Analysis of Recent Monetary Operations & Financial Market Developments

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Abstract

In 2013, developments in the European periphery and emerging markets remained a focus for market participants. Meanwhile, monetary policy announcements by the key central banks continued to be a driver of financial market developments. In this article we review 2013 and early 2014, examining the main changes to the ECB’s operational framework and the evolution of Eurosystem lending, particularly the Early Repayment Operations (EROs) relating to the two 3-year Longer Term Refinancing Operations (LTROs). The article studies the use of the ECB’s standing facilities, while it also reports on the improvements in money markets over the review period. Finally, we also examine the Irish sovereign’s on-going return to debt markets before briefly analysing changes in TARGET2 balances over 2013.

1 The authors would like to acknowledge, with thanks, the helpful comments and suggestions of John Rowe, Thomas Brophy, John Nash and other colleagues in the Financial Markets Division of the Central Bank of Ireland.
Overview

Financial markets remained volatile in 2013 with policy announcements by central banks among the key drivers, while the European periphery and emerging markets were also in focus. In early 2013, market sentiment was positive following a political agreement in the US which averted the “fiscal cliff”. Market conditions worsened in the first quarter and the beginning of the second quarter, amid signs of a potential re-emergence of euro area risks, partly related to developments in Cyprus; however, market contagion was limited with improving sentiment towards the periphery making it more resilient to shocks. Market sentiment remained generally positive towards the periphery throughout 2013 and improved demand for peripheral debt led to a significant tightening towards the core, amid rising safe haven bond yields. Risk appetite deteriorated sharply in late May, amid concerns that the Fed would consider “tapering” its bond purchase programme, with emerging markets in particular experiencing a significant sell off around this time. Speculation around the reduction of the Fed asset purchase programme remained a significant driver of markets for the remainder of the year. However equity markets were generally stronger in 2013, with a number of indices, including the FTSE and S&P 500, hitting record highs in late 2013 and early 2014. Meanwhile, Asian markets benefitted from the Bank of Japan’s (BOJ) expansionary policy, with the central bank announcing that it would conduct money market operations so that the monetary base would increase at an annual pace of about 60-70 trillion yen to end 2014.

At the beginning of 2013 European peripheral bond yields tightened to German bond yields, continuing a trend that began in mid-2012. However, by the end of Q1 2013, peripheral bond yields had risen sharply following comments suggesting that the bailout in Cyprus would form the template for any subsequent bailouts of Eurozone economies, wherein depositors and bond holders would take losses. Prior to these comments, the other peripheral countries had experienced a very limited impact from the crisis in Cyprus. Tensions briefly eased after ECB President Draghi insisted that the bailout would not form the basis of any future funding programmes. However, a number of weak data releases and low inflation expectations resulted in the ECB reducing its main policy rate to a record low of 0.5% at the May Governing Council meeting.

Political tensions in Italy and Portugal sparked sharp rises in these countries’ bond yields, after the coalition governments in both countries came under pressure following some high profile resignations. Other peripheral bond yields remained largely unaffected, suggesting that the periphery was becoming more resilient to shocks and less prone to contagion effects.

Expectations for a reduction of the Fed’s asset purchase programme arose following a series of strong economic data releases from the US in the first half of 2013, although most analysts did not expect such a move to take place until Q1 2014. At the Federal Open Market Committee (FOMC) meeting on 22 May, Fed Chairman Ben Bernanke suggested that should the economic recovery in the US continue the Fed could begin to reduce its bond purchases in the next few meetings. Following Mr Bernanke’s comments, most analysts adjusted their expectations, with a majority believing that tapering would begin by September 2013. The announcement led to a broad based sell off in financial markets, amid a sharp decline in investor sentiment. The Fed maintained this stance at subsequent meetings and as a result positive data releases had at times an adverse effect on market sentiment throughout the rest of the year.

Emerging markets in particular experienced a significant sell-off with the MSCI Emerging Market Equity Index losing 10% of its value in the period from the initial speculation of Fed tapering (22 May) to the end of June. The escalating civil war in Syria exacerbated the situation for emerging markets, pushing commodity prices higher, with oil prices in particular rising sharply. In countries such as Brazil, Indonesia, Turkey and India, equity markets sold off, bond yields rose significantly and currencies fell sharply.

In contrast, bond yields in peripheral Europe remained more stable, although euro area money market rates began to rise in line with increasing US rates. At the Governing Council meeting on 4 July, the ECB introduced forward guidance and committed to keeping interest rates “at present or lower levels for an extended period of time”.

In August, the Bank of England also introduced forward guidance, with the Monetary Policy Committee (MPC) stating that it did not intend to raise the policy rate from the current 0.5% at least until the unemployment rate had fallen to a threshold of 7%, subject to inflation and economic growth remaining in line with the Bank of England’s projections. As data on the UK economy improved throughout 2013, including a fall in the unemployment rate to 7.1% in December, speculation increased that the Bank of England would raise interest rates. However, the MPC decided to maintain interest rates at subsequent meetings, and updated forward guidance to focus on a broader range of economic measures.

In September, the Fed surprised markets again by maintaining bond purchases at $85bn a month, in contrast to market expectations of a reduction of between $5bn and $15bn a month. The Fed argued that more evidence of lasting improvement in the economy was required, particularly in the labour market, to justify a reduction. In its statement the Fed sought to ease concerns around the tapering of bond purchases through enhanced forward guidance, stating that interest rates would not rise until the jobless rate was “considerably below” 6.5%. Market sentiment improved in the wake of the announcement, however the rally was short lived following the release of more “hawkish” than expected minutes from the FOMC and a shift in market focus to the US government shutdown and debt ceiling negotiations. The Fed ultimately began to taper its bond purchase programme in December, committing to reduce the programme by $10bn to $75bn a month, noting that reductions would continue at a steady rate at subsequent FOMC meetings but reiterating that rates would remain low, even after the end of the bond purchase programme. Market reaction to the announcement was relatively muted with a number of analysts suggesting that the reduction had been priced in by markets, while the small size of the cut and the continued accommodative policy also helped to calm markets.

