

ECB Corporate Sector Purchase Programme

The potential impact on European corporate bond market liquidity

A briefing note by the ICMA IG Corporate Bond Secondary Market Practices Committee

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Introduction

The announcement by the ECB on March 10 to extend its Asset Purchases Programme to include investment grade non-bank corporate bonds caught the market by complete surprise. It resulted in an immediate and substantial tightening of credit spreads, not only for corporate bonds potentially eligible for purchase under the programme, but across the euro credit markets as a whole. Since the announcement, the market has been awaiting further details of the Corporate Sector Purchase Programme (CSPP) while contemplating the likely structure and impact of the programme. Key questions include: what will be the exact criteria for eligible bonds, and how will the ECB allocate and execute its purchases? What will be the size of the purchases, and how will this impact market quality and liquidity? And will it make a difference?

This briefing note is an attempt to outline the various considerations that the ECB may need to review as it puts together the final details of the programme, as well as the possible implications for market liquidity and investor and issuer behaviour.

Recap: a surprise ECB package

On March 10 2016, the ECB's Governing Council announced what was by all expectations a surprisingly accommodative package of easing measures intended to *'further ease financing conditions, stimulate new credit provision and thereby reinforce the momentum of the euro area's economic recovery and accelerate the return of inflation to levels below, but close to, 2% over the medium term'*. The package consisted of four main measures.

Firstly, although broadly anticipated and priced-in by the market, the ECB announced cuts in its three policy rates, including moving the rate for the deposit facility from -0.30% to -0.40%. Secondly, it announced an increase in the monthly purchases under the Asset Purchase Programme (APP) from €60 billion to €80 billion from April 2016. This, also, had largely been anticipated, although most commentators had expected an increase to around €70 billion. Then came the surprises.

The third measure was a reintroduction of the Targeted Long-Term Repurchase Operations ('TLTRO II'), designed to offer attractive long-term funding conditions to banks to further ease private sector credit conditions and to stimulate credit creation¹.

The fourth, and very unexpected, measure was an expansion of the universe of eligible assets for the APP to include investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area. The purpose of this newly announced **Corporate Sector Purchase**

¹ The ECB announced four quarterly four-year operations from June 2016 to March 2017, with counterparties able to borrow up to 30% of a specific eligible part of their loans, with the applicable rate varying from the prevailing rate of the main refinancing operations to the prevailing deposit facility rate at the time of the allotment, depending on the size of take-up of eligible loans.

Programme (CSPP) is to *‘further strengthen the pass-through of the Eurosystem’s asset purchases to the financing conditions of the real economy’*, and is due to commence towards the end of the second quarter of 2016.

So what do we know about the CSPP?

What we know...and don’t know

In the initial press conference and subsequent press release² from the ECB, as well as the minutes from the meeting of the Governing Council³, very few details of the CSPP were provided. In fact, the statements have left more questions than answers. In terms of scope, it rules out bank issuers (*‘securities issued by credit institutions and by entities with a parent company which belongs to a banking group’*), but the criteria for determining the eligibility of what is in-scope remains to be determined. For instance, will there be a minimum issue size threshold? Or minimum or maximum maturities? Also, would bonds issued by entities legally established in the euro area, but parented outside of the Eurozone, also be eligible?

The capital key and purchase allocations

Then there is the question of the purchases allocation. Presumably this will be similar to the other purchase programmes and be conducted by the individual national central banks (NCBs) as well as the ECB itself. But then the next question is will the share of purchases be apportioned by country of issuer by applying the ECB’s capital key⁴ which underlies the allocation of purchases for the Public Sector Purchase Programme? This could be problematic given that the distribution of corporate debt by country is very different to sovereign debt. Furthermore, how would this apply to, say, bonds issued by an entity domiciled in one euro area country, where the parent is established in another euro area country?

Execution

The next big question is how will the ECB (and various NCBs) execute the purchases? It would seem likely that purchases will need to be made in both the primary and secondary markets. How purchases are split between the two, however, is open to speculation⁵. Given liquidity conditions in the secondary market, it may be easier to purchase large blocks of issues in the primary market. Furthermore, for secondary market purchases, will they look to execute their purchases as principal, or will they execute orders through selected broker-dealers? And if they go to dealers for pricing, will this be on a direct basis in the over-the-counter (OTC) market, perhaps working orders, or will they employ existing electronic trading platforms or venues, for instance using a request for quote (RFQ) approach? Or will they be more pragmatic and look to identify dealer axes⁶, rather than

² [ECB adds corporate sector purchase programme \(CSPP\) to the asset purchase programme \(APP\) and announces changes to APP, March 10 2016](#)

³ [Account of the monetary policy meeting of the Governing Council of the European Central Bank, March 9-10 2016](#)

⁴ The capital key is a fixed weighting for each euro member national central bank as a proportion of the ECB’s overall capital. The key is calculated according to the size of a member state in relation to the European Union as a whole, size being measured by population and gross domestic product in equal parts. It is recalculated every five years.

