Frontclear: Money Markets Matter

Frontclear Academy

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Money Markets Matter

Course Agenda

1. General overview of the money market
2. Key benefits and challenges

Money Markets Matter

General overview of the money market

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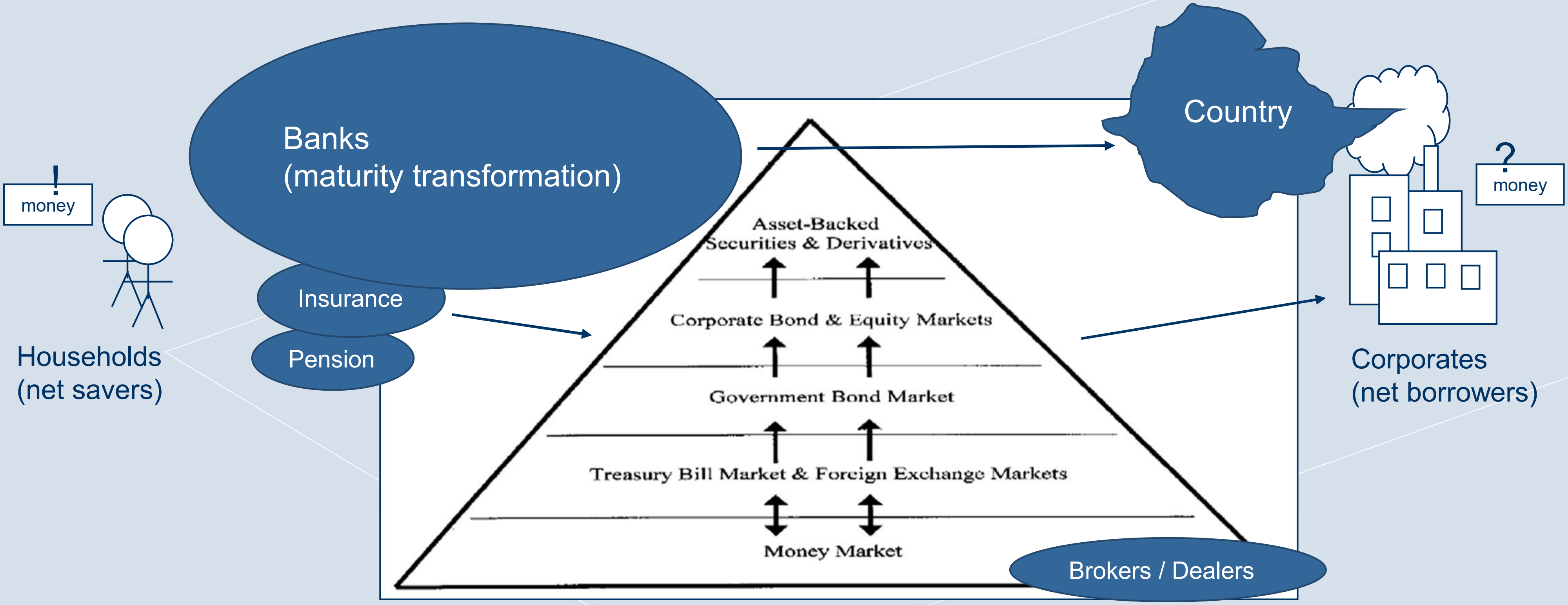
Why do money markets matter?



Source: Karacadag, Cem ; Sundararajan, V. ; Elliott, Jennifer A. Managing Risks in Financial Market Development: The Role of Sequencing; Working Paper No. 03/116.

Why do money markets matter?

