EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 22 November 2012

Money Market Contact Group

Frankfurt, Tuesday, 18 September 2012, 16:00-19:00 CET

SUMMARY OF THE DISCUSSION

1. Basel III liquidity regulations: results of the MMCG survey

Michael Wedow (ECB) presented a summary of the MMCG feedback to the survey on the calibration of Basel III liquidity regulation. In the subsequent discussion, quite some members argued in favour of widening the set of HQLA, to avoid undue concentration on few asset classes which could distort markets and reduce resilience. Some members suggested including for instance the assets which are eligible for use as collateral in Eurosystem credit operations. A few members suggested the inclusion of bank CPs and CDs in the HQLA, as this would support the recovery of the interbank market. The ECB noted that this proposal was not likely to be supported by the regulators as it might encourage banks to circumvent the liquidity coverage ratio (LCR) by issuing paper to each other.

In addition to the LCR definition, the timing of LCR implementation was seen crucial and introducing a strict LCR definition was seen counterproductive at times when banks were already operating in a contingency mode. Hence, some members argued that the current situation would warrant some postponement in the implementation of the LCR rules. Although the LCR is planned to be implemented only by 2015, banks are already taking into consideration the LCR requirements when deciding on their future funding needs. As a result, it incentivises banks to move away from the interbank funding sources as the LCR in its current form provides a strong disincentive for the interbank funding. The MMCG pointed out that the relevance of interbank market in the redistribution of liquidity should not be underestimated, in particular in times of less abundant liquidity conditions, and hence the interbank market should be preserved.

The Chairman reassured the contact group that the ECB has a clear view on the importance of the interbank market and is communicating this view in talks with the relevant regulatory bodies.

2. Money market benchmarks and their future

Holger Neuhaus (ECB) introduced a group discussion. The MMCG supported a need for the unsecured money market benchmark, which could be used by banks to price unsecured loans to their customers. It pointed out that a distinction should be made between the Libor, where clear cases of misconduct were recorded, and the Euribor, which differs from Libor in its definition and governance. The MMCG discussed several options to improve the quality of the Euribor, which ranged from strengthening governance and the code of conduct to possible alternative benchmarks, taking into consideration their benefits and limitations.

The ECB strongly encouraged the members to participate in the European Commission's consultation on the Euribor with feedback to be provided by 15 November. In view of a strong interest in the topic, the MMCG suggested to include a follow-up on the Euribor developments as a discussion item at the December MMCG meeting.

3. 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 centred on the main ECB announcements and the subsequent market reaction. Finally, several indicators were reviewed, which continued to point to a persistent segmentation of the euro area money market and rendered the monetary policy transmission mechanism less effective in certain jurisdictions.

The MMCG discussion revealed both positive and negative effects of the zero interest rate environment. On the one hand, a low and even at times negative level of interest rates in some market segments spurred investors' search for yield, leading to a reduction in credit premium, in particular in longer maturities. Most institutional investors were reportedly avoiding negative rates, looking for alternatives in the other market segments, e.g. in the CD/CP market, which resulted in the extension of maturities from 1-3 month to 6-month and higher. However, the search for yield in the core countries so far has been mostly confined to the domestic market with limited investors' interest for the perceived weaker countries. Nevertheless, in the repo market, some narrowing of the spread between the Italian and German repo at maturities longer than 3-month has been recorded.

On the other hand, due to reluctance from the investors' side to accept zero or negative interest rates, banks have reportedly lost a part of their short-term funding. Furthermore, a pass through of negative rates to the customers has so far only been possible to investors (mostly from outside the euro area) that lack access to the deposit facility and were ready to accept zero or negative rates. Domestic or euro area investors are being paid marginally positive rates (of around 1 bps) in order to provide them with an incentive to invest their liquidity rather than keeping it on the current account. However, it was feared that a marginal positive return might soon become insufficient leading to a further decline in the money market activity.

Several MMCG members reiterated their concerns with regard to a possible further reduction in the deposit facility rate due to several factors. (i) Negative money market rates are expected to have a negative impact on money market activity and on the money market's ability to ensure distribution of liquidity. (ii) Some members argued that the negative rate policy would only be effective in the risk-on market environment, whereas in the current risk-averse environment measures such as the OMT would be more effective in addressing current credit concerns. In this respect, several members noticed a positive impact of the OMT announcement on the banks' and corporate issuance in the longer-term unsecured market. (iii) A pass-through of negative rates to the retail depositors and corporate customers would be limited, negatively impacting banks' profitability, which would need to be compensated elsewhere, e.g. by increasing banks' lending rates. (iv) Reputational risk for the Eurosystem among general public might also arise in view of negative rates charged on customer deposits. (v) Adaptability of banks' internal systems might be a problem, especially for smaller banks. (vi) Negative interest rates would impact money market funds and their customers, as in their current set-up they cannot handle negative rates.

