EUROPEAN CENTRAL BANK

EUROSYSTEM

DG Market Operations
Money Market and Liquidity Division

ECB-PUBLIC
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Meeting of the Money Market Contact Group (MMCG)

Frankfurt am Main, Tuesday 26 September 2017, 15:00-19:00 CET

SUMMARY

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

(i) Market expectations regarding the ECB's monetary policy and policy measures, future developments and key drivers

Market expectations had been shaped by ECB officials' comments, political developments and global central banking trends. The next major event was the ECB's expected announcement in October regarding its asset purchase programmes. MMCG members noted that since the last MMCG meeting, the tone of the ECB's commentary had been regarded as hawkish on the back of ECB President Draghi's speech in Sintra in June. In July, market expectations had been partly reversed, amid low levels of liquidity over the summer and geopolitical uncertainty relating to developments in North Korea. At the time of the meeting, the market was focused primarily on the expected announcement relating to the ECB's asset purchase programmes following the Governing Council meeting in October. Market expectations had, to some extent, been shaped by an article published by Reuters about possible tapering options, which had cited unofficial ECB sources. Most market participants expected that purchases would continue beyond the middle of next year. As regards the ECB's official policy rates, market pricing suggested that these were not expected to be in positive territory until end-2019. In terms of potential drivers of market developments in the near future, MMCG members mentioned the German elections and their implications for European integration, as well as developments in France, core inflation, the exchange rate and monetary policy actions by other major central banks.

Members also touched on a number of other issues, such as low inflation and whether lagging inflation had become a new normal or was just a temporary phenomenon in view of changing trends in consumption.

(ii) The forthcoming quarter-end: expected market impact and market behaviour

MMCG members reported improvements in the functioning of the repo and FX swap markets – both in general and in the run-up to the end of the third quarter at end-September. Some longer-term trades had been reported in preparation for quarter-end, but most members agreed that the majority of trades remained very short-term maturities. Members also reported signs that market participants' balance sheets had an increased capacity to carry out repo trades. Amid other signs of improved market functioning, the number of fails in the repo market had declined, which was attributed to new market rules that allowed the cost of fails to be charged to the failing counterparty.

Members reported increasing demand for securities lending in the market, which was seen as a function of the ongoing asset purchase programmes, rather than a result of the forthcoming quarter-end. Overall, the increased demand for securities lending was also indicative of the limited demand for cash in the market in the presence of high levels of excess liquidity, increased balance sheet efficiency and market demand for collateral swap trades for collateral eligible under the Liquidity Coverage Ratio (LCR).

Members also reported on ongoing market preparations for year-end and the prefunding of year-end needs in view of the developments witnessed at the end of last year. It was felt that those developments had, in part, been driven by a number of special factors which would not affect the market at end-2017, such as certain market positioning, restricting balance sheet capacity), the Eurosystem's less developed securities lending facilities, and the limited preparations made by the market as a whole.

2. Guest speaker from the asset management industry – Union Investment

Christian Kopf, Head of Fixed Income Portfolio Management at Union Investment, had been invited to discuss the impact that the current market environment and negative interest rates were having on the business of Union

Investment Group and the way that the firm's investment funds operated in the money market and made use of money market products.

Asset managers reported successful ways of dealing with the negative interest rate environment. The guest speaker introduced the MMCG to the asset management industry in Germany, talking about the four big players in the market and explaining how the negative interest rate environment had affected the industry. The industry had initially expected outflows, but it had subsequently managed to attract new customers and deliver attractive – albeit negative – rates of return, which remained favourable considering the other alternatives available to certain customers (such as large corporate clients). Another niche available to asset managers was the provision of services to corporations that wished to outsource their treasury functions in order to benefit from economies of scale in the management of their liquidity buffers.

Some concerns were raised regarding the liquidity of certain market segments and potential financial stability implications. The guest speaker was somewhat concerned that, in the current environment of negative interest rates and considerable excess liquidity, the levels of activity in some segments of the commercial paper market had declined strongly. In his view, those less liquid markets could pose a financial stability risk, as markets were no longer used to trading in such instruments.

3. Research paper on the cross-currency basis

Oliver Deutsche presented the main findings of a research paper by DZ Bank on the cross-currency basis.

MMCG members showed great interest in this comprehensive analysis, adding that although the cross-currency market could at times be difficult to predict, it also reflected the balance of liquidity in each currency area. Members noted that as the ECB had supplied more and more liquidity via its asset purchase programmes, the premium for USD funding in the FX swap market had increased.

4. Intraday liquidity management: internal liquidity buffers

Several MMCG members talked about issues relating to the internal organisation of intraday liquidity management and monitoring at their respective institutions (such as the cost of liquidity buffers).

Members agreed that intraday liquidity was not a problem given the current high levels of excess liquidity, which had reduced the need for hands-on management. This was supported by the fact that liquidity buffers had also been established for other purposes, such as the LCR.

Nevertheless, liquidity buffers remained costly, especially for those banks which relied on retail deposits for regulatory ratios, as they continued to be remunerated at an interest rate of zero and were weighing on banks' net interest margins, making banks entirely dependent on fees for their profitability.

Intraday liquidity management was expected to become more challenging with the introduction of the TARGET Instant Payment Settlement (TIPS) service if this entailed additional adjustments to liquidity balances at certain times. Members also mentioned that some countries would be introducing national instant payment systems in the fourth quarter of next year, independently of the ECB initiative. The MMCG would monitor those countries to see how banks adjusted to those new developments.

5. The impact of the Net Stable Funding Ratio (NSFR) on banks' liquidity management and the functioning of the market

Several MMCG members raised issues relating to banks' implementation of the NSFR and the implications for both the functioning of the market and market participants' behaviour.

Members pointed out a number of areas where the current regulatory requirements relating to the NSFR could have unintended consequences for the functioning of the FX swap market and the repo market and could be inconsistent with the treatment of money market instruments under other regulatory ratios, such as the LCR.

On the subject of the repo market, some concerns were expressed regarding the asymmetry between the treatment of repos and reverse repos and the likely impact on the market. This also concerned the transfer of liquidity across individual banking groups using short-term repo instruments. In addition, in view of the large percentage of repo trades taking place in the short-term segment of the market, MMCG members feared a particularly negative impact on the most traded repo market segment, as some market participants could potentially withdraw from the market.

According to MMCG members, the costs of the NSFR had not yet been passed on to customers, which was why those unintended effects had not yet been reflected in the data. Members reported that the current high levels of excess liquidity were also mitigating those negative effects somewhat.

6. Update on money market benchmarks and the ongoing reform process

Patrick Chauvet from BNP Paribas updated members on the LIBOR reforms, following the speech by FCA Chief Executive Andrew Bailey regarding the end of public support for the LIBOR panels after 2021 and the possible discontinuation of the LIBOR benchmarks after that point in time.

MMCG members welcomed the latest announcements regarding the ECB's new unsecured overnight rate and the new working group on euro risk-free rates. On the subject of the new unsecured overnight rate, which is to be launched by the ECB by 2020 in order to complement existing benchmarks and will be based on MMSR data, the ECB explained that market participants would be able to provide feedback on the high-level features of the new rate via several rounds of public consultations. Moreover, the announcement made by several public authorities (the ECB, the European Commission, Belgium's FSMA and the ESMA) regarding the launch of a working group on euro risk-free rates was also regarded as a positive development, as it would facilitate debate on the future of benchmarks in the euro area and issues relating to transition to new or reformed benchmarks. The ECB indicated that more detailed information on the selection procedure for working group members and the mandate of the working group would soon be published on a dedicated web page.