

Box 2

RECENT DEVELOPMENTS IN REPURCHASE AGREEMENTS

The decline observed in annual M3 growth since the intensification of the financial turmoil has been driven mainly by the deceleration seen in short-term time deposits and marketable instruments such as repurchase agreements (henceforth “repos”). In fact, since October 2008 the deceleration in repos has contributed more than 1 percentage point to the decline in annual M3 growth, which is fairly substantial for a component that accounts for only 3% of the stock of M3. Against this background, this box reviews recent developments in repos and puts them into perspective with regard to the current interest rate configuration.

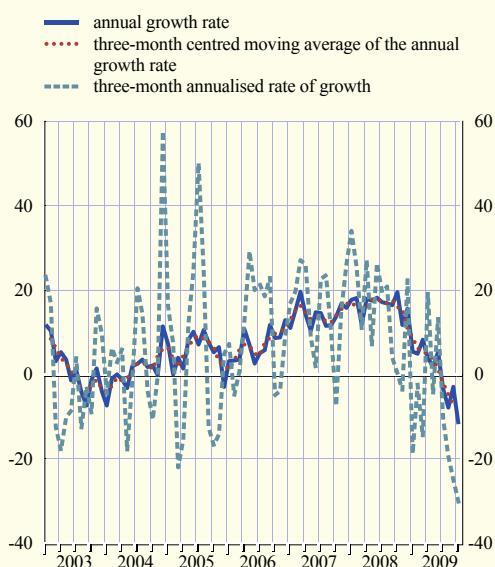
Repurchase agreements and interest rate developments

A repo represents a special form of deposit, as it simultaneously constitutes both a deposit and a collateralised loan. It is, therefore, a twofold transaction, comprising the sale of a security (or a basket of securities) by one party to another party for cash on the initiation date, with the added condition that these assets will be repurchased at a later date established in advance. The main advantage is the high level of security that it offers to the lender in the event of the borrower defaulting, as the risk is covered by the collateral received.

Market participants can be expected to use repos mainly to acquire funds or to put funds to use for short periods. This can help to explain why repos are the most volatile component of M3, with that volatility extending even to their annual growth rates. However, looking beyond this volatility – by focusing on a three-month moving average of the annual growth rate – indicates that there has been a sustained and marked deceleration since the last quarter of 2008, with negative annual growth rates being recorded in October 2009 (see Chart A).

Chart A Repurchase agreements

(percentage changes; adjusted for seasonal and calendar effects)

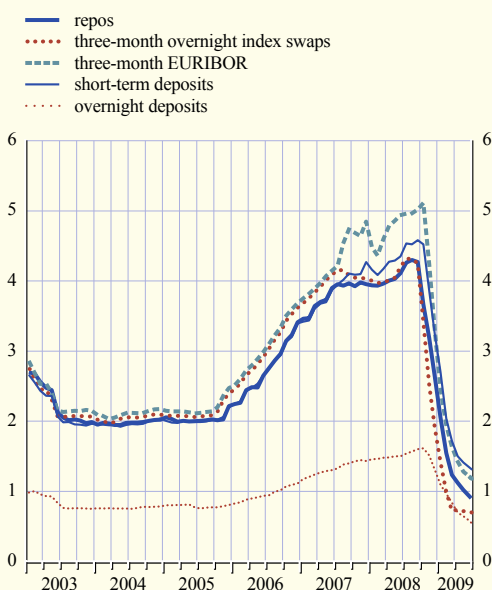


Source: ECB.

This decline in the growth rate – and, more recently, outstanding amounts – of repos is in line with developments in market interest rates and their pass-through to retail banking rates (see Chart B). Indeed, the remuneration of repo transactions conducted with households and non-financial corporations has declined in line with the EURIBOR and overnight index swap rates. Interestingly, since the start of the financial turmoil there has been a high degree of co-movement between the remuneration of repos and that of secured interbank lending (i.e. the rates on three-month overnight index swaps), while the remuneration of short-term deposits has been closer to that of unsecured interbank lending (i.e. the three-month EURIBOR). This decoupling and the resulting relative increase in the remuneration of

