EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 30 March 2012

Money Market Contact Group

Frankfurt, Wednesday 21 March 2012, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Update on the Eurosystem collateral framework

Eloi Espargiliere (ECB) and Evangelos Tabakis (ECB) presented an overview of the Eurosystem collateral framework, including the most recent changes. The collateral availability and usage data showed that the euro area banks are over-collateralised on aggregate, even prior to the recent collateral widening measures, but the situation differs depending on individual banks. Responding to the MMCG members' questions, Evangelos clarified that, for the data on the usage of collateral shown in the presentation, it is impossible to earmark specific assets used in the operations, since collateral pooling systems are mostly used.

The ECB presentation was followed by those of Intesa Sanpaolo, Bankia and Société Générale on the national specifications of the additional collateral measures. In Italy and Spain, the impact of the additional collateral measures was seen as positive but limited so far. All presenters agreed that this measure was particularly beneficial for smaller banks, as it could help them to avoid high costs of securitising their credit claims. In Italy, where limited use was made so far of ACCs [1], a larger use is made of the state-guaranteed bank bonds, which nonetheless bear significant costs, but have been widely used by banks of various sizes (in particular during the first two months of 2012). Italian banks represent roughly 50% of government guaranteed bank bonds pledged by euro area banks as collateral for the monetary policy operations. In Spain, the impact of additional credit claims (ACCs) would be larger if foreign-law credit claims and claims in other currencies were accepted, as Spanish banks have large portfolios of credit extended to Latin American countries. The pre-dominance of French banks in the usage of ACCs[1] could be mainly attributed to the fact that, unlike in Italy and Spain, the currently existing system at Banque de France needed little adjustments to accept ACCs. Furthermore, the regulatory aspect, whereby eligible credit claims pledged for the Eurosystem operations are counted for 100% for the ACP short-term liquidity ratio (vs. 50% for not pledged eligible claims), could be an additional factor.

According to some members, the participation of only seven NCBs in the recent collateral expansion raises a question of level playing field for euro area banks from other jurisdictions. Some MMCG members from non-participating jurisdictions remarked that this measure re-defines liquidity of a certain previously illiquid asset class from a regulatory point of view (e.g. in France), which puts banks in non-participating NCBs at a competitive disadvantage, even if these banks do not face a shortage of collateral. This so called "regulatory liquidity arbitrage" was seen as an undesired implication of the ACCs, in contrast with the general aim of harmonising liquidity regulations across jurisdictions.

Francesco Papadia (MMCG Chairman) pointed out that the recent changes in the Eurosystem collateral framework should be seen as a temporary and non-standard measure, tailored to the current situation in the

---

[1] The following information has been disclosed to the public by the ECB President Draghi in the 8 March Q&A session: "*We have the amount used as collateral in the second operation: 53 billion euros of additional collateral from credit claims. And of this, I would say, roughly 40 billion euros was pledged by French banks that were basically already over-collateralised. The interesting thing about this is that, of the banks that actually used these credit claims – this new option of additional credit claims – most of them used it only to increase their collateral against their borrowing, so one cannot say that they actually borrowed more because of this new option. They simply increased their collateral for the future as a precaution. But they were already over-collateralised.… The remaining 13 billion euros was spread across various countries. Here, again, there was one newspaper that wrote that Italy had taken 70 billion euros against these additional credit claims, when the figure was about 3 billion euros..*"

financial markets. So far around €50 bn of ACCs have been pledged vs. €200 bn of potentially available, but this figure could increase in the future. ACCs were not indispensable for the 3-year operation (VLTRO) although they were useful to increase over-collateralisation. The high haircut of 2/3 on average on ACCs is not unprecedented, e.g. within the current framework a haircut of 65.5% is already being applied for bank loans, and is in line with the risk of these assets.

Marco Antonio Bertotti (Intesa Sanpaolo) presented some charts from the recent BIS Quarterly review published in March 2012, which includes data on the usage of ECB longer-term operations and deposit facility per national jurisdictions and illustrates that usage of these facilities is attributed to different groups of banks. Paul Mercier (ECB) cautioned however about over-interpreting national data as some banks can access the Eurosystem facilities in different jurisdictions.

There was also some discussion on the recent spikes in the usage of the marginal lending facility, which, as clarified by Paul Mercier (ECB), was attributed to the changes in the eligibility of Greek government bonds as collateral for open market operations.

2. Review of the latest market developments

Julija Jakovicka (ECB) provided a brief update on the money market developments since the last MMCG meeting. The main points of the presentation were: (i) a major improvement in risk sentiment and a strong reduction in volatility that took place in equity and credit markets since the announcement of the additional non-standard measures and the allotments of the 3-year VLTROs as well as (ii) a sharp reversal in various money market indicators (Spanish and Italian GC repo rates, deposit-OIS spreads; FX swaps).

