EUROPEAN CENTRAL BANK

EUROSYSTEM

INDICATORS OF MARKET SEGMENTATION

MEDIA REQUEST FOLLOWING THE ECB PRESS CONFERENCE ON 2 AUGUST 2012

The ECB has been continuously monitoring the degree of fragmentation/integration in the euro area financial markets. The latest Financial Integration in Europe report, released in April 2012, showed several indicators pointing to rising fragmentation in various market segments as the sovereign debt crisis has escalated.

In particular for the money markets, the report stated that the cross-border secured and unsecured money market has become increasingly impaired. This is reflected, among other factors, in the pricing of risk in the repo market, which has become more dependent on the geographic origin of both the counterparty and the collateral, in particular when these stem from the same country. Although a number of Eurosystem measures, such as the three-year refinancing operations, have contributed to some convergence of repo market pricing across euro area countries, the price differentiation that started in late 2011 in repo markets based on euro area sovereign bonds can still be observed.

Other price-based integration indicators, such as the cross-country standard deviation of EONIA lending rates, also continue to show an elevated level of price differentiation even in the shortest unsecured money market maturities, although the degree of dispersion has declined significantly following the three-year operations.

In the bond market, the Financial Integration report identified a significant divergence of bond yields among the euro area sovereigns, which in the most intense phases of the sovereign debt crisis have overestimated the risk regarding some euro area sovereigns, leading to an overshooting of the respective yields. The Financial Integration report indicates that not only in the money market but also in covered and corporate bond markets country-level effects have gained significance in driving yield developments.

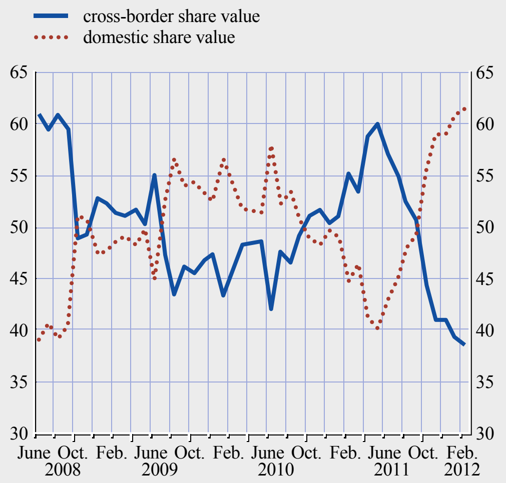
Additional factual and anecdotal evidence that has become available since the publication of the Financial Integration report continues to point to a high level of fragmentation in Europe's financial markets.

THE MONEY MARKET

- Recent analysis of TARGET2 data, aimed at identifying money market loans settled in this payment system (mainly unsecured loans), shows that since mid-2011 the share of cross-border money market loans in the overnight segment has steadily decreased in

Chart 1 Share of cross-border vs domestic overnight money market transactions in TARGET2

(percentages)



Source: ECB.

value terms. In February 2012 cross-border loans represented less than 40% of the money market vs. 60% in mid-2011.

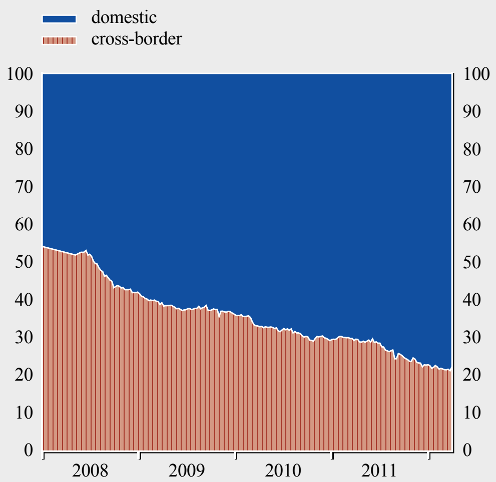
- Similarly, the ECB monetary financial institutions' (MFI) balance sheet data for end-June 2012 show that intra-euro area cross-border interbank lending (measured as a percentage of total assets) is at the lowest level since the start of the financial crisis in 2007. This contraction broadly characterises country developments across the euro area countries with reference to both cross-border loan claims and deposit liabilities.