Money market volatility in the second half of the year resulted in increased speculation that the ECB would introduce further non-standard measures, after President Draghi said the ECB would use “all available tools”, including a possible new VLTRO. In November the ECB cut the policy rate to a new low of 0.25% and maintained the deposit rate at 0.0%, narrowing the monetary policy corridor. The cuts came after the release of data which showed that euro area inflation had fallen to 0.7%. As low inflation readings continued in subsequent releases there was increased market speculation that the ECB may adopt a negative deposit rate or implement new non-standard measures such as adopting a “Funding for Lending” type scheme or suspending the liquidity sterilisation operation in relation to the Eurosystem Securities Market Programme (SMP) holdings.

Money market rates continued to be volatile towards year end, with EONIA rising above the ECB’s main policy rate. The ECB’s SMP sterilisation operations failed to fully absorb the intended amount on a number of occasions in December, as excess liquidity in the Eurozone fell throughout the final quarter of the year. Declining Eurosystem borrowings in 2013, in part due to repayments from the 3-year LTROs beginning in January of that year, reduced the level of excess liquidity and put upward pressure on money market rates.

Money market rates fell and volatility eased following the 2013 year-end period as excess liquidity stabilised and market participants started to price in some further easing measures by the ECB. Strong economic data releases, in particular improved peripheral manufacturing data, were highlighted by President Draghi as a sign that many euro area economies were recovering. As a result, the periphery in particular benefitted, with analysts reporting a shift from euro area core to peripheral debt as investor risk appetite improved.

Through the end of 2013 and into early 2014, peripheral bond yields declined and generally outperformed core bond yields with Irish, Italian and Spanish 10-year spreads to Germany tightening. Italian and Spanish 10-year yields fell below 4% at the beginning of 2014, hitting 8-month and two and a half year lows respectively. Irish bond yields decoupled somewhat from these countries, ending the year with yields 30-64bps lower than Spain across the curve and 24-61bps below Italian bonds.
Market sentiment towards Ireland was further improved towards year end as it was announced that Ireland would become the first European economy to leave its external funding programme and would not be seeking a precautionary credit line. There was further positive news for Ireland when rating agency Moody’s upgraded Irish sovereign debt by one notch to investment grade (Baa3) in January 2014, citing the growth potential of the economy as the main rationale for the upgrade.

Also in January 2014, Ireland returned to the debt markets for the first time since the exit from the funding programme, selling €3.75bn of a new 10-year bond. Demand was strong with investors bidding more than €14bn for the bond and investor interest was reportedly very broad. Following the issuance, Irish sovereign yields were lower across the curve with the 10-year yield 10bps lower at the close of business.

In Section 1 of this paper, we give an overview of the ECB’s key monetary policy decisions over 2013 and Q1 2014. Section 2 discusses money market developments over the same period, while Section 3 looks at overall trends in Eurosystem lending and the use of the ECB’s standing facilities. In Section 4 we examine developments in Ireland with regard to Eurosystem lending as well as the Sovereign and domestic banks return to debt markets. Section 5 reviews movements in TARGET2 balances over 2013 and finally Section 6 gives an outlook for 2014.

1 ECB’s Key Policy Decisions in 2013 & Q1 2014

In 2013 monetary policy announcements by key central banks were a major focus for market participants. In the euro area declining levels of excess liquidity, concerns over low levels of inflation and higher EONIA fixings towards year end, sparked speculation that the ECB may introduce further non-standard measures. Political uncertainty and weak growth in some European economies threatened to adversely affect the recovery in the euro area, while inflation figures significantly below the ECB’s objective resulted in interest rate cuts and increased anticipation of non-standard measures.

The following section summarises some of the measures introduced by the ECB throughout 2013 and early 2014.

On 22 March, the Governing Council adopted Decision ECB/2013/6, which prevents, as of 1 March 2015, the use as collateral in Eurosystem monetary policy operations of uncovered government-guaranteed bank bonds that have been issued by the counterparty itself or an entity closely linked to that counterparty.

On 2 May, the Governing Council reduced the main refinancing operation (MRO) rate by 25bps to 0.5%, and narrowed the interest rate corridor when it cut the marginal lending facility rate by 50bps to 1.00%. The deposit facility rate remained unchanged at 0.0%. In addition the Governing Council decided to continue its main refinancing operation and the maintenance period and 3-month longer-term refinancing operations as fixed rate tender procedures with full allotment as long as necessary and at least until the end of the second quarter of 2014. These decisions were consistent with low underlying price pressures over the medium term and weak economic sentiment.

On 4 July, President Draghi announced that the Governing Council expected key rates to remain at “present or lower levels for an extended period of time”.

On 18 July, the Governing Council decided to further strengthen its risk control framework, by adjusting the eligibility criteria and haircuts applied to collateral accepted in Eurosystem monetary policy operations and adopting certain additional measures to improve the overall consistency of the framework and its practical implementation. The Governing Council decided in particular to:

- Update the haircuts for marketable and non-marketable instruments;
- Adjust the risk control measures for retained covered bonds;
- Replace the current requirement of two ‘triple A’ ratings with the requirement of two ‘single A’ ratings for the six classes of asset-
backed securities (ABSs) subject to loan level reporting requirements;

- Reduce the haircuts applicable to eligible ABS under the permanent and temporary Eurosystem collateral framework.

