



Financial Infrastructure Week

Panel: The Central Role of Liquidity

*The relevance
of interbank markets
for Financial Stability
and for the orderly functioning of
Wholesale Payment Systems*

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Market and Payment System Oversight

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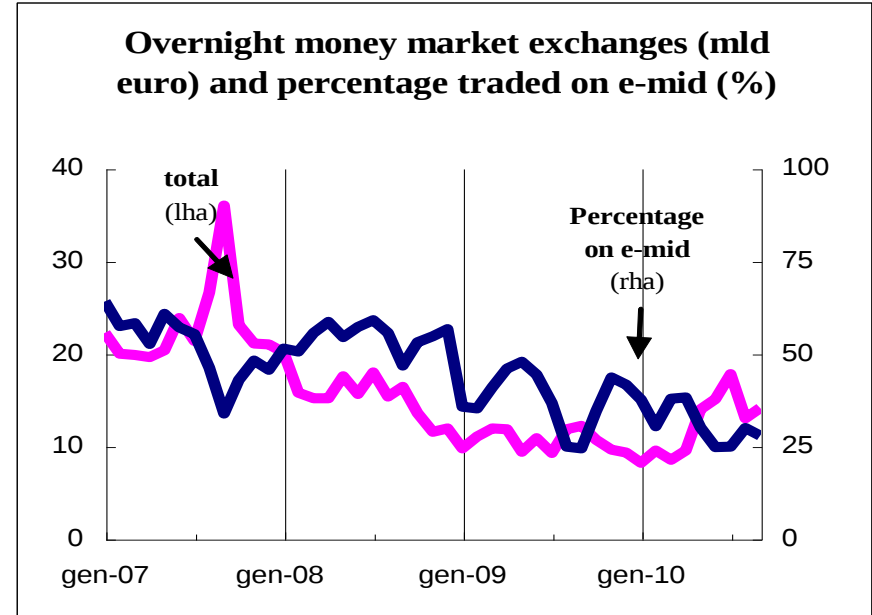
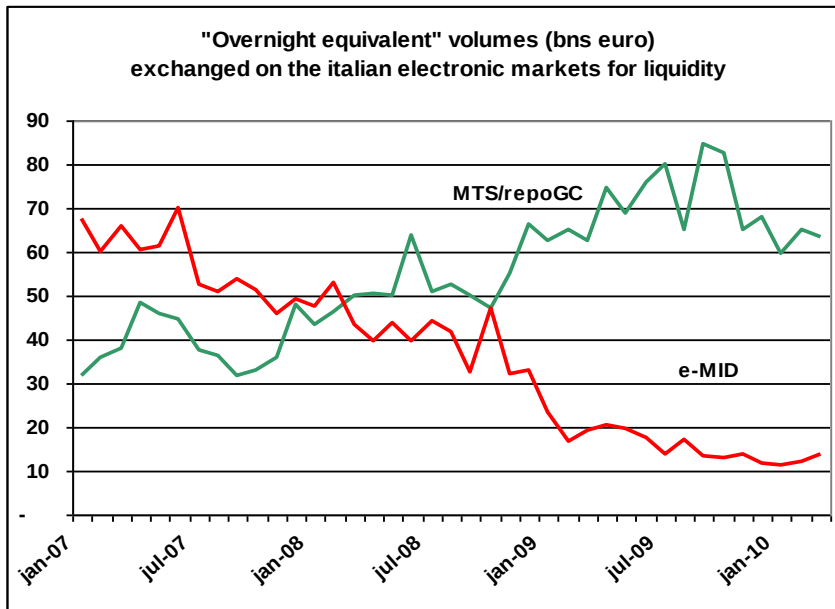
OUTLINE

1. The impact of the crisis on liquidity provision
2. The Italian experience: the MIC – the new Collateralised Interbank Market
 - ✓ 1. stage: the Central Bank as facilitator of trading
 - ✓ 2. stage: the involvement of a CCP
3. Stress testing the Wholesale Payment System: the case of a money market dry up

The integration of the euro area markets for the liquidity since 1999

1. single monetary policy for the euro area
2. Trans-European Automated Real-Time Gross Settlement Express Transfer System TARGET (since 2007 TARGET2)
3. electronic interbank market for secured money market exchanges: MTS Repo, Eurex Repo, BrokerTec
4. electronic interbank market for unsecured money market exchanges: e-MID

SINCE THE OUTBREAK OF THE CRISIS....