- The increasing concentration of the recourse to Eurosystem liquidity-providing operations in some countries is a further illustration of the money market fragmentation. The usage of Eurosystem liquidity provision has increased substantially in Spain and Italy, especially since the start of 2012. Usage by banks in countries under a joint EU/IMF programme remains at elevated levels, while banks from highly rated euro area countries use the Eurosystem liquidity-providing operations only to a limited extent.

- Since the start of the financial turmoil, there has been a trend away from posting cross-border collateral towards a higher use of domestic collateral in Eurosystem liquidity-providing operations. This trend has intensified since the onset of the euro area sovereign debt crisis (see Chart 2). The use of a high share of domestic collateral can be attributed to an increasing "home bias" of investors and, to a lesser extent, to an increase in the use of self-originated marketable assets as collateral. In mid-2012 the share of cross-border use of collateral within the euro area stood at around 20% compared with around 50% in 2006.[1]

Chart 2 Domestic and cross-border use of collateral in Eurosystem monetary policy operations

(percentages)



Source: ECB.

- Recent anecdotal evidence suggests that international central clearing counterparties (CCPs), also in reaction to credit rating developments, might have indirectly contributed to the increase in price differentiation and fragmentation of the repo market by imposing additional margins on repo transactions depending on the geographic origin of the counterparty, the collateral or both, and by limiting the use of collateral based on the geographic criteria. This has created a further disincentive for cross-border activity in the secured money market.

- The growing significance of perceived country risk in the money market is also illustrated by the findings of an informal survey conducted among the major euro area banks represented in the ECB Money Market Contact Group in March 2012. It showed that country risk is the most significant consideration when assigning counterparty credit lines. 75% of the respondents said that they apply different haircuts to the assets in repo operations depending on the geographic origin of the counterparty. In addition, more than 60% of the respondents have operational restrictions on the euro area countries that are most affected by the sovereign debt crisis.

1 An asset is regarded as being used on a cross-border basis when the issuer and the counterparty reside in different jurisdictions.

THE SOVEREIGN BOND MARKET

- Domestic ownership of sovereign bonds, i.e. the so-called "home bias", has increased over the last few years. For instance, domestic ownership of Italian sovereign debt was about 65% in the first quarter of 2012 compared with about 58% in early 2009. The figures for Spain are even more striking. Domestic term investment holdings of Spanish government bonds increased from about 55% in early 2009 to almost 70% in early 2012.

BANK FUNDING AND LENDING

- In addition to the price-based indicators highlighted in the Financial Integration report, quantity-based indicators also continue to point to a further and significant fragmentation of euro area banks' funding markets based on their geographic origin. As a result, banks located in peripheral countries continued to lose market funding, while those in some other countries gained it and managed to issue bank debt at attractive yield levels. Nevertheless, the overall issuance by euro area banks for the year to date has been substantially below last year's level.

- The market for secured bank funding has also been affected by the increased tensions in some euro area government bond markets. In line with rising yield levels in some government debt markets, the secondary market yield spreads of secured bank bonds issued in those jurisdictions also experienced some upward pressure. This has made it even more difficult for issuers from those jurisdictions to become active in the primary market. However, covered bond secondary market yield spreads in several euro area countries have narrowed in parallel with the decline of their respective government bond yield levels, reflecting the fact that the increasing risk aversion is also prevailing in the market for secured bank debt.

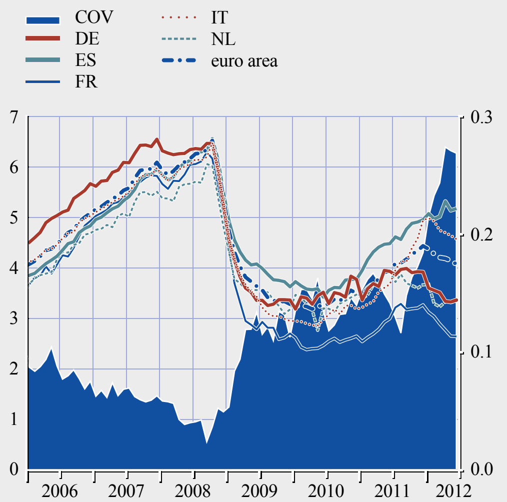
- The correlations between the yield levels of euro area bank bonds and those of the respective banks' sovereigns are elevated and have lately increased somewhat further, particularly in the peripheral economies. This reflects a spillover effect from the sovereign market to the banking sector funding costs and impairs the transmission of lower monetary policy interest rates to the real economy.

