

## **Money Market Contact Group**

Frankfurt, Monday 5 September 2011, 16:00 – 19:00

# **SUMMARY OF THE DISCUSSION**

## **1. The impact of liquidity regulation on money markets and banks' liquidity management**

This item initially consisted of four sub-items, namely of i) an update on the implementation of Basel III in the euro area (from the ECB); ii) a summary of the findings of a questionnaire on this topic (also from the ECB); iii) a presentation on how the upcoming LCR impacts business models (DZ Bank); and (iv) an overview of the changes to the liquidity management in an investment bank (Goldman Sachs). However, the last item had to be postponed to the next meeting due to time constraints.

The first two presentations were delivered one after the other, as they were quite complementary and provided the background for a subsequent broad discussion of the topic.

First Jürgen Kirchhof updated the group on the developments since the last discussion of the liquidity regulation topic in the MMCG (in March). After a recap of the Basel III liquidity framework he focussed on the transposition of the Basel rules into EU legislation, stressing that the proposed CRD IV follows the spirit of Basel, although it is not (and cannot be) a simple copy and paste of these rules. Thereafter he had a closer look at some divergences between the proposed CRD IV and Basel III, although in Jürgen's view these were more a reflection of the use of potential discretion and of different language, which could be easily amended in the consultation process. He finished with an outlook on the next steps, which include the ECB's legal opinion on the proposed CRD IV draft (expected by November) and some further ECB-internal work of a task force dedicated to this topic.

Ulrich Bindseil picked-up on Jürgen's last remark and mentioned that the survey, which had been distributed to the MMCG members in July, was meant to contribute to the work of this task force. He then presented some of the major findings of the survey, which related to i) the expected phasing-in of the liquidity standard; ii) the expected changes in banks' asset-liability management; iii) some results of preliminary calculations of the Liquidity Coverage Ratio (LCR); iv) the expected impact on various asset classes / market segments; and v) the expected impact on central bank operations. Thereafter, Ulrich summarised the key issues that seemed to arise from banks' feedback, namely uncertainty about the availability of sufficient stable/long-term funding in the market to cover all liquidity requirements and the final impact on the real economy as well as level-playing-field concerns regarding the implementation across nations. He concluded with some remarks on the follow-up work on the side of central banks (e.g. input to international fora; set-up of monitoring frameworks).

The two presentations were followed by a series of questions and comments from the members of the group. One aspect of the discussion focussed on the survey question whether banks saw a need for an additional buffer (beyond the 100% requirement) in their LCR fulfilment. Many members were surprised that 43% of the respondents had apparently denied the need for such an additional buffer – they argued that there would at least be the need for some working buffer, as otherwise there would inevitably be frequent breaches of the 100% requirement. This raised some more general questions in how far regulators would be willing to tolerate such breaches – i.e. is the LCR there to provide a buffer that can be used in times of stress or is it a hard limit that should under no circumstances be breached? The two presenters explained that this was one aspect of the regulation that would still need to be further discussed in various study groups.

There was also some repetition of earlier criticism that the level 1 asset definition was too narrow (and already had some impact on asset prices and banks' funding possibilities, as e.g. senior bank bonds are not included and have thus become difficult to issue) and concerns about possibly diverging implementation in different countries (with some examples for this apparently already emerging). Regarding the latter aspect, Jürgen clarified that the observation period was still ongoing and that there was the clear goal among regulators that no such divergences should persist at the end of this period – although such an ideal outcome could of course not be entirely guaranteed.

There were also some questions as regards the ECB's stance on a likely increase of banks' use of non-Basel III eligible collateral in its operations to which Ulrich replied that the ECB will closely monitor these developments and adjust its risk management tools, if deemed appropriate. Francesco added that while central banks seemed best-equipped to take on board liquidity risks, this would of course apply only up to a certain point.

Other points that were mentioned are that the liquidity regulation might trigger a disintermediation trend and that the new regulation for banks (demanding a shift towards longer term funding) seemed to be at odds with the recent regulatory changes for institutional money market liquidity providers like money market funds (calling for a reduction of their weighted average maturities).

After the broad discussion Michael Schneider (DZ Bank) summarised the key impacts of the upcoming liquidity regulation on banks and elaborated on how these were already starting to affect banks' behaviour. In particular he underlined the trend for an intensified competition for retail funds and the acceleration of a shift in banks' issuance of long-term securities (from unsecured bank bonds towards covered bonds). The second part of Michael's presentation was more specific, i.e. focussing on the consequences for DZ Bank as a central institution of the co-operative group in Germany. In this function, DZ Bank also acts as a liquidity pool for the group, which has some implications for its liquidity risk management. At the moment DZ Bank is investigating two possible options on how the provisions of Basel III / CRD IV could be implemented in a way that would not hamper their traditional role as liquidity centre for the co-operative group.

