EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

3 April 2020

ECB Money Market Contact Group (MMCG)

Tuesday, 24 March 2020, 13:00-15:15 CET

Webex conference

Summary of the discussion

1) Money market assessment of asset managers and investment funds

Olivia Maguire – Chair of the Institutional Money Market Funds Association Investment Committee – was invited as a guest to present an overview of the money market situation from the perspective of the money market fund (MMF) industry.

MMFs were usually managed in a way that enabled them to cover clients' outflows with their own resources. They were in a position to do this because they had substantial cash holdings and invested most of the non-cash portfolio in short-term securities. Typically, cash represented 20%-30% of MMFs' portfolios, and average daily net outflows represented less than 2% of the total assets. In addition, 15%-20% of the non-cash portfolio was invested in short-term securities (i.e. commercial paper (CP) and certificates of deposit) with a maturity below one week, while another 35%-50% was invested in securities with a maturity of between one week and three months. The natural redemptions of these short-term investments therefore complemented cash holdings. This meant that MMFs generated their own liquidity in a more efficient manner than by liquidating long-term assets, as these liquidations were exposed to market risk.

However, owing to the coronavirus (COVID-19) crisis, non-financial corporations (NFCs) were now looking for large amounts of cash, obliging MMFs to either sell assets in the secondary market or rely on banks' willingness to buy back their own CP before redemption to generate sufficient cash to honour NFCs' cash outflows. NFCs held around 30% of MMFs' shares/units, and large withdrawals from NFCs led to a substantial increase in MMFs' liquidity needs. Pressures on MMFs' liquidity would be alleviated if banks were to purchase MMFs' CP in the secondary market or buy back their own short term debt so as to either prevent deterioration in the price of these securities or benefit from the price reaction (buying below par).

In the MMCG's view, if the liquidity situation of MMFs were to become a systemic problem, there could be spillover effects on banks. However, MMCG members said they considered that banks were currently not in a position to solve the liquidity difficulties of MMFs, as they were also subject to liquidity outflows from corporate clients as a result of working capital requirements and drawdowns on existing credit lines. They argued that MMFs should preferably address their liquidity issues through funding in the euro repo market or funding from central banks, stating that even though the repo market for euro funding was liquid, MMFs were subject to regulations restricting them to entering into repo transactions only on a temporary basis, i.e. for no more than seven working days, and solely for liquidity management purposes (i.e. not for investment purposes). In addition, such repo transactions were restricted to 10% of their assets. Funds might also be prohibited if the transaction was considered leverage by national competent authorities.

2) Current euro and US dollar money market conditions and assessment of ECB actions

René Brunner (Erste Group Bank), Harald Bänsch (UniCredit Bank), Bineet Shah (Barclays Bank) and David Tilson (Bank of Ireland) summarised the main developments that had taken place since the start of the COVID-19 crisis. They also provided an outlook for the money markets in the coming weeks.

The MMCG noted the improvement in market conditions after the central banks' decisive actions. Euro money markets had calmed down and volatility had declined, as market participants had been reassured to see the funding provided under the central banks' new operations being tapped. The swap lines activated the previous week had also achieved their objective of smoothing offshore US dollar funding stress in short tenors, which had been the segment of the market suffering the largest liquidity strains. However, there was still pressure on US dollar term funding.

The MMCG noted that the new ECB asset purchases and lending operations would cause a large increase in excess liquidity in the system. An excess liquidity level above €3 trillion by the end of 2020 would lead the market to speculate about an increase in the two-tier system multiplier. In the view of MMCG members, further rate cuts would have detrimental effects on banks, and larger tier-two multipliers would not counteract these effects.

MMCG members stated that the bridging longer-term refinancing operations (LTROs) provided at the deposit facility rate (DFR) were an efficient means of insuring their liquidity positions. The terms of the series of bridging LTROs allowed banks to boost their liquidity buffers without negative revenue implications, as the pricing at the DFR created a liquidity buffer at almost no additional cost. Such precautionary liquidity buffers were needed to anticipate potential drawdowns by banks' corporate clients on their credit lines.

