Benoît Cœuré: Ensuring the smooth functioning of money markets

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the 17th Global Securities Financing Summit, Luxembourg, 16 January 2013.

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Ladies and Gentlemen,[1]

It is a pleasure to speak to you today at this annual Global Securities Financing Summit organised by Clearstream / Deutsche Börse Group.

In my remarks today, I will talk about the smooth functioning of money markets and the role of market infrastructures in this respect.

The speech is composed of two parts. I will start with some comments on developments in the euro area (interbank) money markets. As you are well aware, the financial crisis and the subsequent sovereign debt crisis have led to a gradual shift from the unsecured to the secured segment of the money markets. Moreover, the crises have exposed the weaknesses of certain financial institutions, causing the European interbank money market to fragment. Fragmentation has occurred between cash-rich and cash-strapped banks and also between different jurisdictions, leading to a "renationalisation" of money markets. Since money markets can be a source and a propagation channel of financial instability, it is important to ensure their proper functioning and mitigate the potential risks they pose.

In the second part of my speech I will consider the role of market infrastructures in ensuring well-functioning money markets. For this part, I will refer back to work conducted by the Basel Committee on Payment and Settlement Systems (CPSS) in 2010 when it examined the extent to which the market infrastructure for repos added to the uncertainty or instability evident in some repo markets. I will take up two issues identified in the related report published by the CPSS[2] and which can be considered relevant for the smooth functioning of euro money markets, i.e. the role of market infrastructures in providing adequate protection against counterparty risk as well as the efficient use of collateral. In so doing, I will also discuss some tensions which have emerged recently relating to a particular development at market infrastructure level, where it is important to quickly address the underlying issues in order to move forward.

1. Secured and unsecured money markets: developments in the euro area

Well-functioning money markets are an essential component of the financial system. When money markets do not function, financial stability and the transmission of monetary policy are at risk, with potentially severe adverse consequences for the real economy. Deep and liquid money markets insure banks against liquidity risk, a risk that arises naturally in banking, where maturity mismatch is the nature of the business. Unsecured money markets exert a useful disciplinary effect on banks. Money markets also are the starting point for the redistribution of the liquidity provided by central banks and hence the starting point for the transmission of monetary policy. For example, the EONIA rate – the rate of unsecured overnight lending between some of the largest euro area banks – is an important first link in the chain of monetary policy transmission.

Ever since the financial turmoil started in August 2007 – more than five years ago – and then became a severe crisis with the bankruptcy of Lehman Brothers one year later in

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[1] I wish to thank Fiona van Echelpoel, Benjamin Hanssens, Florian Heider, and Marie Hoerova, for their contributions to this speech. I remain solely responsible for the opinions contained herein.

[2] CPSS report: "Strengthening repo clearing and settlement arrangements", September 2010.

September 2008, money markets have not been operating smoothly. The outbreak of the financial crisis has been well documented, but it is worthwhile recalling the extent of the shocks, which are still being felt today.[3] Within a few days after the demise of Lehman Brothers on 15 September 2008, the EURIBOR-OIS spread, which had been zero a little over 12 months before, rose to a staggering 186 basis points (in the United States the spread rose to 365 basis points).

In addition, cash-rich banks were apparently no longer lending to cash-poor banks. The flow of liquidity in the financial system came to a sudden stop. Prior to the bankruptcy of Lehman Brothers, banks hardly ever deposited funds at the ECB (where they earn the deposit facility rate, which at the time was 1% less than the policy rate). After the Lehman bankruptcy, banks suddenly deposited an aggregate amount of around €200 billion. Deposits increased since the ECB responded to the tensions in the market by accommodating the increase in banks' demand for liquidity.[4] The extent of banks' use of the ECB's deposit facility is a useful indicator of the impairment of the flow of liquidity throughout the banking system, especially when the group of depositing banks is different from the group of borrowing banks.[5]

A further troubling indication of the malfunctioning of money markets right after the Lehman bankruptcy came from cross-border transactions. Before the bankruptcy, cross-border transactions accounted for 60% of all unsecured overnight interbank lending. Right after the bankruptcy, this proportion dropped to 50%. A fall in the cross-border flow of liquidity indicates a fragmentation of the euro area money market along national borders and threatens the implementation of a common monetary policy throughout the euro area.

