DG MARKET OPERATIONS 14 September 2010

**Money Market Contact Group**

Frankfurt, Tuesday 8 September 2010, 16:00 – 19:00

# SUMMARY OF THE DISCUSSION

## 1. The Basle Committee's proposal for an international liquidity risk framework

Jeroen Lamoot (ECB) provided an overview of the latest developments as regards the Basel Committee's proposal for an international liquidity risk framework.

Jeroen's presentation was structured as follows: i) a recap of the December consultative document on the liquidity risk framework; ii) the industry reactions to the proposal; iii) the results of the Quantitative Impact Study; iv) the recent agreement of the Governors and Heads of Supervision on a) the Liquidity Risk Coverage Ratio and b) the Net Stable Funding Ratio; and v) the next steps and the way forward.

The subsequent discussion focussed on the changes recently agreed by the Group of Governors and Heads of Supervision (GHoS) and revealed that members of the group were generally quite satisfied with the amendments, in particular the lowering of some run-off rates and the introduction of a rather long transition phase.

At the same time there was also some concern that the relatively long transition period could lead to the persistence of national differences of liquidity rules during these years, as some national regulators might want to introduce the new rules earlier than the deadline, while others might introduce some intermediate and/or additional steps in the implementation, while yet again some others might decide to go beyond the commonly agreed minimum standards. Jeroen acknowledged that this might indeed be a possible scenario, although national regulators are of course fully aware of the desirability to have a harmonised implementation schedule and CEBS/EBA is also working on ensuring a harmonised implementation. Another factor that could be regarded in this respect is the so-called "market pressure", i.e. the assumption that the market will almost immediately view these new requirements as a minimum standard and thus pressure banks to comply with this standard earlier than foreseen in the official timeframe.

Another question that was raised was how the adjusted Basel proposal would interact with the planned timeline for the CRD IV at the European level; Jeroen assured members that the European Commission was currently working to harmonise the liquidity risk implementation schedule within the CRD IV with the Basel proposal so that the two timeframes will look rather similar in the end. The final implementation will, however, also depend on the legislative process at the European Parliament and the Council.

There was also some debate about the relative attractiveness of short-term versus long-term funds, with many members mentioning that sight deposits would become rather unattractive for banks, which seemed likely to be reflected in a lower remuneration in the future. Apparently some banks have already started to design products (ever greens) that are similar to such deposits, but that would have no negative impact for the Liquidity Coverage Ratio. In the same context, some members had doubts about the possible source of the substantial amount of long-term funding the banks would need, given that recent regulatory changes for various asset managers (in particular money market funds) seemed to provide incentives for institutional investors to shorten their duration rather than lengthen it. While a majority of members still thought that it should be possible for the banking industry to raise the necessary term funding, all members seemed to agree that this would ultimately come at the price of higher funding costs for the industry (and eventually the overall economy).

Francesco concluded the discussion by saying that the recent amendments to the Basel proposal were an important step on the way to an effective and harmonised liquidity risk management framework, but that it would appear that we are not yet at the endpoint, which seemed to imply that the group might discuss this topic again in one of its future meetings.

## 2. Presentation of the initial findings of the ECB Money Market Survey 2010

At the beginning of this item Francesco reminded the members that the presentation is based on preliminary data and that the release of the official data is tentatively scheduled for the week 20-24 September 2010. This was also the reason why the presentation was not included in Members' handouts.

Alvaro Santos Rivera (ECB) presented the preliminary findings of the ECB Money Market Survey 2010. The key findings were the following ones:

- In Q2/2010, aggregate turnover in the euro money market decreased for the third consecutive year. In comparison to the second quarter of the previous year, the aggregate turnover declined by 3%. The most notable decrease in activity took place in the unsecured market (-18%).
- The secured market remained the largest segment and aggregate turnover in this segment increased by 9%. Most of this increase was driven by a 15% increase in activity for maturities between T/N to 1 month. The share of repo transactions cleared by central counterparties rose from 38% of total repo transactions in 2009 and to 41% in 2010.
- Overall turnover in the derivatives market declined by 7%. The most significant drop took place in the overnight index swaps (OISs) segment where turnover fell by 19%. Turnover in forward rate agreements, other interest rate swaps excluding OISs and cross-currency swaps also decreased, whereas the only derivatives segment that did not suffer a decline was foreign exchange swaps (+3%).
- Turnover in outright transactions for short term securities in the secondary market saw a large increase (67%) in the second quarter of 2010, which was mainly driven by an increase in transactions related to credit institution issues.
- The qualitative part of the survey showed that a majority of respondents report that liquidity conditions and efficiency in the unsecured market continued to deteriorate. Most respondents, however, report that market liquidity has stabilized or even improved in most of the other segments of the euro money market between the second quarter of 2009 and the second quarter of 2010.

