EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 23 March 2022

ECB Money Market Contact Group (MMCG)

Wednesday, 16 March 2022, 13:00-15:45 CET

Videoconference

<u>Summary of the discussion</u>

1) Developments in money markets since December 2021

David Tilson (Bank of Ireland) and Maria Cristina Lege (Intesa) reviewed how expectations for monetary policy decisions following the Governing Council meetings of 3 February and 10 March 2022 and the fallout from the Russia-Ukraine conflict were affecting money markets.

MMCG members considered that the money market remained functional during the crisis triggered by the conflict. According to the MMCG, there were no liquidity shortages in the money market and trading activities continued, irrespective of certain tensions generated by the Russian invasion of Ukraine. The MMCG observed a general shortening of maturities by investors as the most salient market reaction. Such shortening of maturities – also affecting money market funds' (MMFs) assets – was driven by the uncertainties about ECB rate hikes and precautionary own funding needs in view of the war in Ukraine. Euro area banks reported to be providing liquidity to their clients, including for covering margin calls in commodity derivative markets generated by the large volatility in prices. At the same time, this liquidity might at times be provided at an elevated cost. Overall, the MMCG considered that the high volatility in the money market up to mid-March was attributable more to the uncertainty over the speed of monetary policy normalisation than to tensions stemming from the war.

Nevertheless, some MMCG members also saw cause for concern about future prospects. The risk sentiment varied among MMCG members and three areas of fragility were spelled out. First, a few MMCG members noted that euro area banks might need to limit short-term liquidity lines in the future if the demand for liquidity increases and becomes persistent. To absorb a more permanent liquidity shock, banks would have to increase longer-term funding to provide liquidity support without infringing on their own liquidity coverage ratios. Second, another group of MMCG members noted that the currencies of some Central and Eastern European (CEE) countries were already weakening following the depreciation of the rouble. Establishing EUR facilities with some of the central banks in the region could alleviate some stress. Third, a few MMCG members mentioned that the impact of sanctions needed to be carefully monitored as the implications for market activity were not yet fully mapped out (e.g. the Russian Federation entering into default or changes in the denomination of commodity contracts).

The MMCG identified some short-lived stress in the FX swap segment but noted that it was functioning well overall. MMCG identified some stress at the outset of the crisis but also a reasonably swift recovery. The initial upward pressure on United States dollar (USD) funding costs was mainly attributed to an increase in the demand for USD funds by international investors for precautionary reasons. As a result, pricing in USD term funding initially rose but liquidity soon returned to the market in the form of short-term USD funds, not least due to ample liquidity in the USD market. MMCG members noted that the availability of central bank swap lines helped to alleviate tensions. Some MMCG members thought that the strong conviction that central banks would increase their USD operations if and when needed was breeding some market complacency. One MMCG member felt that the widening of FX swaps prices vis-à-vis the US dollar could probably be attributed to credit rather than liquidity concerns.

Anticipation that the ECB rate hike cycle will likely start in 2022 increased interest rate swaps volumes. MMCG members reported that the anticipation of upcoming rate hikes on asset portfolios triggered the build-up of defensive positions by both financial and non-financial institutions via interest rate swaps. Conversely, liquidity of €STR swaps and futures declined. MMCG members reported that after the Governing Council meeting of 16 March 2022, a first 25 bps ECB deposit facility rate (DFR) hike was priced in for September or October 2022. MMCG members noted that rate expectations for 2023 were less clear and so pricing was more volatile.

Commercial paper issuance after June 2022 may be lower than previously expected owing to reduced early targeted longer-term refinancing operations (TLTRO) repayments. Before the expectations on rate hikes moved forward, the market anticipated large TLTROs repayments by June 2022 and a revival of the issuance of banks' commercial paper. Such developments could also have resulted in an increase in Euribor and in a widening of FRA-OIS spreads in the 6-month to 1-year tenors. However, expectations for TLTRO repayments in June 2022 are being revised downwards for two reasons. First, the outbreak of the war in Ukraine may likely prompt banks to hold TLTRO III liquidity for precautionary reasons at least until December. Second, expectations for rate hikes render keeping TLTRO funding more attractive. For banks fulfilling the lending benchmark, borrowing costs are linked to the average DFR rate over the whole life of the operation, while the remuneration on deposit holdings at the Eurosystem is linked to the outstanding DFR.