- ✓ Drop of the secondary market volumes – substitution through Central Banks' liquidity injections (primary market for liquidity)
- ✓ Unsecured vs Secured money market
- ✓ Preference for bilateral transactions (OTC)
- ✓ Preference for domestic counterparties (Home Bias - tiering)

SINCE THE OUTBREAK OF THE CRISIS....

NEW TRENDS

1) New role for Central Banks as counterparty for banks' liquidity needs

2) Shift from unsecured money market to secured transactions

3) Preference for bilateral transactions (OTC)

4) Preference for domestic counterparties (home bias)

NEW RISKS

1) dependency from the Central Banks' funding (Central Banks internalising the money market): need for an exit strategy

2) increased need of high quality collateral

3) less transparency for market participants and for supervisors

4) less efficient liquidity redistribution at euro area level



MIC (from February 2009 to October 2010): The collateralised interbank market

RATIONALE OF THE INITIATIVE

The Interbank Collateralized Market (MIC) has been launched as a temporary initiative set up by Banca d'Italia, e-MID and the Italian Banking Association. It intends to eliminate two obstacles hampering normal activity on the interbank market for longer maturities:

- ☐ The enhanced perception of credit and liquidity risk
- ☐ The 'stigma effect'

To achieve these objective the MIC has been designed with:

- ☐ mandatory use of transparent and efficient trading and post-trading infrastructures (e-MID and Target2)
- ☐ full collateralisation of exposures, partial mutual sharing of losses and limits to risk concentration
- ☐ role of Banca d'Italia as “facilitator” of trading (anonymity, custody, administration and assessment of the guarantees, management of fails) and as oversight authority



MIC: Main Features

Trading Platform

- ☐ Anonymous trading with an automatic check on collateral usage
- ☐ Maturity from 1Week to 1Year
- ☐ Automatic settlement in Target2 at 9.00 am

The Guarantee scheme

- ☐ each participant posts collateral to cover its own debt position
- ☐ mutual sharing of losses (up to 10% of the collateral posted by each participant)
- ☐ Banca d'Italia is responsible for the valuation of the guarantees and the management of fails

Eligible collateral for MIC

- ☐ assets eligible for the Eurosystem
- ☐ assets/liabilities guaranteed by EU Governments
- ☐ other financial instruments and credits accepted by Banca d'Italia on a discretionary basis

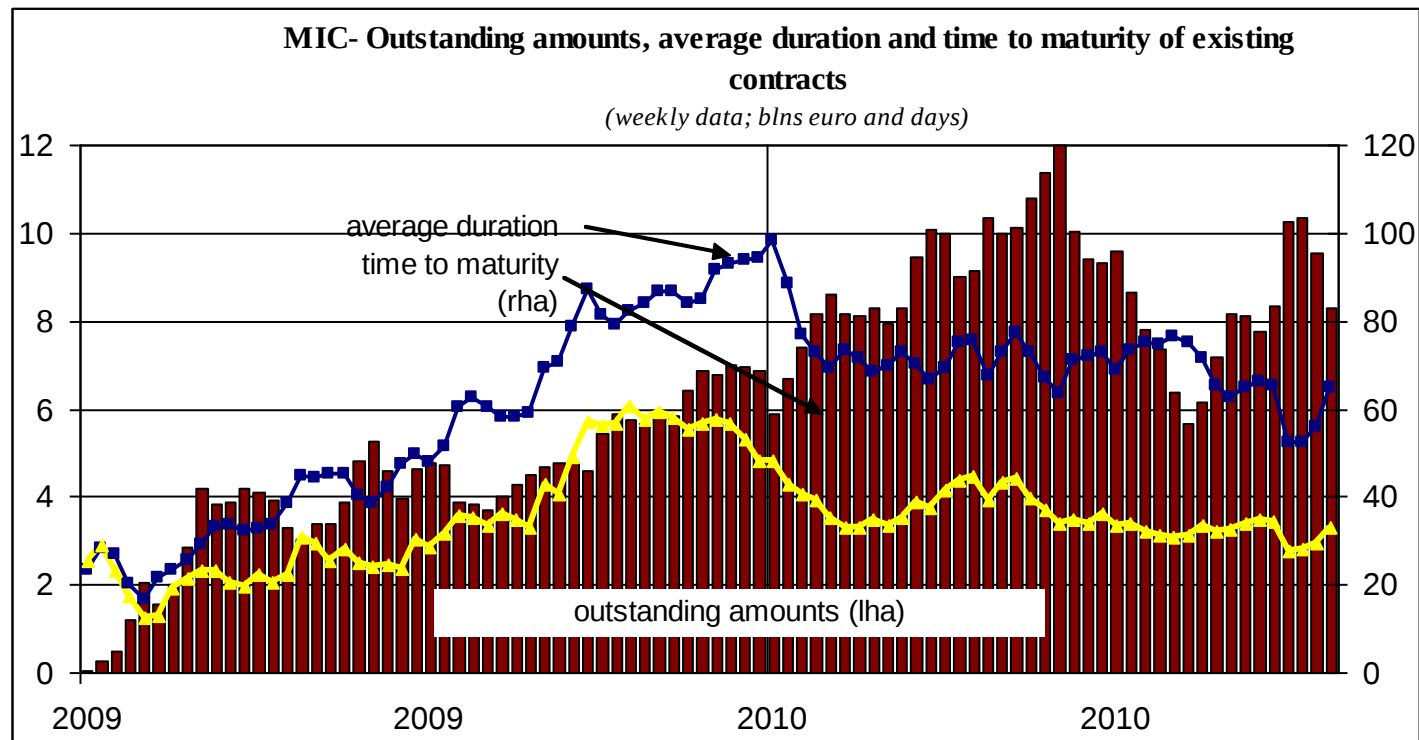
Quantitative limits: The limits are designed to allow a large participation to the market and to prevent an excessive concentration of risks

