EUROPEAN CENTRAL BANK
EUROSYSTEM

DG/MARKET OPERATIONS
BMI/EBM

ECB-PUBLIC
12 July 2016

Bond Market Contact Group

Frankfurt am Main, Tuesday, 21 June 2016, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Natasha Brook-Walters (Wellington) reviewed the main bond market developments and the outlook.

Members discussed the steady decline in major long-term government bond yields, which had been accompanied by a further reduction in market-based long-term measures of inflation expectations. The decline in euro area inflation expectations was also seen as a more global phenomenon affecting other economic areas such as the US and was partly the result of technical factors such as the risk-off sentiment. At the same time, it was recognised that central bank policies had been effective in reducing deflation risk.

It was also mentioned that the low-yield environment has led corporates and sovereigns to lengthen the maturity profile of their new issuance, and may raise corporate sector leverage via increased buybacks. Some members expressed concerns that the decline in bond yields could be creating some yield curve distortions in some euro area core countries. These members argued that an increasing share of sovereign bonds traded below the ECB’s deposit facility rate and had therefore become ineligible for public sector purchase programme (PSPP) purchases, which had led to over-proportional purchases of longer maturities. In addition to the Eurosystem, Japanese investors had become large buyers of European fixed income assets since the introduction of negative interest rates by the Bank of Japan under its Quantitative and Qualitative Monetary Easing in mid-January 2016. The initial implementation of the ECB’s corporate sector purchase programme (CSPP) was perceived as very smooth, although some members doubted that the faster than initially anticipated pace of purchases could be sustained.

2. UK referendum on EU membership

Carlos Egea (Morgan Stanley) and Franck Motte (HSBC) analysed the impact on euro area bond markets from a potential exit of the United Kingdom from the European Union.

There was a broad consensus among BMCG members that market positioning was light two days ahead of the vote, with many investment decisions having been postponed since the announcement of the referendum. Nevertheless, members warned that the market was under-hedged because the ex ante binary outcome was difficult to hedge, and because there was a limited choice of hedging instruments available, partly due to the limited depth of some markets (such as the GBP/USD FX options market, which had pushed implied volatility to levels that were considered to be too expensive to hedge).

During the discussion, it was mentioned that the market was deemed to be most vulnerable to an (unexpected) “leave” outcome, which would likely impact negatively bank valuations and bond yield spreads in the euro area. A “leave” outcome would likely lead to price gaps and increased volatility, with e.g. a sharp decline in German Bund yields, a rise in Italian BTP yields and a fast depreciation of the pound sterling against the US dollar. BMCG members had mixed views with regard to the importance and usefulness of prompt central bank communication and action in the event of a “leave” outcome. Some members believed that an ECB response in the morning of Friday, 24 June 2016 would be crucial in order to prevent lasting damage to risk premia, while others cautioned against central banks responding too quickly and rather suggested to take a wait-and-see approach. This would presumably avoid a perception of panic and allow markets to find a new equilibrium, which may take more than just a few hours.

3. Solvency II impact on European bond markets

Laurent Clamagirand (AXA) and Andreas Gruber (Allianz) analysed the impact of Solvency II on European bond markets. The main changes for insurance companies were the move from book value to market value and the use of a VaR (99.5%) with a one-year horizon. The analysis pointed to a high sensitivity of the solvency capital requirement (SCR) to capital market movements. In order to reduce the volatility of the Solvency II capitalisation, European insurers were incentivised to: (i) reduce their duration gap, effectively buying longer-maturity “risk-free” bonds; and (ii) diversify their portfolio, e.g. by investing in less liquid and higher-yielding asset classes, such as private corporate debt, commercial real estate loans, infrastructure and residential mortgages. Moreover, the volatility adjuster (VA) used in Solvency II was seen as potentially creating incentives for insurers to replicate the notional portfolio on which the VA was calibrated, potentially leading to unbalanced behaviour. Finally, the proposed 25% retention requirement by European Parliament rapporteur Mr Tang was considered as a threat to the European securitisation markets.

4. Other items

4.1. Impact of the recent regulation on repo market activity

Laurent Clamagirand (AXA) updated the group on the impact of the recent regulation – particularly Basel III and the Securities Financing Transaction Regulation – on insurance companies’ use of repos. The new regulation was expected to push repo banking costs and volatility higher, leading to fragmentation and reduced liquidity. These changes would likely force investors to find alternatives to manage their duration risk.

4.2. Capital consumption of a primary dealer’s stylised portfolio

Franck Motte (HSBC) presented updated calculations on the impact of prudential rules on the capital consumption of a primary dealer’s stylised portfolio over time. The analysis suggested that the required regulatory capital had increased by a factor of ten between 2010 and 2016. The returns required for such a portfolio to meet the shareholders’ required return on equity had naturally also increased substantially.

4.3. Global FX Code

Guy-Charles Marhic (ECB) updated the BMCG on the ongoing work to establish global principles for good practice in the foreign exchange market (“Global FX Code”) and to promote and incentivise adherence to the Code under the auspices of the BIS FX Working Group.