EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB - PUBLIC
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Meeting of the ECB's Bond Market Contact Group – 10 October 2017
Summary of discussion

1. Bond market development and outlook

Ingo Mainert (European Fund and Asset Management Association) presented the bond market outlook.

Members were of the view that the euro area macroeconomic outlook was favourable, with only few downside risks to the economy in 2018. This translated into a benign outlook for the euro area bond markets. While some members saw a strengthening of inflation dynamics, others were less optimistic – in part due to the base effect. As regards the ECB's monetary policy outlook, most members agreed that the sequencing had been communicated sufficiently clearly. In line with its forward guidance, the ECB was expected to increase policy rates some time after net purchases had ended (similar to the US Federal Reserve), and, in addition, to reduce the size of the Eurosystem balance sheet only once policy rates had been raised.

At the same time, there was uncertainty about the recalibration of the ECB's asset purchase programme (APP) beyond December 2017. While all members expected some reduction in the monthly purchase volume under the APP, there was some divergence of views regarding the magnitude of this reduction and the length of the net purchasing period.

Several members raised concerns over the perceived high bond valuations, in particular in the credit segment of euro area bond markets. There was general agreement that communication by the ECB, in particular of its forward guidance, as well as advance information about the profile over time of redemptions of the different categories of securities held under the APP, was important to reduce uncertainty and avoid misplaced market expectations or "cliff effects".

2. An update on the impact of regulation on euro area bond markets: MiFID II and MiFIR

Jan Lundstrom (Barclays), Oliver Eichmann (Deutsche Asset Management), and Christoph Rieger (Commerzbank) provided presentations on the impact of MiFID II and MiFIR, and the current stages of their implementation.

Members considered that while plans for the operational readiness of MiFID II were broadly on track, there were still a number of unresolved issues that needed to be tackled and this would take time. Implementation had taken longer than initially anticipated due to the complexity of the matter

and the numerous stakeholders involved. In addition, some EU member states had not yet transposed the MiFID II directive to a sufficient degree for financial market participants to implement the necessary changes. Consequently, some members called for a certain amount of regulatory tolerance during the first months of implementation.

Members were doubtful that MiFID II and MiFIR were leading to a more level playing field. The view was expressed that while large financial institutions were able to cope with the new regulatory demands, smaller institutions faced significant problems implementing all of the requirements and might therefore consider discontinuing certain activities. Moreover, many relevant EU market participants, such as certain public sector entities and bank treasuries (managers of own accounts), were considered “out of scope” of MiFID II and MiFIR, while members reported that many customers and counterparties were not aware that they were themselves de facto “within scope” in relation to certain transactions.

Electronic bond trading venues were likely to benefit because they made it easier, particularly for smaller entities, to demonstrate best execution. Members expected that the average ticket size of bond market trades would decrease and that only larger transactions would take place over the counter.

Members did not expect bid-ask spreads to decline as a consequence of “unbundling” fees for bond market research from transaction value or volume. Market makers had never factored the cost of bond market research into their pricing. Providing research to clients had traditionally been more of a marketing tool or a means of gaining access to clients. Members were of the view that the quantity of bond market research pieces made available to clients was likely to decline on average, due to the unbundling of research fees. At the same time, however, the quality of the research could possibly increase, especially in the cases of research provided by certain specialised providers to clients on demand, and research which some of the larger asset managers would increasingly move “in-house”. This was already the case in the equities market.

3. Sovereign risk concentration and the current position of primary dealership

Kevin Gaynor (Nomura) provided a presentation on sovereign risk concentration in euro area banks’ balance sheets, and its possible implications. Franck Motte (HSBC France) presented information on the current state of primary dealers in the euro area.

Members were of the view that sovereign risk concentration had decreased somewhat over the past few years due to a decline in banks’ balance sheets and the onset of the ECB’s public sector purchase programme. Nevertheless, the level of domestic bias in sovereign bond holding was still elevated.

Some members noted that the treatment of sovereign debt in the upcoming review of the CRD IV/CRR could be a source of concern. If risk weights for banks were set too high on sovereign debt,

this could inhibit the primary dealer model – which has so far relied on banks – and lead to increases in bond yields, at least during a transition period**.** Moreover, an increase in risk weights was perceived as unlikely to fully break the sovereign-bank nexus, given the relatively high concentration of sovereign debt within banks and the traditionally low recovery rates in the event of an actual sovereign default. Other members pointed out that insurance companies already applied risk weights to sovereign bonds and that the requirement for banks to do so was only for the purposes of creating a level playing field.

A trend was noted towards a slightly higher concentration of primary dealers in euro area bond markets. Members attributed this development, in large part, to the regulatory costs of conducting this type of business, which have increased five- to ten-fold since the global financial crisis. In particular, smaller primary dealers had withdrawn from the market as a result.

Members were of the view that a greater degree of primary market harmonisation across the euro area would be highly desirable. Large primary dealers participated in well over 200 auctions each year; this required a substantial operational effort and meant that greater coordination of issuance calendars was necessary – although possibly not a sufficient degree of primary market harmonisation. Moreover, primary dealers noted an increase in direct participation by clients in auctions. While this was generally a welcome development, such participation occurred through a non-transparent process, leading to overbidding. In this context, one member suggested that options which would make the direct participation of clients in primary market auctions more transparent should be considered.