EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 4 February 2013

Bond Market Contact Group

Frankfurt, Tuesday 22 January 2013, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Mandate of the BMCG and Work programme 2013

The Chairman welcomed members to the inaugural meeting of the ECB's Bond Market Contact Group (BMCG) and introduced its mandate, its functioning and the ECB's expectations regarding its input and contributions. Its set up would be similar to that of currently existing ECB's contact groups such as the FX Market Contact Group (FXCG) or the Money Market Contact Group (MMCG), with public disclosure in the ECB's website of its membership, agenda, background documents discussed in its meetings and meeting summaries. The two main aims of the BMCG are: (1) to improve the ECB's market intelligence on structural and on-going market issues in the euro bond markets; and (2) to provide market participants with an opportunity to bring up issues that, in their view, deserve attention at euro area level.

The Secretary presented the draft work programme for 2013 and the list of potential topics. The work programme was agreed to be finalised after the meeting after including the comments and additional items proposed by the members during the meeting. The distribution of the items in the remaining three meetings scheduled for 2013 would be based on the discussion, although topics could be replaced or re-prioritised throughout the year to reflect the latest market issues. Finally, within the expressions of interest, the allocation of each agenda item among members was agreed to reflect the broad composition of the group to get a balanced view of the topics.

2. Review of recent bond market development

The Secretary provided an update on the euro area bond market developments, focusing in the period since July 2012. She mentioned i) a summary of the main policy actions and other announcements strengthening the European and Monetary Union, which contributed to the improvement in risk sentiment and to removing tail (redenomination) risks; ii) several government bond market indicators, which showed an improvement in market functioning and a broader investor demand for peripheral government bonds, although emphasising that a few risks remain; iii) the spread evolution of other bond asset classes, which also evidenced the improvement in market sentiment and market access for periphery sovereign issuers; and iv) a look at euro area corporate issuance since 2012.

The discussion revealed a broad agreement regarding the improvement in financial markets conditions, but differing views on whether bond market developments over the past few months could be considered healthy. *On the one hand*, members considered the improvement in market access indicators and some signs of re-internationalisation in the demand for peripheral euro area government bonds as healthy development. The signs of improvement mentioned by members included tentative signs of reversal of capital flight; market access for the Spanish (and improvement of access for the Italian) sovereigns in the long-end of the curve; and the reduction in the systemic premium embedded in spreads. The higher comparative allocation to Italian and Spanish counterparties in Italian and Spanish government bond auctions up until the second half of 2012 facilitated by the excess liquidity provided by the two 3-year LTROs (vLTROs) had masked a

domestic bias of periphery euro area government bonds. The re-internationalisation over the last few months, while being slow and gradual, was considered to be a healthy development.

On the other hand, some aspects were considered to be less healthy: (i) the improvement in market access for peripheral euro area countries might dis-incentivise governments to make further progress towards a more sustainable fiscal path, despite the fact that more needs to be done in that domain; (ii) the negative nominal yields for some core countries´ bonds in the short end might not reflect fair values; (iii) the recent "hunt for yield" was leading to lower bond yields in those countries where the growth outlook was still unsatisfactory, which pointed to a decoupling between flows and fundamentals; and (iv) the increasing international share of the outstanding holdings of peripheral government bonds since the announcement of the OMTs is regarded so far as unstable and vulnerable to a change in market sentiment. Real money international (mostly European) investors have only recently started purchasing peripheral government bonds again, but many remain sceptical about the long-lasting nature of the recent improvement and might reduce their holdings if the market sentiment deteriorates.

Overall, the recent steady decline in price volatility of euro area non-core government bonds contributed to the increasing demand from international real money investors. Recent European policy actions - like the more market friendly solution reached by the Eurogroup on 6 November 2012 for the disbursement of financial aid for Greece - were also perceived to have contributed to the positive momentum in euro area government bonds. However, secondary market liquidity remains very low and is expected to recover only slowly given the prevailing uncertainty and the structural decline in the investor base. Some members cautioned that these two factors might lead to a permanent upward shift of the yield curve for peripheral government bonds.

