EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 28 May 2010

Money Market Contact Group

Frankfurt, Tuesday 18 May 2010, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Review of the recent market developments

The Chairman introduced the item by announcing that the usual presentation by the Secretary would this time be complemented by Andreas Biewald's presentation on the most recent repo market developments, which had initially been foreseen under Item 2, and by an additional presentation from Danielle Sindzingre on the initial reactions to the ECB's Securities Markets Programme (SMP). These three presentations would then be followed by a joint discussion.

Ralph started his presentation by mentioning that the intensification of concerns related to sovereign credit risk had been the main market driver since the last meeting in February. This was not only visible in the credit markets, but had led to a generally higher financial market volatility, with negative repercussions also on the euro money markets including, in particular, the FX swap markets. Thereafter the Secretary briefly updated the group on the progress of the Eurosystem's covered bond purchase programme (CBPP) and on the availability and use of ECB eligible collateral during the course of 2009. He finished his presentation with a review of the most recent ECB announcements, in particular the ones released on Monday, 10 May.

In the subsequent presentation Andreas Biewald (Commerzbank) provided a closer look on some selected developments in the euro repo market, for which data availability is unfortunately a constraining factor for detailed analyses. The main focus of Andreas' presentation was on the price developments of repos backed by certain types of collateral (based on Commerzbank's internal data). Moreover, he also provided a review of turnover volumes in selected electronic trading systems. His main findings were that (i) there was a substantial spread widening between AAA/AA rated government paper versus single-A paper, which was driven by limited risk appetite of market participants (avoidance of correlation risk & flight to quality); (ii) there seemed to be a return of ‚special' markets particularly in Germany; (iii) ECB-eligible paper issued by non-peripheral countries continued to trade at broadly unchanged spread levels; (iv) there seemed to be an out-performance of covered paper versus government bonds in Spain; (v) one could witness the establishment of new asset classes for repos in EIB / KfW / and municipals from non-peripheral countries, where an increase in turnover and a spread tightening could be observed; and (vi) the overall liquidity in the repo market based on non-peripheral collateral was not negatively affected by the most recent events.

Danielle Sindzingre (SocGen) provided some slides on the initial market reaction to the ECB's Securities Markets Programme (SMP), concentrating mainly on the significant spread reductions in the bond markets. Beyond that she also mentioned some side-effects of the programme on other market segments and reviewed the issuance activity in the primary government bond market that had taken place during the first week of the implementation of the SMP. Her overall conclusion was that the introduction of the SMP was a very successful step of the ECB, which had been really needed by the markets in order to avoid a further deterioration of the situation with potentially systemic effects.

Danielle finished with a number of open questions, which the Chairman passed on to the entire group to start the general discussion that was very lively and active and revealed the following main points:

1) Regarding the renewed provision of USD liquidity by the Eurosystem, members commented that this move had been necessary as it had become much more difficult for European banks to raise USD liquidity (either via the issuance of CDs/CPs or through the FX swap market) recently. Apparently large traditional USD liquidity providers had become more concerned about their credit exposure to European banks as a consequence of the sovereign debt crisis. When being asked about the relatively low demand in the two USD auctions that had been conducted that far, some members attributed this to the rather expensive pricing of the operations, while some others argued that the sheer existence of these back-stop operations had reduced some concerns on the side of USD liquidity providers and thus helped to improve market conditions. Regarding the pricing aspect, Paul made clear that these USD operations of the Eurosystem and other major central banks are on purpose priced as backstop facilities as their aim is not to provide USD funds at attractive levels, but rather to merely guarantee that there would be continued access to such funds. In addition, Paul wondered why banks have apparently not made much progress to reduce their dependency on US dollar funding since August 2007, as otherwise there should not have been such strong calls for a re-introduction of the Eurosystems' USD providing operations at the first signs of a deterioration in the USD funding markets.

2) The SMP was generally being viewed as a necessary and successful intervention of the Eurosystem in the bond markets. Still there were many members that said that market conditions remain fragile with unusually wide bid-/offer spreads, especially at times when the Eurosystem is not present in the market. While some members mentioned that they had observed the covering of short positions by some short-term accounts, there was widespread agreement that the long-term investors had not yet returned back to the peripheral euro area government bond markets.

