Yves Mersch: The possible triangle - frictionless movement of payments, securities and collateral across Europe

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the 2019 Annual General Meeting of the International Capital Markets Association's European Repo and Collateral Council, Luxembourg, 31 January 2019.

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Introduction

This year, we celebrate the 20th anniversary of the euro, the single currency of 19 EU countries and over 340 million Europeans.

But the euro is not only important for European citizens and businesses; it also has a global role. In fact, it is the second most used currency in the world. More than 50 countries or territories in the world use or link their currency to the euro. More than 20% of the international reserves held by central banks outside the euro area are in euro[1] – a percentage that exceeds the euro area's share in global production. Furthermore, the euro has become a widely accepted currency for international payments. In 2017 about 36% of international transactions – in value terms – were invoiced or settled in euro.

The status of global currency is a double-edged sword. Having more weight as an international currency comes with pros and cons. The list of traditional benefits includes higher seigniorage and lower transaction and hedging costs. And – following the experience of recent decades – we can now add the better protection of domestic inflation and reduced dependence on monetary policy decisions of other major central banks.

But the euro's role as an international currency also comes with increased responsibilities. International currencies must be backed by large, stable and efficiently functioning economies and financial systems that are attractive to international users and investors. And last but not least, the effect of monetary policy on import prices is reduced.

The ECB has always held that the international role of the euro develops as a result of market forces. Accordingly, the internationalisation of the euro as such has never been a policy objective.

In December 2018, however, the European Commission presented a set of action points to strengthen the euro's global role. To this end, the euro should become even more compelling as a means of payment and a trustworthy investment currency.

These action points include the completion of Economic and Monetary Union, banking union and capital markets union. Moreover, and without prejudice to the ECB's independence, we take note of the Commission's support for our initiatives on market infrastructure and payments, which help to increase efficiency and financial market integration in the euro area.

Although it is not in our mandate to establish or promote the euro as a global currency, the ECB's responsibility for promoting the smooth operation of payment systems indirectly supports the international standing of the euro.

Since the launch of the euro, the Eurosystem has indeed contributed to reshaping and consolidating the infrastructure for large-value payments, for post-trading services for financial instruments and, most recently, for instant retail payments. The goal is to create a truly single financial market in Europe. In such a single market, payments, securities and collateral could be moved safely and efficiently between market participants in different countries without friction or restrictions.

Today I will briefly look back at what has been achieved so far and discuss how the Eurosystem will move forward over the next two or three years by taking measures to consolidate TARGET2 and TARGET2-Securities (T2S), in particular by delivering a centralised liquidity management function. Furthermore, to increase efficiency in the mobilisation and management of collateral and further level the playing field for Eurosystem counterparties, the Eurosystem is developing a single collateral management system that will be capable of managing the assets used as collateral in Eurosystem credit operations for all euro area countries. In a complementary initiative, the Eurosystem has launched comprehensive work on collateral management harmonisation.

TARGET consolidation: strengthening the backbone of the European financial market

TARGET2 and its predecessor are the longest-standing components of the Eurosystem's financial market infrastructure. Today, TARGET2 is one of the biggest payment systems in the world, processing 90 % of the total value settled by large-value payment systems in euro.

T2S, the integrated IT platform which processes the real-time settlement of securities transactions against central bank money across Europe, was launched in 2015. Full migration took place in waves over the following two years to ensure a smooth transition. T2S facilitates the establishment of a single pool of collateral for banks and intermediaries to settle their entire European business in central bank money, thereby optimising settlement and triparty procedures.

With the introduction of T2S, the average cost per transaction at market infrastructure level has decreased significantly – in particular for transactions between central securities depositories (CSDs). Our cost estimates indicated that, before T2S was launched, the average fee per domestic CSD settlement in the euro area was 73 cent, while cross-border transactions were up to ten times more expensive. T2S has brought the transaction fee per instruction down to a much lower level. Initially, the delivery-versus-payment price for T2S was set at 15 cent per instruction. However, the effects of the financial crisis and delays in the migration of certain T2S markets reduced T2S volume and income in the first few years of its operation. As a result, the T2S pricing structure was adjusted, and fees per instruction were increased from 15 cent to 19.5 cent, plus a temporary surcharge of 4 cent. This is still substantially lower than the average fees of 73 cent observed before the launch of T2S.

