

Money Market Contact Group
Frankfurt, Monday 25 June 2012, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. The impact of liquidity regulation on money markets and banks' liquidity management

Conception Alonso (ECB) provided an update on the implementation of Basel III rules in the euro area and highlighted several outstanding issues. Furthermore, Conception presented a list of areas which were identified by the ECB as requiring some further analysis with respect to the LCR. Among these areas are the treatment of interbank funding (unsecured and secured) and issues relating to a possible broadening of the definition of high quality liquid assets eligible for the numerator of the LCR. In view of tight deadlines related to the Basel III workflows, the MMCG feedback on a number of selected issues will be sought by mid-July.

Luis Soutullo Esperon (CECA) presented [the findings of the MMCG anonymous survey](#)¹ among the MMCG members which shed some light on the banks' risk management practices, their impact on the functioning of the money market as well as MMCG's assessment of possible measures to address current market tensions. The MMCG discussion on the findings of the survey took place under Item 2 on the latest market developments.

2. Review of the latest market developments

Julija Jakovicka (ECB) provided [a brief update on the money market developments](#) since the last MMCG meeting. The main points of the presentation were: (i) a deterioration in risk sentiment with a particular focus on Europe and a strong underperformance of banking shares, as banks' credit remained closely linked to the market concerns about sovereigns. (ii) Money markets remained so far shielded by the abundant liquidity as indicated by the Euribor-OIS spreads, both current and forward, relatively stable levels of the Spanish, Italian vs. German and French GC repo rates as well as the EUR/USD FX swap basis. Money market trading volumes however remained subdued due to a high level of excess liquidity. Furthermore, despite the overall relative money market resilience, some risk factors could be identified that would require close monitoring, e.g. an increase in repo margins for the Spanish and to a lesser extent Italian repo transacted with the CCPs, which had an adverse impact on the repo transaction volumes. (iii) Reflecting re-surfacing tensions in the financial markets, market expectations of the ECB actions intensified as reflected in EONIA swap forwards' pricing. Furthermore, market participants have been widely discussing other possible measures such as the SMP purchases and another longer-term refinancing operation.

The subsequent MMCG discussion revealed that in view of limited or non-existent trading volumes in the longer-term unsecured interbank market and a large amount of excess liquidity in the system, Euribor-OIS spreads were no longer deemed to be a reliable indicator of money market tensions in the current environment. Whereas the Euribor-OIS spreads have remained stable over the recent weeks, liquidity conditions in the unsecured, secured and money market derivatives markets have reportedly been declining over the same period. This could be partly linked to the approaching half-year end but could also be a reflection of market tensions. In the repo market, recent CCP risk management measures aimed at addressing a correlation risk of the repo collateral and repo counterparty were seen as the main risk factor for the repo market functioning, in particular in Italy and Spain. Higher CCP margins on Spanish and

¹ MMCG meeting presentations are available under the MMCG section of the ECB website:

<http://www.ecb.europa.eu/paym/groups/mmcb/html/index.en.html>

Italian repo has forced domestic banks to reduce their exposure to the international CCPs and turn to the domestic market. Considering the importance of this market for banks' funding of their sovereign bond portfolios, some MMCG members called for the ECB action to address the issue of country risk with the international CCPs. Some MMCG members suggested that the ECB could step in by providing guarantees to the government bond settlement in the CCP repo; however others were sceptical about the ECB role in addressing this issue, apart from providing an alternative for banks to refinance these assets in the Eurosystem's operations.

The results of the MMCG risk management survey presented under item 1 showed that the introduction of Eurobonds was mentioned most often as an effective measure to address the current tensions in the markets, including the highly relevant issue of country risk, affecting banks in some jurisdictions. As the second best solution, large SMP purchases by the Eurosystem as well as a guarantee of public debt of euro area countries by the EFSF were mentioned. Some MMCG members were of a view that EFSF/ESM facilities should be used more pro-actively and an option of granting a banking licence to the EFSF/ESM should be considered. However, the preferred creditor status imposes limitations to the use of the EFSF/ESM facilities due to their seniority as investors are concerned about a possible PSI in Spain and other countries.

