Box 8

STRUCTURAL TRENDS IN THE EURO MONEY MARKET

The fifth study on the structure and functioning of the euro money market was conducted in early 2005 by the ECB together with the 15 national central banks (NCBs) that were members of the European System of Central Banks (ESCB) before 1 May 2004.[1] The study was based on turnover data collected from banks covering the second quarters of 2003 and 2004. This Box reports on some of the main findings of this study, and draws attention to the following three main findings. First, although changes in the aggregate turnover of the euro money market were limited between the second quarters of 2003 and 2004, there were some notable compositional changes, especially in terms of growing activity in secured relative to unsecured market. Second, overall activity in the euro money market became less concentrated, although large differences have remained across market segments. Third, the growing use of electronic platforms to make transactions in many market segments produced a further narrowing of bid-offer spreads.

Following the rise that took place between 2000 and 2003, aggregated turnover in the euro money market appeared to stabilise in Q2 2004 (see Chart B8.1). This was due to offsetting patterns in different segments of the market. Although activity fell in the overnight index swap (OIS) market as well as in the cross-currency and foreign exchange swaps markets, there was a rise in turnover in the unsecured, secured, other interest rate swap (IRS), forward rate agreement (FRA) and short-term securities segments (see Chart B8.2). Furthermore, as in Q2 2003, the secured segment remained the largest money market segment in Q2 2004, accounting for around 36% of total market turnover.

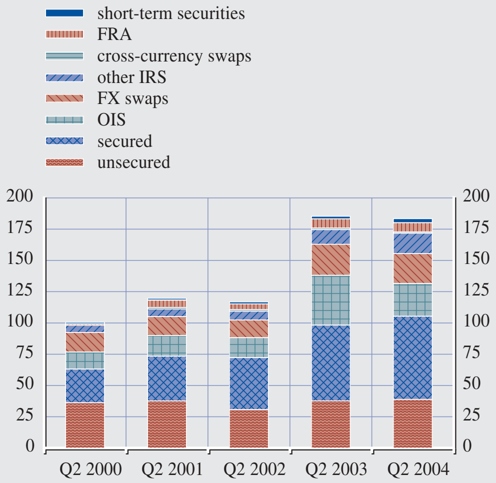
The increasing share of secured transactions can be seen positively from a financial stability point of view, as it shows that market participants have a preference for limiting their credit risk exposures. A further development related to the increase in the secured market segment was a substantial increase in tri-party repo activity.[2] This also reduced the counterparty and operational risks related to settlement.

The degree of concentration in money market activities can provide an indication of both the market's dependency on individual institutions and the risks for market functioning if a significant counterparty were forced to exit. There are indications that the overall level of activity in the euro money market has become less concentrated in recent years. Nevertheless, degrees of concentration vary widely across different market segments. The least concentrated segment of the money market in Q2 2004 was the unsecured segment, where the ten most active

1 See ECB (2005), *Euro Money Market Study 2004*, May. The study is based on data received from a sample of credit institutions, implying that the findings must be interpreted with caution, as they are not necessarily representative of the euro money market as a whole.

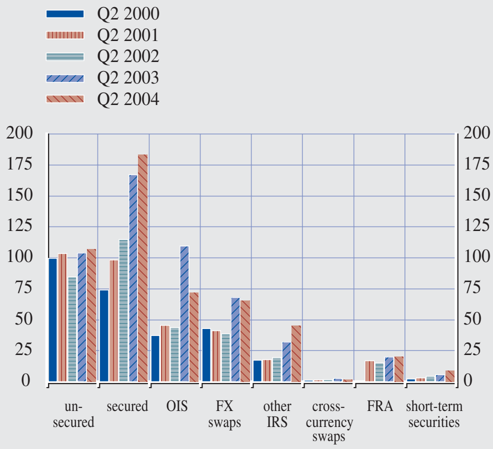
2 A tri-party repo is a repo that involves a third party, commonly a custodian bank, acting as an agent to exchange cash and collateral for one or both counterparties.

Chart B8.1 Aggregated turnover in the euro area money market



Source: ECB.
Note: The Q2 2000 volume is taken as a base. No data on FRA turnover were available in 2000.

Chart B8.2 Average daily turnover by money market segment



Source: ECB.
Note: The Q2 2000 unsecured volume is taken as the base. No data on FRA turnover were available in 2000.

institutions accounted for around 35% of the total turnover. However, some segments have remained highly concentrated. For instance, the FRA, other IRS and cross-currency swap segments remained highly concentrated: the ten most active institutions in each of these segments accounted for around 70% of total turnover (see Table B8.1).