T2S has also been a catalyst for harmonising the post-trade market in the EU and beyond. Faced initially with a wide variety of different practices across European markets, the sound T2S governance structure fostered collaboration between stakeholders, who soon recognised the added value of harmonisation for their business models. The integration of ancillary processes and legal frameworks to a large extent dismantled several of the barriers that had hitherto hindered efficient cross-border clearing and settlement arrangements in the EU. These barriers were identified as early as 2001.

Last but not least, in November 2018 the Eurosystem delivered TARGET Instant Payment Settlement (TIPS), a truly domestic market infrastructure for pan-European instant payments with settlement in central bank money. TIPS enables payment service providers to offer fund transfers to their customers in less than ten seconds around the clock, every day of the year.

The upcoming technical and functional convergence of TARGET2 and T2S will further optimise liquidity management and generate new cost efficiencies. In particular, the consolidation project, which will run until 2021, will introduce a central liquidity management system that will allow participants to monitor and manage their liquidity for all TARGET services. More specifically, it will provide a central liquidity overview on a single screen with easy access to more detailed information. It will enable centralised management and control over the payment capacity with a clear allocation of liquidity for the different settlement purposes. Real-time gross settlement participation will be segregated from interaction with central banks for monetary policy purposes.

The minimum reserve calculation and automatic marginal lending facility will take into account balances in other Eurosystem market infrastructures, such as TIPS. In summary, the introduction of central liquidity management within the new TARGET services makes the use of central bank money even more efficient for market participants.

Thanks to the joint public-private efforts, major steps have been taken to overcome the fragmentation in the European securities trade and post-trade market over the last decade. At the front end of the process chain, however, there is still much to be achieved. For instance, the issuance and distribution of securities still hinges on fragmented legacy standards, structural constraints and complex market practices at the national level. Furthermore, facilitating interactions and procedures between some participants still entails high costs and risks. European issuers and in particular EU institutions needs to collect funds from investors across the continent deserve fair consideration. Reflection on pan-European issuance and distribution channel in the most efficient manner would be in line with the endeavour to deepen the single capital market in the EU. This could have a positive impact on the establishment of a domestic yield curve for the euro money market. Should market participants propose solutions in this area, the ECB will certainly take them into consideration in our own investigation.

Collateral management harmonisation

The second element of the process of pushing for a truly single financial market is the further harmonisation of collateral management. Following the successful harmonisation of market practices in the context of T2S (which I alluded to earlier), the Eurosystem, together with key European financial market stakeholders, is working towards extending such harmonisation benefits to the field of collateral management. The core innovation in this work is that all interaction will be based on ISO 20022 standards. A single model for triparty collateral management based on these standards will allow market participants to benefit from enhanced features. This will also facilitate improved reporting capabilities to support the needs of treasurers and to meet regulatory requirements. Furthermore, the harmonised handling of corporate actions will ensure that securities can remain part of the collateral pool in the event of a corporate action, thus obviating the need for their substitution. Further collateral management harmonisation work will cover, for example, bilateral collateral management and margin calls.

To facilitate implementation, we are working together with the market on a single rulebook for collateral management in Europe which we plan to publish later this year, together with a roadmap for harmonised post-trade services in Europe. The ECB is counting on the continued support of market participants in this work. Early engagement is needed, and it is critical that preparations for the implementation of these – as yet to be developed – standards start **now**.