Impact of the conflict in the secured segment was limited. Developments in the repo market were very reactive to the demand and supply dynamics of certain series of German government bonds.

2) Factors affecting supply and demand for repo transactions against government bonds and impact on monetary policy transmission

Patrick Chauvet and his colleague Eugene McGrory (BNP Paribas) provided an update on the continued tightness of collateral availability and its impact on repo and futures markets. Olivia Maguire (JP Morgan) presented the view of the money market fund industry on the difficulties of placing cash at the year-end.

The MMCG reported a collateral shortage in the repo market, especially for German Bunds. The group discussed the factors affecting the availability of government bonds and the demand for placing cash by non-banks. Scarcity was driven by a combination of factors: (i) ECB asset purchases; (ii) collateralisation of TLTRO; (iii) balance sheet limitations ahead of reporting dates; and (iv) limitations in securities lending programmes. Some MMCG members would have wished for a more forthcoming attitude by the Eurosystem in its securities lending, in particular as regards counterparty limits. With respect to future prospects, several MMCG members felt that fiscal expansion by EU governments and reduced asset purchases by the Eurosystem might alleviate some collateral scarcity. In that context, difficulties with German Bunds and some specific issuances in particular were highlighted. One MMCG member pointed out that the scarcity of German Bunds had negative repercussions on the functioning of German Bund futures.

While repo prices at the end of 2021 showed very unusual levels, prices at the end of March 2022 are not expected to significantly deviate from those of previous years. Members mentioned that contributions to the Single Resolution Fund and bank levies in a number of countries' deposit guarantee schemes limited the conduct of repos over the year-end. In February 2022, there were preliminary signals of another expensive March quarter-end in the German repo market. However, MMFs reported no significant difficulties in placing funds at the current juncture.

Mixed reactions to the implementation of the Central Securities Depositories Regulation (CSDR). Some members reported that no change in settlement efficiency had been registered yet since CSDR implementation on 1 February 2022. One MMCG member expressed the view that CSDR penalties were too small to prevent settlement failures. Others felt that the market might need some time to adjust and that the recommendations made by the International Capital Market Association (ICMA), which has recently published a best practice paper on the topic, might help.

List of participants

Money Market Contact Group meeting

Name of participant	Participant's organisation
Ms Cécile Mouton	Amundi Asset Management
Mr David Tilson	Bank of Ireland
Mr Bineet Shah	Barclays
Mr Harald Endres	Deutsche Kreditbank/BayernLB group
Mr Miguel Ángel Monzón	BBVA
Mr Werner Driscart	Belfius Bank
Mr Patrick Chauvet	BNP Paribas
Mr Eugene McGrory (guest)	BNP Paribas
Mr Olivier Hubert	BPCE/Natixis
Mr Xavier Combis	CaixaBank
Mr Andreas Biewald	Commerzbank
Mr Eric Scotto di Rinaldi	Coöperatieve Rabobank
Mr Pierre Le Veziel	Crédit Agricole/CACIB & CASA
Mr Jürgen Sklarczyk	Deutsche Bank
Mr Oliver Deutcher	DZ Bank
Mr René Brunner	Erste Bank
Mr Frank Odendall	EUREX
Mr Harry-David Gauvin	HSBC Continental Europe
Mr Jaap Kes	ING Bank
Ms Maria Cristina Lege	Intesa Sanpaolo
Ms Olivia Maguire	JP Morgan Asset Management
Ms Corentine Poilvet-Clediere	LCH SA
Ms Ileana Pietraru	Société Générale
Mr Harald Bänsch	UniCredit
Mr Thomas Vlassopoulos (Chairperson)	European Central Bank
Mr Helmut Wacket (Member)	European Central Bank
Ms Maria Encío (Secretary)	European Central Bank