EUROPEAN CENTRAL BANK

EUROSYSTEM

DG-MARKET OPERATIONS 18 October 2013

Bond Market Contact Group

Frankfurt, Tuesday 8 October 2013, 13:00 – 17:00

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Zoeb Sachee reviewed the main market developments affecting bond markets since the last meeting, as well as Citi's main outlook and risks. Euro area fixed income markets were deemed to be now more resilient to shocks than at any point during the crisis, given the improvement in structural reforms and investor positioning, with a prominent share of domestics in non-core jurisdictions providing some stabilisation against market swings, and at the same time renewed interest of non-domestic investors. Therefore, looming risks related to the US debt ceiling/fiscal shutdown, Fed tapering, political uncertainty in Italy, concerns over a Spanish downgrade or a renewal/end of financial assistance in Portugal and Ireland were seen as manageable. This notwithstanding, fragmentation remained high and lending rates and domestic banks' ability to provide new business loans in jurisdictions that had been affected by the sovereign debt crisis were not supportive of an economic recovery, potentially leading to a two-tier recovery.

During the discussion, members expressed divergent views on the path of long-term US and core European bond yields. While some members expected a de-coupling, with German yields staying broadly unchanged under a scenario of a US bond market sell-off once the Fed started tapering, others remained sceptical given the historical correlation in previous bond market sell-offs. The magnitude of a sell-off reaction might be possibly amplified due to the reduction in market makers' capacity to absorb volatility resulting from regulatory changes such as 10-day value at risk (VaR), stressed VaR calculation and incremental risk charge, with the upcoming leverage ratio framework in Basel III seen as an additional constraint. Price discovery had reportedly not improved due to these new constraints.

2. European banks and corporates funding models

Antonio Ordás and Zoeb Sachee analysed the implications of the euro area sovereign debt crisis on banks' and corporates' funding models. Public issuance from euro area banks had declined steadily since 2010, affecting most fixed income assets and possibly driving valuations to artificially tight levels. Banks in those jurisdictions that had been affected by the sovereign debt crisis had been particularly affected by the reduction in public issuance, due to concerns on asset quality and capital adequacy. The contraction in public supply was initially compensated by deleveraging, retail funding and retained bond issuance used as collateral; e.g. in ECB monetary policy operations. Retained issuance had slowed down sharply in 2013, reportedly on the back of improved market access and scarcity of underlying assets for generating retained ABS or retained covered bonds. Conversely, retail deposits, subordinated debt and hybrid forms of capital like contingent convertible capital instruments (CoCos) had increased their share in banks' funding structure. This was seen as a way for banks to adjust to the new regulation and the Single Resolution Regime (SRR). With regards to the SRR, members thought that there were still some fields which left room for national discretion, which could result in different winding-up approaches and to differences in relative funding costs within the capital structure among EU countries. While theoretically the SRR was seen as increasing the funding advantage of covered bonds versus senior unsecured bonds, members reported that there had not been any observable impact on long-term (i.e. beyond 2018) senior debt funding costs for good credit quality names. Finally, banks' deleveraging focus had reinforced a disintermediation trend in European corporates' funding across industries, with corporate bonds representing 52% of the total new corporate debt in the first half of 2013. The disintermediation had been much stronger for high yield issuers, which had been extending their maturity profile in 2013 taking advantage of the improvement in investors' risk appetite. On the other hand, the crisis and banks' balance sheet constraints, in particular for lower-rated banks, had led to a sharp contraction in lending to SMEs and to a large differentiation of lending rates between regions. The upcoming Balance Sheet Assessment for European banks might temporarily reinforce this trend, although members believed that its effects would crucially depend on the ex-ante definition of a credible backstop and on the parameters of the assessment.

Finally, members mentioned a trend among banking groups towards a principle of self-funding per country for the groups' subsidiaries, partly led by regulatory changes and partly as a means to create a natural ring-fencing in periods of distress.

3. Update on the ABS market and outlook

Gareth Davies (JP Morgan) reviewed the trends in European securitisation markets and the future outlook. European public ABS issuance had partially reopened in 2009, although volumes had declined significantly to an average annual issuance of EUR 29 billion for the euro area since 2009. Compared to covered bonds where the issuer can fund at different points in time out of the same programme and can thereby 'syndicate' elevated funding costs across the programme, each securitisation must work on a standalone basis given that it is overwhelmingly structured from stand-alone SPVs. While for issuers in non-stressed jurisdictions, the levels demanded by ABS investors for new distributed issuance had become economical again, economics remained a major roadblock in other jurisdictions. Furthermore, covered bonds remained a cheaper option for refinancing mortgage loans compared to RMBS also for highly rated issuers. ABS issuance was expected to remain subdued also in 2014, partly due to changes in regulation like Basel III or Solvency II, which would result in large increases in capital charges for investors and reduce their attractiveness compared to other alternative investments. Still, investors welcomed some initiatives designed to improve access to information, such as the European DataWarehouse (EDW) and the Prime Collateralised Securities (PCS) label, although these initiatives were still in too early stages to enable an assessment of their full impact on counterparty behaviour. These initiatives could reduce the stigma of this asset class over time and facilitate investors' due diligence as a 'single data point of access'.

BMCG members largely agreed with this view and confirmed that the punitive regulatory treatment of this asset class was one of the main hurdles preventing a meaningful recovery of public issuance, compared to other secured means of funding like covered bonds.

4. Update on the covered bond market and outlook

Ted Packmohr (Commerzbank) reviewed the trends in covered bonds and their outlook. Market sentiment remained dominated by low supply, although the most recent new issues pointed to a better equilibrium between supply and demand. The market is now accessible also for Tier-2 issuers in most jurisdictions, although these needed to carefully consider timing/market conditions. Finally, the covered bond market was seen as evolving and moving beyond so-called traditional covered bonds, with new securities being well received by investors, such as the conditional pass-through covered bond issued by NIBC or the structured covered bond backed by SME loans issued by Commerzbank.

The ECBC covered bond label was seen as a promising approach towards improving transparency and harmonisation. Members generally expected the criteria to be tightened over time, possibly leading to increased recognition and use of the label by market participants and to higher liquidity conditions for that sector of the market.