The Eurosystem has taken advantage of the progress made so far in collateral harmonisation when designing the Eurosystem collateral management system (ECMS), which is currently being built. The system is due to go live in 2022. It will – if agreed – replace the individual collateral management systems currently in use by Eurosystem national central banks. Counterparties, central securities depositories and triparty agents in different countries, which today interact with national central banks through those national collateral management systems, will in future be able to use the same harmonised system. This will simplify processes that involve multiple jurisdictions, notably the mobilisation of cross-border collateral. The ECMS has considerable potential to trigger a wider harmonisation of collateral management practices.

Given that the demand for collateral and the interest in collateralised transactions has grown substantially in recent years, for example owing to the increased need for collateral as a margin for centrally cleared and bilateral derivative transactions, collateral mobility has become an even more valuable attribute. This is why we are taking action.

Potential issues in the repo market

Let me make a few remarks on potential issues in the repo market.

The secured segment is the largest segment of the euro money market, representing two-thirds of the total money market turnover, and is an important contributor to the overall resilience and efficiency of financial markets. Several factors explain the resilience of the secured segment to the crisis:

1. the demand for high-quality and liquid securities for regulatory purposes and for covering margin calls at CCPs;
2. the protection against counterparty risk through collateral;
3. the impact of the asset purchase programme, which reduced the supply of collateral effectively available to the market and boosted the supply of excess liquidity, offering business opportunities for those with access to the Eurosystem deposit facility.

Turnover in the secured segment has increased significantly since the third quarter of 2016. In an environment of excess liquidity, and with a purchase programme acquiring large quantities of euro-denominated securities, the activity is mainly driven by the demand for securities rather than by funding needs. This demand for securities is fuelled by regulatory requirements, by the need for collateral to cover margin calls in order to trade over-the-counter interest rate derivatives via CCPs, and by the supporting role of security financing transactions for fixed income desks.

The evolution of prices in the last two years also highlights how the repo market has become largely a platform for collateral exchange.

Rates move from above to below the deposit facility. For many securities, demand has become so strong that counterparties searching for that security agree on a repo rate that is less favourable than the central bank's deposit rate.[2]

Let me briefly touch upon our asset purchases. Certain factors, most notably new regulations, have led to increased bond scarcity and consequently to an increased share of bonds that trade "special", especially ahead of reporting dates. In order to support the smooth implementation of the public sector purchase programme as well as the liquidity and functioning of the euro area repo market, in December 2016 we introduced the option of borrowing securities against cash collateral. This technical amendment, along with some others, made our facilities more accessible and was one of the contributing factors to the subsequent improved repo market conditions. In 2017, and even more so in 2018, we generally observed lower repo market tensions ahead of quarter-ends and futures delivery dates. The ERCC's recent report concluded that the 2018 year-end in the repo market was relatively uneventful, and we at the ECB share this assessment.

Conclusion

Let me conclude.

In just 20 years, the euro has become the second most used currency in the world. Its global success relies on a large, stable and efficient economy, as well as a financial system that is attractive to international users and investors. In its provision of safe and efficient financial market infrastructure services, the Eurosystem plays an integral role in strengthening the international role of the euro. Our current activities – the consolidation of TARGET2 and T2S and the mobilisation and management of collateral through the development of the ECMS – are the cornerstones of the Eurosystem's ambitious agenda up to 2022.

All these enhancements will help improve the functioning of the repo market, responding to some of your concerns on the post-crisis context, with the effect of allowing greater and more fluid movement of payments, securities and collateral across Europe.

I therefore strongly encourage the post-trade industry to embrace the collateral management harmonisation agenda and to start preparing already for its implementation. Efforts will be required from all of us, but the ultimate goal of efficient harmonised collateral management will greatly benefit Europe at large and support a truly single financial market in Europe that will underpin European autonomy in the globalised world.

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1 See ECB (2018): The international role of the euro – Interim report; June 2018.

2 For instance, the price of German sovereign collateral is fuelled by the strong demand for high quality and liquid assets and the impact of the asset purchase programme on collateral supply. Moreover, around the year-end, repo rates on the securities with higher ratings decline further to levels significantly below the deposit facility.