In addition, the Governing Council adjusted the eligibility criteria and haircuts applied by National Central Banks (NCBs) to pools of credit claims and certain types of the additional credit claims (ACC) eligible under the temporary Eurosystem collateral framework.

These measures entered into force on 1 October.

On 5 September, President Draghi confirmed that the monetary policy stance would “remain accommodative for as long as necessary, in line with the forward guidance provided in July.”

On 9 September, the Governing Council decided to enhance the loan-level reporting requirements for residential mortgage-backed securities (RMBS), and ABSs backed by loans to small and medium-sized enterprises that are used as collateral in monetary policy operations. As of 16 October 2013, the Eurosystem may temporarily accept as eligible collateral non-compliant residential mortgage-backed securities (RMBS) and ABSs backed by small to medium sized enterprises on a case-by-case basis and subject to the provision of adequate explanations about the reason for the failure to satisfy the 3 January 2013 deadline. For each adequate explanation the Eurosystem will specify a maximum tolerance level and a tolerance horizon. The tolerance horizon indicates that the ABS data quality must improve within the specified time period.

On 16 September, the Governing Council decided, in agreement with the Bank of England, to extend the liquidity swap arrangement with the Bank of England up to 30 September 2014. The swap facility was established on 17 December 2010 as a precautionary measure.

On 19 September, the Governing Council decided to introduce loan-level reporting requirements for ABSs backed by credit-card receivables, when these are used as collateral in the Eurosystem’s monetary policy operations. The provision of loan-level information for these instruments is mandatory as of 1 April 2014, with a nine-month phasing-in period.

On 10 October, the ECB and the People’s Bank of China established a bilateral currency swap agreement. Under the agreement, which will be valid for three years, the swap line will have a maximum size of 350 billion Chinese yuan and €45 billion. This swap line will serve as a backstop facility.

On 31 October, the ECB established standing swap arrangements with the Bank of Canada, the Bank of England, the Bank of Japan, the Swiss National Bank and the US Federal Reserve. The temporary bilateral liquidity swap arrangements which existed before this agreement were converted to standing arrangements, allowing for the provision of liquidity in any of the five currencies foreign to that jurisdiction.

On 7 November, the Governing Council reduced the MRO rate by 25bps to 0.25%, and cut the marginal lending facility rate by 25bps to 0.75%. The deposit facility rate remained unchanged at 0.0%. These decisions were in line with the Governing Council’s forward guidance of July 2013 and the diminishing underlying price pressures in the euro area over the medium term.

On 8 November, the Governing Council decided to continue its MROs as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the 6th maintenance period of 2015 on 7 July 2015. The Governing Council also decided to conduct the three-month LTROs to be allotted every month from 30 July 2014 to 24 June 2015 as fixed rate tender procedures with full allotment.

On 24 January 2014, the Governing Council, in cooperation with the Bank of England, the Bank of Japan and the Swiss National Bank, decided to gradually reduce the offering of US dollar liquidity-providing operations. The decision was made in view of the considerable
improvement in US dollar funding conditions and the low demand for US dollar liquidity-providing operations. Operations with a maturity of three months will continue until 30 April 2014, those with a maturity of one week will continue to be conducted until 31 July 2014. The ECB will continue to assess the need for one-week US dollar operations beyond 31 July 2014, taking into account the fact that the recently established swap lines provide a framework for the reintroduction of US dollar liquidity-providing operations if warranted by market conditions.

2 Money Market Developments

Euro area money markets continued to stabilise over the course of 2013, strongly influenced by accommodative ECB policy decisions, the declining but still relatively high levels of excess liquidity within the euro area and the continued improvement in banks’ overall funding conditions. Rates remained low and broadly stable over the course of the year, reflecting accommodative liquidity conditions despite the decline in the liquidity surplus, while longer maturities have been more volatile, amid some instability in US money market rates and market uncertainty regarding the impact of 3-year LTRO repayments on excess liquidity.

The accommodative policy stance maintained by the ECB in 2013 was perceived to have had a positive effect in easing money market fragmentation. The ECB cut the policy rate twice in 2013, while tightening the monetary policy corridor to the current 0.0% for the Deposit Facility, 0.25% Policy Rate, and 0.75% Marginal Lending Rate. This tightening of the corridor saw EONIA fixing at between 0 and 25bps for most of the year. In addition, the ECB announced forward guidance with an embedded downward bias on policy rates, and extended the fixed rate full allotment policy in its MROs to mid-2015. These measures helped to keep EONIA at historically low levels, averaging 8.9bps over the course of 2013 compared to 23.1bps a year previously.

The liquidity injected by the ECB via the two 3-year LTROs in December 2011 and February 2012 continued to have a stabilising effect on the money market, addressing short to medium term bank refinancing and funding risks. Liquidity provided through Eurosystem operations peaked at nearly €1.3tn in mid-2012, and remained around €1.2tn through January 2013, when the ECB introduced the opportunity to repay 3-year LTROs through the Early Repayment Operations (EROs).

As banks throughout the Eurosystem began to repay long term funding through the EROs, the level of excess liquidity in the system began to fall. Despite declining levels of excess liquidity, there was little effect seen in interbank markets until November and December, when EONIA rose to an average of circa 14bps, although this was likely due to year-end effects.