The ECB reacted and succeeded in calming markets, including money markets, first by conducting two monetary policy operations with a three-year maturity, and then, most recently, by committing to remove redenomination risk in countries having signed to an ESM assistance programme (the so-called Outright Monetary Transactions, OMTs for short). For example, the share of the cross-border overnight transactions increased gradually from 30% to 50% following the OMT announcement.

The rise and fall of the EURIBOR-OIS spread, of the use of the ECB's deposit facility and the proportion of cross-border transactions all indicate that banks are more risk-averse than they were before the financial crisis. Money markets, especially unsecured ones, suffer from counterparty risk, that is, the fear of not being repaid.

Accordingly, driven by the desire to protect and ensure repayment, transactions in money markets have become both more short-term and secured. There is no official data on the overall size of the repo market in the euro area, although surveys are regularly conducted by ICMA and the ECB. According to the latest ICMA survey, the total value of repo contracts outstanding on the books of the 62 participating institutions was €5.6 trillion in June 2012, down from €6.2 trillion in December 2011.[6] The ECB's Money Market Study of

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[3] See, for example, F. Heider, M. Hoerova and C. Holthausen, "Liquidity hoarding and interbank market spreads: The role of counterparty risk", ECB Working Paper No 1126, 2009. See also B. Cœuré, "The importance of money markets", speech delivered at the Morgan Stanley 16th Annual Global Investment seminar, Tourrettes, Provence, 16 June 2012.

[4] Injecting liquidity in the financial system increases the assets of the Eurosystem, which leads to an equivalent increase in liabilities, in this case in the form of more deposits from banks.

[5] A similar cessation of interbank lending after the Lehman bankruptcy has been documented in the United States. See G. Afonso, A. Kovner, and A. Schoar, "Stressed, Not Frozen: The Federal Funds Market in the Financial Crisis", Journal of Finance, Vol. 66, No 4, 2011.

[6] See International Capital Market Association, "European Repo Market Survey", No 23, June 2012, available at http://www.icmagroup.org/assets/documents/Market-Info/Repo-Market-Surveys/ICMA-ERC-European-Repo-Survey-June-2012.pdf.

December 2012 with 172 banks participating shows a similar development.[7] The Money Market Study also compares the development of the secured with the unsecured market. And indeed, while the unsecured money market has steadily contracted since 2007, the secured money market has held its ground over the same period.

Another, more recent and troubling development in the functioning of the money markets is the on-going investigations into manipulations of key money market reference rates. The ECB is closely following this development and is supporting the attempts to reform reference rates, given the role they play in the transmission of monetary policy. In our response to the European Commission's public consultation, while stressing that reference rates should remain private market initiatives, we have called for short-term governance reforms to restore and uphold the credibility of these reference rates, associated with longer-term measures involving changes in the calculation methodology. In the short term, governance reforms and increased supervisory and regulatory scrutiny can help to restore the market's confidence in the integrity of the benchmarks and to ensure their continuous viability. An appropriate balance must be found between a sound production process with adequate controls and safeguards on the one hand, and cost-efficiency for contributing banks on the other hand. Also it is important that regulation is uniformly applied and enforced within the EU to avoid risks of further fragmentation in the money markets, and that international coordination is sought. In the longer term, a broader overhaul can be conceived, involving changes in the calculation methodology and possibly other changes to reflect the structural changes that have taken place in terms of the functioning of the money market since the onset of the crisis, such as the shift towards secured transactions. However, this process should be primarily driven by the market, based on the needs of end-users, while being supported by the public sector.