The discussion revealed that the MMCG members viewed the 3-year operations as having a positive impact on restoring market confidence. However, they also pointed out some drawbacks for money market activity, primarily in the interbank market. Illustrating the latter, it was mentioned that daily trading volumes on the e-Mid interbank trading platform declined from €4-5 bn prior to the 3-year VLTROs to around €1.5 bn currently. Also in the secured market, trading activity has reportedly declined by some 30-50%. Furthermore, according to some MMCG members, low levels of money market rates are offering little incentives for the credit departments to re-open new or even maintain existing credit lines.

However, in order to asses the impact of the 3-year VLTROs on the money market activity, it is crucial to distinguish between the interbank and non-interbank money market. The activity in the <u>unsecured interbank market</u> had already been declining prior to the start of the crisis and since then has deteriorated further, as credit lines were reduced and banks have been unwilling to trade among each other. Some MMCG members pointed out that the large allotment at the 3-year operations has further reduced the incentive to trade among banks. However, Paul Mercier remarked that the size of the Eurosystem operations reflects the dysfunctional interbank market, which imposes the intermediation role of the money market to be partly taken over by the ECB. Besides, regulatory aspects and internal risk management constraints offer little perspective of recovery in this segment for maturities beyond 1-month.

Some discussion also arose on the issue of the unsecured money market benchmarks, which are widely used in various market segments (derivatives, loans etc), even if their reliability has been repeatedly questioned recently. Paul Mercier noted that the value of benchmarks is closely linked to market's confidence in them. Should this confidence be damaged, new benchmarks can be established, a task best left to the market itself.

One of the major positive effects of the 3-year VLTROs was, in the MCCG view, the improvement in the <u>unsecured (non-interbank) market</u>. There are encouraging signs that central banks outside the euro area are regaining confidence and re-starting to lend to euro area banks. As most of this lending is in USD, it also facilitated some tightening of the FX swap basis. Furthermore, more flows have been registered from other investors such as money market funds and pension funds even at maturities beyond three months. US investors however remain cautious. These investors are closely watching (i) the finalisation of the Greek debt restructuring and (ii) macroeconomic developments in the individual euro area countries and the impact of the reforms and austerity measures, which would be decisive factors for regaining confidence.

The ability of the euro area banks to issue in the unsecured senior and covered bond market since the start of the year was mentioned as another positive and one of the most important side-effects of the 3-year

VLTROs. Furthermore, there are some indications from several MMCG members that lower cost of funding will also be passed internally within banks and subsequently find its way to the economy.

Following the allotment of the 3-year VLTROs, the trading activity in the secured money market declined, whereas the rates on the Spanish and Italian GC repo declined markedly and were trading close to the repo rates for the "core" GC collateral. This was seen largely related to the shortage of assets in the repo market. As a result of declining trading activity, in some countries there was a shift from the CCPs business into the bilateral repo. A decline in the repo market trading volumes could also be attributed to high capital costs of managing banks' sovereign bond portfolios, which forces banks to reduce their portfolio and hence the need to refinance it in the repo market. This notwithstanding, the MMCG members were constructive on the outlook for the repo market and noted that, barring some decline in trading activity, it remains functional.

Despite the success of the 3-year operations, some MMCG members cautioned that the benefits of the 3-year VLTROs should not be expected to last until the maturity of these operations and banks should use the coming months to readjust their balance sheets and funding sources. National central banks should also work on exit plans with institutions which heavily participated in these operations.

There was also some discussion on the issue of TARGET2 claims. Paul Mercier pointed out that TARGET2 balances are not a new concept and merely reflect flows between different countries, reconciling balance sheets between the NCBs.

Francesco Papadia concluded the market discussion by noting that the ECB has to perform a difficult balancing act. On the one hand, there is the overriding goal to preserve price stability as well as financial stability. On the other hand, the non-standard measures, which are needed to achieve these goals, have a number of drawbacks and even pose some risks. Among these are lower incentives for money market activity, higher risk for the Eurosystem, even if this risk is well managed, moral hazard and a potentially negative impact on the homogeneity of the euro area financial market. The MMCG discussion illustrates that there are different views on how to achieve the optimal balance but this balancing act is of utmost importance.

3. Proposals for the enhancement of the Euro Money Market Survey

Annette Kamps (ECB) presented a number of proposals on possible ways to further develop the Euro Money Market Survey. It was decided that the MMCG feedback on the proposals would be sought by means of a written procedure.

4. Update on the STEP developments (time permitting)

This item has been postponed to the next MMCG meeting.

5. Other items

The Chairman mentioned that the next meeting is scheduled for Tuesday, 19 June and the following potential topics could be envisaged: the regular review of recent market developments; an anonymous survey of risk management practices, as suggested by Luis Soutullo Esperon (CECA); some feedback on the initial experience with the lower minimum reserves ratio (the item has been initially scheduled for the March meeting but was postponed to one of the forthcoming MMCG meetings); and an update on the STEP market, an item which had already been postponed a few times.

The Chairman informed the MMCG about a change of the status of the Operations Managers Group (OMG), formerly a sub-group of the MMCG and FXCG, which has now been given peer status with the FXCG and the MMCG. It will be chaired by the Director-General Market Operations of the ECB.

Finally, the Chairman thanked all the members for their support over the years and informed them that he would soon retire.