EONIA became more volatile in early 2014 as excess liquidity declined by around €40bn on 14 January to a low of €125bn, a level last seen in September 2011. This decline was mainly due to a reduction in ECB borrowing in the prior week. Market commentators suggested the effect of the reduced liquidity was likely amplified as it occurred at the beginning of the reserve period when banks may have been focused on building up reserves to meet their reserve requirement and in turn were less likely to lend in the interbank market. EONIA rose by 20bps to a peak of 36bps on Monday 20 January, before returning to a stable level of around 15bps after banks took additional funding through ECB operations. Notably, there was a failure to fully absorb excess liquidity through the ECB’s SMP-related fine-tuning operations (FTOs) in late 2013 and early 2014. This is discussed further in section 3.2.

EONIA volumes averaged circa €20.8bn in 2013, compared to circa €24.5bn during 2012, and may continue to be adversely affected by the continuing withdrawals of contributing banks from the EONIA panel. The number of participants has fallen from 42 at the beginning of 2013 to 34 at the end of the year. With the falling number of panel banks, market participants are reportedly showing an increased interest in the repo market indicators, such as Eurex repo indices and the ICAP/MTS Repo fund Rate indices.

The increased volatility in money market rates in late 2013 did not appear to have an impact on the volumes traded between banks in either
secured or unsecured money markets. Indeed, market commentators stated that the higher level of short-term rates towards the end of the year provided an incentive for banks which were long on cash to lend in the interbank markets, which saw volumes increase towards the end of the year.

Money market rates also remained at low and stable levels at longer tenors throughout 2013, with the 3-month EURIBOR rate averaging 22bps, and trading in a range between 19bps and 30bps over the year. This compares to an average level of circa 58bps in 2012. The fall reflects ECB rate cuts and the flatter yield curve, while also taking into account the perceived lowering of credit risk in unsecured money markets over the year, in conjunction with the ECB’s forward guidance on rates.

In secured money markets, General Collateral (GC) repo rates of different euro area countries converged further over the year, particularly in term maturities, as sentiment in the periphery improved. German 1-week GC rates averaged 3.1bps over the year, compared to circa 2.6bps in 2012, while the Spanish and Italian 1-week GC spreads to Germany were on average 9bps and 10bps over the year, tightening by 4bps and 6bps respectively compared to 2012.

The evolution of both secured and unsecured money market rates in 2014, especially at the front end, will depend mainly on the ECB’s monetary policy decisions, which in turn are likely to be driven by concerns over low inflation levels. Market expectations are for EONIA to stay in the 10-15bp range over the next year, moving to around the 25bp policy rate in mid-2015, which coincides with the ECB’s minimum extension for the fixed rate full allotment policy.

3 Developments in Eurosystem Liquidity Provision

At the beginning of 2013, Eurosystem lending stood at €1,132bn, down from a peak of €1,282bn on 28 June 2012. In early 2013, Eurosystem outstanding lending initially increased, but then began to decline as counterparties availed of the option to repay 3-year LTRO borrowings early, with total lending falling by circa €380bn in 2013 to circa €752bn at year end. As of 13 March 2014, Eurosystem lending stood at circa €649bn (see Chart 1).

The maturity profile of Open Market Operations (OMOs) lengthened significantly following the large allotments in the two 3-year LTROs which took place in December 2011 and February 2012. As a result, as of 1 January 2013, LTRO borrowings accounted for 91% of the total Eurosystem liquidity provision (of which, 96% was 3-year LTRO borrowings), with MRO borrowings comprising 8% and USD operations the remaining 1% of borrowing. As counterparties throughout the Eurosystem repaid 3-year LTRO borrowings through the Early Repayment Operations (EROs), some switched into shorter term operations, which changed the maturity profile of OMOs considerably over the year. At 31 December 2013, 3-year LTRO borrowings accounted for circa 78% of total borrowings (of which 93% was 3-year LTRO borrowing), while MRO borrowing now accounted for circa 22% of the borrowings. Use of the US dollar operations declined significantly over the year, as market conditions improved, and stood at just 0.03% of total borrowing at year end (see Charts 2 and 3).
3.1: 3 Year Longer Term Refinancing Operations (LTROs)

The major changes in Eurosystem liquidity provision over the last 2 years have been driven by the allotment and subsequent repayment of the 3-year LTROs. The first 3-year LTRO was conducted in December 2011 with 523 bidders allotted €489bn, while the second 3-year was conducted on 29 February 2012 with 800 bidders allotted €530bn. In total, €1,019bn was allotted in the two 3-year LTROs, with a net liquidity addition of €525bn, as some counterparties switched from shorter dated operations.

The large amount allotted across both of these operations kept Eurosystem lending at historically elevated levels throughout 2012, and into the start of 2013.

The terms of the 3-year LTROs gave counterparties the option to repay borrowings from either operation after one year. With market conditions improving in the euro area in H2 2012, many banks that had regained access to debt markets indicated their intention to repay this long term ECB funding. Prior to the opportunity to repay, many counterparties had been placing surplus liquidity with the Eurosystem on the overnight deposit facility, which has not been remunerated since July 2012.

While the Eurosystem does not release a breakdown of individual country or counterparty repayments, many counterparties had indicated their plans for the repayment of Eurosystem borrowings. Some indicated they would repay all their borrowings at the earliest opportunity, while others signalled an intention to repay a percentage of their borrowings but to retain a portion as an “insurance policy” in the event of a renewed escalation of interbank tensions. As a result, market commentators suggested that some banks who may not have been in a particularly strong liquidity position would repay the 3-year borrowings to avoid appearing weak in comparison to rival banks.