⁵ The experience from the third Covered Bond Purchase Programme (CBPP3) is that for much of the early part of the programme the ECB made the majority of its purchases in the secondary market, but in the latter part of the programme it made most of its purchases in the primary market.

⁶ An axe is essentially a trade that a dealer (or investor) wants or needs to do. For example, this could be an existing position that they are looking to unwind, or perhaps an interest, or client order, to buy or sell a specific security.

requesting market-maker quotes? And if they do choose to take an axe-driven approach, could they even contemplate purchasing blocks directly from buy-side holders?

Ratings

Finally, while the ECB has specified that it will limit purchases to investment grade bonds, it is assumed that an investment grade status from any of the three, or even four, main rating agencies⁷ will be enough to warrant eligibility, particularly if the ECB wishes to maximize the size of the eligible pool of purchasable bonds. This, of course, will include a universe of cross-over bonds, or ‘fallen angels’, that could be purchased. But would they still look to purchase the lowest rated investment grade bonds if they are on credit watch? And would they be forced to sell any holdings that subsequently lost their investment grade status?

Flexibility could be key

Clearly the ECB is currently contemplating all of these issues, and more, and we should expect more clarity before the CSPP is launched by the end of June. However, it is equally likely that the ECB may choose to retain some degree of flexibility, particularly given the potential limitations and complexity of making largescale corporate bond purchases, in which case there may still be some unknowns even after the purchases begin.

What will this mean for market liquidity?

Size matters

Of course, the most burning question of all, the answer to which will have the most significant outcome for market quality and liquidity, is how much does the ECB intend to purchase under the CSPP? Comparing this to the relative size of estimated supply should give some indication of the potential for adverse impacts on liquidity, particularly with the well documented impact of the ECB’s third Covered Bond Purchase Programme (CBPP3) on that market as the obvious point of reference⁸. The minutes from the March 10 meeting also note concerns from some members of the Governing Council that the European corporate bond market is not particularly large or liquid, certainly with respect to many issues, and that the programme could raise ‘level playing field’ issues and lead to market distortions.

The overall outstanding stock of euro-denominated non-bank corporate debt is more than €2 trillion; however, limiting this to euro area entities quickly reduces the pool to a bit more than €1 trillion. Then the next considerations boil down to the ECB’s sensitivity to ratings, minimum size issues, possible maturity restrictions (it may wish to exclude very short-dated bonds, which it would need to replace before the purchases are unwound, or it may decide to avoid very long maturities or perpetuals), and complexity of structure (it may want to avoid bonds with more exotic optionality imbedded into their terms). Estimates of the eventual size of the eligible pool are clearly speculative at this point, but a number of market assessments suggest a secondary market supply of around €500 to €600 billion⁹.

⁷ Moody’s, Standards and Poor, Fitch, and, possibly, DBRS

⁸ FT, [‘ECB’s buying challenges covered bonds’](#), July 15 2015

⁹ FT, [‘ECB’s expanded QE ignites Eurozone corporate debt market’](#), April 13 2016

Based on these assumptions, were the ECB to attempt to purchase somewhere in the region of €5 billion per month in the secondary market, this could clearly be problematic, particularly if they are hoping to rely on the liquidity provided by broker-dealers, which has retrenched significantly since the financial crisis. In reality, secondary market purchases may have to be significantly smaller, particularly if the intention is to avoid causing market distortions.

Primary could be easier

It therefore seems likely that most of the ECB's purchases will need to be in the primary market¹⁰, where it has the hope of better liquidity and more chance of acquiring reasonable blocks. But again, supply may be a deciding factor. Once more, this will depend on the ECB's eventual eligibility criteria, but estimates of the potential purchasable pipeline for the remainder of 2016 range from around €40bn to €60bn. Given the relatively rude health of the investment grade corporate bond primary market, where order books are often oversubscribed multiple times, the ECB may find itself competing with an already aggressive throng of investors. This has the potential to create a number of problems related to the relative size of new issuance that the ECB will go in for, and then the allocation process itself (will issuers choose to allocate to the ECB on a *pari passu* basis, or will they prioritize their long term 'relationship' investors?). Again, if the ECB was hoping to purchase much more than €5 billion of new issuance per month, this could distort the primary market, while potentially earning them the opprobrium of asset managers, and possibly even issuers.