Chart B Selected bank retail rates and money market interest rates

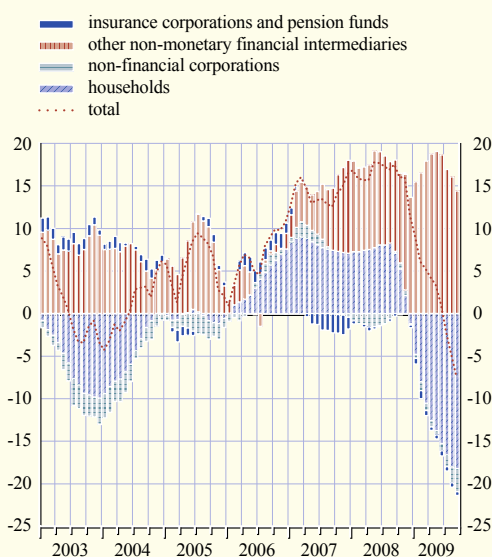
(percentages per annum)



Source: ECB.
Note: Data on repos, short-term deposits and overnight deposits are annualised agreed rates applied to the household and non-financial corporation sectors.

Chart C Developments in repurchase agreements and sectoral composition

(annual percentage changes and percentage point contributions)



Source: ECB.

short-term deposits has probably had a negative impact on holdings of repos, especially after governments announced guarantees on households' bank deposits. Moreover, having widened significantly between the start of 2005 and mid-2008, the spread between the remuneration of repos and that of overnight deposits has since declined substantially. Thus, the relative remuneration of repos has fallen markedly since mid-2008 and stood close to zero in the third quarter of 2009.

Developments in sectoral holdings of repurchase agreements

From a sectoral perspective, repos are held mainly by households and by non-monetary financial intermediaries other than insurance corporations and pension funds (OFIs). Since 2004 the holdings of these two sectors have averaged 25% and slightly more than 50% of total outstanding amounts respectively. The decline seen in the annual growth of repos since the last quarter of 2008 can be explained mainly by the strong reduction observed in households' holdings of this instrument, with the value of those holdings declining by more than €60 billion in the year to October 2009 (see Chart C). This is in line with the declining spread between the remuneration of repos and that of overnight deposits (and thus the falling opportunity cost of more liquid holdings).

It should be noted that the size of sectoral repo holdings tends to differ strongly across the various countries of the euro area, with the result that country-specific developments can have a large impact on figures for the euro area as a whole. For instance, most of the changes in households' repo holdings tend to reflect developments in Italy, where repos are typically held as an alternative to time deposits, having both an attractive level of remuneration and advantages in terms of fees.

By contrast with households, substantial inflows have, overall, continued to be recorded for repos held by OFIs. These inflows have totalled

around €40 billion over the past 12 months and have offset part of the reduction in households' holdings. Although these inflows appear to have declined somewhat in the last few months, the past strength of OFIs' accumulation of repos is fairly striking, as OFIs' portfolio allocation is typically very strongly (and immediately) influenced by remuneration considerations. Two factors should be considered in this respect. First, OFIs may be more inclined to use secured deposits in the form of repos while financial tensions persist, a factor that is not as relevant for households given that their bank deposits are covered by deposit insurance schemes (within certain limits). Second, repos held by OFIs also include interbank repo transactions – often associated with electronic trading – that are cleared by a central counterparty.¹ Increased activity on such platforms (as observed in 2005, for instance) can have a strong impact on the volatility of the repo series and may make it more difficult to ascertain the activities of the OFI sector itself. During the financial turmoil banks may have had more recourse than usual to such secured trading. Looking at individual countries, most of the operations conducted through a central counterparty are taking place in Germany.

In MFI statistics, an operation conducted through a central counterparty is accounted for in two ways: (i) as a loan in the institution providing liquidity; and (ii) as a repo deposit in the institution receiving that liquidity. Thus, they have an impact on M3 developments, although they should not be regarded as purely monetary developments. Indeed, pure over-the-counter repo transactions between two MFIs do not have an impact on monetary developments. In that sense, it could be argued that these counterparties should be removed from the money-holding sector, thereby removing their deposits with MFIs from the monetary aggregates. However, it is not yet statistically possible to single out such counterparties.²

Overall, recent developments in repos mainly reflect changes in market interest rates and the remuneration of such instruments relative to other forms of deposit. At the same time, the financial turmoil may have given rise to some offsetting factors given that repo transactions are collateralised and given that interbank repo transactions cleared by central counterparties are included in the repo holdings of the OFI sector.

1 See “The role of other financial intermediaries in monetary and credit developments in the euro area”, ECB Occasional Paper No 75, October 2007, p.17.

2 However, as of June 2010 it will be possible to isolate repo-related business conducted through central counterparties, following the entry into force of an updated statistical regulation on the reporting of MFI balance sheet data (Regulation ECB/2008/32).