In January 2013, the first opportunity for counterparties to repay funds, 278 counterparties chose to repay €137bn of borrowings or 28% of the total allotment of the first 3-year LTRO, significantly above market expectations. The larger than expected allotment in the first ERO was received positively by markets as a sign of the ongoing improvement in the Eurozone banking system. The first ERO of the second 3-year LTRO on 27 February 2013 saw a lower repayment amount, with counterparties repaying circa...
€61bn, or 12% of the total €530bn borrowed. The repayment amount was lower than forecasts, although many market analysts attributed the lower than expected repayment to heightened uncertainty among European banks ahead of the Italian general election.

Over the course of the year, a total of circa €259bn was repaid from the first LTRO (circa 53% of the total amount borrowed), while €187bn was repaid from the second LTRO (circa 37% of the total amount borrowed). Overall, circa 44% of the total 3-year borrowings were repaid as at 31 December 2013.

3.2: Weekly SMP Liquidity Absorbing Operation

Following the announcement of the technical features of the programme for Outright Monetary Transactions (OMT) on 6 September 2012, the SMP was terminated. However, in order to neutralise the effect of the additional liquidity supplied to the system through the SMP, the ECB continues to sterilise this liquidity through the use of liquidity absorbing FTOs, and continues to hold the existing securities in the SMP portfolio to maturity. Following bond maturities and revaluations, the size of the outstanding SMP portfolio stood at €178.5bn at year end.

After the cut in the deposit facility rate to zero in July 2012, the weighted average allotment rate in SMP FTOs dropped to an average of just 1bp above the deposit facility in 2012. However, in 2013, with excess liquidity declining as a result of 3-year LTRO repayments, the marginal and weighted average rates in the SMP FTOs have risen towards the main policy rate, with the bid-to-cover ratios in the operations also falling.

As excess liquidity fell below €150bn in late 2013, interbank money market rates rose towards the ECB policy rate, with the Eurosystem unable to fully absorb the intended weekly amount in four of the last six FTOs in 2013. This trend continued in early 2014, with two of the first four operations not fully absorbed. The marginal rate in each of the last six operations of 2013 was 25bps, while the weighted average rate averaged 20bps over this period.

As a result of the non-absorptions, and with the relatively low levels of excess liquidity continuing to place pressure on EONIA levels, market commentators suggested that the ECB may stop absorbing the additional liquidity through FTOs, thereby increasing the level of excess liquidity in the system. ECB policymakers have acknowledged that this is a potential policy option, but as of the Governing Council meeting held on 6 March 2014, FTOs are still conducted on a weekly basis.

3.3: Fulfilment of Minimum Reserve Requirements

During 2013, the majority of counterparties maintained the practice of frontloading reserve balances at the beginning of each maintenance period and then reducing the surplus towards the end of the maintenance period. Reserve requirements fell slightly over the year, from €106bn at end 2012 to €103.2bn at end 2013.

On average, reserve account balances held in 2013 were €311.7bn, a slight increase on the previous year, which averaged €310.3bn.

3.4: Standing Facilities: Deposit Facility

Deposit facility usage averaged €100.2bn per day in 2013, down from a daily average of €494bn in 2012. Use of the facility has fallen significantly since the remuneration rate on the deposit facility was reduced from 25bps to zero (effective from 11 July 2012). The level of reserves left on the current account has remained broadly unchanged over the year, indicating that counterparties are content to leave excess reserves on their current account rather than on the deposit facility, as neither are remunerated.
3.5: Standing Facilities Marginal Lending Facility

Use of the Marginal Lending Facility averaged at €468mn in 2013, down from €1.93bn in 2012. The highest amount borrowed on any single day was €6.54bn on 19 June. During the year, the Marginal Lending Facility rate was cut twice, in line with policy rate cuts. On 8 May, the marginal lending facility rate was reduced from 1.5% to 1%, while on 7 November the rate was cut further to 0.75%, (see Chart 4).

![Chart 4: Deposit Facility Usage and Excess Reserves](chart.png)

Source: ECB Data.

3.6: USD Funding Developments

In response to stressed funding market conditions for US dollars in the euro area, the ECB reintroduced 84-day US dollar (USD) operations in September 2011, alongside the existing 7-day operations. Participation in USD operations was high in the months following its introduction and the first half of 2012, and peaked at approximately $90bn (approximately €67bn) in February 2012.

In the latter half of 2012 and throughout 2013, borrowing in USD operations declined in line with a reduction in US dollar funding pressures for European banks. Borrowing in USD operations stood at circa $9bn (approximately €7bn) at the end of 2012 and fell to just $259mn (approximately €190mn) at end 2013. The decrease in participation occurred amid a decline in the euro-dollar basis swap, a measure of US dollar funding costs, which fell throughout 2013 and turned positive towards the end of the year. In light of the reduced usage of this operation, the ECB announced on 24 January 2014 that the 84-day operations would cease in April 2014. One-week US dollar liquidity-providing operations will continue to be conducted at least until 31 July 2014, but will be reviewed at that point.

This decision takes into account the fact that six major central banks (Bank of Canada, Bank of England, Bank of Japan, European Central Bank, US Federal Reserve, and Swiss National Bank) announced in October 2013 that their existing temporary bilateral liquidity swap arrangements were being converted to standing arrangements. This provides a framework for the reintroduction of US dollar liquidity-providing operations by the ECB if warranted by market conditions.

4 Ireland Overview

Eurosystem liquidity provision to Irish domiciled counterparties decreased from circa €71bn at 2012 year-end, to circa €39bn at the end of 2013, a decline of €32bn (45%). There was a decline in Eurosystem borrowings both for domestic banks (from €48.7bn to €27.9bn) and for non-domestic banks (from €22.7bn to €11.2bn).

