EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 11 June 2008

Money Market Contact Group

Frankfurt, Tuesday 27 May 2008, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Policy initiatives in the field of liquidity risk management

Philippe Molitor (ECB) provided a presentation on current policy initiatives on liquidity risk management. The main part of his presentation was devoted to the ongoing initiatives on a number of different levels: the Basel Committee on Banking Supervision, the Financial Stability Forum, the EU Commission and the ECOFIN, the Committee of European Banking Supervisors (CEBS) as well as the ESCB Banking Supervision Committee.

While there were already a number of ongoing initiatives in the field of liquidity regulation, the market turmoil has triggered many new requests and put some urgency in the ongoing work. Philippe also mentioned that the CEBS is organising a public hearing on the second part of its advice on liquidity risk management. It will publish its consultation paper on its proposals on liquidity risk management in mid June 2008. A public hearing open to all interested parties will take place on 4 July 2008.

At the end of his presentation, Philippe recalled the current regulatory framework in the EU and gave a tentative outlook how this framework might evolve over the coming months and years. He mentioned that the fact that regulators were still working on sound practices seemed to suggest that more analytical work was needed before rules for internal liquidity management models could be established at a global level.

In the following discussion several members of the group stressed that they were looking forward to a more harmonised approach towards liquidity regulation in the EU, as the current framework demanded a lot of efforts and resources from banks that are active in several countries. At the same time it was often mentioned that there should not be a “one size fits all” approach given the large diversity in size and structure of EU banks. Some members also opined that, while there seemed to be a pretty large consensus among supervisors and banks in the various countries about the qualitative aspects of a sound liquidity risk management, this did not seem to be the case for quantitative measures.

Some banks also tried to link the discussion with the current situation in the money markets, with one member arguing that the lack of a common quantitative benchmark for liquidity management might have contributed to banks’ hoarding behaviour, while another warned that new strict quantitative rules might be detrimental to an already rather illiquid market.

2. Review of the results of the latest ICMA repo survey

Like in February 2006, Danielle Sindzingre (SocGen) and Johan Evenepoel (Dexia) provided a presentation on the results of the latest ICMA repo survey. The scope of the presentation was however much wider, as they compared the findings with data from the most recent ECB money market survey and also showed some figures from Clearstream, Euroclear and JP Morgan. Moreover, the presenters tried to compare the European repo market before and after the start of the turmoil, focussing on aspects like market concentration; currencies; maturities; counterparties and collateral.

The main findings of the presentation were: Overall, the turnover data indicates that the repo markets have passed the money market turmoil without any major damage. The currency analysis shows that the USD share has declined – according to some data sources even markedly. The maturity analysis shows that the share of the shortest dates has – contrary to many people's expectations – declined. Related to the maturity analysis, there was a significant increase in open-ended transactions, partially explained by some new participants in the repo market, which seemed to have a preference for this type of transactions, as they have some operational advantages compared to a constant roll-over of an overnight transaction. The data shows that voice brokers have been able to reverse the earlier trend and to increase their share in the overall transactions. The counterparty analysis also reveals the reversal of an earlier trend, as the domestic share of the repo business increased for the first time in a while. Some of the data seems to indicate an increase in the use of collateral issued in the UK and in the euro area. At the same time, the share of repos involving government bonds has continued to decrease (maybe a bit contrary to expectations). The rating breakdown of the collateral shows that the share of securities with a high rating increased, but less than one might have expected.

In the following discussion one member mentioned that the declining share in short-term repos might be explained by the experience of a total shut-down of the repo market at the peak of the turmoil last year. Even if this was experienced only for half a day, it might have led some market participants to increase the (average) maturity of their repo transactions. Some other members noted that they had been reported about an increase in the turnover of repo transactions based on equities as collateral. Moreover there was some debate about the repo rates paid in triparty O/N transactions, which had risen from around Eonia +6 basis points before the turmoil to currently around Eonia +25 basis points or even more, which seemed very strange. One member mentioned, however, that this increase might be related to the increase in the allotment rates in the ECB operations, as the spread between the O/N repo rates and the allotment rates had remained quite stable.

At the end of this item the Secretary mentioned that the questionnaire for the next Money Market Survey had been distributed and was currently with the banks. He stressed that it is important for banks to provide high quality data right from the beginning and to respond quickly to ECB enquiries. He said that, subject to receiving properly completed questionnaires on time, the ECB expects to have a relatively reliable set of data compiled by the end of August and asked, if two members of the group were willing to present the data at the next meeting on 11 September. Jean Michel Meyer (HSBC France) and Frederic Mouchel (JP Morgan) volunteered to do so.

