
The Euro Area Interbank Market and Liquidity Management of the Eurosystem in the Financial Crisis

by
A Hauck and U Neyer

A comment by

Filippo Altissimo
Brevan Howard Asset Management LLP

Rome, 30 September 2010

Disclaimer

The data provided in this document is presented as at 30 September 2010 (unless otherwise stated). This presentation is the work of the author and any opinions stated herein represent the personal opinions of the author and not of Brevan Howard Asset Management LLP ("BHAM") or any of its affiliates (together, "Brevan Howard"). The author has used reasonable skill and care in the preparation of this material from sources believed to be reliable but neither the author nor Brevan Howard gives any warranties or representations as to the accuracy or completeness of this information.

This document is being issued for educational, information, and discussion purposes only, is not a financial promotion, does not purport to be full or complete and is not intended to provide a sufficient basis on which to make an investment decision. This document is not intended to constitute, and should not be construed as, investment advice. Recipients of this document should seek their own independent financial advice. BHAM neither provides investment advice to, nor receives and transmits orders from, recipients of this document, nor does it carry on any other activities with or for such recipients that constitute "MiFID or equivalent third country business" for the purposes of the rules of the UK Financial Services Authority ("FSA Rules"). This document is not independent investment research and you must not treat it as such. This document has not been prepared in accordance with the requirements in the FSA Rules designed to promote the independence of investment research or the rules of any other regulatory body. This document does not express a particular investment recommendation in relation to, or express an opinion as to the present or future value of, particular financial instruments. This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase, any shares or any other interests nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract therefore.

No reliance may be placed for any purpose on the information or opinions contained in this document or their accuracy or completeness and neither the author nor Brevan Howard accepts any liability for the accuracy, validity, timeliness, merchantability or completeness of any information or data contained herein. Neither the author nor BHAM, nor any of its affiliates, nor its or their directors, officers or employees will be liable or have any responsibility of any kind for any loss or damage that any person may incur resulting from the use of this information. Neither the author nor BHAM gives any undertaking that it shall update any of the information, data and opinions in this document. References to past performance or events is not a reliable guide for the future and is not indicative of future performance or events.

This information is being circulated by the author on a confidential basis. The information contained herein is confidential to such person and is neither to be disclosed to any other person, nor copied or reproduced, in any form, in whole or in part without his prior consent.

The paper

The paper wants to reconcile four empirical facts:

- The strong increase in the demand of ECB funding since late 2008;
- The strong increase in the ECB depo usage;
- The decrease of the volume in the interbank market;
- The soft trading of the Eonia below the MRO rate.

They use a two-stage game between banks and the CB to show that:

- In a low cost env., banks trade in the interbank market, there is no excess funding and CB facilities are not utilized;
- In the high cost env., weak banks want to avoid excessive interbank transactions and so, ex ante, they take more CB liquidity. Ex post, this extra liquidity ends up in the CB depo facility.
- In the ultra high cost env., weak banks are even forced to use the CB marginal lending facility.

Comment 1 – Just an issue of price?