On a separate topic of central clearing counterparties (CCP), CCP risk management practices were seen by the members as being crucial for the functioning of the repo market in certain jurisdictions where a lack of credit limits and avoidance of the 'wrong-way' risk deterred foreign lenders from bilateral trades in such markets and CCPs were the only platform for the foreign lenders of cash and domestic holders of securities to meet. Spanish repo market was reportedly most affected, but also in Italy some shift from CCP transactions into bilateral repo has been recorded.

4. Review of the main findings of the latest major money market surveys.

Annette Kamps (ECB) reviewed the main preliminary findings of the latest ECB Money Market Survey, which covers money market activity in Q2 2012. The survey data showed that the overall turnover in the euro money market decreased by 14% in Q2 2012 vs. Q2 2011. After a significant increase in turnover in 2011 the downward trend in aggregate turnover since 2008 continued. The most notable decline took place in the OIS segment (-50%) and in the unsecured market (-36%). Market activity in the unsecured market remains highly concentrated in the overnight market (share of more than 70%) while turnover in the segment beyond 1 month remains very limited (only around 2% of total unsecured activity). The secured market remained the largest segment of the euro money market, although turnover declined by 15% in Q2 2012, broadly in line with the findings of the June 2012 ICMA European Repo Market Survey. The decline of turnover was driven by a 26% decrease in activity for the overnight maturities.

The members mentioned a large amount of excess liquidity as a major factor behind the decline in the unsecured market turnover, noting that some recovery could be expected once liquidity situation normalises. The MMCG attributed a decline in the OIS market turnover to a low level of volatility in the short term euro money market segment and market expectations of the accommodative ECB stance which reduced a need for hedging interest rate risk. Meanwhile, a pickup of the activity in the FX swap market (+ 12%) on the contrary reflected the attractiveness of this source of funding due to settlement efficiency and low settlement risk. The FX swap market has been largely used both to raise the US dollars (replacing the unsecured market) and to generate euro funding at a favourable price.

5. Q&A session with the ECB Executive Board Member Mr. Cœuré

Mr. Cœuré expressed his high appreciation for the MMCG contribution to the market intelligence of the ECB, which has been particularly valuable during the crisis.

With regard to money markets, Mr. Cœuré mentioned that the Eurosystem has undertaken several steps to alleviate severe symptoms of market malfunctioning by conducting very long-term refinancing operations, expanding collateral eligibility and continuing its commitment to a fixed rate full allotment in the open market operations. As expected, these measures did not address the root-cause of market concerns, which are driven by the perceived counterparty risk and are further aggravated by the adverse feedback loop between banks and sovereigns. While able to address the symptoms, the root-causes of these concerns are outside of the ECB's remit. However, Mr Cœuré said that he is hopeful that the ongoing policy and regulatory initiatives will be successful in addressing these concerns.

They could be helpful from two angles. On the one hand, the initiatives aimed at ensuring adequate capital ratios and healthy balance sheets would help raising confidence in the banking sector. On the other hand, the establishment of a true banking union would break the negative bank-sovereign loop. In order to achieve this objective, a banking union should include a pan-euro area bank resolution framework, a single supervisory system with central decision-making, and eventually a pan-euro area deposit insurance fund. If the European Stability Mechanism could inject capital directly into banks, with strong conditionality and control, this would help breaking the bank-sovereign loop.

Mr. Cœuré also stressed the importance of banking regulation, explaining ECB's interest to be actively involved in the shaping up of the new regulatory environment and to ensure that the regulations do not hamper the functioning of funding markets.

In response to Mr. Cœuré's intervention, the members expressed their support to the idea of a single banking supervision, as it would help to address national 'ring-fencing' practices by national regulators, which were seen negative for the monetary policy transmission mechanism and costly for banks operating across jurisdictions.

Some members stressed the importance of a pan-European deposit guarantee scheme for the success of a single supervisory initiative. Mr Cœuré acknowledged its importance, but noted that its implementation would take time. He noted that postponing implementation of the single banking supervision until the pan-European deposit insurance scheme is in place would only unduly delay this important process. A gradual implementation approach was hence seen more feasible.

6. Other items

The MMCG Chairman mentioned that the next MMG meeting is scheduled for Monday, 10 December. The following potential topics were identified for a group discussion: (i) a regular review of recent market developments; (ii) an update on the money market benchmarks; (iii) a presentation by two MMCG members on the current market initiatives with regard to credit claims and ways to refinance them in the market, which has been postponed from the September meeting.

The Secretary asked the members to review the proposed meeting dates for 2013 and to provide feedback, in case the suggested dates would imply major inconveniences. The final meeting dates for 2013 will be distributed in the December meeting.