

Money Market Contact Group

Frankfurt, Wednesday 1 June 2011, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. The role and the impact of CCPs in the repo market

This item consisted of two sub-items, namely of a presentation on the general role of CCPs (from the ECB), and of two presentations from CCPs (Eurex Repo and LCH.Clearnet) on their respective risk management practices. The three presentations were delivered one after the other, as they were meant to provide the background for the subsequent discussion of the topic.

In the first presentation Andreas Schönenberger started with an overview of the significant public initiatives in the field of central clearing, which should be implemented by the end of 2012. Thereafter he presented the relevant considerations as regards possible pro-cyclicality and the details of the approach that was currently followed by CPSS-IOSCO. He finished with an outlook on the likely impact of this approach on CCPs and banks.

The presentation from Eurex Clearing was quite detailed as Thilo Schwind first gave an overview of Eurex Clearing's links to various exchanges and (I)CSDs and recalled the general benefits of CCP settlement. Thereafter he focussed on Eurex' margining and collateral procedures and finally he elaborated on its default protection.

Finally, in the presentation from LCH.Clearnet John Burke first mentioned LCH's role as a central counterparty. Then he focussed quite extensively on the background for the introduction of its sovereign risk framework and the details thereof. An interesting aspect was that LCH's communication, which had originally been targeted only to their members, had recently attracted much broader market attention and had thus become a much more complex task for them.

The presentations were followed by a series of questions from the members of the group. Of particular interest were the following aspects: i) how are CCPs regulated; ii) which pricing sources do they use; iii) how do they re-invest the cash margins that they receive; iv) how do they avoid a "race to the bottom" as regards their risk management standards; v) how do they manage correlation risks; and vi) do they have access to central bank liquidity.

i) Regarding CCP regulation, Andreas stressed that all CCPs are regulated and supervised, which seems to be quite natural given that regulators encourage their use. Thilo and John added that their interactions with regulators had increased significantly recently, both in terms of frequency of contacts and also of scope of the discussions.

ii) While John stressed that LCH would clear only bonds that can be easily priced and for which they have multiple price sources available, Thilo mentioned that Eurex also uses theoretical prices for some securities. Francesco clarified once again that CCPs have no access to Eurosystem prices.

iii) Both, Eurex and LCH stressed their conservative approach as regards cash re-investments (which are performed only in short-term repos with selected counterparties and against a narrow list of accepted collateral).

iv) All presenters acknowledged that a "race to the bottom", i.e. the lowering of risk management standards with the aim to attract business from competitors, was a theoretically plausible concept. The

representatives from the two CCPs stressed, however, that they would absolutely not be willing to endanger their own credit quality and integrity by such behaviour. Moreover, Andreas stressed that regulators would find ways to prevent such dynamics.

v) Both, LCH and Eurex actively manage correlation risk (e.g. between counterparties and posted collateral). This is, however, not done according to a publicly announced framework. While they have great interest in re-assuring their stakeholders that these risks are managed prudently, they refrain from discussing these issues too concretely in the public domain. They rather engage in bilateral discussions with the counterparties concerned in order to avoid a potential pro-cyclical acceleration of certain market dynamics. Regarding the pro-cyclicality aspect, John also stressed that LCH.Cleartnet believes that it is important to be transparent and predictable, where possible, regarding the margining methodology. In that way, in a situation where markets become more volatile and the risks increase, their members would expect them to increase their margins and such decisions, if required, should then ideally no longer come as a surprise.

vi) Regarding central bank access, Andreas recalled the general attitude of regulators and overseers: CCPs should use central banks' settlement facilities, while the use of their credit facilities should be potentially allowed, but not necessarily encouraged.

At the end of the discussion Francesco thanked all three presenters for their efforts and the useful contributions to the work of the group.

2. Review of the recent market developments

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 financial sector continued to underperform); ii) a review of the usual money market indicators, which generally remained in recent ranges; iii) a review of the development of outstanding tender volumes and the use of the standing facilities, where the positive trend of the previous quarters seemed to have come to a halt; iv) a look at the continued high Eonia volatility; and v) a review of the use of collateral in ECB operations in 2010.

In the discussion there was some focus on the recently higher Eonia volatility, which was generally not viewed as being problematic from the perspective of market liquidity. However, several members commented on the recently lower Eonia volumes, which might also have contributed to the higher volatility. Many members considered that there is an ongoing trend away from unsecured overnight lending to secured business. While this is in line with the overall trend across all maturities, it is also fostered by infrastructure developments, which make O/N repos more easily tradable. One member expressed his surprise that even the cash takers in the overnight market were increasingly asking for secured transactions.

Reacting to these comments, Francesco remarked that this development might eventually raise the question whether the Eonia rate would indefinitely remain the most appropriate unofficial target for the implementation of monetary policy. Paul Mercier added that the shift from unsecured to secured funding was indeed an important development, which would need to be closely followed, but that the currently most burning problem of the euro money market seemed to be the continued segmentation (between different institutions and jurisdictions).

The discussion then moved to the question, whether there had been a further normalisation in money market conditions. Most members were rather cautious in this respect, mentioning, among other things, that the demand for excess liquidity (and the related use of the deposit facility) had not declined any further. In line with this assessment, most banks suggested that the ECB should continue the current full allotment procedures in all its refinancing operations also in the third quarter. Moreover, one member suggested that the ECB should also continue its US dollar providing operations beyond the currently foreseen expiry date of the swap agreement with the Federal Reserve (1 August 2011) in spite of the fact that there had been no demand in these operations recently. The

latter phenomenon was, in his view, a reflection of the rather expensive pricing of the operations and would thus not challenge the assessment of their usefulness as a confidence-building backstop facility.

Another issue that was briefly touched upon was the demand in the weekly SMP-related 1-week liquidity absorbing operations. Based on recent experience, one member suggested that these operations could see an increasing number of underbidding incidents should the excess liquidity in the system decline further and approach more neutral levels.

Towards the end, the discussion moved, once again, to regulatory issues with several banks arguing that the incentives set by regulators (e.g. lengthening of funding maturities; increased use of CCPs) would have significant long-term impacts on market structures and market functioning. One member noted that the market and also the regulators still seemed to be lacking a comprehensive analysis of the combined effect of the various regulatory initiatives on banks, the overall financial system and the economy as a whole.

Francesco concluded the discussion by stating that the reform of the liquidity regulation, which had started as a pure regulatory initiative, had gained much broader attention within central banks and he also offered to have another broad discussion of this topic at the next meeting.

3. Other items

The next meeting is scheduled for Monday, 5 September 2011. The following potential topics were identified: The regular review of recent market developments; an update on the latest developments in the field of liquidity regulations; a tentative look at the business impact of the upcoming introduction of the Basel III LCR; and a brief review of the history of liquidity management in a US investment bank.