Key functions of the money market

1. Clearing of short-term liquidity and risk positions between money market participants (up to 1YR)
2. Offering liquidity to government securities markets
3. Creation of a reference rate that serves as an anchor to the short end of the yield curve
4. Monetary policy transmission

Instruments traded in the money market

Clearing of short-term liquidity and risk positions between money market participants (tenors up to 1YR)

- Unsecured interbank loans / deposits
- Secured transactions up to 1YR (repurchase transaction or “repo”)
- Short-dated interest rate swaps (IRS)
- FX Spot / FWD / Swap
- Treasury Bills
- Central Bank Bills
- Certificates of Deposit (CD, mostly issued by banks)
- Commercial Paper (CP, mostly issued by corporates)

Instruments traded in the money market

Clearing of short-term liquidity and risk positions between money market participants (tenors up to 1YR)

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- Liquidity management purposes
- Mostly between banks
- Tenors up to 3M
- For tenors longer than O/N two issues:
  - Credit risk
  - Liquidity risk

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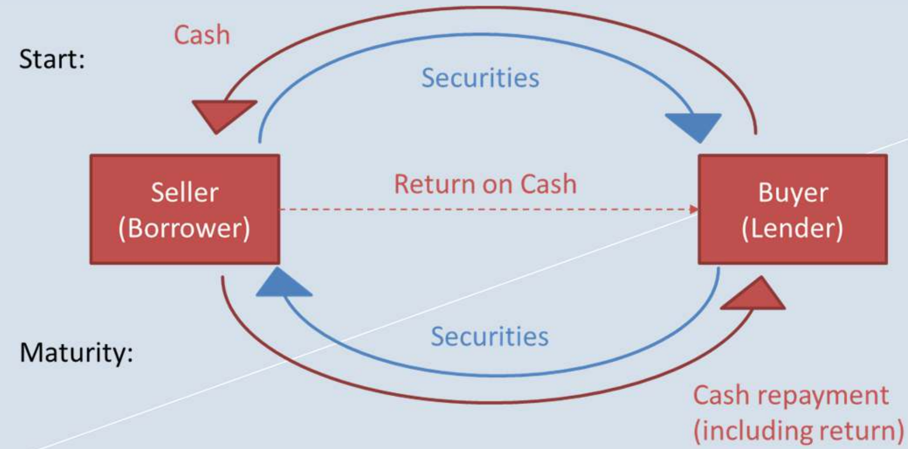
- Buy and sell-back of securities, with difference between selling and buying is remuneration for funds received
- Seller transfers title to buyer but retains economic risk of the securities – only accounts for a loan taken
- Repo mitigates both credit risk and liquidity risk for the buyer / lender



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- Exchange of fixed interest payments for a series of floating interest payments between two counterparties (but no exchange of principle)
- Traded between professional market parties
- Allows parties to manage interest rate risk on the balance sheet
- E.g. pay fixed rate to receive daily overnight index rate over the period of 1M
- Depends on the availability of a defined and predictable floating rate index

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- Exchange of currency amounts at agreed FX rate
- Standard settlement date T+2 (Spot)
- Any other settlement date (FWD) leads to adjustment of Spot rate for interest rate differential between the two currencies over the settlement period ("covered interest rate parity"):
  - $\text{FWD} = \text{Spot} \times (1 + i_{lcy}) / (1 + i_{fcy})$
- FWD is an interest rate product and relies on the availability of market determined short term interest rate for the local currency

