EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 12 June 2013

Money Market Contact Group meeting

Frankfurt, Monday, 18 March 2013, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Market developments.

1 A. Review of the main findings of the quarterly MMCG money market survey.

Annette Kamps presented first results of the quarterly euro money market survey, which in the abridged form takes stock of euro money market developments based on the MMCG members' data.

Since Q2 2012, the total money market activity of the MMCG members declined by 4-5% over Q3 and Q4 2012. The main money market segments registering declines were unsecured (-50%) and FX swaps (-15%). The turnover in the repo market on the contrary remained robust and increased by 14%.

A decline in the money market turnover in Q3 and Q4 2014 was mainly attributed to: (i) ongoing deleveraging of European banks, (ii) regulatory requirements and the Liquidity Coverage Ratio (LCR) in particular incentivising banks to reduce their reliance on short-term funding by replacing it with longer-term funding and customer deposits or alternatively to adjust banks' balance sheets thereby reducing their liquidity shortages. (iii) Finally, due to a lack of liquidity in the unsecured money market, banks may have turned to alternative sources of funding.

It is interesting to note that for the first time since Q2 2006, in **the unsecured market lending of contributing banks outpaced their unsecured borrowing.** Furthermore, the decline in the unsecured borrowing was much more pronounced than the decline in the unsecured lending. Also in the repo market, **turnover on the (cash) lending side rose** and outpaced (cash) borrowing. These developments could have been attributed to a built-up of liquidity buffers by contributing banks ahead of the 3-year LTRO repayments, which resulted in a shift from the cash borrowing into cash lending side.

The large increase in the **FX swap market turnover**, which was observed over the past years and was attributed to larger USD funding needs, has been partly reversed in Q3 and Q4 2012 as the USD funding needs of European banks declined. Furthermore, arbitrage opportunities in the FX swap market also decreased due to a very low level of interest rates in most major currencies.

1 B. Review of the latest market developments.

Julija Jakovicka presented the regular review of market developments since the last MMCG meeting. MMCG members generally noted **that market conditions improved since January 2013,** which was also reflected in the improved access to funding markets, also for the non-core countries.

The repo market was among the main beneficiaries of the recent improvement in market sentiment. Recapitalisation of a number of Spanish banks with the ESM bonds helped Spanish banks to regain access to the international repo market where volumes increased markedly. This allowed Spanish banks to significantly reduce their recourse to Eurosystem operations. Also looking forward, increasing investors' preference for secured transactions is expected to support a further recovery of the repo market, in particular when excess liquidity recedes.

Some members pointed out **three important elements** which need to be addressed **to support a fully functional and cross-border repo market:**

(i) **Central clearing counterparties (CCPs) and their risk management practices** continue to be seen as potentially hampering the recovery of the funding markets (and cross-border flows). Despite the improvement of the bilateral repo market, CCPs have been slow in changing their margins and there remain strong country-specific constraints in the CCP policies. A number of MMCG members were concerned about **a growing regulatory pressure for market participants to centrally-cleared transactions**, thus making them systemically relevant institutions, without them however taking into account their systemic impact in decision making on limits and haircuts. It was also noted that there are **little regulatory efforts to address the systemic importance of CCPs**. Banks argued in favour of more regulation of CCPs as this would (i) facilitate a level playing field and (ii) protect CCPs in view of the increasing share of centrally cleared transactions driven by the regulatory changes (EMIR). **MMCG members placed large hopes on the SSM to address these issues** by ensuring a level playing field and reducing country-specific constraints and possibly regulating the discretion of CCPs in changing their margin requirements.

(ii) **A uniform implementation of LCR definitions of the HQLA across national jurisdictions.** It was mentioned that in the recent ad-hoc COGESI meeting, it was noted with great concern that there might be various interpretations of HQLA by national authorities, which would lead to a violation of a level playing field and would be detrimental for the cross-border repo market.