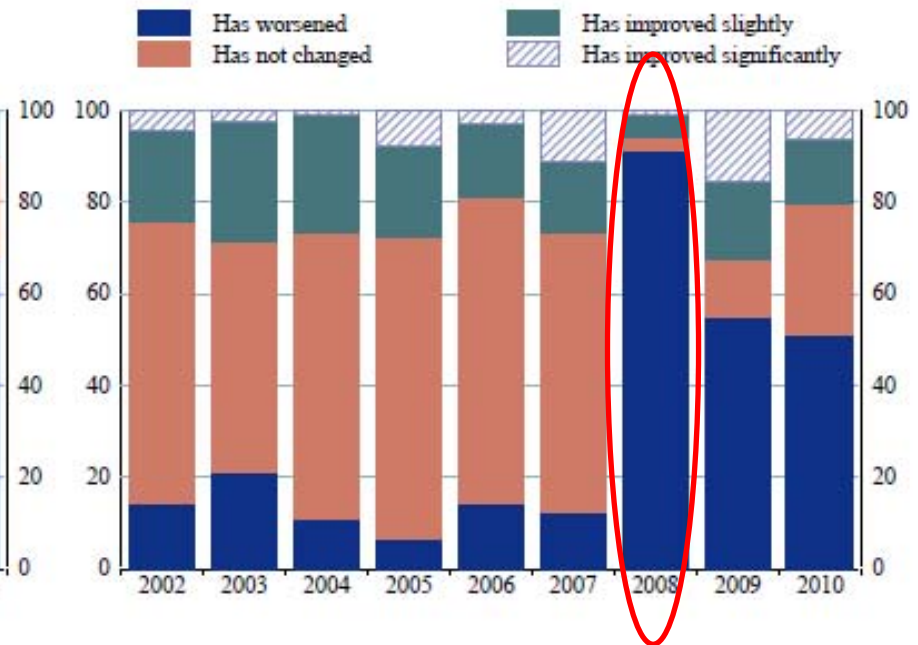
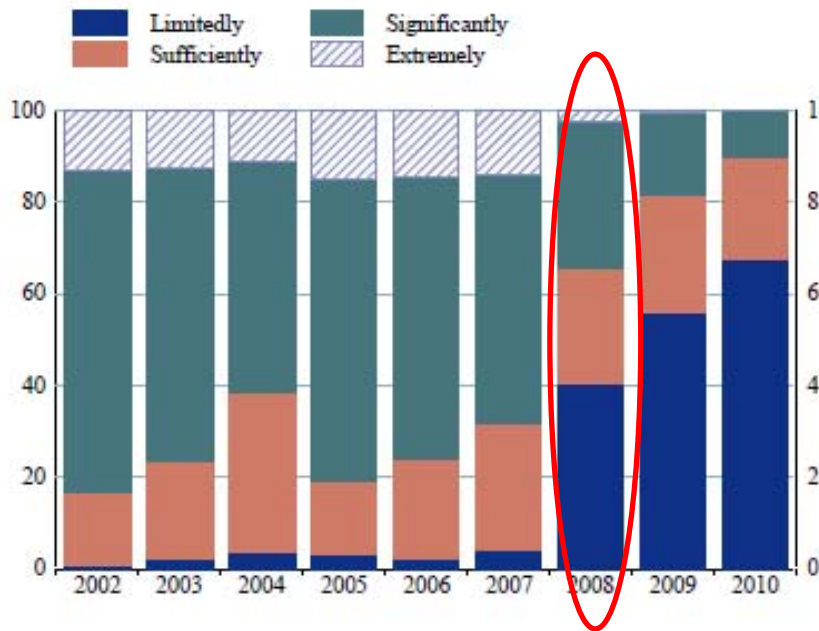
- After Lehman, the high price in the interbank market forced the ECB to take an intermediation role. So, it was just an issue of price...
- I have a more extreme recollection of those events ...
- ... it was not an issue of price but of trust.... the market was suffering one of those “*contagious illiquidity*” episode (Akerlof and Moore).

- The unsecured market was frozen; banks were only lending overnight. The LIBOR rates quoted in the market were not representative of the cost of funding (which was much higher!!!).
- The possible cost of a liquidity short-fall by a bank was huge.
- Banks had a huge difficulties funding certain assets (ABS).
- The unlimited funding policy and the widening of the collateral in Oct 2008 was necessary to stop the domino effect given that banks were willing to exchange only via ECB reserves.