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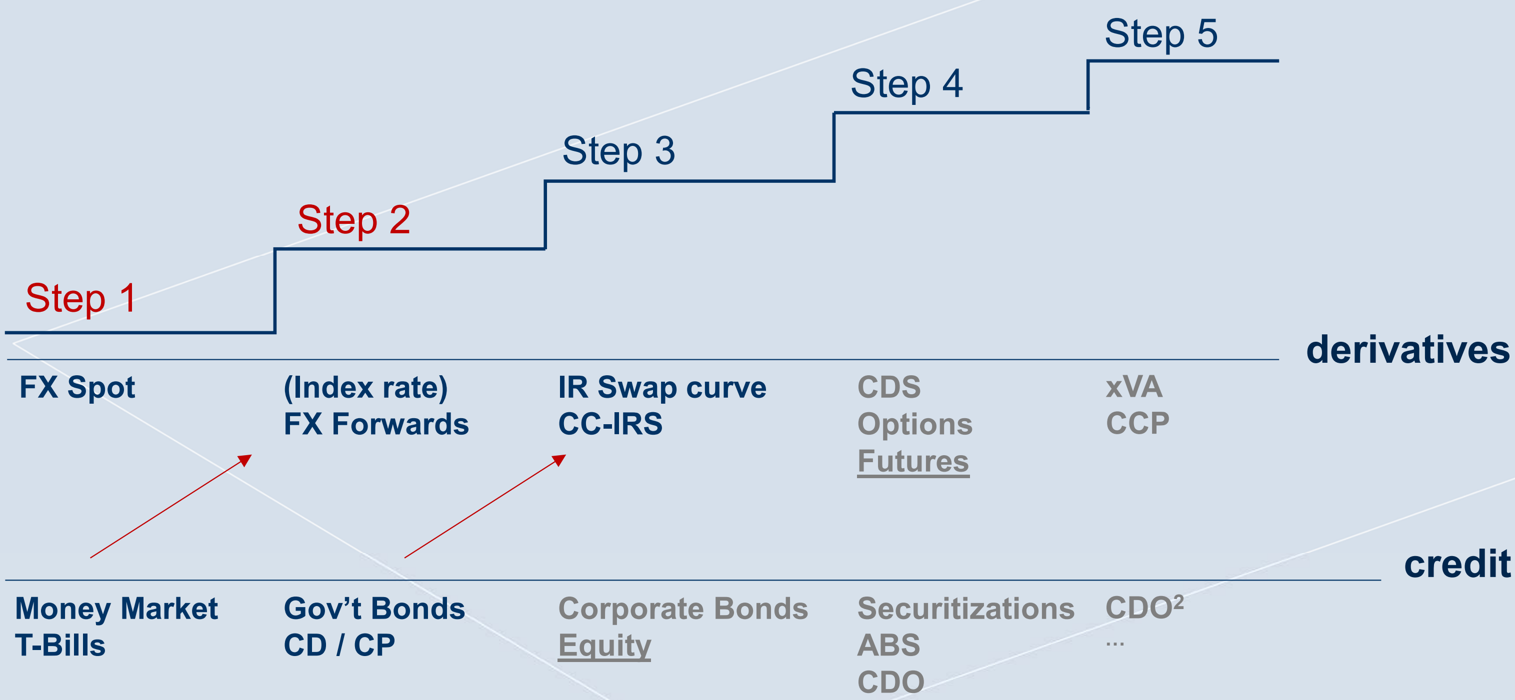
- Tradeable short-term instruments issued by different type of issuers
- Either carrying a coupon or traded on discount basis (redemption at face value)
- Increasing level of credit risk
- Treasury and Central Bank Bills
  - should be offered for different tenors (alternatively the central bank might use Treasury Bills for Open Market Operations)
  - Determine the short end of the local yield curve

Instruments traded in the money market

Market Escalator - Developments in the credit market are leading the development of the derivatives market



Money Markets Matter

Key benefits and challenges

Why money markets matter and key challenges

Key Functions of the Money Market

- Clearing of short-term liquidity and risk positions between money market participants (tenors up to 1YR)
- Offering liquidity to government securities markets
- Creation of a reference rate that serves as an anchor to the short end of the yield curve
- Monetary policy transmission (preferably with IT light regime)

Benefits

- Price discovery for interest and FX rate in interbank market
- Reduction of excess liquidity in the system
- Redistribution of risk leading to reduced overall risk in the system
- Increase of credit available to the market
- Responsible lending practices – positions resulting from deposits and loans on client terms can be managed in the interbank market

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Challenges

- Market segmentation
- Monetary policy regime not conducive to money market development
- Lack of capacity of market participants to trade advanced products
- Lack of enforceability of transaction documentation
    - General Master Repurchase Agreement (GMRA) for repos
    - ISDA Master Agreement for derivatives

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Benefits

- Price discovery in government securities
- Increased liquidity and reduced bid-ask spreads
- Reduced risk / cost of trading leading to increased investor base
- Increase of investor base leading to lower cost of funding for the government
- Creation of government yield curve – basis to price bank loans and securities issued by other issuers