Over the course of 2013, a combination of deleveraging, asset sales, increased deposit flows and the return of the Irish domestic banks to international funding markets has allowed these banks to reduce dependence on central bank funding. The removal of the Irish Eligible Liabilities Guarantee (ELG) scheme for new issues, which was effective from 28 March 2013, was another positive step in the normalisation of the Irish banking system.

For financial stability reasons the Bank also provided Exceptional Liquidity Assistance (ELA) to Irish Bank Resolution Corporation (IBRC) until February 2013. ELA is distinct...
and separate from regular funding operations carried out for monetary policy implementation purposes through the ECB. At end-December 2012, the Bank had extended ELA of €40bn. Following the appointment of special liquidators to IBRC, the Bank acquired collateral that had been provided by IBRC as security for ELA which then stood at €39.5bn. As a result of these developments (including an exchange of ministerial promissory notes for marketable Irish Government bonds), the Bank was recompensed in respect of the ELA it had provided. Following the liquidation of IBRC in February 2013, the Bank’s ELA operations ceased.

4.1: Ireland’s return to debt markets in 2013

In July 2012, the National Treasury Management Agency (NTMA) recommenced auctions of Treasury bills (T-bills) for the first time since the beginning of the EU/IMF Financial Support Programme in November 2010. The NTMA continued to hold regular 3-month T-bill auctions until September 2013, with demand remaining strong for all auctions and the yield at issuance generally decreasing during the period. Table 1 below illustrates the results of Irish T-bill auctions since September 2010, before Ireland’s entrance into a financial support programme. In addition to the issuance of T-bills, the NTMA initiated a return to the bond markets in 2012 with new issuance continuing in 2013 and 2014. In January 2013, the NTMA raised €2.5bn through the sale of a syndicated tap of its treasury bond which matures in October 2017. In March 2013, the NTMA raised a further €5bn through the sale of a new benchmark treasury bond at a yield of 4.15% maturing in March 2023. This was the NTMA’s first new 10-year issuance since January 2010. Demand for issuance in 2013 was spread across a wide range of international investors.

In December 2013, the NTMA completed a buy-back of €4.1bn of its January 2014 bonds at 10bps, reducing the nominal outstanding from €6.8bn to €2.7bn.

By the end of 2013 the NTMA was in a comfortable position with regard to access to the bond markets, there was positive market sentiment towards Ireland and a strong interest in Irish sovereign bonds as shown by falling bond yields throughout 2013. Ireland’s exit from the EU/IMF programme without a precautionary credit line was received positively by investors, with the Department of Finance announcing that the decision not to take a credit line was in part related to the sovereign’s strong funding position. The NTMA announced that the sovereign remained “well-funded until mid-2015”.

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<th>Table 1: Recent Irish T-bill Auctions</th>
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<td>23-Sep-10</td>
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**Source:** Bloomberg; National Treasury Management Agency
On 7 January 2014, the NTMA successfully returned to the bond markets for the first time since the end of the IMF/EU Funding Programme, selling €3.75bn of a new 10-year syndicated bond at a yield of 3.54%, receiving a total bid in excess of €14bn for the bond. The majority of issuance was sold overseas (83%) while interest reportedly came from a broad range of international investors. The NTMA noted that it intended to issue a total of €6-8bn of bonds in 2014, indicating that the 10-year issuance achieved around 50% of 2014’s funding requirements.

The improved funding conditions of the Irish sovereign and banks added to Moody’s decision to upgrade the Irish sovereign rating to Baa3 (from Ba1) on 17 January. The move was positive for Irish bond issuance as it meant that all major ratings agencies held Ireland as investment grade, opening up a broader investor base which previously would have been closed to Irish sovereign debt due to its sub-investment rating from Moody’s. Market analysts noted that there has been an increased demand for Irish sovereign debt from Asian and Middle Eastern investors, including fund managers and pension funds.

4.2: Irish Bank Bonds and Other Debt Issuance

The improvement in investor sentiment towards Ireland was also seen in the Irish domestic bank bond markets, with Bank of Ireland (BOI) and Allied Irish Banks (AIB) experiencing strong demand for a number of bond issuances in 2013. Both banks successfully issued their first senior unsecured bonds since 2009 and 2008 respectively, while the Electricity Supply Board (ESB) also issued bonds in November 2013.

On 9 January 2013, the Irish government sold €1bn of its Bank of Ireland Contingent Capital Bonds (CoCos). The sale was almost five times oversubscribed with a yield of 9.62%.

In May, Bank of Ireland issued its first senior unsecured bond since September 2009 selling a 3-year €500mn senior unsecured bond at a yield of 2.8%. The issuance received strong demand with orders exceeding €1.25bn. AIB also returned to the debt markets with a 3-year €500mn senior unsecured bond issuance in November. This was the bank’s first such issuance since 2008. The AIB issuance also saw strong demand, with the price 15bps tighter than initial projections at 2.91%.

Bank of Ireland returned to the bond markets in early 2014, selling a €750mn 5-year senior unsecured bond on 8 January 2014 at a yield of 3.34%. The issuance was five times oversubscribed, receiving €3.75bn worth of orders, 97% of which were said to be from overseas investors.

AIB issued two covered bonds in 2013. The first, a €500mn 3.5-year covered bond was issued on 22 January 2013 by AIB Mortgage Bank at a yield of 2.65%. Then on 3 September, AIB issued €500mn of a new 5-year ACS covered bond, at a yield of 3.22%, 22bps above the equivalent Irish government bond at the time. The yield on both bonds fell after issuance as strong demand in secondary markets, in part due to positive market sentiment towards Ireland, pushed prices higher.