Ulrich Bindseil (MMCG Chairman) explained the ECB stance as highlighted in the recent FT interview with the ECB Executive Board Member Mr Cœuré who said that *“current circumstances would probably warrant EFSF intervention in the secondary market – provided that this happens against the right background of political decisions and solutions to the underlying issues and strong conditionality”*. The ECB has offered to act as an EFSF agent for the bond purchases and is technically prepared to assume this role if requested. In order to activate the EFSF purchases, an official request by a government needs to be made.

Despite a relatively high probability of a rate cut priced in by the market indicators, the MMCG survey revealed that neither of the MMCG members supported a rate cut as an efficient measure to address the impaired functioning of the money market. The MMCG discussion revealed that potential advantages of lowering the MRO and the deposit facility rate outweighed the negative implications of such a move. On a positive side, a rate cut would reduce the financing costs of banks participating in the Eurosystem operations. Counterbalancing this argument, several negative side effects of a deposit facility at zero or even a negative rate were mentioned by some members. These include: (i) a detrimental impact on the market activity as it would remove an incentive to trade. In this case, financial corporations could be expected to shift outside of Europe, buying assets elsewhere. (ii) EONIA volumes as well as GC repo volumes are expected to decline further even if the deposit facility rate is lowered by only 10-15 bps. (iii) Technical difficulties to handle negative rates from the IT as well as legal perspectives are expected to particularly affect smaller savings banks and corporate customers. (iv) Negative money market rates in combination with other adverse factors (e.g. a possible introduction of bank taxes in some euro area countries, stringent liquidity regulations) create a large burden for banks and their profitability. (v) The MMCG survey revealed that 75% of respondents said that a rate cut of deposit facility to zero or even in a negative territory will not lead to a change of their behaviour regarding offering deposits (10% responded “yes”, while the remaining 15% said “yes in some cases”). (vi) Finally, a rate cut was not seen helping to address current tensions in financial markets and instead a political solution towards more integrated Europe was seen as the only measure that could restore confidence in the market.

Among other possible measures, the recapitalisation of EU banks and supporting private initiatives to recover market activities were also mentioned among possible options. However, some MMCG members remarked that it would be difficult for the ECB to improve market functioning without a framework of political measures on behalf of European governments.

A recent Eurosystem's decision to expand the eligibility criteria for certain types of ABSs was seen as positive as it showed Eurosystem's flexibility which was seen crucial in times of crisis. Ulrich Bindseil (MMCG Chairman) explained that this was a precautionary measure aimed at counteracting possible deterioration of collateral in some jurisdictions where banks' ability to issue ABS at the threshold had been lost.

Ulrich Bindseil (MMCG Chairman) concluded the MMCG market discussion by noting that country risks and associated negative feedback loops were seen as the main drivers of current market tensions. The MMCG reached the view that only measures on the side of governments could bring relief to market tensions. With regard to the ECB actions, a rate cut was not seen as an efficient measure to repair the functioning of money markets. The recent collateral measures announced by the ECB were viewed positively by market participants. The main negative money market dynamic was related to the CCP restrictions towards Spanish and Italian counterparties in using domestic collateral in the repo transactions.

3. Update on the STEP developments

Michael Schneider (DZ Bank) provided [an overview of the developments in the Short-Term European Paper \(STEP\) market](#). The STEP market represents around 50% (EUR 439.4 bn equivalent) of all CP and CD issuance in the euro market. The decision as of January 2012 to grant the eligibility of the STEP paper issued by credit institutions to the Eurosystem's operations contributed to an increase in the STEP market volumes. The STEP market is seen as the main unsecured funding instrument for financial institutions (87%) whereas other issuers represent a minor part. The STEP market volumes are concentrated in the higher rated segment, i.e. the first rating category corresponding to the issuers' rating of A1, P1 and F1, which accounts for 95% of the overall STEP market volume. However, in view of recent broad-based rating downgrades of banks by Moody's it remains to be seen whether trading volume in the second, lower rated category of issuers picks up. In the first rating category STEP paper is reportedly issued at around 10 bps below EONIA, whereas in the 40 to 100 days segment, the rates are around 10 bps below the Euribor rates. Geographically, the STEP market volumes are dominated by those countries where CD and CP issuance represented an important source of bank funding. The STEP paper issuing financial institutions reportedly benefited from the 3-year LTROs and was able to extend their STEP maturity up to 100 days in some countries.