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Challenges

- Fragmentation in government security issuance – no maintenance of benchmark issues
- Lack of diversified investor base
- Lack of capacity of market participants to trade advanced products
- Lack of enforceability of transaction documentation for repurchase transactions (GMRA)
- Lack of financial market infrastructure

Why money markets matter and key challenges

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Benefits

- Index rate (or reference rate) that is the market price for short-term liquidity
- Operational Target for monetary policy
- Anchor for the short-end of a term curve of interest rates
- Basis for floating rate loan products

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Challenges

- Market segmentation
- Lack of liquid, traded tenor that can provide a reference rate
- Secured or unsecured reference rate?
- Lack of capacity of market participants to trade advanced products
- Lack of enforceability of transaction documentation (GMRA)

Why money markets matter and key challenges

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Benefits

- Ability to steer inflation through central bank operations
- Increase capacity to absorb shocks and facilitate balanced economic growth
- Support the development of long-term interest rates

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Challenges

- Fundamental economic imbalances challenging monetary policy objectives
- Selection of monetary policy type, objectives and tools
- Design of central bank operations
- Lack of interbank target rate

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Summary overview - Key challenges in SSA markets

Building Blocks for Market Development- Main challenges in select SSA markets*				
Money Market	**Primary Market**	**Investor base**	**Secondary Market**	**Market infrastructure & Legal**
Structural excess liquidity in the banking system	Create new types of instruments	Mutual funds	Limited number of domestic institutional investors	Operational risks
Concentration of banks	Smoothen the redemption profile	Pension funds	Lack of benchmark bonds	Settlement risks
Concerns for counterparty risk	Issue benchmark securities	Insurance companies	Limited number of international institutional investors	Absence of DVP
Market infrastructure	Increase tenors	Foreign Investors	Prevalence of buy-and-hold strategies	Inadequate access to electronic data/information
Full transfer of collateral	Improve currency composition	Retail investors	Not-well established trading mechanisms	Settlement finality not defined in law
Small number of banks	Improve interest rate composition	Banks	Lack of security lending facilities	Absence of RTGS
Lack of instruments	Increase number of instruments (of the same type)		Insufficient number of market intermediaries	Net settlement cycles for securities
Absence of Treasury Single Account	Increase use of marketable debt		Underdeveloped market infrastructure	High costs for custody and settlement
Lack of market data	Securitize government arrears		Insufficient regulation and surveillance over market activities, including PDs	

Based on % of replies

100%	80%	60%	40%	20%	0%

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Summary overview -Key challenges in SSA markets

Repo maket	Scope for improvement in banking system liquidity management	Areas for further consultation with monetary authority
Encourage trading between banks by limiting the role of the Central Bank	Coordination between the Central Bank and the government	Issuance of government and central bank securities for debt management and monetary policy
Vertical interbank repo (i.e., repo between large and small banks)	Forward-looking forecast of government cash flows	Information sharing on cash flows/liquidity forecast
Increase the volume of instruments available	Government cash management	Maturities of central bank' securities
Legal structure of contracts (e.g., GMRA, MRA, SBB)	Forecasting of aggregate liquidity	
Increase the use of repos in the Central Bank's open market operations	Settlement of government payments	
Increase the number of participants	Interbank liquidity management	
Market infrastructure	Central Bank instruments	
Reduce the number of instruments available	Government instruments	
Adjust the collateral haircut	None	
Other (please specify)		

Based on % of replies

100%	80%	60%	40%	20%	0%

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Member of the Cardano Development B.V. Group that manages The Currency Exchange Fund (TCX) and Guarantco. Frontclear Management B.V. is registered with the Dutch Financial Markets Authority (AFM) as an exempted alternative investment fund manager. Frontclear Management B.V. relies on the exemption of paragraphs 1 and 2 of article 2:66a of the FMSA, which incorporates the stipulations in the Alternative Investment Fund Management Directive (AIFMD, regulation (EU) No 231/2013)

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Thank you

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