International
Capital
Market
Association

ICMA

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Ms. Imène Rahmouni Rousseau
Director General of Market Operations
European Central Bank
60640 Frankfurt am Main
Germany

cc: Torsti Silvonen, Deputy Director General of the Directorate General Market Operations, ECB
Ulrich Bindseil, Director General of the Directorate General Market Infrastructure & Payments, ECB
Nathalie Aufauvre, Directrice Générale de la stabilité et des opérations, Banque de France
Sebastian Schuetz, Hauptgruppenleiter Bewertung notenbankfähiger Sicherheiten, Deutsche Bundesbank
Livio Tornetta, Head of Market Operations Directorate, Banca d'Italia

Dear Ms. Rahmouni Rousseau,

Industry concerns about current Eurozone repo and money market conditions

ICMA is writing to you on behalf of its broad membership and its dedicated constituencies representing the repo and collateral markets, the commercial paper and certificates of deposit market, the international bond market, as well as the asset manager and investor community. ICMA and its members would like to provide you with some colour on current liquidity conditions in the Eurozone repo and money markets, with a concern that rising dysfunction in the market could imperil the transmission of monetary policy. The conditions can largely be attributed to a disequilibrium situation of excess liquidity in the Euro banking system and a scarcity of high-quality, liquid collateral. The resulting risks are accentuated by constraints on bank intermediation.

While the environment of excess reserves and collateral scarcity has been the norm for a number of years, it has led to major market dislocations only on a limited number of occasions, notably certain year-end reporting periods and the COVID-induced turmoil of March-April 2020. However, as we enter a new phase of the monetary policy cycle, with the normalization of interest rates and associated market volatility, the potential for both the scale and frequency of such dislocations is likely to increase. The market focus and associated pricing for 2022 year-end is already indicating such concerns, as is the persistent widening of asset swap spreads of short-dated high-quality euro securities. For example, we have observed the 3-month Bubill-EURIBOR spread invert to around 60bp (reaching 100bp in early September), while the swap spread for the on-the-run Shatz has become ever more deeply inverted to around 110bp (having reached 120bp last month). Meanwhile, German General Collateral over year-end is implying a rate for the "turn" of between -10% and 12%, while the USDEUR FX Basis Swap is also implying a rate of around -14%. The recent September 2022 quarter-end, which saw the widest quarter-end dislocation between collateralized and uncollateralized rates since the introduction of the euro, has only added to these concerns.

These pressures on short-term markets and collateral scarcity could be further accentuated by less favourable rates for the Targeted Long-Term Refinancing Operations or the introduction of reverse tiering to the ECB deposit facility. This extreme sensitivity to any changes in the liquidity-collateral equilibrium was highlighted at the start of the September 14 maintenance period when despite the ECB deposit rate being 75bp higher, repo rates actually tightened, with euro General Collateral trading around -0.30%.

In order to ensure the smooth transmission of the ECB's policy objectives, ICMA suggest that the ECB may wish to consider broadening its policy toolkit. In particular, ICMA would point to two targeted central bank interventions to manage the disequilibrium of excess liquidity and collateral scarcity. Importantly, both of these initiatives are standard market interventions aimed at improving market functioning by providing an additional supply of collateral while removing excess liquidity: these are not measures intended to "back stop" the market in times of stress.

Firstly, the Federal Reserve's Overnight Reverse Repurchase Facility. This has proven to be a useful pressure valve since its introduction in 2013, particularly more recently as excess reserves held at the Federal Reserve have increased. A notable example is the $1.9tn uptake at the end of 2021 which ensured that there was no year-end scramble for collateral and repo rates remained steady. Perhaps one complication with implementing a similar facility in the Eurozone is the reliance of bank intermediation for end users to access the facility. The ability for certain funds (such as Money Market Funds or Pension Funds), and even CCPs, to access such a facility, whether bilaterally or through a centrally cleared model, may also be a prerequisite for the effectiveness of this form of intervention.

Secondly, the Swiss National Bank's recently announced initiative to issue tradable Treasury Bills, either through auction or private placement. Not only would a Eurosystem bill-issuance program, potentially, be less complex to implement than a reverse repo facility, but it would have the additional advantage of not tying up bank balance sheets in the process of intermediation.

A further, and possibly complementary, consideration relates to the capacity for banks to intermediate in the euro repo and money markets (and potentially the bond and derivatives markets more broadly). While the euro repo and money markets function relatively well on the whole, there are clearly identifiable pressure points around bank reporting dates (primarily quarter-ends and year-ends), as well as during times of heightened volatility, both of which have direct impacts on bank balance sheets and available risk capital to support market intermediation. A targeted recalibration of the Leverage Ratio (such as for certain transactions counterparty types) or the ability to re-allocate capital buffers to supporting liquidity provision, particularly at such times, could contribute to both market stability and resilience. While such refinements to the regulatory capital framework are beyond the gift of the ECB, it may be something where its support and guidance could be helpful.

ICMA would welcome the opportunity to discuss its concerns and policy suggestions with the ECB and proposes a meeting on this specific issue involving representatives from ICMA's key market constituencies.

Yours sincerely,

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