3. Global outlook for public sector and private sector bond issuance

Following-up from the previous item, Carl Norrey (JP Morgan) presented the 2013 outlook for public sector and private sector bond issuance, with a particular focus on euro area developments. The presentation - which had been jointly prepared with Adrian Averre (BNP Paribas) - focused on three main areas: (i) the outlook for euro area sovereign funding, including the evolution of the sources of demand for German, French, Italian and Spanish government bonds, the risks and the sources of liquidity; (ii) supranational, sovereign and agency issuance estimates for 2013; and (iii) bank funding for senior unsecured, covered bonds and securitisation. The outlook for bond market issuance remained uncertain and subject to some of the risks already discussed under the previous agenda item. Key risks foreseen were: (i) the question on whether Spain can maintain sufficient market access given its expected higher supply of €120 bn, also in view of rating risks; (ii) the outcome of the Italian elections next month; (iii) solutions adopted by euro area policy makers on stressed euro area economies that do not yet have a programme; and (iv) how peripheral banks can meaningfully reduce their dependency on official funding.

Laurent Clamagirand (AXA) provided his outlook for the euro area bond supply and challenges from the view of an investor. According to him, the most important technical factors likely to drive bond prices in coming months were: (i) a substantial decline in issuance from AAA/AA Eurozone countries in a context of higher need of highly rated paper for collateral uses (EMIR and central clearing requirements); (ii) the challenging macro situation in Europe and the risk of further rating downgrades; and (iii) the substantial net new issuance from France, Spain and Italy (€62bn, €28bn and €23bn expected for the year 2013).

Pontus Åberg (ECB) presented the most recent developments regarding eligible collateral and the amendments of collateral rules concerning Eurosystem monetary policy operations. The financial crisis has revealed the existence of some clustered shortages of collateral, which has raised the danger of hampering the transmission of the monetary policy mechanism in some regions. This has led the Eurosystem to take decisions to preserve and increase collateral availability, with an emphasis on those assets that were deemed to be more effective for fostering bank lending, like ABSs and credit claims.

Members noted that the sovereign crisis and the increase in the outstanding volume of ECB's open market operations, especially due to the two 3-year LTROs, had led to an increasing own use of collateral, for instance in the ABS market since late 2007. While the same phenomenon has recently evolved in euro area covered bonds, members generally regarded it as a positive feature from the ECB's collateral framework. In fact, the possibility to use retained covered bonds provided flexibility to financial institutions during times when public market access was challenging. In their view, this feature did not require intervention but was self-correcting, as issuers could recall retained issuance or place the covered bonds with investors (particularly via private placements) when they regained market access.

4. Impact of recent regulatory changes & other structural issues

Martin Scheck (ICMA) analysed the most recent regulatory changes in four main areas: (i) the progressive introduction of harmonised CACs in euro area government bonds; (ii) the covered bond label; (iii) the Prime Collateralised Securities (PCS) label; and (iv) recent decisions on the regulatory ("Basel III") treatment of assets.

Members agreed that greater transparency in the terms and conditions of bonds - and in particular of government bonds - is an important factor for regaining investor confidence. This is one of the lessons learned from the Greek PSI experience in the summer of 2012. In this regard, the progressive introduction of harmonised CACs for euro area government bonds was an important step towards harmonisation, although further disclosure of the terms and conditions was still needed, such as legal opinions of their applicability under the national laws.

Regarding the labels initiatives, members regarded both the European Covered Bond Council (ECBC) Covered Bond Label and the PCS ABS label as contributing towards greater transparency and standardisation, which responds to investors' increasing demand for more detailed and public disclosure. Both labels are in their initial phases and it would be important to follow their progress.

Regarding the proposed new regulation, members concluded that it was important to engage in discussions with regulators at an early stage of the regulatory process to avoid or limit misunderstandings or unintended consequences. Two examples of unintended consequences were given as: (i) the proposals on pre and post trade price transparency under the MIFID review, which could reduce secondary market liquidity if market participants are not allowed sufficient time to hedge before the publication of the transaction, and (ii) the proposed risk-weighting for credit positions with maturities beyond 5-years in Solvency 2. The current regulatory draft makes it punitive to hold credit positions with remaining maturities above 5 years, but provides a strong incentive to hold government bonds compared to private paper. It was mentioned that this preferential treatment might have an impact on bond prices and reduce the incentive of governments to pursue fiscal reforms.

5. Other items

The Executive Board member of the ECB, Mr Benoît Coeuré, welcomed the creation of the contact group and its members and provided some concluding remarks. He emphasised that the BMCG would complement the other sources of market intelligence on bond market area and contribute to the dialogue between policy makers and market participants.

The next meeting would be held in Frankfurt on 9 April 2013.