EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS | ECB-PUBLIC

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ECB Money Market Contact Group

Tuesday, 13 June 2017, 13:00-17:30 CET, Piazza Gae Aulenti 3, Milan

UniCredit Tower A, floor 12, Room Pizzi Cannella

Summary of the discussion

1. Intraday liquidity management: four case studies on the management of intraday liquidity and market implications

Four Money Market Contact Group (MMCG) members, Michael Schneider, Ileana Pietraru, Johan Evenepoel and Peter Schmidt, presented the internal organisation of intraday liquidity management and monitoring in their respective institutions and the challenges and implications for market functioning and market participants' behaviour.

As part of the presentation, MMCG members provided a recap of the current regulatory framework, which, so far, has been limited primarily to monitoring tools. With regard to intraday liquidity management implemented by banks, the main objective was to manage liquidity in a smooth way, while minimising liquidity buffers. The maintenance of liquidity buffers came at a cost, which depended on internal assumptions and stress scenarios concerning how the liquidity buffer should be funded; e.g. in some banks it should be funded on a four-year horizon. Banks were looking into ways to integrate the costs of intraday liquidity into internal transfer pricing.

With regard to the outlook for intraday liquidity and its potential market impact, including in view of new developments in the area of payments and market infrastructure, MMCG members questioned how these developments would impact on the need for additional liquidity buffers, what would happen to the cost of liquidity buffers when the level of excess liquidity declined and how this would affect the cost of performing certain trades in the market which require liquidity buffers

2. Involvement of market practitioners in the area of payment systems and market infrastructures at the ECB

The ECB presented an overview of existing fora with market practitioners in the area of payment systems and market infrastructures at the ECB as well as the ongoing public consultations in this area. Some of the questions raised under Item 1 would be submitted for a discussion at a joint Advisory Group on Market Infrastructures for Payments (AMI-Pay) and MMCG workshop on the TARGET2/TARGET2-Securities (T2/T2S) consolidation consultation hosted by the ECB on 26 June.

3. Review of the latest market developments and other topics of relevance

(i) Recent developments in market expectations for the ECB's monetary policy and in market pricing

The MMCG reviewed recent developments in market expectations for the ECB's monetary policy, market pricing as well as main drivers of those changes. Franck Carminati and David Tilson introduced the discussion.

The MMCG noted that the market was no longer pricing in a downward bias in the ECB rates, as had also been confirmed by Mr Draghi in the latest ECB press conference. While market participants had been debating whether the ECB rates would be raised prior to the reduction of asset purchases, the market has recently adjusted its expectations and no rate hike was currently priced for the near future. Some market participants had hoped that the ECB might wish to seize the opportunity of a better economic environment to hike rates. In their view, this could reduce the adverse impact of negative rates on banks, while active purchase programmes would contain adverse market reactions. Some members mentioned that banks remained concerned about negative rates and profitability, noting difficulties in placing money in the market, especially as existing instruments matured and needed to be renewed.

With regard to the Eurosystem's asset purchase programmes, in the view of market participants, technical factors were increasingly restricting possible further extension of the purchases and the market was encountering scarcity, especially in German government bonds.

Finally, the market expected the excess liquidity to continue growing also in 2018, and it was not expected to decline until 2020/2021, i.e. until the repayment of TLTRO-II loans.

(ii) Market outlook for forthcoming quarter-end developments in the euro money market. Lessons from the end of March experience. Role of the Eurosystem's securities lending facility.

Based on market developments at the end of March, the MMCG discussed expectations for the end-June developments in the euro money market and the expected impact on bank funding and market liquidity. Harald Endres introduced the discussion. MMCG members reported good liquidity conditions in the repo market with less volatility in rates on the balance sheet reporting dates, in particular at the end of March. It is worth noting that the lowest repo rate levels at end-March were reached in Dutch and French collateral rather than in German repo trades. The occasional very negative levels of repo rates were related to the bonds which were cheapest to deliver for the bond futures contracts.

The high level of excess liquidity continued to weigh on repo rate levels; e.g. in some jurisdictions an increasingly larger share of repo trades were conducted below the ECB deposit facility rate with no adverse impact on trading volumes. At the same time, MMCG members reported lower fragmentation in repo rates across euro area jurisdictions. This was partly attributed to the Eurosystem securities lending arrangements and the adjustment of market behaviour towards expanding the range of acceptable collateral. While appreciating the much improved transparency of the Eurosystem, some MMCG members called for a more granular disclosure of securities lending data by the Eurosystem.

