EUROPEAN CENTRAL BANK

EUROSYSTEM

DG Market Operations
Money Market and Liquidity Division

ECB-PUBLIC
13 March 2018

Meeting of the Money Market Contact Group (MMCG)

Frankfurt am Main, 13 March 13:00-17:00 CET

SUMMARY

Cornelia Holthausen (ECB) informed MMCG members of changes to MMCG procedures and documentation which had been published on the MMCG website. In particular, she referred to the Terms of Reference, which had been updated and included an explicit mention of the treatment of commercially sensitive information. She went on to add that the application process to the MMCG had been more formalised and that the ECB particularly encouraged applications from institutions nominating female representatives, with a view to further enhancing the diversity of the contact group.

1. Evolution of market expectations for ECB monetary policy actions

Ileana Pietraru opened the MMCG discussion by giving a presentation on market expectations concerning the latest ECB monetary policy actions. She recalled that no major changes had been expected from the March Governing Council meeting and that even if market participants had been slightly surprised by the change in forward guidance through the modification of language in the introductory statement, this had been counterbalanced by the reference to underlying inflation and the ongoing accommodative stance of the ECB. She added that the reaction in the EONIA OIS market had been muted and that the end of negative rates had been priced in for the end of 2019. It was also mentioned that asset swaps remained stable and that the end of the ECB's asset purchase programme had not yet been priced in. One MMCG member was of the opinion that there was unlikely to be a rate hike before 2020 or 2021, but this view was not shared by the main market strategists and not in line with the MMCG consensus view. With regard to the magnitude of the first ECB rate hike, opinions were split. Although market consensus seemed to point to the first rate hikes being in small increments, some MMCG members were of the opinion that that would be difficult to implement and argued in favour of a rate hike of 25 basis points.

The MMCG views also differed with regard to the sequencing of hikes in the rates on the ECB deposit facility and main refinancing operations (MRO). Some members noted that it was likely that the deposit facility rate would be raised first as part of the unwinding of the non-standard policy measures, while others argued that even if the deposit facility rate was relevant for the money market rates, the MRO rate could be raised first to signal a general tightening of monetary policy.

With regard to the ECB's forward guidance and market expectations of future changes in the ECB's policy rates, some MMCG members pointed out that the effectiveness of the forward guidance depended on inflation pressures remaining subdued. There was no expectation that rates would be raised prior to the reduction of the asset purchase programme. Some members noted that policy rate changes were currently less relevant for the market than indications of how the ECB would handle the level of excess liquidity in the future. One member warned that market participants seemed to be complacent about the current situation and did not seem to fully factor in that the quantitative easing would stop one day, something that would inevitably have an impact on market rates and premia.

The majority of members believed that, despite the high levels of excess liquidity, early repayments of outstanding TLTRO-II amounts were not likely to be of a great magnitude, as long as the remaining maturity of the TLTRO-II funds stayed above one year and could be used to meet net stable funding ratio requirements.

2. Review of structural developments in the FX swap market and the US dollar funding of European banks

Jürgen Sklarczyk and Olivier Hubert provided an update on the main drivers of developments in the FX swap market and FRA-OIS spreads, and of the market dynamics around the 2017 year-end reporting period.

It was noted that the 2017 year-end was characterised by high volatility, but that there were significant differences in the market tensions compared with those at the end of 2016. First, earlier market preparations implied that the increase in the year-end premia had started sooner than in the previous year, but that market conditions had already returned to more normal levels before the actual year-end reporting date. Second, earlier preparations had also led to fewer market players and lower volumes being traded on the last few days of the year, resulting in rates being more volatile amid very low volumes. Additional factors that played a role in 2017 included the absence of the usual US-based US dollar providers, who had allegedly avoided lending because it would have led to higher capital charges. It was mentioned that, despite some signs of improvement on reporting dates at quarter-ends in 2017, market volatility at the year-end remained a source of concern and that regulation and balance sheet constraints remained the main driver of those developments. As a result, markets were not a two-way market, but were driven by single orders. Furthermore, it was said that high volatility increased the value at risk metrics, which led to a market participants having a lower capacity to trade in such market conditions. At the same time, banks found it difficult to pass through the real cost of the balance sheet and market volatility to their customers and also via internal transfer pricing.