Self-limiting

One way in which the ECB could reduce potential liquidity impacts is to limit the amount of any issue it purchases (say to 25%), as it does with other components of the APP. However, a bigger problem may be how it chooses to allocate purchases across individual issuers as well as country of issue. Given the disproportionate distribution of corporate debt toward Germany and France, as well as to larger corporates, it may be less distortive for the market if the ECB apportions its purchases to reflect this. However, from the perspective of providing support to the Eurozone corporate sector where it is most needed, this might be the least effective approach. Meanwhile, rigidly applying the capital key used for sovereign purchases could also be distortive for countries with a relatively small corporate debt sector.

Price sensitivity

The price sensitivity, or rather insensitivity, of the ECB (or NCBs) in executing their purchases is also a key factor for market liquidity. As broadly recognized, screen pricing for the corporate bond secondary market is largely indicative and, often, transacting in anything other than retail size¹¹ will require accepting a price some distance away from the screen price. Trading in large blocks¹², in what is characteristically a thin market, not only demands a degree of flexibility with respect to pricing, but may also take longer to execute, requiring splits into multiple orders. Given the unlikelihood of the ECB's willingness to build its purchases through accumulating odd-lots, requesting offers in sizeable blocks of targeted bonds could be extremely market distortive. Unless, of course, it decides to take a more pragmatic and patient 'axes-driven' approach. Similarly, a strategy of aggressive bidding in the primary market, while a bonus for issuers, might only help further to 'crowd-out' traditional investors.

¹⁰ Article 123 of the Treaty on the Functioning of the European Union prohibits the ECB and ESCB members from purchasing public sector debt in the primary market, but not private sector debt

¹¹ Generally, less than €1 million nominal value

¹² Generally, transaction sizes larger than €10 million nominal value

Repo

Another important consideration for supporting market liquidity will be the availability of the ECB's (or NCBs') purchases for repo and securities lending. The ability of market-makers to provide offer-side liquidity is impaired by the lack of an effective and liquid repo market for the underlying securities. This was recognized by the ECB with regard to its sovereign purchases, which are made available to the market. However, there is no centralized or harmonized facility for this; rather, bonds are made available through the individual central banks' different facilities. This can range from a direct repo arrangement with the central bank, to bonds being made available to the ICSD lending programs.¹³ Should the CSPP take a similar approach to the PSPP and CBPP3, such an uncoordinated approach to putting bonds back into the market could be problematic. Particularly with respect to the CBPP3, a number of analysts have pointed out that the lack of harmonization and transparency in the lending facilities for covered bonds has been a major contributor to undermining liquidity in the secondary market. Furthermore, any repo or loan cannot be secured against cash¹⁴, raising the question of what collateral will be acceptable (will the ECB or NCBs take investment grade corporate bonds in return?).

Monitoring liquidity

Finally, given the general fragility and precarious liquidity conditions of the European corporate bond market, the ECB may need to consider carefully monitoring the impact of the CSPP on the general liquidity of the market, as well as that of individual issues. This raises a number of challenges, including what should be the appropriate liquidity measures and data points, and how will these square with the diverse range of liquidity measures being used across the market? As anybody who has tried will know, creating a meaningful, objective, standardized measure of liquidity is fraught with dangers, and may not tell you what you need to know until it is too late. A further challenge relates to regulatory determinants of market liquidity, in particular those under MiFID II/R used to calibrate pre- and post-trade reporting requirements and deferrals. The ECB may need to assess carefully the potential impact of their secondary market purchases on such calibrations, and the repercussions for market participants.

What is the potential impact on investor and issuer behaviour?