(individual participation: min=€5 million of collateral (eligible) and max $\leq$ 75% of regulatory capital or $\leq$ 5 billions euro; maximum limit to the gross individual exposure=20% of the total amount of collateral posted; collateral composition: at least 30% must be Eurosystem eligible collateral)

MIC Trading Activity/1

MIC outstanding deposits account reached a peak of 12 billions euro in 2010.

After an initial stage, the average weighted duration of the outstanding deposits ranged between 60 and 100 days.



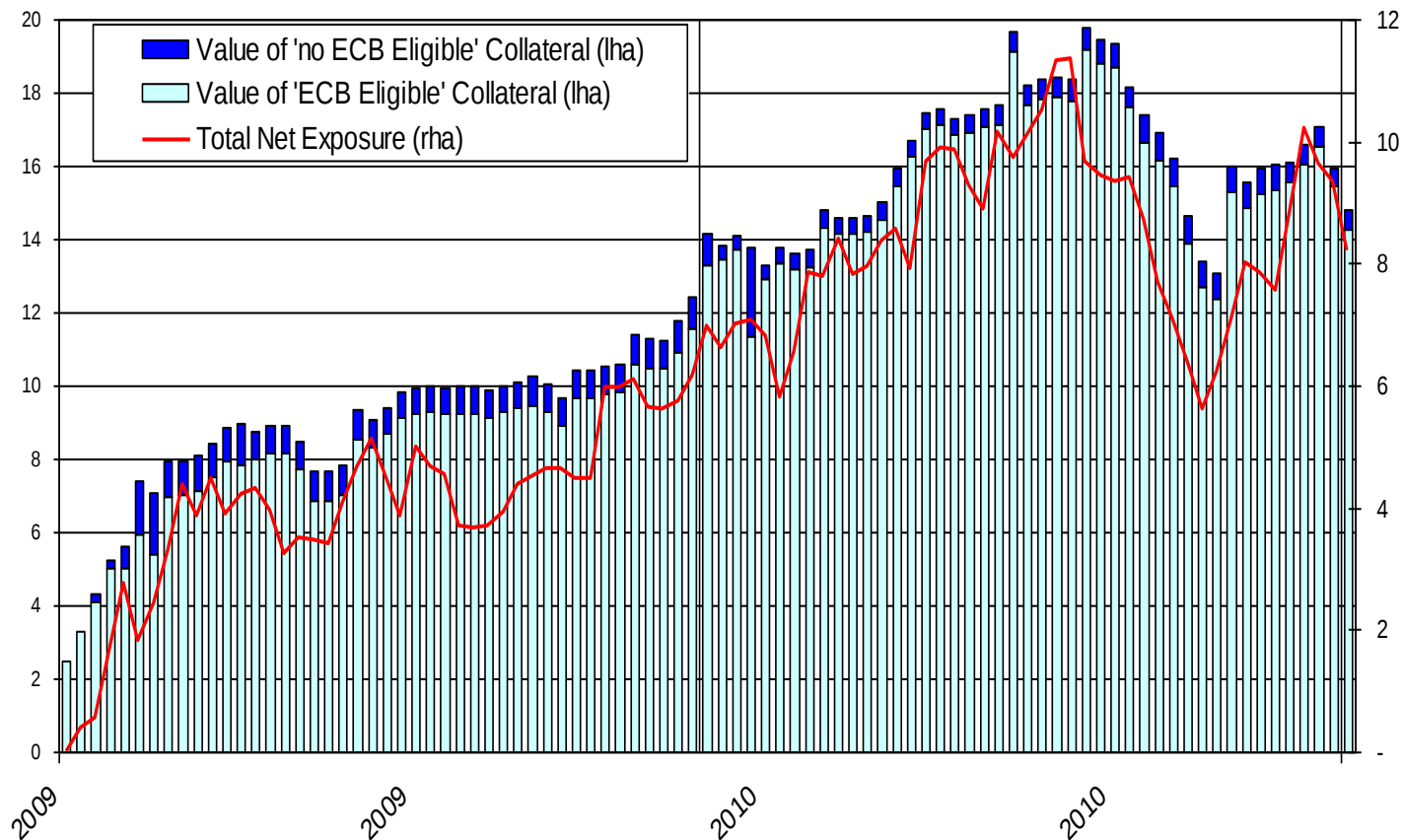
MIC Trading Activity/2

Collateral posted in the MIC guarantee scheme has reached in 2010 nearly 20 billion euros.

60 banks posted collateral in the scheme; they account for more than 80% of Italian banks' consolidated assets.

97% of the collateral is represented by Eurosystem eligible assets.

Collateral posted in the MIC scheme and total net exposure
(weekly data ; bln euro)





The NewMIC (since October 2010)

MIGRATION OF THE CENTRAL BANK'S GUARANTOR ROLE TO A PRIVATE SUBJECT

- the same collateralised interbank market on the e-MID platform as in the MIC with the Italian CCP (CC&G) as manager of a guarantee scheme
- CC&G interposes between two counterparties in all executed money market exchanges on the NewMIC.
- Banca d'Italia is responsible only for the supervision of the efficiency and orderly functioning of the market
- The traded maturities have been expanded: also spot and tom next
- Easily expandable to the non-Italian banking community
- It represents a new complementary and non-rival money markets segment for European banks for maturities longer than overnight.

The overall MIC experience:

- The MIC contributed to keep the market alive in which the market forces are price makers versus the alternative of an internalised market within the Central Bank where all banks are price takers (fixed rate and full allotment)
- Small and medium banks could profit from rates generally lower than those on unsecured contracts
- Positive effects for banks testified by the limited use of central bank refinancing

