EUROPEAN CENTRAL BANK
EUROSYSTEM

DG MARKET OPERATIONS 6 January 2012

Money Market Contact Group
Frankfurt, Wednesday 14 December 2011, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. An overview of the changes to the liquidity management of an investment bank over time

Olly Benckert (Goldman Sachs) provided an overview of the changes to the liquidity management that occurred in his investment bank over time. This presentation, which had to be postponed from the last meeting due to time constrains, is linked to the broader topic of "liquidity regulation" and here in particular to the (expected) impact on banks' liquidity management approach.

Olly focussed his presentation on the maximum liquidity outflow (MLO) model, which defines the global core excess liquidity of the institution. This global core excess, which is basically the liquidity buffer of Goldman Sachs, has seen a 367% increase over the last 10-years and stood at USD 168 billion at the end of 2010. It is traditionally held only in the most liquid assets, so that Basel III should not lead to any significant changes. The three pillars for maintaining a liquid balance sheet are i) the various risk limits (both at regional and global levels), ii) the importance of a proper transfer pricing system as a key incentive tool leading to efficient allocation decisions; and iii) an age limit for certain inventories that is designed to maintain a permanent turnover in the balance sheet, which supports the mark-to-market reporting.

In the discussion Paul enquired about the explicit statement that Goldman Sachs wanted to avoid central bank reliance and Olly clarified that, while they have access to central bank facilities and also the necessary collateral, they nevertheless try not to use these facilities. At the same time he acknowledged that there was an ongoing debate about this approach, not least in light of some recent offers by central banks, which were perceived to be quite attractive.

Regarding Francesco's question on the possible substitutability between the different components of the global core excess liquidity, Olly mentioned that there was some substitutability but not a lot, given that the MLO needed to be respected on a currency-by-currency level and as also various regulatory requirements had to be taken into account.

In reply to another question, Olly explained that the rather restrictive approach for the EUR components of the global core excess liquidity was not due to the most recent market developments, but had been in place since a long time – and that the choice was based on the large liquidity in the repo markets of different assets.

2. Review of the main findings of the latest major money market surveys

Francesco introduced the next topic by mentioning that, contrary to past practice, we had merged the review of the main findings of the latest ECB Money Market Survey and of the latest ICMA Repo Market Survey in order to gain some time for the third topic, which would look at the most recent developments in the repo markets.

Vladimir Tsonchev (ECB), who presented these main findings, first put the review periods into context, i.e. he mentioned that the ECB survey covered data from Q2/2011 and the ICMA survey represented a snapshot taken on 8 June 2011. In both cases the data thus referred to a time in which the money market situation was still relatively benign when compared to current conditions. The main

findings of the ECB survey were that i) aggregate turnover in the euro money market increased by 15%, after three years of declines; ii) the secured market remained the largest segment, with aggregate turnover increasing for the second year in a row (by 10%); iii) the percentage of secured market transactions that were cleared by central counterparties remained broadly stable at 50%; iv) all derivative segments showed increases in turnover: the most significant increases were observed in cross currency swaps (+68%) and overnight index swaps (+42%). Vladimir mentioned that the ICMA data confirmed many of the ECB findings, while there where, however, also some differences, which were probably due to the different approaches and different panels of the two surveys.

The subsequent discussion seemed to confirm Vladimir's assumption that the higher interest rate volatility in Q2/2011 (vs. Q2/2010) could be an important factor explaining the significant increase in turnover in OIS and other short-term interest rate derivatives. Some members mentioned that the grouping of FX swaps in the derivatives part of the ECB Survey was somewhat misleading, as the character of these swaps was becoming more and more that of a secured funding tool.

There was also a somewhat longer discussion on the importance of CCPs in the repo market, with some members highlighting again their important role for maintaining access to secured funding, in particular in light of the heightened aversion to so-called correlation risk (between counterparty and collateral). Some other members made slightly more cautious remarks, saying for example that CCP limits would need to become very large, if more and more business was to be shifted to these institutions or that tri-party repo should be considered as an interesting alternative to CCPs, especially, if the tri-party business also catered for a link to central bank liquidity.

There was also a discussion on how the Money Market Survey could possibly be further developed (in scope and frequency of the data collection) in the future. While the discussion on the various ideas was not conclusive at this stage, it was agreed that the ECB would present some concrete proposals for possible improvements at the next meeting.

3. Update on the most recent repo market developments

Following-up from the previous item, four members of the group presented an update on various topical developments in the repo markets.

Franck Carminati's (HSBC France) presentation was very rich of data on various different repo market segments. It illustrated differences between GC repos and repos based on so-called specials as well as an increasing segmentation of collateral funding spreads (with the funding of core countries' government bonds becoming cheaper and that of peripheral countries' bonds more expensive).