In light of the fundamental importance of money market reference rates, we are closely following the developments taking place as regards the shrinking number of panel members for establishing EURIBOR and EONIA rates. Given the authorities' commitment to addressing the shortcomings revealed in the rate-setting process, it is in the interest of markets that banks remain in the panel while the regulatory framework is being amended and behave as responsible market participants, thus preventing potential disruption in the functioning of an important financial market segment.

Related to the shift of money market transactions to the secured segment is the use of central counterparties (CCPs).[8] In 2012, CCP repo transactions accounted for 55% of all repo transactions (up from 50% in 2010). In addition to the use of CCPs, triparty repo[9] has become more important. Triparty repo accounted for 11% of all repo transactions in 2012 (up from 9% in 2010).

I will come back to CCPs and triparty repo later on, but would first like to say some words on collateral and haircuts.

Collateral of course is intended to hedge default risk, while haircuts are usually seen as being intended to hedge the risk on that collateral. In times of market stress however, large and sudden margin increases can create self-reinforcing, pro-cyclical spirals of increasing weakness, exacerbate market swings and oblige market dealers to provide collateral to

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[7] See ECB Money Market Survey: http://www.ecb.int/pub/pdf/other/euromoneymarketstudy201212en.pdf?4261e943bbcfec98572319740bda877b

[8] A CCP is an entity that interposes itself between the buyer and the seller of a repo, thereby reducing counterparty risk for both seller and buyer as long as the CCP itself is well diversified and well governed.

[9] Under triparty repo, a central securities depository (CSD), an international CSD or a custodian bank, for example, acts as a facilitator between the buyer and the seller of a repo. The triparty agent handles the related collateral management, including valuation and substitution as well as re-use of the collateral with a central bank where possible.

support secured transactions just when it is most costly to do so. Two examples come to mind.

First, when the sovereign debt crisis intensified, haircuts on government bonds under stress also went up because the rise in yields reduced their collateral value. For example, when the spread on Italian ten-year government bonds relative to core issuers rose to over 450 basis points in November 2011, the haircut for Italian government bonds was increased by 500 basis points, leading to a posting of intraday margins about 12 times greater than in any other preceding month in 2011. On the day of the increased haircut alone, the spread between Italian and German government bonds rose by 60 basis points.

In addition, margin increases generally reduce the amount that a repo seller can borrow, which might increase the seller's probability of default. This can trigger a negative feedback loop: increases in the probability of default might cause repo buyers to increase the haircuts imposed on the seller, which reduces the amount the seller can borrow (when it needs to borrow subsequently), and so on.[10]

The ECB/Eurosystem has been successful in easing market tensions using standard and non-standard tools. However, the underlying structural problems which relate to uncertainty about risk, whether in the form of counterparty, credit, liquidity or redenomination risk, need to be solved. When implemented, the Single Supervisory Mechanism will play a key role in comforting confidence in euro area banks and re-establishing cross-border liquidity flows within the region. Market re-integration has now started. It will succeed only if it is supported by continued efforts by governments to bridge fiscal and competitiveness imbalances. We can consider how the further development of market infrastructures can be an important part of this process.

2. The role of market infrastructures

In the second part of my remarks today, I would like to consider the role of market infrastructures.

Market infrastructures have proven very resilient to the crisis.[11] Resilient market infrastructures also play an important role in helping to address some of the issues that have been identified in the money markets. In this regard we can usefully build on the CPSS' analysis of areas for further development and for enhancing market infrastructures in repo markets. The CPSS has identified seven issues directly or indirectly related to repo market infrastructure that may affect the resilience of repo markets. I would like to pick up on two of these seven issues now in the context of euro area money markets. The first issue concerns "effective protection against counterparty credit risk", which I believe can be addressed to some extent by the use of CCPs, while the second issue relates to "the inefficient use of (high-quality) collateral due to constraints within repo clearing and settlement arrangements", which is being addressed via collateral optimisation initiatives.

a) Role of central counterparties (CCPs)

CCPs play a major role in reducing counterparty risk, thereby mitigating the potential risks associated with the drying-up of funding sources. First, as independent clearing agents, CCPs are well positioned to offer effective protection against counterparty risk through the application of consistent margin requirements to a wide range of counterparties and through

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[10] See T.V. Dang, G. Gorton, and B. Holmström, "Financial Crises and the Optimality of Debt for Liquidity Provision," working paper, November 2009.