(iii) **The FTT proposal** in its initial form will also prove detrimental for the repo market, in particular in short maturities (see section 2B).

A number of members noted a pick-up of activity in the term (3-, 6- and even 12-month) unsecured market which has been driven by the LCR requirements and a search for yield. This pick up in term activity was mainly observed in **the short-term paper market, where investors are non-banks**. The unsecured interbank market remains subdued and concentrated in short maturities (up to 1-week). Regulatory requirements make interbank funding very expensive if capital and liquidity regulatory costs are correctly priced in and volumes were not expected to recover to the pre-crisis levels. The 'new' unsecured interbank market is likely to remain **a liquidity tool with maturities up to one-week and mostly O/N** and mainly for large players. Considering the importance of the unsecured interbank market **for banks' short-term liquidity management,** market participants continue working **on market-led initiatives to support the interbank market**.

Another area of concerns was related to **weak economic conditions and SME funding**. The gap between SME financing costs between Germany and Spain reached fresh highs, pointing to a segmentation of the euro area markets. The future ECB's SSM mandate was seen as one important element to address this issue. However, until the fully operational SSM, **the ECB was encouraged to take actions supporting SME lending**.

1 C. Update on the STEP market developments.

Michael Schneider presented an overview of the STEP market developments, which is an important segment of the unsecured market. Although financial institutions are actively involved in this market segment and MFIs account for 65% of issuance, STEP market is, however, not an interbank market. Main part of issuance (62%) is short-term (up to 3-month), of which 50% is in the O/N tenor. However in 2012, longer term STEP issuance picked up due to investors' search for yield in the low interest rate environment. With regard to credit quality, most STEP issuance (90%) is top rated (A1/P1) and is predominantly (73%) in euro. In 2012, the share of non-euro issuance rose somewhat due to low interest rates on EUR-denominated STEP.

Over the past years, the following factors have had a major influence on the STEP market: (i) granting eligibility to the MFI-issued STEP in the ECB monetary policy operations at end-2011 resulted in a 7% increase in the outstanding) and (ii) 3-year LTRO allotment (resulting in a decline in the STEP outstanding amount) and repayments (resulting in a small increase in STEP issuance). (iii) Regulatory initiatives with regard to MMFs are also likely to have an impact on the unsecured money market and STEP market in particular.

2. Regulatory developments and their impact on the market.

2 A. Update on money market benchmarks and on the on-going reform process.

Roberto Schiavi informed about the Euribor/EBF-led initiative, which per request of the EBF is also supported by the ECB, to carry out **a study of different possibilities for a transactions-based money market benchmark**. In this way, the ECB, as already mentioned on earlier occasions, acts as a catalyst for the market-driven initiatives to consider ways to facilitate robustness of the existing money market benchmarks. Roberto Schiavi encouraged all Euribor panel banks as well as all other large players to participate and asserted that confidentiality of the provided data would be ensured.

The MMCG was also informed that on 18 March the BIS published a report on the central banks' view on references rates, mentioning their importance and systemic relevance.

2 B. Financial transaction tax (FTT) and its implications for the money market.

Florian Walch provided an overview of the current FTT proposal and explained the procedural steps towards its finalisation. Harald Endres provided an assessment of FTT's potential impact on the money market.

MMCG members pointed out some drawbacks of the current **FTT** proposal, stressing (i) a possible adverse impact on short-term funding markets as the level of tax is not adjusted to maturity of the instrument, (ii) a larger incentive to rely on the central bank funding as it was exempt from the tax, (iii) uncertainty about the treatment of tri-party repo (collateral substitutions) and sell/buy backs; (iv) an adverse impact on the bond market liquidity due to a reduction of market making activities; (v) a possible increase in the level of risk by making hedging activities more expensive as well as a number of other implications.

The MMCG deemed also important to consider similar cases of taxes, e.g. Sweden, and their impact on the market.

Other business

The next MMCG meeting will take place on Monday, 17 June and will be hosted by Nordea.