Simulating the impact of a money market dry up on Wholesale Payment System TARGET2:

- Due to the severity of the money market shock during the financial turmoil, the Bank of Italy has carried out **simulation exercises** to assess **the ability of Italian banks to fulfil their RTGS payment commitments** in the event of **further contractions** in the supply of funds on the **unsecured overnight market**.
- The **size of the shock is made to vary from 10 to 90** per cent of the total value of trading in unsecured deposits, whereas the repayment of the deposits obtained on the previous days and all the other outgoing payments settled on TARGET 2 are kept unchanged.
- The exercise was carried out by relying on the **Bank of Finland Payment System Simulator**

Simulating the impact of a money market dry up on Wholesale Payment System TARGET2:

The results of the exercise show that even a
drastic fall in
trading on the interbank market **would have**
limited
effects on the functioning of the system, in
terms of
unsettled payments

The **high degree of resiliency** showed by the system seems to be due to:

- The **liquidity** provided “**unconventionally**” by the Eurosystem
- The shift from the **unsecured** to **collateralised** market



Challenges for Central Banks

Central banks' liquidity injections have played a crucial role in tackling the crisis. The MIC experience shows however that the effectiveness of monetary policy instruments can be enhanced by appropriate interventions on trading and post-trading infrastructures.

The Central Bank could provide the system with tools to mitigate the impact of systemic liquidity risk and promote as a catalyst a cooperative approach among market participants in stressful times.

Finally, the Banca d'Italia's experience seems to stress the important synergies existing between oversight on Payment Systems and the supervision of specific financial markets, critical for the Financial Stability of the system.



Thank you !!

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