 13 October 2015, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Jan Lundström reviewed the main developments affecting bond markets since the last meeting, as well as the outlook. Bond portfolio performance has generally been positive since the last Bond Market Contact Group (BMCG) meeting at the end of June, with ten-year German Bund yields declining by around 40 basis points since their peak in mid-June.

Some members of the BMCG considered that the asset purchase programmes undertaken by the major central banks have pushed global bond market yields to artificially low levels. According to this view, the general bond market overvaluation increases the risk of bond market sell-offs and volatility spikes. There is also a limited willingness among potential buyers to absorb temporary supply shocks because (i) investors are reluctant to increase their exposure at levels that they consider to be overstretched, and (ii) the elasticity of bank inventories is restricted owing to new regulations and negative carry at current low bond yields.

At the same time, members regarded the risks of lasting bond yield increases as limited, as several downside risks to growth and inflation would tend to prevail: (i) China's growth moderation; (ii) a sustained period of US dollar appreciation, which could have systemic implications given its broader use as funding currency, including in emerging markets; (iii) weak consumer sentiment, possibly negatively impacted by the decision of the Federal Reserve System to postpone its "lift-off" at its September 2015 meeting; (iv) low consumer demand, which might lead to a further reduction in commodity prices; and (v) a potential increase in sovereign debt in some emerging markets, if governments take over part of the large growth in corporate debt of past years.

2. Impact on bond markets of specific regulations

Pauli Mortensen and Zoeb Sachee analysed the impact on fixed income markets of the MiFID II framework for pre-trade and post-trade transparency. Overall, BMCG members raised some concerns that pre-trade transparency requirements could reduce incentives for dealers to offer fast and competitive quotes and to be active in some market segments, leading to lower liquidity and wider bid-offer spreads. The waivers allowing some categories to be excluded from these transparency requirements – including instruments that are considered not to be liquid, transactions above a specific size in specific instruments

and block trades – needed to be properly calibrated. In addition, BMCG members saw risks in the discretion available to national competent authorities (NCAs), which could lead to an unlevel playing field. In some cases, post-trade transparency may also imply additional risk for liquidity providers, as the current provisions for delays in the disclosure were deemed to be insufficient in the case of large trades and illiquid instruments, as dealers were likely to be left with part of the position on their books at the time of the disclosure. Investors saw some benefits for market efficiency, particularly as regards post-trade transparency, which would provide more accurate information on the real liquidity and tradable prices of fixed income assets. However, the categorisation of instruments as liquid would need to be correctly calibrated and periodically assessed.

Laurent Clamagirand and Franck Motte reviewed the impact of recent regulations related to derivatives: the European Market Infrastructure Regulation (EMIR) (in Europe) and Dodd-Frank (in the United States). These regulations were expected to affect all users and to lead to higher cash collateral requirements via two channels: (i) the mandatory clearing obligation for certain derivatives; and (ii) margin requirements for non-cleared derivatives. The BMCG concluded that the new rules would probably lead to higher costs for hedging and to lower liquidity in derivatives and in repos. Local regulations had the potential to lead to fragmentation with regard to participants, central counterparty clearing houses (CCPs), geographies and products with, for example, methodological differences in the computation of initial margins across CCPs. Investors also faced challenges resulting from their business models, which resulted in a lower share of cash/higher share of bonds on their balance sheets compared to those of banks.

Antonio Ordás analysed the impact of new capital regulations on bond market functioning and liquidity. European banks included in the category of global systemically important banks (G-SIBs) would need to meet the total loss-absorbing capacity (TLAC) requirements, as well as the European Banking Authority's (EBA's) transposing minimum requirement for own funds and eligible liabilities (MREL). Overall, the differences in implementation as regards timing, the group of banks affected and NCA discretion regarding national transposition were seen as posing several potential risks: (i) an unlevel playing field across European countries with regard to the hierarchy of senior unsecured debt; (ii) different approaches to subordination with potential implications for pricing and collateral eligibility; and (iii) a lack of transparency, given that MREL and Pillar 2 add-ons would be negotiated bilaterally.

3. Self-regulated best practices

Frederic Lasry and David Hiscock reviewed current frameworks for standards of good market practice in debt capital markets in Europe, including the ICMA's primary market handbook and secondary market rules and recommendations. The BMCG had a first tentative discussion on self-regulated best practices applicable to the euro area's fixed income markets, with members pointing out some issues regarding adherence and scope. Some members also considered that certain market segments, such as corporate debt, were currently dysfunctional, limiting the capacity to apply and enforce codes of conduct and best market practices.