Bank of Ireland was also active in the covered bond market, selling a total of €2bn in covered bonds through three issuances in 2013. On 15 March, Bank of Ireland concluded the sale of €500mn of new 5-year covered bonds, backed by Irish retail mortgages, at a yield of 2.82%. On 25 September Bank of Ireland issued a €500mn 7-year covered bond at a yield of 3.55% and a €1bn 3.5-year covered bond on 6 November at a yield of 1.74%. As with the AIB covered bond issuance, the yields fell after issue in the secondary market.

On 20 November, PTSB raised €500mn from the sale of Irish residential mortgage backed
securities (RMBS). This was the first publically placed new issuance of this kind by an Irish bank since 2007 and the first by PTSB since 2006. The RMBS sold at a yield of 1.87%, significantly inside the secondary market for Irish RMBS at the time (2.5-2.7%).

In other non-financial bond issuance, ESB returned to the market on 5 November 2013 issuing a €300mn 10-year senior unsecured note at 3.5% slightly below the equivalent sovereign yield at the time of 3.55%.

4.3: Stress Tests

In 2014, the ECB will conduct a comprehensive assessment of the European banking sector ahead of assuming full responsibility for supervision as part of the Single Supervisory Mechanism (SSM). The assessment will seek to enhance the quality of information available on the condition of banks and will identify risks and implement necessary corrective actions with the goal of restoring confidence in the stability of the European banking sector. The exercise will comprise of an Asset Quality Review (AQR), a full supervisory risk assessment and stress tests applied to 128 significant banks across Europe, and is due to be completed by November 2014.

5 TARGET2 balances

TARGET2 (T2) is the payment system of the euro that is operated by the central banks of the Eurosystem. All payments are settled in central bank money (that is to say they are booked on the accounts that banks hold with their central bank) and are settled in real time. The payments are primarily between banks and ancillary systems (e.g. security settlement systems, central counterparties, retail payment systems) as well as payments as part of Eurosystem operations such as OMOs.

The T2 balances of national central banks (NCBs) reflect cross-border euro transfers. When an NCB has a T2 claim, it implies that there has been an inflow of euro funds to that country’s banking system, whereas a T2 liability balance implies that an outflow has taken place. The settlement of such cross-border transfers between banks in the euro area in T2 thus results in intra-Eurosystem balances (which are netted off with the ECB). As a result, some NCBs have a T2 claim (asset) and others a T2 liability vis-à-vis the ECB.

5.1: The main changes in T2 balances in 2013

T2 imbalances gradually decreased over the year with a general flow of funds back from the core countries to the periphery, which had amassed significant T2 liabilities between 2010-2012. Following comments by President Draghi in July 2012, and the subsequent announcement of OMT in August 2012, euro area tensions eased somewhat and T2 imbalances narrowed in the later stages of the year and into 2013. The narrowing of imbalances continued at a steady pace through 2013, highlighting a gradual reduction in fragmentation which has been observed across European markets.

The most notable changes in 2013 were on the balance sheets of the Bundesbank and the Banco de España. Over the course of the year the German T2 claim decreased by €145bn to €510bn while the Spanish T2 liability fell by €124bn to €214bn. The Dutch T2 claim fell by €75bn to €46bn and the Irish T2 liability fell by €24bn to €55bn, while the Italian and French liabilities also fell, by €26bn and €39bn respectively. Ireland’s T2 liability has fallen by nearly two-thirds from the end of 2010, when it stood at €145bn (See Chart 5).

The €24bn reduction in Ireland’s T2 liability in 2013 results from a number of different factors; the inflow of programme funds from the EU and the IMF, the sale of sovereign debt to foreign investors, deleveraging receipts and an increase in Irish banks’ access to the international funding market.
In addition, a major reason for the reduction is the repayment of 3-year LTRO funding from non-domestic counterparties of the Bank. These non-domestic counterparties borrow in the ECB’s operations via Ireland and repatriate their borrowings to their parent, which creates a T2 liability for Ireland and a T2 claim for the other Eurosystem NCBs where their parent is located. Over the course of 2013, Irish non-domestic counterparties reduced their borrowing by circa €13bn, the majority of which was through the EROs. In doing so, this decreased the Bank’s T2 liability and reduced the claim of the NCBs where the parent is located.

6 Market Focus in 2014

Developments in central bank policy continue to be a key factor for financial markets in 2014. In the US, following the Fed’s decision to begin tapering in December 2013, market participants will be keenly watching economic data, in particular employment and inflation figures to assess if there is likely to be any increase or slowdown in the rate of reduction. Market participants currently expect the Fed to complete its wind down of the bond buying programme by the end of 2014 and to begin increasing interest rates in 2015. Given the Fed’s forward guidance reference to unemployment and inflation data, any unexpected movements in these figures may have a significant impact on volatility.

The ECB will complete its Asset Quality Review (AQR) in October 2014. The ECB intends the exercise to force banks to identify risks and realise losses, improving transparency and confidence in the banking system. President Draghi has commented that it is imperative that the review is comprehensive stating that some banks will fail the review.

In Ireland, developments in the banking sector will continue to be a focus, with the domestic banks AQR results and continuing return to the debt markets closely watched. The sovereign remains funded until 2015, however remaining debt issuance in 2014 will rely on continuing positive market sentiment. Ireland’s return to economic growth remains reliant on global economic growth and developments in other peripheral countries. Further European shocks may also be damaging to Ireland’s growth potential and debt issuance. Despite Ireland’s exit from the EU/IMF funding programme, markets will continue to closely monitor the country’s ability to reform and its adherence to its fiscal targets.