Investors

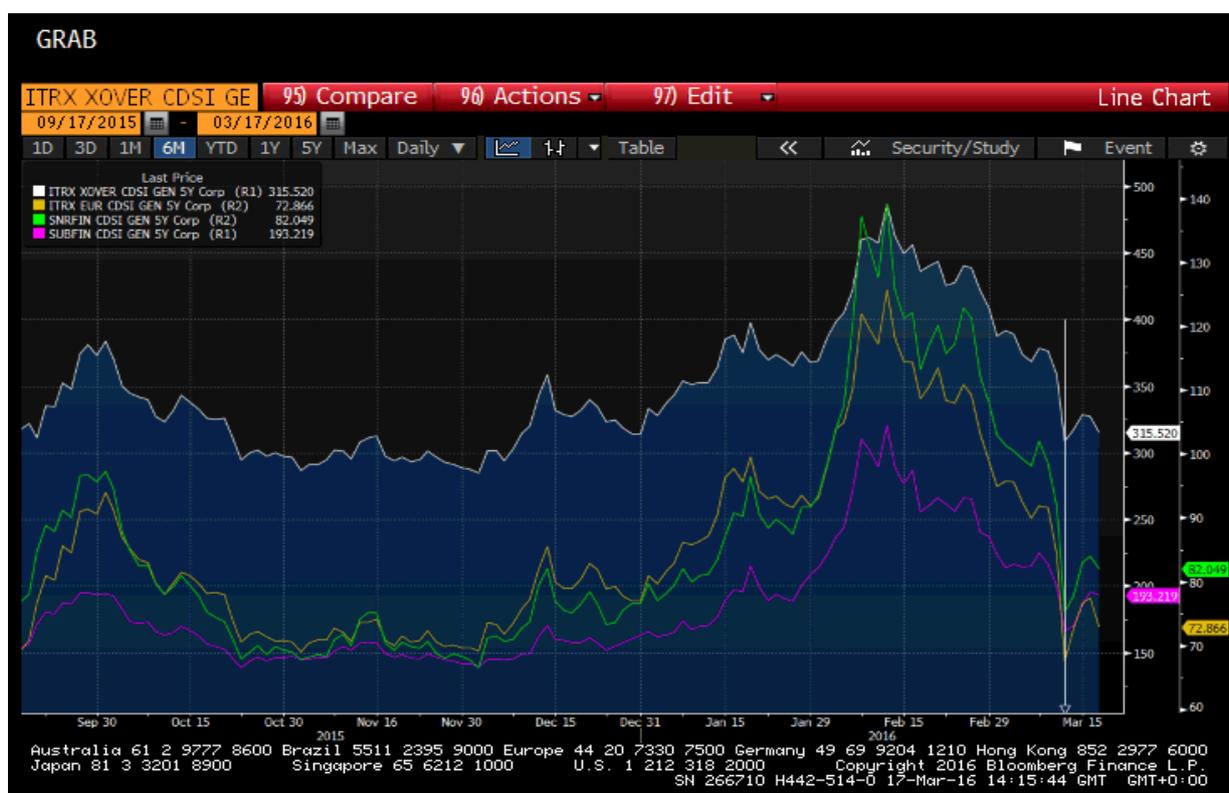
It is difficult to predict how the CSPP will impact market behaviour. On the one hand, it could help provide support for the market, reducing the likelihood of any major sell-off in the near future, and smoothing volatility. The ECB 'back-stop' bid could therefore make holding European investment grade non-bank corporate bonds relatively attractive, limiting any potential downside, at least in the near term. However, this could go completely the other way, particularly if the size or nature of purchases are perceived to jeopardize market functioning and liquidity. Investors may see this as an opportunity to 'cash in' on their eligible holdings and instead move into other parts of the credit curve or different asset classes, with the potential for higher returns. To a large extent this is

¹³ For example, Clearstream's Automated Lending and Borrowing Service (ALS)

¹⁴ If any repo or loan is secured with cash, this effectively 'unwinds' the impact of quantitative easing since it is a drain of money from the banking system. In the case of repos (repurchase agreements) this requires a matching reverse repo of the bond being borrowed, and the repo of similar collateral back to the relevant central bank.

possibly the intention of the CSPP, driving portfolio rebalancing into less safe corporate sectors, such as high yield or SMEs, where the need for credit and market investment is more pertinent. It also helps to explain how the initial reaction to the announcement of the CSPP was not only a significant tightening in investment grade corporates, but also in bank debt and sub-investment grade spreads (see *Figure 1*, below). However, the counter-risk is that investors instead look to move into non-eligible issues, such as the deals of non-Eurozone issuers, where there is more liquidity and better returns, and which would effectively provide an unintended benefit to untargeted sectors and corporations. Again, this would seem to be a lesson learned from the CBPP3, where there was a notable investor switch into UK and Nordic deals.

