EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

29 January 2015

Money Market Contact Group

Frankfurt am Main, Friday, 21 November 2014, 1 p.m. to 5 p.m. CET

Summary of the discussion

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

Sascha Weil presented an overview of the main developments in the euro money market since the last Money Market Contact Group (MMCG) meeting. The presentation outlined the developments in market inflation expectations and commodity prices during the intra-MMCG meeting period, which were shaping market expectations of future ECB policy measures. Markets were expecting ABS and covered bond purchase programmes (CBPP3) to be launched in the near future, whereas purchases of sovereign assets were only seen as being a possibility. Looking at covered bond market dynamics, the announcement of the CBPP3 contributed to a narrowing of covered bond spreads, but at the same time the programme was also expected to contribute to the current supply and demand imbalance, as net supply was already negative in this market segment. The presentation also addressed the mid-October risk-off episode, which in market participants' view was aggravated by lower market liquidity and banks' deleveraging.

With regard to the money market, the ECB's forward guidance helped to suppress the term premium which resulted in significant flattening of the money market curve. One member of the MMCG reported that the release of the asset quality review (AQR) results had had a positive impact on reviewing and reopening credit lines, although this was not a view broadly shared by the MMCG.

Members of the MMCG were not concerned about developments in excess liquidity in the coming months, nor the year-end conditions: in the run-up to the second TLTRO, any decline in excess liquidity below €100 billion was expected to be compensated for by an increase in the main refinancing operations (MROs), whereas the maturity of the three-year VLTRO was not a concern, as banks could easily roll over maturing amounts into other operations. The views of the MMCG on participation in the second TLTRO were divided. Banks from core countries were somewhat sceptical about a potentially high level of participation in view of the weak credit demand from companies and the regulatory demands on banks (e.g. the leverage ratio, bank levies), which did not facilitate balance sheet expansion and increased lending. On the other hand, a number of banks from non-core countries pointed to tentatively positive developments in domestic lending.

2. Market functioning and technical adjustments in market practices in the negative rate environment

Jaana Sulin introduced a discussion on market functioning in the negative rate environment. Overall, markets were surprised by the limited impact of the September rate cut and attributed it mainly to the reluctance of market participants to charge negative rates, as the rates were floored at zero for a variety of customers. So far, negative rates were applied to the interbank market and to professional investors. Several members mentioned that banks were cautious about making the first move to charge rates on other accounts. In particular, interest rates for retail and small corporate customers were not expected to become negative, owing to legal issues and fears of customer outflows. Even for large corporations and wholesale deposits, banks were very cautious about charging negative rates, and decisions to apply fees for some accounts were taken on a case by case basis. Unless excess liquidity were to increase significantly from the current levels, banks did not expect to change their current practices on applying negative rates.

3. An update of regulatory developments and the impact on banks' regulatory compliance

Michael Wedow, Michael Grill and Pär Torstensson provided an update on several regulatory developments since the last meeting. The MMCG was concerned about the regulatory impact on the repo market. In view of the low margins earned on repos, banks were seen as being likely to downsize balance sheets by reducing their repo activity in order to meet the leverage ratio requirements and to minimise charges levied under the Bank Recovery and Resolution Directive. There were also concerns about the impact of the leverage ratio on banks' balance sheets, forcing them gradually into assets with higher returns (and risk), which would greatly affect banks with large mortgage books. Some members argued that some categories of repo market activity (such as large matched repo books and long re-use chains of collateral) may indeed be a concern for regulators, but there was also a large category of "useful" repos which was used by (i) bank treasuries to manage liquidity and liquidity buffers; and (ii) primary dealers and market makers in government securities. In the view of the MMCG, if regulatory demands were too punitive for such repo activities, then central banks could become the main counterparty for banks to manage liquidity buffers, whereas liquidity in the government bond market would deteriorate. Furthermore, the composition of liquidity buffers for banks relied heavily on the market liquidity of underlying assets and affected the building of such buffers using market assets.

Members of the MMCG argued that regulatory requirements should be adapted to local market specificities. In Europe, the existence of several government bond markets would justify larger bank balance sheets (for primary dealership) compared with the United States. European market conditions were already considered in the European Commission's Liquidity Coverage Requirement Delegated Act, but the MMCG argued that this also had to be done for other regulations.

Members of the MMCG were invited to respond in writing to a number of the questions that were raised in the presentation on regulatory developments and their impact on the market.

4. An update on structural reforms in the Spanish banking system and a European comparison

Luis Soutullo presented an overview of recent changes in the Spanish banking system and how it stands in comparison with other European countries. The presentation showed a significant adjustment in the size of the Spanish banking sector since 2009, as reflected by the reduction in a number of banking institutions and banking groups, which resulted in a higher concentration, bringing it closer to the EU average. Structural reforms in the Spanish banking sector, alongside other measures, contributed to improved market access for the Spanish government and Spanish counterparties, as reflected by lower outstanding balances in Eurosystem operations.

5. Update on developments in T2S

José-Ignacio Terol updated the MMCG on the main developments in the T2S project. The presentation prompted a number of technical questions from the members of the MMCG on the settlement cycle, cut-off times and the auto-collateralisation feature of T2S. Members of the MMCG were invited to send their detailed feedback to José-Ignacio.

6. Other items

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

Owing to time constraints at the meeting, this item was postponed for discussion at the MMCG teleconference.

b. Planning of the next meeting

The next MMCG meeting will take place on Wednesday, 18 March 2015, in Frankfurt am Main, starting at 1 p.m.