The MMCG also discussed the drivers of the recent global increase in the cost of the US dollar funding against major currencies and the widening of the USD LIBOR-OIS spreads. In the MMCG's view, the driving factors were primarily attributable to domestic developments in the United States and reflected a lower supply of US dollar liquidity effectively available in the United States and globally. Among the main drivers were supply-side factors, such as the reduction in the Federal Reserve System's balance sheet and the higher issuance of T-bills by the US Treasury, which absorbed US dollar liquidity from the market. Broker/dealer capacity was reportedly also affected by the need to absorb the large issuance of T-bills, which resulted in there being less balance sheet capacity for other business. Furthermore, higher uncertainty owing to the expected tax-related earnings repatriation flows by US corporates and the Federal Open Market Committee's tightening cycle provided a disincentive to US investors to lend out funds in longer tenors and to demand a higher term premium. Some MMCG members reported outflows from non-US money market funds and a shortening of investment horizons by some investors.

Going forward, it was suggested that the combination of the above factors might lead to a further tightening of the US dollar funding conditions, both in the United States and abroad, affecting non-US banks – and among them European ones.

While European banks had learned from the sudden decline in US dollar funding in 2011 by reducing their US dollar assets and lengthening the duration of the funding, the positive interest rate environment in the United States had in recent years provided an incentive for US dollar-denominated assets to be added to the balance sheet of international market participants, including banks. The recent and expected developments during the normalisation highlighted that it might be difficult to increase the duration of the liabilities funding those assets. If this situation were to exacerbate, international players would be incentivised to critically review the scope of their business activity on US markets.

Some MMCG members reiterated that the stigma bank supervisors attach to the ECB's US dollar liquidity-providing operations was negatively affecting the effectiveness of those operations as a backstop.

3. Functioning of the euro area repo market: main drivers of recent developments and rising repo volumes

Harald Endres opened the MMCG discussion on the recent developments and main trends in the euro area repo market. He mentioned that the repo market had recorded a sharp increase in trading volumes in 2017 and, in particular, in 2018. Meanwhile, trading volumes backing the GC Pooling Deferred indices had remained stable.

MMCG members attributed the higher volumes in the repo market to several factors: (i) the continued shift from the unsecured to the secured market (in transactions between banks and professional clients), with the repo instrument being used as a tool to circulate liquidity in the market within certain risk restrictions; and (ii) a higher need for collateral, driven in part by the need to post margins. There had also been a pick-up in the cross-currency repo, where euro-denominated collateral had been used to secure US dollar funding. Members also reported that more new players had entered the repo market and that they had observed greater interest from large corporates and asset managers seeking to benefit from attractive repo levels for their security holdings. The latter had also often been counterparties in collateral upgrade trades, lending LCR-eligible bonds to banks. T2S was mentioned in this regard as facilitating cross-border trades. Overall, it was noted that the prominence of the securities lending business had increased significantly over the years, but that there was little statistical evidence available on this part of the market. Furthermore, over the years banks had optimised their internal capital allocation based on risk return considerations. In line with increasing returns earned in the repo market, more balance sheet capacity had been allocated to the repo business.

The majority of the members agreed that there was less tension in the functioning of the repo market at the 2017 year-end compared with 2016, even if the price indicators had recorded a strong decline. MMCG members attributed this development to earlier preparations by market participants, a greater share of the balance sheet being allocated to the repo business and improvements in Eurosystem securities lending facilities. Furthermore, MMCG members noted that more collateral had been made available by end investors, such as pension funds, insurance companies and asset managers, incentivised by the possibility of optimising return on their security holdings. In Italy, the decline in repo rates over the 2017 year-end was attributed mainly to the build-up of excess liquidity in the Italian banking sector.