All of the changes to the third series of targeted longer-term refinancing operations (TLTRO III) were welcomed except for the new lending benchmark horizon starting in April 2020. The MMCG praised the decision to allow outstanding TLTROs to benefit from a temporary interest rate reduction (down to a minimum of the average DFR minus 25 basis points) during the period from June 2020 to June 2021. They welcomed the fact that the borrowing allowance had been increased from 30% to 50% of the stock of eligible loans and that the bid limit per operation had been lifted. They also welcomed the fact that the lending performance threshold had been reduced to 0% (from 2.5%) and that the early repayment option would now be available one year from settlement instead of two years, starting in September 2021. In the view of the MMCG, the combined package was enough to prevent a lock-in if conditions swiftly improved. The incentives provided by the design of TLTRO III would also ensure that the funding cost relief reached the targeted sectors. The incentive for banks not to deleverage was determined by the steepness of the decline in the borrowing rate and the stimulus concentrated on the upcoming months. However, MMCG members criticised the fact that the new lending performance would be evaluated over a period starting in April 2020. In the first weeks of the crisis, banks had already satisfied a huge requirement for credit line drawdowns on the part of their corporates' clients. Choosing a starting point at the likely peak of the loan portfolio therefore made fulfilling the conditions regarding lending performance very challenging. MMCG members would have preferred lending performance to be assessed against an earlier, less demanding threshold so as to take the ongoing deterioration in economic conditions into account. Given that Decision ECB/2020/13[1] did not introduce changes in the interest rate or lending performance threshold, but only addressed the borrowing allowance and the earlier repayment option, the MMCG made a plea for this issue to be reviewed if still possible. It was also reported that small banks lacking the infrastructure to meet the notification requirements would appreciate a simplified process that encouraged the participation of less significant institutions specialising in lending to local small and medium-sized enterprises.

The MMCG urgently called for collateral easing measures, saying that such measures were needed to enable sufficient access to the new ECB funding options and should be aimed at unlocking additional parts of banks' balance sheets. According to MMCG members, liquidity remained a problem. ECB actions had been effective in calming market prices but not in restoring liquidity, as only repo funding remained fully liquid. Unsecured market funding was only open to banks with access to central bank funding and sufficient eligible assets. The problem was expected to worsen, as current eligible collateral was insufficient to replace unsecured outflows (i.e. deposit withdrawals, working capital drawdowns by corporate clients) with secured inflows (central bank

[1] Decision (EU) 2020/407 of the European Central Bank 16 March 2020 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2020/13) (OJ L 80, 17.3.2020, p. 23).

funding or repo borrowing), while marketable assets were susceptible to valuation losses (owing, for instance, to repricing and the risk of rating downgrades). MMCG members also said that collateral easing should be harmonised across jurisdictions in terms of the amount and composition of eligible collateral, making for a more level playing field.

MMCG members put forward three proposals for collateral easing measures: (1) temporarily lowering the credit quality requirements (by one or two notches) and/or lowering haircuts; (2) increasing the concentration limit for unsecured bank bonds; (3) making individual loans eligible in all jurisdictions with a common framework and with a manageable operational burden. The individual loans that should be accepted would include (i) loans below €500,000, (ii) loans with a residual maturity longer than five years, (iii) loans denominated in US dollar, and (iv) loans assessed by the former Eurosystem internal rating system. Finally, some MMCG members said they were in favour of introducing an unsecured ECB funding line.

3) Development of the euro short-term rate (€STR) benchmark

Maria Cristina Lege (Intesa Sanpaolo) reviewed the main developments in the unsecured segment of the euro money market and the evolution of the business based on the new €STR benchmark rate since the start of the COVID-19 crisis.

There had been a slight increase in volumes and rate of the €STR benchmark. MMCG members attributed additional liquidity flows into banks mainly to the recent developments affecting MMFs. They expected the trend of increasing volumes of €STR-linked trades to continue. They also believed that the switch by central counterparty clearing houses to a €STR discounting regime (instead of using the euro overnight index average curve) would be the most significant event in 2020.

List of participants

Money Market Contact Group meeting

Participant's organisation	**Name of participant**
Bank of Ireland	Mr David Tilson
Barclays Bank	Mr Bineet Shah
Bayerische Landesbank	Mr Harald Endres
BBVA	Mr Fernando Soriano
Belfius Bank & Insurance	Mr Werner Driscart
BNP Paribas	Mr Patrick Chauvet
BPCE/Natixis	Mr Olivier Hubert
Caixabank	Mr Xavier Combis Comas
Caixa Geral de Depósitos	Mr António Paiva
Commerzbank	Mr Andreas Biewald
Coöperatieve Rabobank U.A.	Mr Frank Beset
Deutsche Bank	Mr Jürgen Sklarczyk
DZ Bank	Mr Michael Schneider
Erste Group Bank	Mr René Brunner
HSBC	Mr Harry Gauvin
ING	Mr Jaap Kes
Intesa Sanpaolo	Ms Maria Cristina Lege
LBBW	Mr Jan Misch
Nordea	Ms Jaana Sulin
Société Générale	Ms Ileana Pietraru
UniCredit Bank	Mr Harald Bänsch
European Central Bank	Ms Cornelia Holthausen (Chair)
European Central Bank	Mr Helmut Wacket
European Central Bank	Ms Maria Encio (Secretary)
JP Morgan Asset Management	Ms Olivia Maguire (item 1 guest)