The ECB Money Market survey: in 2008 unsecured market was impaired

Chart 8 Is the unsecured segment in your opinion efficient?
(percentages of total)

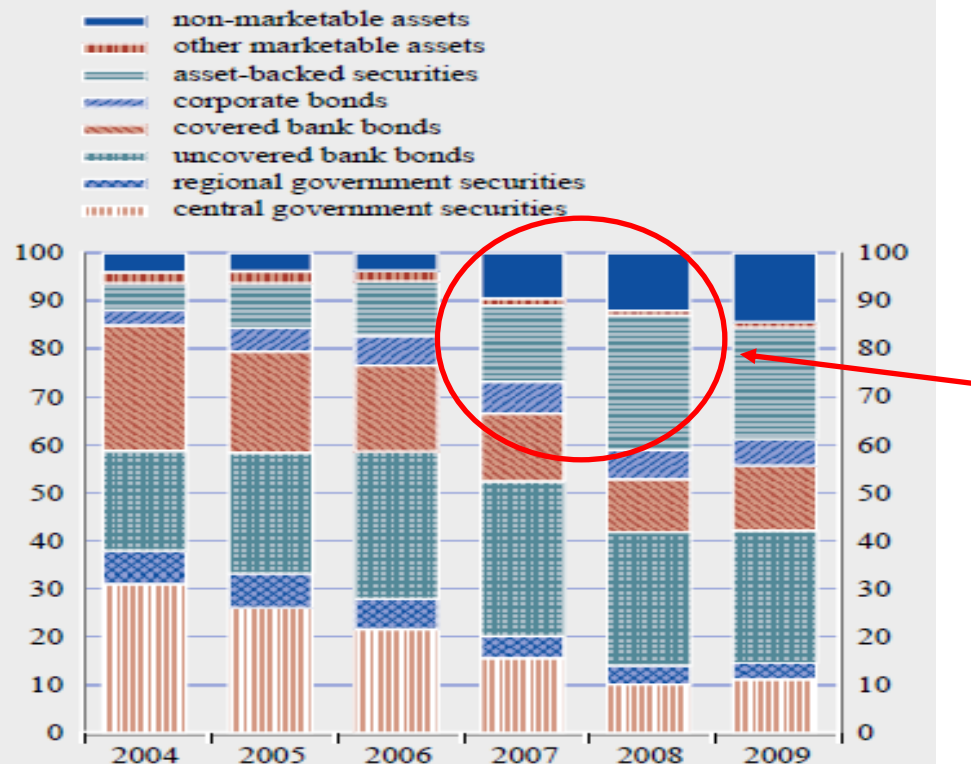
Chart 9 Has the market liquidity in the unsecured market
changed with respect to last year? (percentages of total)



The ECB collateral composition: increase in ABS

Chart 50 Breakdown of assets (including credit claims) put forward as collateral by asset type

(percentages)