Mirco Brisighelli (Unicredit) focussed on the Italian repo market and highlighted in particular the decline in Italian MTS volumes from EUR 70-80 billion before July to currently around EUR 50 billion. He also remarked that private margin decisions (e.g. the recent increases from LCH and CC&G) can have a substantial impact on banks' funding choices, as ECB operations (conducted under a stable collateral/margin framework) became relatively more attractive compared to private transactions following these decisions.

Colin Bermingham (Barclays) shared some observations on the client behaviour in the repo market and focussed also on the basket of EU government bonds that are eligible for the FSA liquidity buffer. He mentioned that Italian bonds had recently dropped out of this FSA basket, given the FSA's AA-minimum rating requirement, and that this has had a noticeable impact on the Italian repo markets. Colin mentioned also that a similar development could not be excluded for Spain (in case of further rating downgrades) and explained that EFSF bonds were not included in the FSA list in spite of their top rating, as their liquidity was apparently deemed insufficient.

Andreas Biewald (Commerzbank) finally presented the idea of creating an overnight repo fixing, which would be based on contributions from major European CCPs (volume weighted daily average rates of all GC repo trades) and for which the ECB should ideally be the calculation agent – as is presently already the case for the EONIA. Andreas also reported about an ongoing initiative to establish an electronic database listing all LCR-eligible securities, which would ideally be identical in all EU countries and which could become the basis for a new collateral basket in the repo markets.

The discussion revealed somewhat diverging views whether there was a market need for a more restrictive collateral basket than e.g. Eurex' GC pooling basket. Some members argued that this could help bring some liquidity providers back into the private repo markets, while others argued that the ECB's 1-week liquidity absorbing operations related to the Securities Markets Programme seemed to be a more attractive alternative and should thus limit the success of any such new collateral basket.

4. Review of the latest market developments

The Secretary provided his usual update on the money market developments since the last meeting, in which the main points were: i) a short background look at equity and credit markets, where the financial sector remained under significant pressure and volatility also remained high; ii) a review of the usual money market indicators, which kept on deteriorating over the review period; iii) a review of the development of outstanding tender volumes (also in USD) and the use of the standing facilities (which revealed a further increase in liquidity demand and a corresponding higher use of the deposit facility); and iv) a detailed summary of the main ECB announcements since September 2011.

The following discussion revealed that members unanimously welcomed the introduction of the two 3-year operations and were particularly pleased by the perceived cheap pricing (at the MRO rate without spread) and the options for early termination after the first year. They mentioned that these operations were likely to reduce the funding and deleveraging pressures for banks and would support their profitability. Some indicated that they should therefore also help banks to maintain their lending and investment activities

Regarding the possible demand in the December 3-year operation banks generally expected a significant demand with most estimates mentioning EUR 200-250 bn as a realistic scenario. A few members remarked that the demand may be not as high as expected by others, as some banks apparently still had reservations to make (aggressive) use of the ECB operations. They mentioned the experience of the latest 84-day USD operation as an example, as this had not led to a sustained easing of the premia in the FX swaps markets, which seemed to underline that at least some banks had refrained from using the ECB operations although they have apparently a USD liquidity need (and thus cause the continued pressure in the FX swap market). In reaction to these remarks Paul explicitly clarified that the ECB offers its operations – both in EUR and USD – for them to be used and that it does not attach any form of stigma to their use – on the contrary: banks that would see merit in using the offered operations should actually feel encouraged to do so. Moreover, banks should also be reassured that the ECB would never disclose any counterparty data

There was also some discussion about the announced widening of the collateral framework. While several members welcomed the possibility for NCBs to re-introduce certain credit claims as "Tier2 collateral", there were also some critical questions about a potential negative impact on the level playing field between euro area countries. In reply to the latter, Paul explained that credit claims have always been a heterogeneous asset class and that the further increase in this heterogeneity had also to be seen in light of the prospect of its relatively speedy implementation. Paul nevertheless recognised the possible trade-off between a harmonised approach throughout the whole euro area and the desire to quickly implement further enhanced credit support measures.

5. Other items

The Secretary presented the draft work programme for 2012, which is based on this year's work programme. Members were asked to provide comments and feedback by the end of the year. The Secretary also mentioned that the tentative meeting dates for 2012 had now been confirmed and that the next meeting is scheduled for Wednesday, 21 March 2012.

The Chairman mentioned that the following potential topics could be envisaged: The regular review of recent market developments; some feedback on the initial experience with the lower minimum reserves ratio; and an update on the STEP market, an item which had already been postponed a few times.