4. Update on money market benchmarks and the working group on euro risk-free rates

Cornelia Holthausen reported to MMCG members on the inaugural meeting of the working group on euro risk-free rates which had taken place at the ECB at the end of February and had been chaired by Koos Timmermans, CFO and Vice-Chair of ING. This working group is tasked with, among other things, identifying and recommending alternative risk-free rates. Such rates could serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area. The presentations, minutes and speeches are available on the ECB's webpages dedicated to the working group. Jaap Kes presented ING's proposal for the mandate, scope and organisation of the work, which had been drawn up during the meeting and is available on the ECB's website.

The MMCG discussion focused on several key policy messages that had been delivered during the inaugural meeting: (i) the sense of urgency given the timing imposed by the EU Benchmarks Regulation, under which there is no possibility of an extension of the transitional period beyond 2020 for non-compliant benchmarks, implying the prohibition of their usage in new contracts and possibly in legacy contracts, under specific conditions to be assessed by the Belgian regulator and the college of supervisors; (ii) the communication and transparency challenge that the working group will face to reach out to an as wide as possible range of market participants and certainly beyond the banking industry, so that the recommendations and guidance of the working group can be followed and adopted smoothly by the benchmark users; in this regard, retail users were seen as a particular challenge; (iii) the difficulty in amending the stock of legacy contracts, especially given that legal frameworks are very diverse across the whole euro area. In this context, MMCG members highlighted that risks of the transition period could be reduced the earlier the ECB were to publish its new rate.

5. Other business: planning of the next meeting, preliminary discussion of the MMCG work programme for 2018

The next meeting will take place on 7 June 2018 in Paris. Julija Jakovicka presented the allocation of the structural items in the MMCG work programme for the 2018 meetings.

List of participants at the 13 March MMCG meeting

Participant's organisation	**Name of participant**	
European Central Bank	Ms Cornelia Holthausen	Chairperson
European Central Bank	Mr Holger Neuhaus	
European Central Bank	Ms Julija Jakovicka	Secretary
Bank of Ireland	Mr David Tilson	
Barclays Bank PLC	Mr Sascha Weil	
Bayerische Landesbank	Mr Harald Endres	
BBVA	Mr Miguel Monzon	
Belfius Bank	Mr Werner Driscart	
BNP Paribas	Mr Patrick Chauvet	
BPCE/Natixis	Mr Olivier Hubert	
Caixabank	Mr Xavier Combis	
Caixa Geral de Depósitos, S.A.	Mr António Paiva	
Deutsche Bank AG	Mr Juergen Sklarczyk	
DZ Bank	Mr Michael Schneider	
Erste Group Bank AG	Mr Neil McLeod	
HSBC France	Mr Harry Gauvin	
ING Bank	Mr Jaap Kes	
Intesa Sanpaolo	Mr Marco Antonio Bertotti	
LBBW	Mr Jan Misch	
Nordea Bank Finland	Ms Jaana Sulin	
Société Générale	Ms Ileana Pietraru	
UniCredit Bank AG	Mr Harald Bänsch	

National central banks	**Name of participant**
Nationale Bank van België/ Banque Nationale de Belgique	Mr Kristof Vandermeersch
Deutsche Bundesbank	Ms Judith Kilp
Banco de España	Ms Elisa Sánchez Pérez
Banque de France	Ms Sophie Mages
Banca d'Italia	Ms Patrizia Ceccacci
De Nederlandsche Bank	Mr Daniel Overduijn
Národná banka Slovenska	Mr Peter Andresič

Via teleconference	**Name of participant**
Eesti Pank	Ms Leo Kristel
Central Bank of Ireland	Mr Ken Egan
Banque centrale du Luxembourg	Ms Christina Rivellini
Central Bank of Malta	Ms Ioanna Giannakopoulou
Oesterreichische Nationalbank	Ms Maria Thury
Banco de Portugal	Mr Luís Sousa
Banka Slovenije	Ms Tina Ritonja
Suomen Pankki – Finlands Bank	Mr Jukka Lähdemäki