Figure 1: reaction of European credit spreads to the CSPP announcement



Source: Bloomberg

The above chart shows the price reaction of the various iTrax CDS (five year) indices to the announcement of the CSPP on March 10. The far right hand axis relates to the generic investment grade index (the yellow line) and the senior financial index (the green line), while the near right hand axis relates to the subordinated financial index (the pink line) and the cross-over index (the white line).

Issuers

How corporate issuers may react is also an interesting prospect. While issuers of eligible debt (and even non-eligible debt) are already enjoying better issuance terms since the CSPP was announced, beyond the benefit of cheaper funding it is difficult to anticipate any radical change in issuer behaviour. Issuance programs, for the most part, are already in place, borrowing needs pre-determined, and the opportunity for cheaper funding is unlikely to lead to more issuance. Furthermore, many corporates are already awash with cash. It is not inconceivable that where an order book includes a healthy interest from the ECB an issuer may decide to 'up-size' for that

particular tranche; but we should probably not expect an overall increase in issuance from eligible issuers.

Perhaps more likely is the prospect of non-Eurozone issuers looking to take advantage of better funding conditions in the euro corporate sector as a result of the CSPP, and so a flow of US, UK, and other corporates domiciled outside of the euro area looking to tap the euro market. This, at least, was the experience of the ECB's CBPP3.

Will the CSPP achieve its objective?

The objective of extending the APP to include corporate bonds, on the face of it, is for QE to have a more direct impact on credit provision and 'real economy' financing conditions in a bid to return inflation close to target (although a more cynical suggestion has been that the ECB was in danger of running out of assets to purchase). While there is a strong argument for directing QE closer to the heart of the real economy, this is not without its challenges.

Firstly, to be impactful, the total amount of corporate bond purchases will almost certainly need to be sizeable. But, as discussed already, executing significant monthly purchases, particularly in the secondary market, runs the risk of 'breaking' the market, or simply may not be practicably possible. While many commentators estimate monthly purchases of €3 to €5 billion per month, split across primary and secondary, the reality could be that the actual size of purchases is considerably smaller.

Secondly, as also mentioned, to have any meaningful impact on the sectors, issuers, or countries that require the most support will require targeted purchases. If the ECB chooses to apportion its purchases in line with the capital key, this could benefit issuers in the larger countries (in particular Germany and France) who least need central bank support, at the expense of the corporations that need it most.

However, as we have already seen with the PSPP, the impact could be to force investor portfolio rebalancing and a shift out of eligible assets into higher risk assets. It would seem that these spill-over effects are high in the mind of the ECB, and the minutes from the March 10 meeting note the potential second-round benefits of the CSPP for SME financing.

But, the ultimate question is whether this will help the overall QE initiative in bringing Eurozone inflation back to below, but close to, 2%? The most recent IMF World Economic Outlook¹⁵, while acknowledging the positive impact of the APP in supporting recovery through improving confidence and financial conditions, also notes that to be fully effective monetary policy needs to be part of a triad of measures including both fiscal stimulus and structural reform. Without broader euro area political support and coordination, the ECB may be fighting an up-hill battle, with the increased likelihood that the APP may certainly need to run for longer than the currently projected end-date of March 2017, the possibility of increased monthly purchases, and even the chance of a further broadening of the pool of eligible assets. In turn, any further expansion of the APP would only raise potential risks to underlying market quality and liquidity.

¹⁵ International Monetary Fund, '[World Economic Outlook: Too slow for too long](#)', April 2016

Conclusion: not easy

The ECB's expansion of quantitative easing to include corporate bonds is as ambitious as it is bold. As the Governing Council itself seems to acknowledge, the European investment grade credit market is relatively small and liquidity, at least in the secondary market, is at best already fragile. Executing anything remotely approaching a substantive share of the additional €20 billion of monthly purchases could be difficult from a practical perspective, and damaging to both primary and secondary markets as an unintended consequence. Concurrently, trying to have any meaningful impact on improving credit conditions for the parts of the corporate euro economy where it is most needed is also likely to prove challenging, with second-round, spill-over effects being the best hope of achieving this. Finally, there is also a question-mark over whether quantitative easing, in isolation, can fully achieve the objective of driving inflationary economic expansion. From the perspective of non-standard monetary policy implementation, the CSPP may well prove to be the ECB's biggest challenge so far.

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