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Benchmark for the secured money market

RISK MANAGEMENT The financial crisis revealed many weaknesses. Interbank trading, too, was disrupted in some instances. Well-known money market benchmarks, the LIBOR and EURIBOR, were suspected of having been manipulated. Regulators and market participants alike thus take a different view of the money market now than before the crisis. Institutions are switching over to the secured money market and opting for anonymous trading via regulated platforms. This has considerably improved the opportunities for calculating neutral and reliable money market benchmarks. The first financial instruments on the new, neutrally calculated money market benchmarks will support to banks' risk management in the future.

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The financial crisis not only hampered interbank trading; it also damaged the reputation of and confidence in the familiar benchmarks used to indicate short-term interest rate development: the LIBOR and the EURIBOR. Money market rates are suspected of having been manipulated for a long time by agreements between the banks involved in raising the money market rates. The previously negligible money market transparency, subjective determination of money market benchmarks via a survey of selected banks and the existing conflict of interest created by using them for products and investments have fostered manipulation. While the events are still being reappraised, the market created alternatives for money market trading and new benchmarks.

Secured money market volumes rise

The Deutsche Börse subsidiary, Eurex Repo GmbH, for example, has offered a highly liquid market for secured funding in euros and US dollars via a neutral trading platform since 2005 – the GC Pooling Market.

Despite trading getting off to a slow start, banks have increasingly used the platform since 2007. At the end of 2007, average outstanding volume was still less than €20 billion. Today, by comparison, almost 3,000 transactions are concluded on the platform each month, with outstanding volume of over €150 billion. ►**1.** More than 120 market participants from 14 countries are present on the trading platform, with around 50 of them from Germany.

Trading volume in the unsecured money market in contrast has decreased by more than €300 billion, according to the International Capital Market Association (ICMA), of which the lion's share is now transacted in the secured market. Liquidity trading via the central platform is growing quickly as market participants use it to limit their credit and market risks, while simultaneously being able to meet the requirements for depositing capital via a platform. Moreover, secured markets adhere to the principles set by the regulator for financial market infrastructures and published by the International Organization of Securities Commissions (IOSCO) in April 2012. Central securities depositories and central counterparties like Clearstream and Eurex Clearing, that participate in the secured money market, comply with these regulatory principles.

Central counterparty and collateral provision

Trading via neutral platforms is very different from direct interbank trading that dominated until recently. Platform transactions are not concluded directly between banks, but with a central counterparty. Consequently, there is no default risk between the banks, but instead vis-à-vis the central counterparty. During the financial crisis, bilateral trading in the unsecured money market, in contrast, was disrupted on occasion, as default by the respective counterparty was feared. The central counterparty assesses the risks of each position every 20 minutes, thus offering efficient central management of the risks. It also offsets the individual positions created in settlement of the transactions, which in turn lowers transaction costs.

A further important difference to bilateral trading in the unsecured money market is that liquidity is the sole motive for transactions via the central counterparty. They can thus be clearly distinguished from trading with collateral, which is pledged for individual securities.

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This difference was difficult to identify in the financial crisis, as similar valuation models were used in both areas.

Unlike in interbank trading, secured money market participants furnish collateral for their positions, which lowers default risks. Collateral management is also central and automatic. In this manner, participating institutions can either reuse or replace collateral received. Positions in euros are settled in liquidity, which is provided by the European Central Bank (ECB) or other market participants and is thus in line with ECB or Bundesbank monetary policy. As for most other asset classes, Clearstream provides settlement in the money market as well. The international securities depository has three different baskets for pledged collateral: the GC Pooling ECB Basket for securities with a minimum rating of A-, the GC Pooling ECB EXTended Basket for securities with a minimum rating of BBB- and the GC Pooling Equity Basket for equities. Equities that are furnished for the first two securities baskets meet ECB collateral requirements and are deemed eligible by the ECB. The collateral can thus also be used for refinancing via central banks. The first securities basket contains approximately 7,500 securities recognised by the ECB, while the extended securities basket comprises around 23,000 securities. The collateral pledged may be reused within each securities basket.

Basis for alternative money market benchmarks

Regulators have not only been occupied with the infrastructure of the financial markets, however.

As a result of the manipulations in calculating the money market benchmarks, the financial supervisor developed a number of criteria to improve this calculation as well as that of indices in general, i.e. the market barometer for other asset classes as well. The proposals made by the European Securities and Markets Authorities (ESMA), the European Banking Authority (EBA), the European Commission and the International Organization of Securities Commissions (IOSCO), among others, primarily aim to accomplish the following:

- determine the application area for regulation and important benchmarks
- ensure a high degree of transparency
- avoid conflicts of interest
- set rules for non-EU members and an external supervisor
- create an external control and monitoring body
- and determine management, reporting and data publication of indices

As a result of the manipulations in the money markets, however, the regulator has not limited these principles solely to subjectively calculated indices, such as the well-known money market benchmarks, which are not calculated on the basis of market data but on estimates of certain groups. Rather these rules apply to all indices, including the rule-based indices for other asset classes objectively calculated on the basis of market data. The financial authority has taken the suspicion of manipulation of subjectively calculated money market benchmarks as an opportunity to also more stringently regulate indices calculated on the basis of objective market data and used for other asset classes.