3. Round up on market developments since the previous meeting

In his presentation the Secretary first took a somewhat broader view, mentioning the improvement in stock and credit markets, which seemed to be in contrast with the ongoing tensions in the money market. Having a more detailed look at the money market tensions, Ralph mentioned the relatively high O/N volatility, the high allotment rates in the ECB's tender operations and the wide Euribor-OIS spreads (also on a forward basis). He also recalled the ECB's current approach as regards liquidity management, namely the continued front loading strategy and the introduction of two supplementary 6-month LTROs. Finally, Ralph also mentioned the results of the Eurosystem's USD auctions under the Federal Reserve's Term Auction Facility and the development of interest rate expectations in the euro area.

Before entering the subsequent discussion, which was very active and revealed a number of interesting points, both the Chairman and the ECB Member thanked the members of the group for their numerous and very useful responses to the little questionnaire that the ECB had distributed at the end of April.

Several members mentioned that there had been an improvement of banks' funding conditions with a marked increase of issuance activity in the 2-5 year segment. Nevertheless, many members cautioned that investor supply remained very limited, both in the term money markets (1-12 months) and also in the longer bond market maturities (beyond 5 years).

The discussion on the ECB's liquidity management was slightly controversial with several banks questioning the reasons for the recently less generous excess benchmark allotments (compared to the previous maintenance period). Although these members generally acknowledged that there had been some improvement in the tender spreads recently, they were concerned that the ECB seemed to be focussing too much on these small improvements and seemed too eager to try to return to more normal allotments. In their view such an approach was, however, premature (as the tender spreads were still very high) and risky (as a renewed worsening of the situation could not at all be excluded, especially with the approach of the end of semester).

Paul recalled the principle of the ECB's current front-loading approach and stressed that the main aim of this approach was to keep very short-term interest rates stable and close to the policy rate. Francesco added that the ECB's philosophy had always been to help the euro area banks where necessary, but not to overdo this help. The latter was important in order not to crowd-out the market, making banks too dependent on ECB financing, and to avoid any potential moral hazard issues. Referring to the numerous proposals sent by the members of the group in response to the little questionnaire, he stressed that the ECB, while certainly being very thankful for the input, always reserved the right to come up with its own judgement. This means that even if all the banks agreed on a proposal, which was by the way not the case, the ECB would only take up such a proposal, if it was convinced of its usefulness.

Replying to specific questions from the group, Francesco re-assured the members that the ECB was fully aware that the end-of-semester was an important point in time for the banks and Paul made some remarks on the collateral framework of the Eurosystem. He stressed that there had been no change to this framework since the start of the turmoil, but noted at the same time that there had certainly been a number of smaller periodic changes over time. Further such evolutionary changes (none of those had questioned the overall strategic orientation of the framework) could of course not be excluded.

4. Other items

- Holger Neuhaus and Jean-Louis Schirmann (both ECB) provided an update on the Short-Term European Paper (STEP) project. While Holger focussed on the evolution of the related statistics, Jean-Louis wrapped-up the latest market developments and also explained the most recent developments on the institutional side. The most important point of the presentation was that despite the financial market turmoil and its impact on other markets, the STEP market displayed a steady growth over the last months. Moreover, the ESCB had agreed to continue to be involved in the STEP labelling process for another 2 years until June 2010. This agreement is however subject to the provision by the EBF (by end 2008) of a business plan to ensure effective implementation of the STEP labelling without ESCB involvement and an in-depth legal assessment of the STEP market convention.

- Orazio Mastroeni (ECB), the Secretary of the Operations Managers Group, presented a summary of the last OMG meeting, which had been held one week prior to the MMCG meeting. He focussed in particular on the ongoing work on Standard Settlement Instructions and Trade Confirmations also mentioning the envisaged way forward for these two topics. (Further information can be found on http://www.ecb.europa.eu/paym/groups/omg/html/index.en.html)

- The next meeting will take place on Thursday, 11 September 2008 in Frankfurt; 16:00-19.00. It will be followed by the annual photograph and the annual dinner. Potential agenda items for this meeting are the regular review of recent market developments; a presentation on the findings of the latest ECB money market survey; an update on the use of collateral in ECB operations and/or a presentation on the impact of the T2 / T2S / CCBM2 projects on banks' liquidity management.