4. Developments in the FX swap market: evidence from MMSR data

Holger Neuhaus reviewed the main trends in FX swap market activity based on Money Market Statistical Reporting (MMSR) data. The data revealed resilient and increasing trading volumes in the FX swap market segment, which was in line with the secured market segment but in contrast to the unsecured market segment, which has contracted significantly over recent years. When looking at the geographical distribution of prices and volumes, the data suggested that the market is not displaying any major signs of fragmentation, either in terms of pricing or volumes.

A survey conducted among the MMCG members on the functioning of the FX swap market confirmed the analysis. MMCG members indicated that the FX swap market was generally estimated to be liquid and efficient. Furthermore, some MMCG members reported an improvement in FX swap market liquidity when swapping euro directly against other currencies. MMCG members confirmed the absence of geographical counterparty fragmentation in the FX swap market, which was attributed to the presence of continuous linked settlement (CLS) and credit support annexes (CSAs) which significantly reduced counterparty risk. The survey furthermore revealed that existing central bank swap lines also had an impact on market pricing by providing a cap to market rates.

5. Market reaction to the announcement of the results of the EURIBOR pre-live verification exercise and expectations for the future of euro money market benchmarks

Sascha Weil reviewed market reaction to the announcement by the European Money Markets Institute (EMMI) of the results of the EURIBOR pre-live verification exercise and market expectations for the future of euro money market benchmarks. The EMMI's announcement on 4 May that it would not be feasible to switch to a transaction-based EURIBOR methodology meant that the initial plan for the reform process as envisaged had been halted, and the EMMI suggested adopting a "hybrid" approach (i.e. a methodology supported by transactions when they were available, and relying on other pricing sources when they were not). MMCG members expressed some doubts whether a hybrid approach would meet all of the objectives, such as compliance with the Benchmark Regulation, being able to reflect market conditions and allowing a smooth transition from the existing EURIBOR benchmark without legal and contractual challenges.

MMCG members also expressed concerns about the EONIA benchmark in view of low trading volumes, which raises questions about its representativeness, and the fact that a substantial number of banks have left the EONIA panel over recent months. The remaining banks on the EONIA panel regretted those departures, as it would result in a higher contribution burden for a smaller number of panel banks.

The current contribution process was considered to involve significant costs (operational, regulatory) as well as reputational and litigation risks, which explained the departures of panel banks. Some MMCG members argued for regulatory support for the contributing banks in order to limit those risks.

Several MMCG members saw mandatory reporting and an enlarged panel of reporting banks as necessary prerequisites for supporting both the EURIBOR and EONIA benchmarks, although some members were sceptical whether this would be possible under the current Benchmark Regulation. Such mandatory reporting would allow the work to continue under an alternative approach. However, no matter which alternative approach were adopted, the smooth transition of existing contracts was considered to be challenging and the private sector called on public authorities to be involved in supporting contract continuity.

The ECB representatives encouraged the EMMI and the banks to endeavour to reform the existing EURIBOR and EONIA benchmarks and to develop their own solutions for providing benchmark rates. However, in view of the potential financial stability repercussions and the impact on the transmission mechanism of monetary policy that could result from the absence of reliable benchmarks, the Eurosystem stood ready to investigate the possible provision of an unsecured overnight benchmark based on data already available to the Eurosystem. Such a benchmark might serve as an alternative reference rate in the event that market participants were unable to sustain similar types of benchmarks. The ECB representatives emphasised that this would not address the market need for reference rates spanning tenors longer than overnight. In the light of this, the hybrid approach proposed by the EMMI seemed to be currently the only feasible way forward so far. The private sector was encouraged to put sufficient effort into the hybrid approach to forestall the consequences of the absence of reliable benchmarks. The Benchmark Regulation sets a clear deadline of 1 January 2020 for the critical benchmark rates to be successfully reformed. After that date, current benchmarks that are not deemed to be compliant with the Regulation will no longer be able to be used in contracts.

The International Swaps and Derivatives Association (ISDA) is currently working on a fall-back solution should EURIBOR/LIBOR no longer exist and, in this context, overnight rates are being considered in particular. However, the ISDA's initiative covers only part of the contracts linked to EURIBOR. They do not remove the need for EURIBOR reform and the issue of a successor of the current EURIBOR still needs to be addressed.

6. Planning of the next meeting

The next meeting of the MMCG will take place on 26 September 2017 in Frankfurt.