3) On the Chairman's question about what it would need to make these investors return, there was widespread agreement that it would take quite some time to rebuild the confidence of asset managers and that the latter would crucially depend on the fiscal adjustment measures in a number of countries and on the EU/IMF support package. While there had been impressive commitments made, most of those were still lacking implementation or final approval, so that the widespread uncertainty had not yet disappeared.

4) There was also some discussion about whether the Eurosystem should repo the purchased government bonds back into the market or not. While some members argued in favour of such an approach to improve market liquidity, others cautioned that this might undermine the effect of the purchases. In addition there was some debate about the transparency surrounding the SMP, with some banks asking for more precise information (e.g. daily amounts; overall size and duration of the programme). Paul clarified that the ECB had chosen to leave the market with some "constructive ambiguity" as it is of the view that too much transparency might run the risk of challenging the success of the programme.

5) There were also a few questions as regards the purpose of the liquidity absorbing 1-week operations linked to the SMP in an environment that is in any case characterised by excess liquidity given the continued full allotment procedures. Francesco clarified that this had been decided in order to underline that the SMP should not be confused with quantitative easing measures as its motivation was not to create or increase central bank liquidity but rather to restore a proper market functioning in impaired market segments.

6) Related to these liquidity absorbing operations, several members stressed again the striking tiering that can be currently observed in the euro money markets with, on the one hand, 223 banks willing to return 1-week cash to the ECB at levels far below 1.00%, while on the very same day 81 other banks were willing to pay 1.00% to the ECB for receiving such 1-week liquidity. No one seemed to expect an improvement of this impaired market functioning in the near term.

2. Review of recent developments in the repo markets

This item had to be postponed due to the longer than anticipated discussion on the first item. The Chairman nevertheless thanked the two presenters, Johan Evenepoel (Dexia) and Franck Carminati (HSBC France), for their efforts.

3. The Basle Committee's proposal for an international liquidity risk framework

As a follow-up from several earlier meetings of the group, Evangelia Rentzou (ECB) provided an overview of the feedback received in the public consultation on the Basel Committee's recent proposal for an international liquidity risk framework. She structured her remarks along the following lines: (i) first; she quickly recalled the background for the BCBS's proposal; (ii) she presented the general comments that were received in the consultation, before dealing with more concrete feedback on (iii) the impact on the real economy and the interbank market; (iv) the impact on the financial system; (v) the impact on specific business models and jurisdictions. Thereafter she mentioned some (vi) technical comments on the liquidity standards and (vii) received suggestions to address the comments provided. And (viii) finally she outlined the envisaged way forward.

Evangelia's presentation was followed by a short discussion during which members were eager to understand the likelihood for the initial proposal to be changed in light of the comments received. Evangelia was, naturally, not able to provide a concrete answer to these questions, but explained that the comments would now be reviewed in different work-streams and that the assessments of the comments would be ready for the meeting of the relevant substructure of the BCBS in June.

Points of particular interest were whether the rules would need to be fulfilled at the group or the solo level and whether they needed to be fulfilled on a currency-by-currency level or just in one currency. Evangelia clarified that the BCBS proposals aimed in principle at the group level, but that local regulators have the possibility to apply them also at the sub-consolidated or legal entity level. Furthermore, it was clarified that the BCBS proposal was not asking for a currency by currency fulfilment of the standards. At the same time she was confident that local regulators within the EU would strive to agree on a harmonised approach on such issues of high relevance.

Finally there was a short debate about the desirability of a public disclosure of the liquidity ratios, as some members argued that this might prove counterproductive when banks would face a decline in their liquidity levels. Evangelia acknowledged the concern expressed, but also highlighted the importance of providing market participants with the possibility to assess the liquidity position of financial institutions as the opposite could lead to uncertainty and thus to hoarding of liquidity in times of stress.

4. Other items

Francesco mentioned that the next meeting is scheduled for Wednesday, 8 September 2010 from 16:00 to 19.00 and will be followed by the annual dinner of the group.

The following potential topics were identified: The regular review of recent market developments (including an assessment of the SMP); a discussion about the initial findings of the 2010 Money Market Survey (possibly together with the review of the ICMA repo market survey, which had to be postponed today); and possibly a short presentation on the new graduated haircut schedule to be released in July.