[11] Speech by Benoît Cœuré, at the joint ECB-MNB conference on "Cost and efficiency of retail payments: Evidence, policy actions and role of central banks", Budapest, 15 November 2012. https://www.ecb.int/press/key/date/2012/html/sp121115_2.en.html.

multilateral netting and risk sharing. Second, CCPs also provide enhanced transparency for the markets they serve, which in turn facilitates appropriate risk management and may also help to reduce excessive leverage. Third, as a result of multilateral netting, CCPs may also free up collateral.[12]

Overall, provided that it is well-managed and in line with applicable regulatory and oversight requirements, a CCP can be expected to guarantee trade execution under a wide range of market conditions, including extreme or exceptional scenarios. This supports trading also at times of distress when uncertainty and risk aversion may disrupt activity and exacerbate volatility in markets.

Given the benefits of central clearing for market resilience and financial stability more broadly, the ECB welcomes the overall increase in the share of transactions that are cleared through CCPs. It also supports the execution of repo transactions via CCPs. In Europe, market incentives seem sufficiently strong to favour use of CCPs, and we would not see a need at the current juncture to advocate regulatory action to impose central clearing of repos, as has been the case for OTC derivative transactions.

At the same time, an expanded use of CCPs should be accompanied by effective supervision and oversight, which always needs to be kept up to date and in line with new market developments. The global Principles for Financial Market Infrastructures (PFMIs), developed jointly by CPSS and the International Organisation of Securities Commissions (IOSCO) and published last April, are a key pillar in this regard. Major jurisdictions around the world are now updating their supervisory and oversight requirements for CCPs in response to the new PFMIs, thereby leading to an even more robust set-up for CCPs. Another major strand of work currently underway at both international and EU level concerns the development of recovery and resolution regimes for CCPs. In the EU, the European Commission has recently consulted the public on a possible framework for the recovery and resolution of financial institutions other than banks, covering CCPs and other market infrastructures. We trust that the European framework will be closely aligned with the respective global work of the CPSS and IOSCO.

Besides CCPs, another key infrastructure to be considered in relation to the repo market is the trade repository.[13] Trade repositories provide a comprehensive overview of the transactions in the markets they serve, which contributes to better risk management, public supervision and oversight as well as market discipline. The ECB actively supports the current work to develop such a central database for the EU repo market.[14] It could be established in a joint effort by public authorities and the financial industry.

b) Collateral optimisation

Let me now turn to the second point on collateral optimisation.

As recognised in the CPSS report, the "efficient and flexible use of collateral facilitates market participants' collateral management and can contribute to the development of liquidity and smoothly functioning repo markets". This was considered to hold true for repo markets in normal times as well as allowing an enhancement of the resilience of repo markets in times of stress. The need for efficient and flexible use of collateral facilities has even become

[12] See, for instance, D. Duffie and H. Zhu, "Does a Central Clearing Counterparty Reduce Counterparty Risk?", Review of Asset Pricing Studies, Vol. 1, Issue 1, December 2011.

[13] Trade repositories are central databases that compile and aggregate data across various execution and clearing venues.

[14] See Vítor Constâncio, Introductory remarks to the ECB workshop – Repo market and securities lending: towards an EU database, 3 December 2012, see https://www.ecb.int/press/key/date/2012/html/sp121203.en.html.

greater in the past couple of years, taking into account the generally increasing demands for collateral assets coming from various quarters. Efforts are therefore being made to seek out creative and innovative ways to make better use of existing collateral in terms of making these assets available, when and where they are needed.

Both the Eurosystem and the industry have taken a number of initiatives in this respect. At today's conference, you will probably hear more about the many innovative solutions that are coming from the industry in this respect, so I will limit myself to some key initiatives in which the ECB/Eurosystem is directly involved, although naturally cooperating closely with the industry.