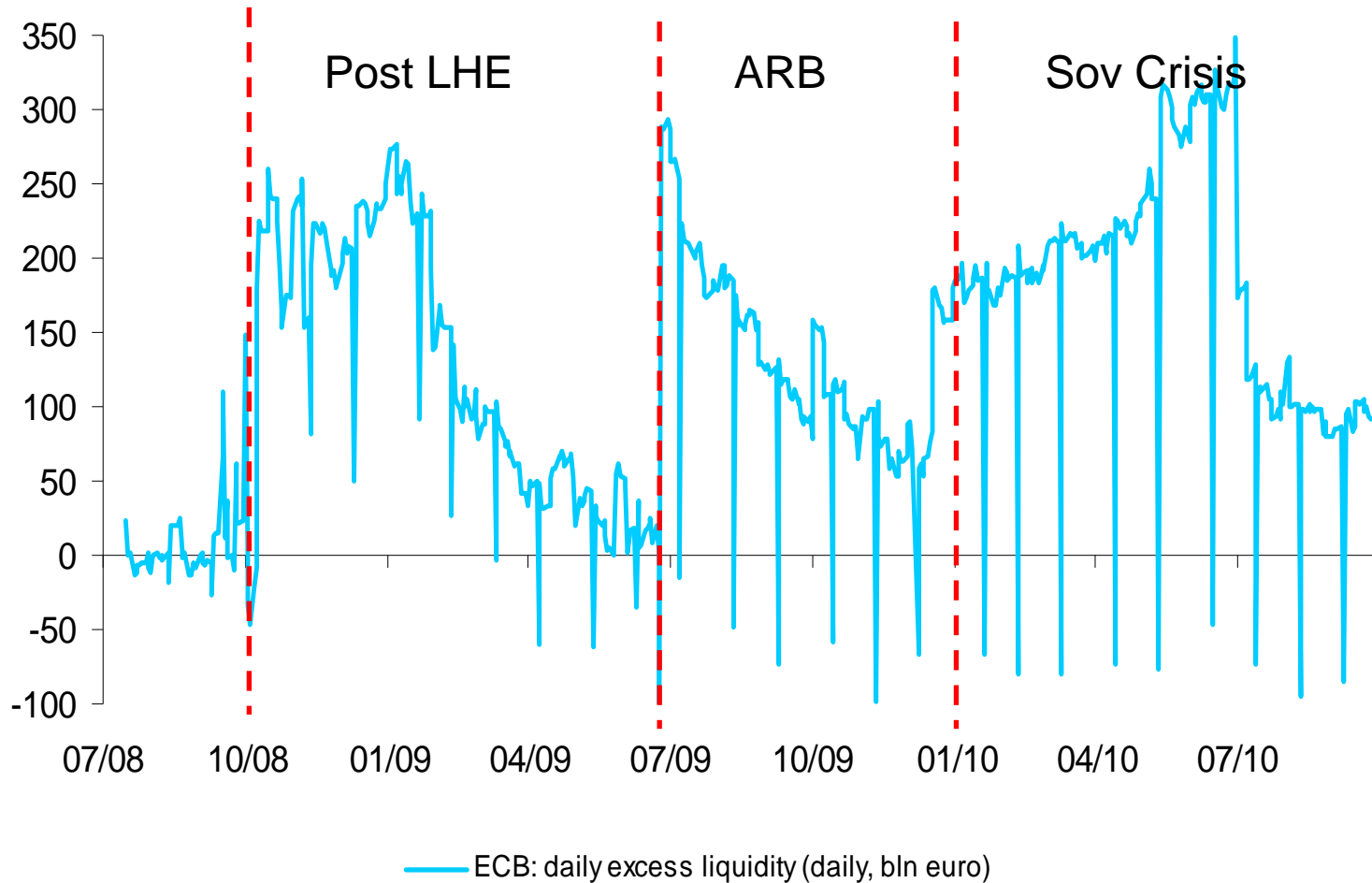


Source: ECB.

Comment 2 – In “normal times” liquidity surplus cannot persist.

- The liquidity game is a repeated one.
- All banks do have a structural liquidity deficit versus the CB (reserve requirements and autonomous components).
- Banks with surplus of liquidity will reduce their liquidity demand to the CB and this will foster the adjustment of the liquidity excess (in the model this is not possible because surplus banks has zero need of CB funding).