Objective indices are transparent and avoid conflicts of interest

Regardless of regulation, the following features are important to make the advantages of indices available to investors in the future too, and to offer high-quality and objective benchmarks. Most indices have already met these requirements for a long time. Firstly, it must be ensured that the indices are reliably calculated in a traceable manner. Especially the database of indices that reference market data that is not publicly accessible should be checked in this context. Conflicts of interest are also to be avoided. They are often at the root of manipulation. Conflicts of interest can be effectively excluded if the index provider or data supplier does not earn a profit on the performance of the index. This can normally be ensured through independent index calculation. These independent index providers are the only ones to have no advantages at all from index performance and serve all market participants equally. Their business model is based on the reputation of the benchmarks as independent and objective indicators of the relevant market performance. The important thing is that regulation promote innovations rather than hinder them. Intelligent and objectively calculated index concepts have supported the further development and efficiency of financial markets for many decades.

Meeting regulators' money market requirements

Regulators' requirements apply to indices on all asset classes. Conditions have improved with the strong growth in the secured money market, also for calculating benchmarks for these asset classes – benchmarks that are similarly objective and based on actual market data, as have long been available for other classes. Central counterparties and the strong rise in trading volume are the reason for the reliable basis which has developed, that can be used to calculate benchmarks for the secured money market. The new benchmarks comprise the transactions that have actually been concluded via the central counterparty.

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In contrast to the LIBOR and EURIBOR, which are determined on the basis of bank information on the unsecured money market, the high number of recorded transactions and market participants provide a broad and reliable basis for calculating money market rates. Moreover, the money market benchmarks are calculated independently and objectively. The amount of the money market rates determined is irrelevant to the business success of the index provider, which is why there is no incentive at all for controlling rate development. High transparency is also created through the benchmark calculation performed twice every exchange trading day at 1 p.m. and 6 p.m., and through publication of index rules and methods. As for all other asset classes, investors can check the publicly available index rules of money market benchmarks. For example, the index rules prescribe a minimum transaction size, in order that multiple small transactions do not disproportionately affect the benchmark. Independent calculation based on clear index rules ensures that conflicts of interest are excluded and benchmarks can be determined at all times on the basis of objective criteria.

Broad scope of application

Investors can use the alternative money market benchmarks for a variety of purposes. All 45 indices can be used to track the entire money market curve up to a residual maturity of twelve months. Moreover, a total of four calculation options support a variety of investment objectives. One index version is weighted according to the volume-weighted average, while another is based on total volume. The deposit version measures continuous return performance on a rolling basis. The benchmarks in the current version reflect trading over the course of the day and the current market level, by indicating the latest transaction in each case for short-term maturities, without taking into account the transaction volume. The broad index family enables investors to cover their different information needs.

Managing money market risks

The Deferred Funding Rate benchmark takes into account funding rates in the secured money market for transactions executed overnight, or from tomorrow until the day after tomorrow (Tom next) or in two days (Spot next) and furnished with collateral deemed eligible by the ECB. The Deferred Funding Rate is already based on higher trading volumes than the EONIA rate and is showing stable development against the well-known money market benchmark. ► **2.** It is thus suited as a benchmark for development in the secured money market. This and the high liquidity of the underlying market also make it interesting for tracking exchange-traded financial instruments. The alternative money market benchmark will soon also be investable via an exchange-traded futures contract and tradable on the Eurex derivatives exchange. Market participants can then use the futures contract to hedge against fluctuations in the secured euro money market and trade interest rate risks in the secured and unsecured money markets against each other, use the interest rate differences and manage investment risks in both markets.

Conclusion

Working through the aftermath of the financial crisis will continue to occupy regulators and financial markets. Independently of further regulation, however, the market has reacted to weaknesses of the past and is increasingly taking advantage of the secured money market and central counterparties. The conditions have also improved for calculating independent, transparent benchmarks that exclude the possibility of conflicts of interest. As a result of the growing secured money market, comprehensive market data is available to help calculate high-quality benchmarks, like those investors have been familiar with in other assets classes for decades already. With a view to the future, the possibilities are thus improving of actively managing risks and opportunities on the money market, for example via derivatives, such as futures, on the basis of objective market data. This gives banks another instrument to manage risks in the money market. ■

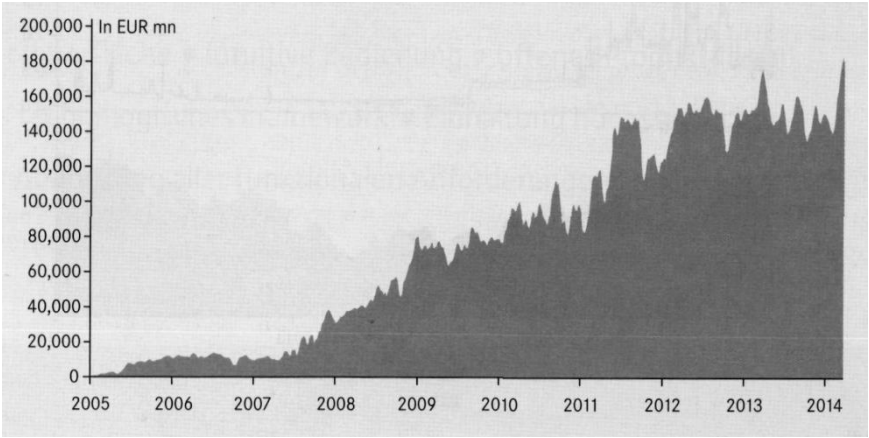
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Development of outstanding volume in GC Pooling market
(March 2005 – June 2014)



Performance of EONIA and STOXX GC Pooling Deferred Funding Rate