The first initiative in this respect of course is TARGET2 Securities – T2S. The main objective of establishing this single European infrastructure for securities settlement is to reduce risk and increase efficiencies in the post-trade environment, especially as far as cross-border settlement is concerned. This greatly enhanced process for transferring collateral across national borders in Europe will in itself be a huge benefit to market participants – both to cover collateralised money market transactions as well as collateralised credit operations with central banks. Moreover, T2S incorporates several features that aim to help banks optimise their collateral management. Once T2S goes live for example, banks will no longer need to hold multiple buffers of collateral when settling in several European countries and can instead use the state-of-the-art T2S auto-collateralisation and self-collateralisation features, also on a cross-border basis.

The second initiative that I want to mention is the implementation of cross-border triparty collateral management services within the Eurosystem collateral framework. Triparty services, as you know, involve a triparty agent acting as a facilitator between the two parties to the repo. Triparty services are already used within the current operational framework of the Eurosystem, although only on a domestic basis and limited to a small number of euro area countries (Germany, Luxembourg, France and Italy). In 2014 however, the possibility to collateralise Eurosystem credit operations by using triparty services on a cross-border basis will be introduced, thereby allowing for greater efficiencies in collateral mobilisation and re-use of collateral received in triparty repo with the respective central banks of the Eurosystem.

Another initiative with which the ECB is associated relates to triparty settlement interoperability.[15] When we refer to this, we should keep in mind that an important feature of the European repo market set-up is the (increasing) integration between the repo clearing, settlement and collateral management layers. While there is an increasing integration across these layers however, there remains in some cases a certain fragmentation that limits traders' opportunities based on the location of the collateral. Working in close cooperation with the European Repo Council (ERC), the international central securities depositories (ICSDs) have started to develop a triparty settlement interoperability model to support settlement of general collateral trading cleared by CCPs. With the interoperability between the two ICSDs' collateral management systems, market participants would avoid the fragmentation of their liquidity pools.

The ECB is fully behind this market-led triparty interoperability initiative because of its collateral pooling benefits and efficiencies. Moreover, it reduces the costs for triparty repos related to collateral management, settlement and legal charges, and allows trading to be executed regardless of the location of the collateral. Non-discriminatory, risk-based access to and by market infrastructures is an important element of the new international regulatory framework. With market participants increasingly moving to central clearing, the business

[15] Triparty interoperability is especially relevant for standard interbank operations/repos, which are cleared at CCPs and where CCPs use standardised baskets of eligible collateral (also referred to as general collateral (GC) baskets).

case for triparty interoperability is growing. Furthermore, the new CPSS-IOSCO principles for financial market infrastructures were specifically strengthened to facilitate access and interaction between such infrastructures.

Some of the key parties involved in this triparty settlement interoperability initiative have started to show signs of retreating in past months. While the ECB understands the complexity of establishing a triparty interoperability model and the substantial efforts and in particular the investment costs required to make it work, it would like to strongly urge all parties to continue to work together. Interoperability will bring important benefits – by allowing a more efficient use of collateral by bringing together separate pools of liquidity. The ECB remains ready to continue to support the triparty settlement interoperability initiative and to help bring the project forward.

Concluding remarks

Let me conclude.

The resilience and proper functioning of market infrastructures is of paramount importance to ensure well-functioning money markets. Public authorities and central banks have both an interest and an obligation to ensure that market infrastructures have a high level of security and operational performance. The market infrastructures in the euro area are performing well in this respect and, as we have heard, there are a number of initiatives under way to further enhance this (in particular as regards the collateralisation processes).

I would, however, urge industry representatives to further pursue the triparty interoperability project, and seek to find ways to address the issues which have recently appeared. In particular, where these issues are not going to be addressed by T2S, I would encourage the industry to find a solution now. It is of great importance that collateral can flow freely, regardless of its location.

I am confident that further improvements will be made.

Thank you.