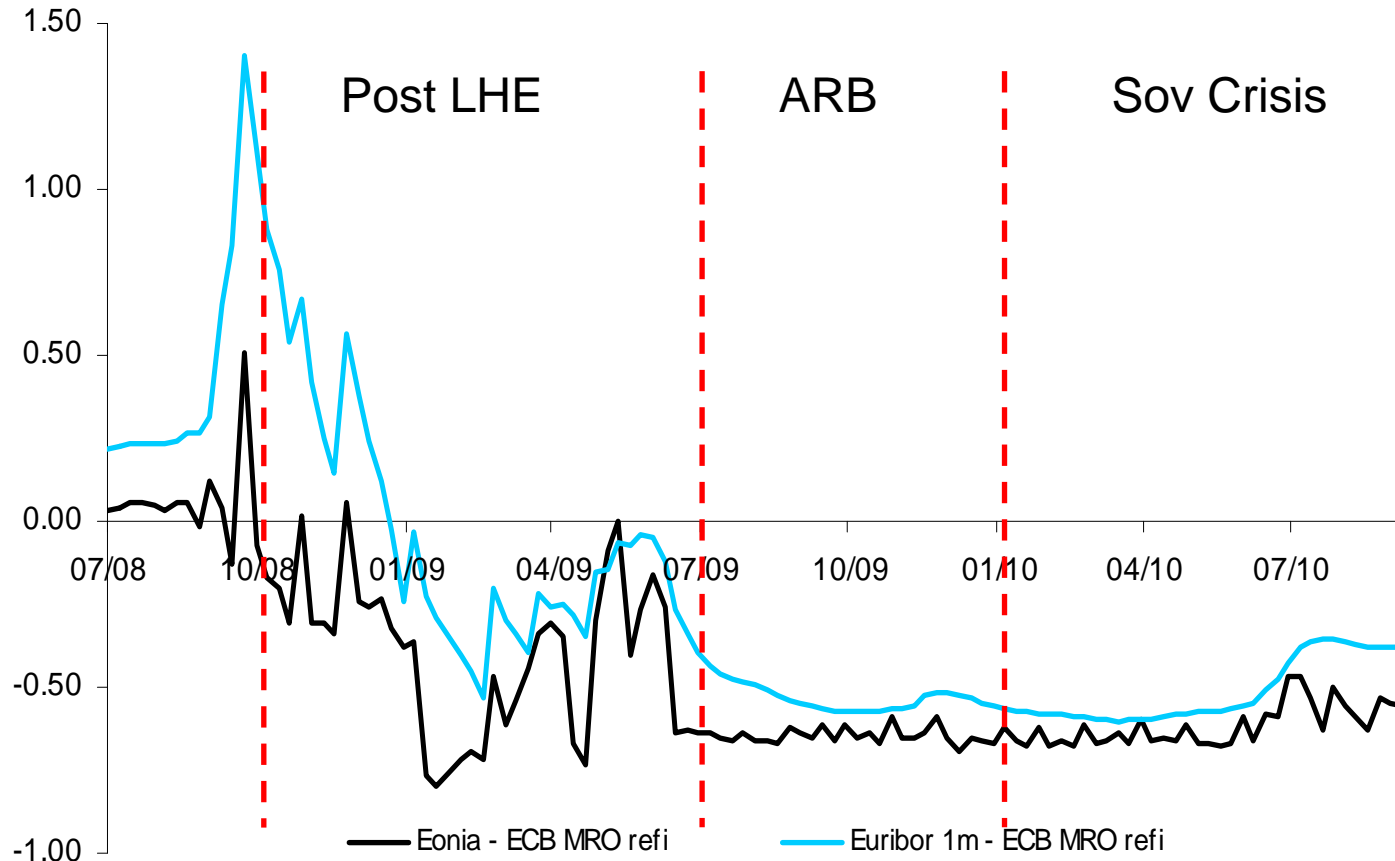
Comment 3 – There is not a single story



Comment 3 – There is not a single story

- Post LHE – Severe adverse selection in market. The ECB actions and the Government guaranties helped and there were some signs of normalization in April/May 2009.
- ARB – The liquidity operations was used to indicate that rates will be on hold for long time. The first 1y repo created a large arbitrage opportunity in the market. Banks were stuffed with reserves that they could not unload.
- Sovereign Crisis – Despite the low rates, banks had a renewed preference for ECB funding due to the difficulties in the repo markets of certain countries.

Comment 3 – There is not a single story



Large excess of reserves also in period of low rates.

Comment 3 – There is not a single story

- The policy conclusions of the paper (return to fixed allotment and tighter collateral rules) need to be taken with a bit of caution.
- At the moment, there is a too large share of ECB funding that it is borrowed to “certain” bank in “certain” countries. While those banks have a much lower amount of reserves.
- Solving this anomaly (i.e., recapitalization of “certain” banks) is necessary for the normalization of the ECB operational framework.

Many Thanks