The following discussion revealed that the overall results of the survey were broadly in line with MMCG members' expectations. Participants were in particular not surprised by the continued decline of the unsecured market and by the increased turnover in the FX swaps segment. Regarding the latter, many stressed that this instrument has become an important cash funding tool for European banks during the crisis, which made its classification among the "derivatives" somewhat problematic. FX swaps seem to have also benefited from their relative security as they are usually cleared via CLS.

Participants mentioned that the surge in the turnover of short-term securities might at least partially be explained by the increased use of such paper as eligible collateral for ECB operations.

## 3. Review of the recent market developments

As usual the Secretary provided an update on the money market developments since the last MMCG meeting. The main points of his presentation were: i) a short background look at equity and credit markets (where the situation seemed to have somewhat improved since May); ii) a review of the latest developments of some money market indicators (with some modest spread widening and a significant decline in 2012/2013 Euribor futures rates); iii) a review of the development of outstanding tender volumes / tender participation / use of the standing facilities / Eonia level (with a noticeable impact of the maturity of the first 1-year LTRO); iv) some information on the conclusion of the Covered Bond Purchase Programme and the development of the Securities Markets Programme including the related 1-week liquidity absorbing operations; and v) some information on the review of the risk control measures in the Eurosystem's collateral framework.

The discussion revealed a generally somewhat more positive assessment of the market functioning, following the maturity of the first 1-year LTRO and the publication of the stress test results of European banks. This related in particular to an increase in trading volumes in very short-term maturities and to a pick-up in activity in the secured market segment, whereas volumes in tenors of 1 month and beyond were reported to still remain rather limited. Some market participants also noted the most recent increase in banks' issuance of capital market instruments. Moreover, there was some discussion about the importance of repo market infrastructures, as several members stressed the positive effect of central counterparties (CCPs), as evidenced, in their view, by the improvement of funding conditions for certain banks after those had established access to such CCP platforms.

Regarding the likely liquidity conditions for the remainder of the year, most banks expressed the expectation that demand for liquidity would remain high, in particular in the 3-month LTRO to be conducted at the end of September, when significant amounts will mature. Some members mentioned that this LTRO was particularly attractive, as it will mature in December, when it can be rolled-over into another 3-month LTRO, which might, according to some banks' expectations, be the last LTRO with full allotment. This scenario would, in all likelihood, cause Eonia rates to remain (significantly) below the ECB's MRO rate. In this context some members mentioned that they had been surprised about the continued high level of excess liquidity (and the resulting low level of Eonia rates) following the maturity of the first 1-year LTRO.

Related to this expected continued high demand in liquidity providing operations, there was also a short discussion on how far the ECB should take into account the situation of banks, which seemed to have lost market access and were assumed to rely more or less exclusively on the Eurosystem for their funding, when deciding on the features of its liquidity provision. Most members expressed the view that this problem should not impact the ECB decisions, as it was more in the responsibility of supervisors and/or finance ministries.

There was rather limited feedback on the expected impact of the new haircut schedule in the collateral framework, with only one member mentioning that, according to his institution's own calculations, the impact, while not being very substantial, was also not negligible.

There was equally little discussion on the Securities Market Programme, except for a few members expressing their surprise about what they considered the recent rather low purchases. One member also mentioned that the related 1-week liquidity absorbing operations might have a detrimental impact on market functioning, as they further increase the ECB's intermediation role.

## 4. Other items

Francesco mentioned that the next meeting is scheduled for Wednesday, 15 December 2010 from 13:00 to 16.00. The following potential topics were identified: The regular review of recent market developments and a review of the upcoming ICMA repo market survey – also in comparison with the findings of the ECB Money Market Survey. In addition, Francesco offered to contact his colleague in the Directorate General Payments and Market Infrastructure to see, whether she would be willing to provide a presentation on topical issues in the field of market infrastructures.