With regard to the investor base, the STEP paper market is dominated by the non-bank investors, i.e. mostly asset managers. Corporates also invest in the STEP paper in view of its liquidity compared to bank deposits. Interbank trades are estimated to account for around 10% of the STEP investor base. Some MMCG members remarked that the regulatory treatment of the STEP paper might potentially lead to a declining investors' demand.

The availability of STEP market statistics, including the weighted average maturities data which will become available around Q1 next year was viewed to be of high importance in order to assess market activity in the euro unsecured market. Holger Neuhaus (ECB) noted that the ECB welcomes all initiatives aimed at improving data quality in this market segment, in particular in times of crisis.

4. Other items

Fiona van Echelpoel (ECB) debriefed the MMCG on the outcome of the ad-hoc COGESI meeting on collateral harmonisation, which took place on 3 May. In this regard, she mentioned the very good participation to the new ad-hoc group which is composed of representatives nominated by COGESI and the MMCG. In relation to the discussions on triparty services / interoperability, she explained that 3 items were identified on which further work would be conducted. The 3 items are: (i) a gap analysis exercise on collateral eligibility requirements (the aim is to better understand and compare which assets are eligible under different frameworks, e.g., for use with central banks to receive credit, to comply with regulatory requirements, for use in triparty services, etc.); (ii) extension of operating hours of (I)CSDs/link arrangements (also taking into account the Eurosystem context as regards TARGET2 and the future T2S, as well as the market side); and (iii) elaboration of a report on minimum common features for CCPs / (I)CSDs triparty interoperability.

Concerning use of non-marketable assets in the secondary market, the discussion in the ad-hoc Group reconfirmed the many complex issues still outstanding in this dossier. It was concluded to pick up the topic after the summer; in the meantime, ICMA, together with the ICSDs and some market representatives, continue to work on the outstanding issues. The next meeting of the ad-hoc COGESI is scheduled to take place in September.

In a brief exchange among the MMCG, some members stressed the need of cooperation on this important topic across various areas (Payment systems, Financial Stability and Market Operations) in order to achieve the most optimal outcome for market practitioners and the central banks.

Fiona van Echelpoel (ECB) also informed the MMCG about a survey conducted by a new working group of the BIS Committee on the Global Financial System (GFS) on “Increased demand for collateral assets: implications for markets and policy”. The working group is to examine current developments in collateralise funding markets and regulatory reform initiatives with a view to understanding how increased collateralisation and asset encumbrance may affect the cost of bank funding and how the potential scarcity of collateral supply may impact market functioning and central banks operations. The group intends to gather information from market practitioners based on a questionnaire, which is being finalised at the moment. The MMCG members’ feedback on the questionnaire will be highly appreciated. The results of the survey could be presented at the next MMCG meeting.

The MMCG Chairman mentioned that the next meeting is scheduled for Tuesday, 18 September and will be an afternoon meeting (16:00-19:00), which be followed by the annual dinner and joined by the ECB Executive Board member Mr Cœuré.

The following potential topics could be envisaged: (i) a regular review of recent market developments; (ii) a presentation of the preliminary results of the Euro Money Market Survey (tentative depending on the availability of the results); which could be complemented with (iii) a presentation on the ICMA Repo June Survey results which is usually published in September; (iv) as specified in the MMCG work programme a presentation on “the developments of the ECB balance sheet”, i.e. an update on the developments of the most important balance sheet items, including an update on autonomous factors, could also be envisaged. Furthermore the MMCG expressed its interest in (v) a presentation by the two MMCG members on the current market initiatives with regard to credit claims and ways to refinance them in the market.