The subsequent discussion showed that banks having a similar role for their respective groups (i.e. liquidity pooling and re-distribution) are currently engaged in similar investigations on how to best implement the new liquidity regulations without having to change the overall function for their groups. In reaction to the first part of the presentation, some banks mentioned that many of the trends that Michael described as likely to emerge had already manifested themselves in practice. An additional remark concerned the consolidation trend that was likely to emerge in the banking industry, which would, however, not be without risk (as suggested by the ongoing moral hazard discussions).

## **2. Review of the recent market developments**

The regular review of recent market developments was this time joined by Mr. González-Páramo, the Member of the Executive Board of the ECB in charge of Market Operations. The Secretary provided his usual update on the money market developments since the last meeting, in which the main points were: i) a short background look at equity and credit markets (where the underperformance of the financial sector worsened even further, in line with the renewed escalation of sovereign risk concerns); ii) a review of the development of several money market indicators (which deteriorated significantly over the review period - not least in the USD funding market); iii) an overview of the development of outstanding tender volumes and the use of the standing facilities (where a renewed increase in demand for excess reserves / use of the deposit facility was witnessed); and iv) a summary of the main ECB announcements since June 2011.

The following discussion revealed that members generally shared the view that money market conditions had, once again, become more challenging and that no substantial improvement was to be expected as long as a further escalation of the sovereign debt crisis remained a lingering threat. Members reported in particular that maturities had been shortened and that risk management standards had been tightened even further. The latter resulted in the re-introduction of country limits (as opposed to limits for individual banks), an even higher sensitivity towards correlation risk in the repo markets

(i.e. unwillingness to enter into transactions where counterparty and collateral come from the same country) and an increased preference for trading repos via CCPs, which is also reflected in increasing CCP turnover volumes.

In this respect many members welcomed the ECB's earlier decision to commit to fixed rate / full allotment (FRFA) procedures beyond the end of the year, as it was providing certainty about central bank funding conditions. The announcement/conduct of another 6-month operation in August was also commented with some sympathy, although some members mentioned that they had been surprised by this decision of the Governing Council. In this context it was also noted that there seemed to be no general short-term funding problem, but that the bigger worry might be the impaired access to long-term funding – in particular as significant maturities of bank bonds (also government-guaranteed) were lying ahead. Many members also mentioned the substantial change in interest rate expectations that had taken place since the last meeting. There seemed to be widespread expectation in the group that the ECB would re-adjust its economic and inflation assessments at the September meeting of the Governing Council and that the next rate move would be a cut rather than another hike.

As in previous meetings members also stressed the importance of the ECB's 1-week USD operations and the announcement that the swap line with the Federal Reserve had been prolonged until August 2012. Even though these operations are priced as a back-stop facility, they are viewed as an important confidence-building tool – some members even mentioned that the premium in the FX swap market (to swap EUR liquidity into USD liquidity) would probably be even larger without these operations. There was, however, some concern about the widespread commenting of the one-off use of these operations in mid-August, which not only seemed largely exaggerated, but also carried the risk of introducing some kind of stigma into their use. The Chairman's question, whether a potential re-introduction of longer maturities for the USD operations could help alleviate the apparent challenges that European banks are facing in their USD funding, met some scepticism. Most members seemed to be of the view that as long as the 1-week operations provide funding certainty (albeit at a premium) and as long as the FX swap markets are working effectively (even for longer maturities, albeit also at a premium) there was no compelling case for such a re-introduction – unless these longer term repos would be offered at more favourable conditions than the current back-stop pricing of the 1-week operations.

Another issue that was briefly touched upon was the outlook for banks' supply in the SMP-related 1-week liquidity absorbing operations given their recent steady increase in volumes. Views were somewhat mixed with some mentioning that supply might eventually fall short of the ECB's intended amounts, while others argued that, as long as the current situation of significant excess liquidity (and related low overnight rates and high usage of the deposit facility), prevails there should normally be enough interest in these operations, as the ECB is committed to pay up to the MRO rate. Only if liquidity conditions were to change towards more neutral levels then underbidding could become a more frequent feature of these operations.

### **3. Other items**

The next meeting is scheduled for Wednesday, 14 December 2011. The following potential topics were identified: The regular review of market developments; a presentation of the findings of the ECB's 2011 money market survey; the presentation on the changes to the liquidity management in an investment bank, which had to be postponed; an update on the STEP market; the presentation of an initiative to establish a secured O/N fixing; a look at the regulatory constraints for institutional liquidity providers in the money market (e.g. money market funds); and a review of the increased importance of CCPs for the funding markets. Some of these topics may, however, need to be postponed to the meeting in March 2012.

The Secretary asked the members of the group to review the proposed meeting dates for 2012 and to provide feedback, in case (one of) the suggested dates would imply major inconveniences. The final meeting dates for 2012 will be distributed in the December meeting.