June 17, 2016
Financial Markets Department
Bank of Japan

Minutes of the Third Round of the "Bond Market Group" Meetings

1. Outline

(1) Date	Commercial banks group (22 firms)	June 6 at 4:00 pm
	Securities firms group (25 firms)	June 6 at 5:30 pm
	Buy-side group (21 firms)	June 7 at 5:00 pm

(2) Place The Head Office of the Bank of Japan

(3) Participants

- Persons in charge of bond market issues in financial institutions, participating in the "Bond Market Survey"
- Persons from Osaka Exchange
- Director-General of the Financial Markets Department, Head of Coordination and Market Analysis Division, Head of Market Operations Division[1], Head of Market Infrastructure Division

2. Introduction by the Bank of Japan and presentation by Osaka Exchange

- The Bank explained to each group (1) the results of the "Bond Market Survey," (2) liquidity in the JGB market, and (3) recent developments in the financial markets and market operations.

- The Bank also invited Osaka Exchange as the presenter and observer to give a presentation on the developments of the JGB futures market.

3. Views provided by participants

The Bank exchanged views with participants on the above topics. Views provided by participants are as follows.

[1] Director of Market Operations Division attended the buy-side group meeting as the presenter on behalf of the Head of the Division.

Bond market under negative interest rates

- Following the introduction of the negative interest rate policy, liquidity and functioning of the JGB market have largely declined and I feel that they are yet to recover. The sluggishness of trading in the market can be described as "contracted equilibrium."

- More and more financial institutions are refraining from selling JGBs to prevent their current accounts at the Bank from increasing, while it is becoming increasingly difficult to reinvest in yen-denominated bonds with negative interest rates that are unprofitable.

- The extremely negative yields of short- to mid-term JGBs may be due not so much to the domestic investors' expectation of additional monetary easing, but rather to active purchases of JGBs by foreign investors who are taking advantage of the negative foreign exchange swap-implied yen rate.

- Yields on super-long-term JGBs are declining significantly as the pursuit for positive yields and lack of sellers accelerated the tightening of supply and demand.

- Demand for JGBs with negative yields is mostly from collateral use, while that for super-long-term JGBs is from their positive interest rates. This gives us the impression that the JGB market is divided into two.

- Participants in the super-long-term JGB market with positive yields have diversified. Some point out that this has created difficulty in conducting repo transactions that borrow specific super-long-term bonds in a case where these issues are possessed by those who are not active in the repo market.

Current interest rate level and volatility

- From a standpoint of being responsible for guaranteeing a certain level of return to customers, investment in JGBs has become extremely difficult at the current interest rate level.

- Current interest rates have stabilized within a narrow range with decreased transaction volume after some confusion was triggered by the introduction of the negative interest rate policy. In that sense, it can be described as a sort of equilibrium. However, the market does not seem to have the ability to correct the interest rate level spontaneously, as the Bank continues to purchase large quantities of JGBs.

- The reason for the seemingly low volatility of JGB yields is due to the fact that the results of the Bank's operations and the Ministry of Finance's JGB auctions do not largely deviate from market expectations.

Impacts of financial regulations

- It seems that market-making capacity of some securities firms using their own balance sheet are decreasing due to regulations. This can also be one of the reasons for the decline in bond market functioning.

- The direct impact of the regulation of interest rate risk in the banking book, which will be implemented in the future, on the JGB market may turn out to be more limited than expected.

- It may be necessary to extend the duration of assets to comply with the regulation. What is troubling is that the extremely low yields of super-long-term JGBs would hold down the profit.

The super-long-term JGB futures market

- The needs for super-long-term hedging tools have been in part met by utilizing long-term JGB futures.

- It is essential to have a broader range of hedging tools as more and more investors are participating in the 20-year cash JGB market. It is believed that the potential demand for trading super-long-term JGB futures is increasing, but the liquidity in the market seems to remain low.

- If market makers actively provide liquidity, the number of market participants would increase and liquidity in the market would naturally improve. This will also have a good influence on the cash market.

- We hear that there is potential demand for super-long-term JGB futures, but such argument assumes ample liquidity as given, which is a circular argument. The role of market makers is important but that alone is insufficient.

- Possible measures to improve liquidity include designing the super-long-term JGB futures market in consideration of foreign investors, who account for the majority of the market, and constructing a market that allows investors to trade the spreads with long-term JGB futures.

- Improving the liquidity in the super-long-term JGB futures market and stimulating the JGB cash market are inseparable from each other. The super-long-term JGBs need to recover their yield levels in order to activate the cash market, and without this, liquidity in the futures market would be difficult to improve.

The Bank's Operations

- The purpose of the current monetary easing is to stimulate the economy by pushing down the yield curve even at the expense of market liquidity, and hence the recent decline in market liquidity is a sign that the policy is indeed working. If the liquidity had not declined, it would mean that the policy was not effective.
- As the introduction of the third dimension, namely the negative interest rate, made it even more difficult for us to predict the Bank's monetary policy, changes in the "Outline of Outright Purchases of Japanese Government Bonds" are prone to generate speculations.
- Finding investment opportunities will be even more difficult if the super-long-term yield turn negative. Considering that the monetary policy has sufficiently pushed down the yield curve, we would like to ask the Bank to consider measures to prevent further decrease in the curve.
- The yield curve is not likely to reflect the market speculation these days with the Bank purchasing such large quantities of JGBs. We would like to suggest setting a range of residual maturity to which the Bank conducts small amount of offers for the market operations, so that the market's view could be reflected in that particular range.
- The Bank's holding share of deliverable long-term JGB futures may increase in line with the Bank's purchases.
- We would like to once again ask the Bank's stance on the U.S. dollar funds-supplying operation, given the recent changes in the market environment such as the increased demand for foreign bonds.

Other topics

- It is getting harder to make deals in the long-term interest rate swap market, as interest rate differences among the clearing houses are widening.
- Although the number of fails is increasing, it is more important to make the fail practice acceptable as deemed necessary and to maintain the stability of the market, rather than to prevent fails from happening indiscriminately.
- Although there has been an increase in issuance of super-long-term corporate bonds, the corporate bond market is not large enough to substitute for the JGB market to meet investors' demand. The volume of attractive yen-denominated bonds is still insufficient.