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Bond Market Contact Group

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SUMMARY OF THE DISCUSSION

1. Implications of Brexit

Carlos Egea (Morgan Stanley) reviewed the implications for the functioning of the euro-denominated government bond markets, market infrastructure and wholesale banking following the United Kingdom's decision to leave the EU. In his view, moving relevant parts of London's financial centre to the Continent would likely result in multiple smaller EU hubs rather than a single hub. The related loss of agglomeration benefits could entail the risk of a deterioration in the EU's competitiveness at a global level and benefit other international financial centres outside of Europe. For the financial institutions involved, a partial relocation could also result in some loss of efficiency (as operations would have to be maintained in two locations) and higher costs of running their euro-denominated fixed income business, which might entail strategic decisions such as resizing some of their activities. This might eventually lead to somewhat less liquid markets. The three key factors that were expected to shape market participants' relocation decisions were: i) balance sheet impact, ii) non-financial costs, and iii) human resources. Longer transition periods coupled with early regulatory certainty would facilitate market participants' plans. As regards the businesses integrated in sovereign financing, sovereign coverage (relationship with EU issuers) was deemed to be less sensitive to location, whereas syndication (relationship with investors) and trading were considered harder to move out of London.

The subsequent discussion revealed mixed views with regard to the impact of Brexit on the liquidity of bond markets. Some members, in particular the investor side, did not expect it to have a significant and protracted impact on the liquidity of cash securities, irrespective of the resultant number of continental European locations for fixed-income trading, given the latter's fungibility, as well as the trend towards automation and electronic trading. However, other members, in particular banks, saw a risk that the fragmentation in terms of locations would reduce operating efficiency and willingness to take risk, as information would not flow as smoothly owing to the loss of personal proximity with key ancillary services such as risk management and legal services. Members agreed that a timely clarification as regards the financial services that would need to be reallocated to the EU27, and adequate transition times, were important for a smooth transition of capital markets towards the post-Brexit arrangements.

2. Secondary market liquidity and impact of repo liquidity

Laurent Clamagirand (AXA) and Martin Scheck (International Capital Market Association) reflected upon the impact of repo market functioning on secondary market liquidity and the functioning of bond markets. They said that the regulatory changes introduced since the 2007 financial crisis had in relative terms had their largest impact on interest-rate and repo businesses, which had become more capital-intensive. In euro area repo business, this had resulted in three discernible trends: i) greater counterparty concentration, with the largest ten players accounting for 61% of business; ii) increased size of their gross repo books among the global systemically important financial institutions (G-SIFIs); and iii) more optimisation of repo netting and quarter-end/year-end balance sheet reduction. Tentative evidence showed that balance sheet constraints for regulatory reporting and tax levies for some jurisdictions over the year-end, and to a lesser extent the constraints and heterogeneous structure of the ECB's public sector purchase programme securities lending facilities across Eurosystem central banks, might be leading to large repo market dislocations over reporting periods, although the effect over end-March 2017 had been more modest than for end-2016.

There was broad agreement among members that the ongoing trends required more careful planning of repo needs over reporting periods. While the liquidity in repo markets had not deteriorated markedly, surveys evidenced a more pronounced tiering in terms of clients (smaller buy-side institutions reported a deterioration in repo liquidity) and type of collateral. This also affected users of derivatives markets, which could not plan their cash positions resulting from margining well in advance and experienced considerable difficulties placing cash over year-end owing to bank balance sheet reductions. As a result, some buy-side companies reported that they were now using foreign exchange swaps instead of repo markets for cash management purposes. A number of members were of the view that if the bank levy was based on the average balance sheet rather than on a snapshot at the end of reporting periods, much of the quarter-end/year-end volatility could be avoided.

3. An overview of FinTech and update on electronification

Steve Hall (Tradeweb Europe) and Zoeb Sachee (Citigroup) analysed the implications of Fintech and electronification on banks, bond markets and central bank policy. While the impact of FinTech had been very large in retail banking, wholesale banks had been somewhat less affected. The main areas of focus were post-trade activities owing to their labour-intensive nature (e.g. custody and clearing via the use of distributed ledger technology) and regulation. Artificial intelligence was seen to enable a greater level of automation and to have the potential to help wholesale banks become more efficient in most business areas including fixed income trading. There were various ongoing initiatives in fields such as machine learning applied to real-time risk management, robo-advisors for customers, robo-traders for electronic trading platforms, analytics for portfolio and asset management, and image pattern recognition to identify trading patterns. Official institutions were committing some resources to FinTech, but remaining so far on the sidelines and voicing some concerns regarding the additional value and risks of some of its elements. These included systemic risk associated with credit intermediation and the impact of cyber and operational risks on the financial system.

Members reported that regulatory requirements (e.g. pre-trade and post-trade reporting) and the search for efficiency and streamlining of the trading workflow were supporting the increased market share of electronic trading platforms (ETPs). On the other hand, the increasing share of ETP business was perceived as having reduced market depth, potentially leading to stronger "cliff effects" in stressed markets. Cliff effects were likely to be exacerbated by a reduction in market diversification as a result of the wider use of artificial intelligence, which can lead to more crowded trades. Finally, the view was expressed that the wider use of these technologies required banks to find the optimal interplay between the power of computing and human judgement, rather than fully replacing humans. In particular increased attention would have to be paid to an effective control infrastructure.

Jens Tapking (ECB) summarised the ECB's current involvement in FinTech, via its promotion of the smooth operation of payment and settlement systems, its acting as a catalyst for financial market integration and its assessment of its oversight framework in the light of technological developments. He also mentioned analyses undertaken by various central banks including the ECB on digital currency.

4. Bond market outlook and other topics of relevance

Christoph Rieger (Commerzbank) presented the main bond market developments and the outlook for the market. The current market environment seemed to be one of the calmest in the last five years, with substantial economic growth based on consumer and industrial demand, rather than on pure sentiment.

Members saw the volatility in euro area long-end government bond yields over the past few months as a reflection of the changes in market structure. These had resulted in reduced market depth (and hence more intra-day volatility), reduced diversification in positioning (with a higher impact of the news flow), and a situation where the fixed income markets were driven more by monetary policy than by macroeconomic fundamentals. The reduced market depth was cited as explaining the sudden readjustment in Portuguese government bond yield spreads following an improved growth outlook. Members said that the global economy had become more synchronised and economic indicators had generally improved – most notably in the United States and Asia, but also in Germany, Ireland, Spain and France. This was also evidenced by the reduced correlation of bond market reactions to recent idiosyncratic events, such as the impact of the political uncertainty in France ahead of the presidential election. Looking ahead to the second half of 2017, members said central bank communication, in particular by the US Federal Reserve System and the ECB, was the primary factor influencing bond market conditions.