EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS | ECB-PUBLIC

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ECB Money Market Contact Group

Frankfurt am Main, Tuesday, 14 March 2017, 13:00 – 17:00 CET

Summary of the discussion

1. Endorsement of the Money Market Contact Group (MMCG) Terms of Reference

MMCG members will be given additional time to approve the final version of the MMCG Terms of Reference, which will subsequently be published on the MMCG web pages.

2. Results of the MMCG survey on MMCG functioning

Julija Jakovicka presented key points from the MMCG members' feedback and how suggestions for improvement had been incorporated into the MMCG work programme for 2017. MMCG members will be asked to provide their comments on the work programme via written procedure and to select items that they would like to present in 2017.

3. Review of recent developments in euro money market activity. Presentation of the main results of the quarterly MMCG euro money market survey and additional insights from the ECB's Money Market Statistical Reporting (MMSR) data on euro money market turnover

The results of the MMCG survey showed a general increase in euro money market turnover in the fourth quarter of 2016 (+3.4%), led by the secured segment (+4.7%), whereas the unsecured market had recorded a 2.1% decline. With regard to the outlook for the forthcoming quarters, there were split views among MMSR members on whether the TLTROII operation to be allotted in March would lead to a decline in the short-term funding needs or whether, instead, it would crowd out some of the longer-term issuance in the three to five-year segment.

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

(i) Drivers of the year-end developments in the euro money market and market functioning at the year-end reporting dates

The euro money markets exhibited some unprecedented moves at the end of 2016 that were attributed to a combination of factors. First, various regulatory and reporting requirements had resulted in a surge in banks' balance sheet costs, limiting their ability to engage in transactions over the year-end. As a result, this rendered those transactions either very costly – thus explaining the very negative levels of repo rates over the year-end – or non-existent, as some banks were facing very limited flexibility to adjust their balance sheets over the year-end and ran down their activity in general. Second, the large amount of surplus liquidity in euro resulted in a higher demand for secured cash investment, boosting the demand for repo. Finally, the balance sheet monitoring dates had a large impact for non-banks, e.g. cash-rich investors often had a mandate to invest in certain names and/or certain securities at the quarter-ends. Similarly, an ICMA study attributed the year-end 2016 developments to three main factors: a shortage of highly liquid assets, market positioning and the reduced ability of banks to intermediate in the market. Notwithstanding the large volatility, a number of MMCG members concluded that despite the very expensive levels, the repo market had remained functional.

The year-end volatility and premia priced in in the FX swap market surpassed those in the repo market and were evidenced across most major currencies against the US dollar. This was attributed to several drivers, such as the shortage of the US dollar in the market and the absence of US dollar liquidity providers outside of the United States. The volatility was exacerbated by the fact that the FX swap market was seen as the main backstop for sourcing US dollars on the financial reporting dates in the off-shore markets due to its balance sheet efficiency. MMCG members mentioned balance sheet restrictions as the main factor preventing banks from obtaining US dollar funding via other sources.

Some MMCG members argued that the tensions to be expected over subsequent year-ends would probably be more limited, as banks would have a clearer view on their breakeven costs for the year-end transactions and would be able to arbitrage away very extreme moves.

(ii) Recent developments in the euro area repo markets: main drivers

Since the start of 2017, the euro area repo market had been affected by a number of drivers but, unlike other financial market segments, the recent market volatility had had no major impact on it. Furthermore, repo market volumes had increased lately on the back of both the recent steepening of the bond yield curve and misalignments between the General Collateral (GC) and non-GC rates, which had led to an increase in investors' positioning and activity in the repo market. The current level of repo rates might have made it attractive to bond holders seeking to benefit from additional income. The bid for collateral had remained strong, both among investors searching for high quality assets and among those needing to invest liquidity.

Eurosystem asset purchases have an impact on the availability of collateral, but the magnitude of this depends on the size of the purchases compared to the size of the bond market, which might explain the widening of the repo spreads between euro area countries.