Concerning the integration of the euro money market, the most relevant change in the geographical counterparty structure in Q2 2004 was the loss of predominance of transactions with national counterparties for short-term securities. Indeed, in the short-term securities (and cross-currency swap) segments, cross-border transactions with other euro area counterparties became the highest among all market segments (see Chart B8.3). From a financial stability viewpoint this development is important as it reduces country-specific risks by spreading risks more widely. By contrast, however, the share of transactions with national counterparties remained relatively high in the secured market segment, indicating that the integration of national repo markets across the euro area continued to proceed at a slower pace.

Table B8.1 The share of the five and ten largest banks in total activity in OTC derivatives market

(%, Q2 2004)

	OIS	other IRS	FRAs	FX swaps	cross-currency swaps
top 5 banks	42	62	57	38	52
top 10 banks	62	79	78	64	75

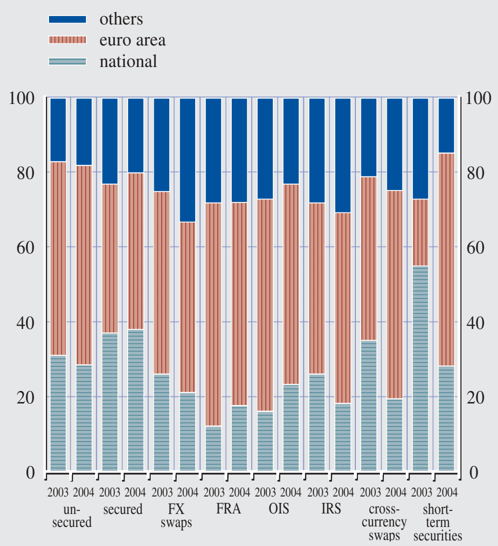
Source: ECB.

Finally, the following two additional structural developments were observed in the euro money market. First, electronic trading continued to grow in Q2 2004 in most market segments (e.g. in the secured, IRS and foreign exchange swap segments), and especially in the secured market segment (see Chart B8.4). While electronic trading accounted for a very large share of total activity in the secured markets, it has remained rather small in most of the other over-the-counter (OTC) derivatives markets.

Overall, the increasing share of electronic trading in some segments of the euro money market can be seen as a positive development from the market's viewpoint, as it can enhance the price discovery process and liquidity, reduce operational risks, and lower the cost of trading. However, in the case of abnormal market conditions, the role of electronic trading platforms, especially those of quote-driven systems, can have a destabilising effect on the functioning of markets and can for example lead to sudden withdrawals of liquidity from the markets.[3] Second, the creation of the EONIA Swap Index[4] by EURIBOR-ACI will probably further stimulate the development and enhancement of the overnight swap market segment, since it should provide a new benchmark for derivatives markets. By improving the choice of instruments available to market participants for hedging against, or speculating on interest rate risks, the development of derivatives products in the euro money markets should contribute positively to financial stability by facilitating the dispersion of risks.

Chart B8.3 Geographical counterparty structure by money market segment

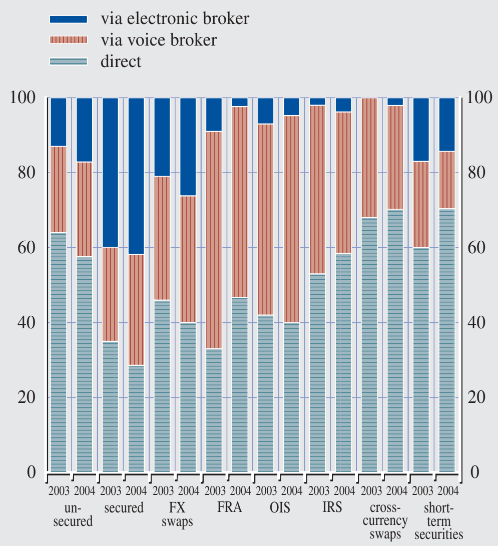
(%)



Source: ECB.

Chart B8.4 Trading structure by money market segment

(%)



Source: ECB.

3 See, for instance, ECB (2005), *Financial Stability Review*, June.
4 The EONIA Swap Indices were calculated for the first time on 20 June 2005.