

14 September 2022

Meeting of the Bond Market Contact Group (BMCG) on 13 September 2022

Summary of the discussion

1) Review of bond market developments

Harriet Hart-Fox (Morgan Stanley) reviewed the main bond market developments since the last BMCG meeting on 23 June 2022. The presentation was followed by remarks from Thomas Weinberg (German Finance Agency, DFA), who provided some insights into the repo market activity of the DFA.

The first presentation showed strong repricing of USD, GBP and EUR short-end forward rates, and the prevailing high volatility in bond markets, which has made also the pricing of cheapest-to-deliver (CTD) bond switches more challenging, and potentially affected bond market liquidity. The second presentation explained how challenging it is for Debt Management Offices to estimate required cash buffers in the middle of economic and geopolitical uncertainty.

Participants widely welcomed the ECB decision to temporarily remove the 0% interest rate ceiling for the remuneration of government deposits¹ as an important step to support repo market functioning also over year-end. However, some members mentioned that the decision did not solve the scarcity problem, a fact which would need to be assessed carefully ahead of the expiration of the temporary measure end April 2023. It was asked whether the temporary removal of the 0% remuneration ceiling also applied to deposits of foreign central banks at Eurosystem NCBs (Euro Reserve Management Services – ERMS – deposits), as no information had been disclosed on this specific point. The ECB replied that the remuneration arrangements for foreign central bank accounts were not public, but that the Governing Council had considered the risks of the 0% remuneration ceiling more broadly and that a similar type of approach than for government deposits was being applied.

Members discussed the ongoing squeeze in repo markets, which is, in their view, related to a combination of factors. While they appreciated ECB's timely decision on government deposits, they also mentioned the ongoing demand for highly rated and liquid collateral by non-European central banks, which are looking to deposit their cash. Some mentioned also higher demand by hedge funds, which have been increasingly engaged into technical arbitrage of the cash-future basis using leverage.

¹ <u>https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220908~0705913289.en.html</u>

Several members expressed concerns over rising collateral scarcity ahead of year-end and reported some early demand for liquidity placement trades that cover year-end. It was also mentioned that the liquidity provision in repo markets is uneven with some smaller banks or buy-side firms occasionally facing some challenges to access the market.

As regards ECB monetary policy, a number of market participants mentioned that a clearer guidance on the level of the neutral and terminal interest rates and on the ECB's plans for a potentially upcoming Quantitative Tightening could help to reduce the high level of uncertainty currently prevailing in the markets.

At the same time members pointed out that the environment for Quantitative Tightening by central banks is currently not very constructive, as many market makers and banks are constrained in their balance sheet risk capacity due to regulatory constraints and have a low willingness to hold inventory, which complicates larger repositioning of investor portfolios. Beyond the regulatory constraints, it was mentioned that most of the banks use value-at-risk (VAR) models as part of their internal risk management framework, which had a long look-back window of around two years, so that the recent increase in volatility might lead to lower risk tolerance and limits going forward.

Members concluded that overall, the liquidity of euro area government bonds had been resilient, in particular when considering the multiple shocks and higher volatility which affected markets. The inflation-linked-bond segment was the exception and seems to have suffered from lower liquidity. BMCG members emphasised the importance of Securities Lending facilities provided by central banks and by Debt Management Offices for mitigating the impact of year-end related tensions.