In early 2014, a number of weak data releases from China raised concerns of a slowdown in the economy. Markets are concerned that a dramatic slowdown could spill over to other countries, particularly emerging market economies and could restrict global economic growth. In Europe, developments in the periphery will continue to be a major focus for market participants in 2014, with economic data releases remaining key. Markets will closely watch the on-going structural reforms and macroeconomic adjustments being undertaken by peripheral economies, for example, in Italy where the new government’s attempts to reform taxation and labour markets will be closely monitored. Elsewhere, the IMF has warned that the Greek economy faces significant challenges ahead amid considerable uncertainty. Meanwhile, Portugal is scheduled to exit its external funding programme in June 2014, although markets expect the country will do so with a precautionary credit line.
Annex 1: Glossary of Terms

**EONIA (Euro Overnight Index Average)**

is a market index computed as the weighted average of overnight unsecured lending transactions undertaken by a representative panel of banks.

**EURIBOR (Euro Interbank Offered Rate)**

is the rate at which interbank term deposits are offered by one prime bank to another prime bank. This is often the reference rate for maturities of one, two and three weeks, and for maturities of one to twelve months.

**Excess liquidity** arises when the supply of liquidity (as provided via ECB open market operations and the marginal lending facility), exceeds the demand for liquidity (as dictated by minimum reserve requirements and autonomous factors outside the direct control of individual NCBs), there is said to be **excess liquidity** in the banking system. In this situation, the excess will likely end up being deposited with the ECB via deposit facility usage or via the weekly fine-tuning operation.

**Excess Reserves**: Current account holdings in excess of the average minimum reserve requirements.

**Liquidity Provided**: The net amount of liquidity provided by the ECB through its open market operations.

**Liquidity Shortage**: This is determined by the minimum reserve requirements and autonomous factors outside the direct control of individual NCBs.

**Maintenance period (MP)**: The period over which compliance with reserve requirements is calculated. The MP begins on the settlement day of the first MRO following the policy meeting of the Governing Council.

**Minimum reserves** are determined on the basis of the institutions’ average daily reserve holdings (calculated on the basis of certain balance sheet liabilities) over a maintenance period of about one month. Each bank in the Eurosystem is required to maintain a balance with their respective NCB. The required reserve holdings are remunerated at a level corresponding to the average interest rate over the maintenance period of the MROs of the Eurosystem.

Open Market Operations (OMO’s) include Main Refinancing Operations, Longer-Term Refinancing Operations, Fine-Tuning Operations, structural operations and the Early Repayment Operations, as defined below.

(i) **Main refinancing operations (MRO)** are regular liquidity-providing reverse transactions with a frequency and maturity of one week. The MRO rate is currently 0.25%.

(ii) **Longer-Term Refinancing Operations (LTRO)** are liquidity-providing reverse transactions that are regularly conducted with a monthly frequency and a maturity of three months. Longer-Term Refinancing Operations are conducted at irregular intervals or with other maturities, e.g. the length of one maintenance period, six months, twelve months or thirty-six months are also possible. The ECB conducted two 36-month operations (VLTROs) the first in December 2011 and the second February 2012, the terms of these operations gave counterparties the opportunity to repay any part of the amount they were allotted after one year. In January 2013, the ECB conducted the first Early Repayment Operation (ERO) allowing banks to repay some or all of their borrowings from the first 36-month LTRO (transacted in December 2011) before the stated maturity date of the LTRO. Throughout the rest of 2013, the ECB conducted weekly EROs (one for each of the two 36-month LTROs) at the discretion of the Governing Council.

(iii) **Fine-Tuning Operations (FTO)** can be executed on an ad hoc basis to manage the liquidity situation in the market and to steer interest rates. In particular, they aim to smooth the effects on interest rates caused by unexpected liquidity fluctuations. Fine-Tuning Operations are primarily executed as reverse transactions, but may also take the form of outright transactions, foreign exchange swaps and collection of fixed-term deposits. Since May 2010, a weekly FTO has been held to absorb the liquidity provided through the
Securities Markets Programme (SMP), which involved purchases of sovereign debt in the secondary market.

(iii) Structural operations are executed by the Eurosystem mainly in order to adjust the structural liquidity position of the financial sector vis-à-vis the Eurosystem. They can be carried out through reverse transactions, outright transactions and the issuance of debt certificates.

Standing facilities aim to provide and absorb overnight liquidity, signal the general monetary policy stance and bound overnight market interest rates. Two standing facilities, which are administered in a decentralised manner by the NCBs, are available to eligible counterparties on their own initiative:

(i) Marginal Lending Facility (MLF): Counterparties can use the MLF to obtain overnight liquidity from the NCBs against eligible assets. The interest rate on the MLF is currently 0.75% (50bps above the MRO rate) and normally provides a ceiling for the overnight market interest rate.

(ii) Deposit Facility (DF): Counterparties can use the deposit facility to make overnight deposits with the NCBs. The interest rate on the deposit facility is currently 0.0% (25bps below the MRO rate) and normally provides a floor for the overnight market interest rate.

Variable rate allotment: In normal circumstances, the Eurosystem, when conducting its OMO’s, assesses the total liquidity need of the banking sector and, in competitive tenders, allots this amount. Usually these tenders are conducted as variable rate tenders, meaning that banks pay the interest rate that they offer when they make their bids.

In exceptional circumstances, the ECB may decide in advance to allot the full amount of liquidity that banks request, i.e. to accommodate all bids, at a fixed interest rate (known as fixed rate full allotment). The ECB currently operates a fixed rate full allotment policy for all refinancing operations.

The Eurosystem may also execute its tenders in the form of fixed rate tenders, where the interest rate is specified in advance and banks bid the amount of money they wish to transact at the fixed interest rate.