MMCG members voiced some suggestions for possible enhancements of the Eurosystem securities lending programme in order to increase its effectiveness.

(iii) Developments in the FX swap market and drivers of the recent narrowing of the US dollar basis

The US dollar premium had normalised after the year-end and had narrowed to levels last observed in May 2016. The magnitude of the narrowing had come somewhat as a surprise for market participants, in view of the continuing divergence of monetary policies between the United States and the euro area. Although the monetary policy outlook in the euro area had shifted somewhat, this was not seen as the main driver of the spread narrowing and the following drivers were discussed. First, reserve managers and sovereign wealth funds are reportedly more inclined to lend out their US dollar holdings at times when their domestic currencies are appreciating. Second, the measure of the credit premium, the FRA-OIS spread, had declined significantly for the US dollar, reducing the gap versus comparable measures of credit premia in the euro market. In market participant's view this was usually closely correlated with the developments in the US dollar FX swap basis against the euro. Among other factors, lower issuance of US government debt might also have contributed to the narrowing, as well as higher increased supply of US dollars stemming from the high net issuance activity in US dollar-denominated paper by European investors in January and February, which had thereafter been swapped into the euro.

One MMCG member noted that the flows related to the US tax repatriation plan were not expected to take place in the coming three to six months. The forthcoming March quarter-end was expected to result in a high US dollar premium in the FX swap market, but it was expected to be smaller than at the end of 2016.

(iv) Impact of political developments in Europe on the euro money market

Political developments had been one of the main drivers of the French sovereign bond market over the past months, with some spillover effects to other jurisdictions. However, euro money markets had seemed to be well shielded from the developments in the sovereign bond markets. In the repo market, the repo rates for cheapest-to-deliver collateral had temporarily declined to deeply negative levels, which was seen as indicative of investors' positioning in the bond futures market, but they subsequently recovered to their previous levels.

5. Intraday liquidity management: framework, initial market feedback. Recent developments in the payment system infrastructure and their implications for intraday liquidity management

Stefano Perin (SSM) presented the regulatory framework for intraday liquidity management, while pointing out that monitoring tools still need to be developed centrally. He recalled the objective of the framework and also highlighted the impact of the rules on both direct market participants and related correspondent banking activities. The impact was expected to be seen in collateral availability and the opportunity cost of additional liquidity buffers.

Olivier Hubert (Natixis) presented a market perspective on intraday liquidity monitoring. In the subsequent discussion, MMCG members indicated a number of issues that could arise with regard to intraday liquidity management. First, the impact on correspondent banking is particularly relevant, as it is outside the direct control of market participants using correspondent bank services, but it may impose restrictions on their business activity due to additional requirements for pre-funding and additional collateral, as correspondent banks have reduced the availability of intraday credit. Second, the impact in terms of higher collateral buffers would come as an additional cost, although the impact could be transitory if other initiatives, such as T2S, result in lower collateral needs in the future. Third, MMCG members pointed out that the cost of additional liquidity buffers could rise significantly in an environment with a less abundant excess liquidity surplus.

Sylvain Debeaumont (ECB) presented the anticipated developments in financial market infrastructure, such as Target Instant Payments Settlement (TIPS) and the new real-time gross settlement (RTGS) services, which were expected to have an impact on intraday liquidity management. The modalities of these innovations were still at the development stage and the market consultation was envisaged for May/June 2017. MMCG members emphasised the potential costs for the banks in terms of the need for higher liquidity buffers and expressed a preference for having the possibility to pool liquidity across various accounts in order to minimise the segregation of buffers.

6. Update on the global FX code

The item was postponed.

7. Presentation of the work programme of the Operations Managers Group

The feedback will be collected by means of a written procedure.

8. Planning of the next meeting

The next meeting of the MMCG will take place on 13 June 2017 in Milan.