

Meeting of the ECB's Bond Market Contact Group – 10 October 2018

Summary of the discussion

1) Bond market outlook for the year ahead

Frederic Lasry (BNP Paribas) reviewed the main bond market developments over the last quarter and provided an outlook for the fourth quarter of the year.

In the subsequent general discussion, members expressed concerns over ongoing developments in the Italian sovereign bond market. The release of the Italian draft budget for 2019 appeared to raise questions regarding the long-term sustainability of Italian sovereign debt. The prevailing high daily volatility, combined with the abrupt sell-off in May, has reportedly sidelined a number of investors. Domestic banks and insurance companies, who traditionally act as a counterweight during market sell-offs, initially supported the market, but, owing to the high BTP volatility, they appear to have had limited room for manoeuvre in recent months, which has been reflected in lower bond market liquidity. International investors were considered unlikely to return to the market before the rating agency updates towards the end of October 2018.

As regards the ECB's envisaged reinvestment period for the asset purchase programme (APP), members considered that markets were awaiting clarification on four parameters in particular. These are, in order of importance, (i) whether there will be flexibility to move reinvestments between APP programmes, (ii) whether there will be a duration target for the APP portfolios or whether the ECB will continue to adhere to the principle of market neutrality, (iii) whether reinvestments for the public sector purchase programme (PSPP) will continue to be smoothed over up to three months, and (iv) whether the old or the new 2019 capital key will guide the PSPP in a reinvestment phase. While not expressing particular views on these four issues, BMCG members highlighted the importance of eventual clarity about them.

Members were also of the view that the anticipated phasing out of the APP was no longer considered a market event. While earlier changes in the pace of APP net purchases (e.g. from EUR 60 billion to EUR 80 billion per month) had an impact on financial markets upon announcement, the actual implementation of those decisions did not lead to discernible market movements. At the same time, some members were of the view that in some periods the Eurosystem's market presence through its regular monthly purchases had been useful in helping to contain market volatility.

2) Electronic trading in bond markets and MiFID II

Garry Naughton (Goldman Sachs) and Enrico Bruni (Tradeweb) reviewed the latest developments in electronic trading in euro area bond markets and the impact of the revised Markets in Financial Instruments Directive (MiFID II) on electronic trading.

The use of electronic trading platforms is estimated to have increased by around 10 percentage points since the introduction of MiFID II at the beginning of 2018. Members believed that the best execution requirement had been the most likely driver behind this trend. However, so far MiFID II has had no discernible impact on bond market liquidity. Members expect the share of electronic transactions to increase further, but they are of the view that a part of the market will continue to rely on over-the-counter transactions, in particular for larger transactions or less liquid securities.

Members would welcome in particular the creation of a consolidated tape of MiFID II data in order to make the generated data useful. While a framework to collect data has been established, the challenge is to aggregate all of the data stored with over 100 different trading venues or approved publication arrangements (APA) to make it useful for the markets. Moreover, there are still data quality issues and differences in deferral schemes that need to be addressed before market participants could make use of such data. Some members suggested that, as the relevant authorities now have data available, they could adjust the relevant thresholds to better allow markets to follow the trading of less liquid instruments. Some members suggested that the relevant authorities could maintain the golden source around static instrument data (e.g. issuer, outstanding amount, trading venues, etc.) in order to facilitate the analysis of the MiFID II data by market participants.

Market participants did not expect the increased use of machine learning or other algorithms per se to improve bond market liquidity. The use of advanced analytics and algorithmic trading will allow asset managers (for portfolio allocation) and trading desks (for quoting and hedging) to operate in a much more efficient way than at present. However, members considered that, in periods of volatility, bond markets would lose liquidity and would tend to revert to human intervention, as algorithmic models are inherently weak in dealing with regime shifts. Several members cautioned that the increased automation required a much more robust control infrastructure, in particular when it came to trading decisions.

3) An update on the impact of Brexit

Paul Richards (ICMA) and Kevin Gaynor (Nomura) reviewed the preparations for the United Kingdom's exit from the European Union and potential cliff-edge effects that could arise.

Members generally viewed themselves as well-advanced in their Brexit preparations, but the complexity of the process was inherently risky and costly. Members felt that several of their clients seemed complacent in their preparations, possibly because they had discounted the possibility of a hard Brexit in March 2019. The main concerns of members related to central counterparties (CCPs), in particular for derivatives clearing. A lot of (legal) uncertainty appears to surround the

process of moving derivative contracts from a UK-based CCP to a CCP based in an EU27 country and vice-versa. Many members were also concerned about the increasing possibility of operational mistakes. The complexity of a wholesale shift of the industry, which requires moving transactions, “repapering” contracts and dealing with legal uncertainty, increases the likelihood of inadvertent errors and, in any case, increases costs for the banking sector, which is already facing profitability challenges.

In the absence of further clarity on the future EU-UK relationship by the end of this year, several members would be forced to implement plans catering for a hard Brexit to be able to continue serving their clients. Should this scenario materialise, some members worried that there could be a decline in the efficiency of euro area bond markets over the medium term. This would be the result of fragmentation induced by the relocation of not only sales but also some trading and risk management staff. Even though mitigating solutions can be found, they are, according to these members, likely to be costly and of a second-best nature. Some members emphasised the importance of proceeding with the capital markets union, as there was also a substantial risk that certain types of business would migrate from Europe to financial centres in other parts of the world.