- The divergence in bank funding conditions is an important factor in the differences in MFI loan interest rates that banks offer to non-financial corporations and households. Similarly, the International Monetary Fund (IMF) recently stated that the pass-through of monetary policy to lending rates has weakened, especially in the periphery. Since late 2010, retail lending rates have started to rise, while policy rates have remained low. This is partly due to increased sovereign stress, as banks' wholesale funding and lending rates are priced off (domestic) sovereign yields.

- Regarding short-term loans to non-financial corporations in large euro area countries, the dispersion of interest rates on both small and large loans increased significantly in late 2008 and early 2009. Since mid-2011, dispersion in interest rates on both small and large loans has been increasing. In particular, short-term interest rates have tended to fall smoothly in Germany, France and the Netherlands, while they have increased in Italy and Spain (see Charts 3 and 4).

Chart 3 Short-term interest rates on small loans to non-financial corporations

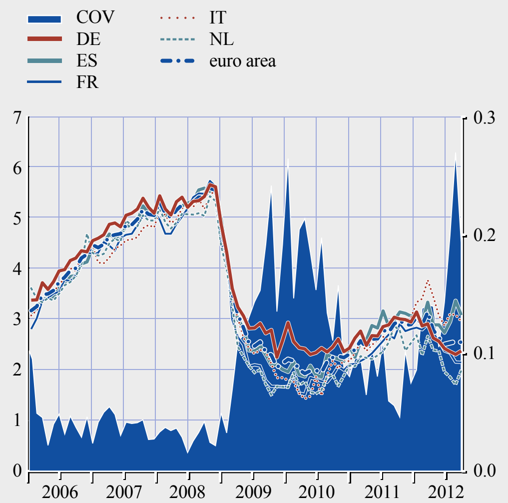
(percentages per annum; rates on new business)



Source: ECB.
Notes: Loans up to one year maturity, up to €1 million. COV stands for Coefficient of Variation. Last observation is June 2012.

Chart 4 Short-term interest rates on large loans to non-financial corporations

(percentages per annum; rates on new business)

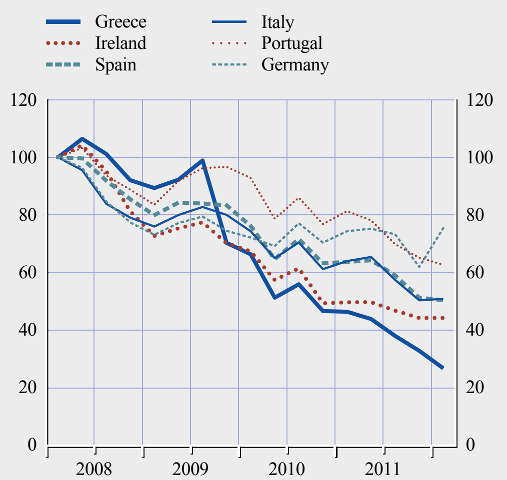


Source: ECB.
Notes: Loans up to one year maturity, over €1 million. COV stands for Coefficient of Variation. Last observation is June 2012.

- As a further indicator of market segmentation, the Bank for International Settlements (BIS) first quarter data showed that cross-border claims of European banks on EU/IMF programme countries and on Spain and Italy have decreased significantly since 2008. Meanwhile, cross-border claims on Germany rose sharply, reflecting safe-haven flows (see Chart 5).

Chart 5 Consolidated foreign claims (ultimate risk basis) of reporting European banks vis-à-vis selected countries

(Q1 2008 = 100)



Sources: BIS and ECB calculations.

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