



EUROPEAN CENTRAL BANK
EUROSYSTEM

DG MARKET OPERATIONS

28 May 2009

Money Market Contact Group

Frankfurt, Tuesday 19 May 2009, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Round up on market developments since the previous meeting

The item was introduced by the usual presentation of the Secretary on market developments since the last MMCG meeting. Ralph started by having a short background look at the recent improvements in equity markets and credit markets, before outlining similar signs of improvement in the euro money markets. He then reviewed the development of outstanding tender volumes; the tender participation; the use of the standing facilities; and the Eonia level before eventually providing an update on the use of collateral. Ralph finished his introduction with an overview of the recent results of the ECB's USD and CHF liquidity providing operations.

The following discussion revealed several interesting points:

Members generally agreed that money market conditions had improved markedly as evidenced e.g. by narrower deposit-OIS spreads, narrower spreads of government guaranteed bank bonds, easier access to liquidity (also in foreign currencies) and declining demand for excess liquidity. Regarding the latter, several members referred to the result of the MRO, which had been conducted on that day and had revealed another decrease in demand for excess liquidity. They viewed this (and the immediate market reaction of a rise of very short term rates towards the MRO rate) as a positive sign pointing towards a slow return to normality. At the same time a number of members warned against becoming too optimistic, as there were still a number of factors that highlighted ongoing tensions in the market. They mentioned the following examples: Banks' CDS spreads are still higher than before the bankruptcy of Lehman Brothers; the money market curve is still rather steep, especially between 1- and 3-months; the market is still tiered with prices differing considerably depending on the counterparty; and banks' high reliance on government guaranteed issuance.

Regarding the impact of very low short-term rates on market functioning, some members made the point that too low rates could become a problem for institutional money market investors, especially if this situation were to prevail for a prolonged period of time. The point was also made that banks have to offer their retail customers a minimum remuneration, as otherwise they could face significant outflows (either in the form of cash withdrawals or as customers invest in other, off-balance sheet products), which would have negative balance sheet consequences.

Another topic that emerged during the discussion related to the level of the Eonia fixings, which seemed to have an upward bias according to some members, and the perceived unpredictability of those fixings. Especially the latter seemed to have an adverse impact on liquidity in the Eonia swap market. The Chairman clarified that the ECB's role in the setting of the Eonia rate was limited to that of a calculation agent. This role of course included some consistency/plausibility checking of the data, but it did not include the assessment whether certain trades are in line with the spirit of the definition

according to the Eonia Code of Conduct or whether the definition should be changed. These issues would fall under the responsibility of the Euribor Steering Committee and members were encouraged to raise their issues with this committee, in case they felt strongly about them. At the same time, Francesco underlined that it was obviously also in the ECB's interest that the Eonia rate would fully retain its credibility as a fair representation of the euro overnight market.

2. Feedback on the ECB's recent announcements of non-conventional measures

Paul Mercier introduced this item by recalling that the ECB's Governing Council had decided

- to conduct liquidity-providing LTROs with a maturity of one year. The operations will be conducted as fixed rate tender procedures with full allotment, and the rate in the first of these operations will be the rate in the main refinancing operations at that time. In subsequent longer-term refinancing operations with full allotment, the fixed rate may include a spread in addition to the rate in the main refinancing operations.
- to prolong until the end of 2010 the temporary expansion of the list of eligible assets, announced on 15 October 2008.
- that the European Investment Bank (EIB) will become an eligible counterparty in the Eurosystem's monetary policy operations on 8 July 2009.
- that the Eurosystem will purchase euro-denominated covered bonds issued in the euro area. At this stage, the ECB expects to engage in a programme that could be around EUR 60 billion.

There was only a relatively short discussion on the 1-year LTROs, as basically all members perceived this instrument, especially the first auction without any spread over the MRO rate, as very attractive and predicted rather high demand. Some mentioned that the announcement might also have been an additional factor helping to explain the recent decline in demand for 3- and 6-month operations.

The main focus of the discussion was on the planned covered bond purchases. There was broad consensus that already the announcement of the programme has had a strong positive impact on secondary market spreads, primary market activity and repo market activity. The amount of EUR 60 billion was generally viewed as appropriate, with some members mentioning that the ECB could surely increase it should the need arise at a later stage.

Regarding the discussion which covered bonds the Eurosystem should purchase (only UCITS compliant or also other / only private underlying assets or also public), several members were of the view that this would not matter so much, as there would be a positive spill-over effect from the eligible bonds to those that would not be eligible, possibly even beyond the asset class of covered bonds. There were, however, also somewhat more sceptical views as regards this spill-over effect. With respect to the maturities that should be bought, there seemed to be widespread consensus that the ECB should focus on longer maturities (5 years and beyond), as this had been the traditional maturity of most covered bonds and as there was less need to support shorter maturities, given that banks already benefited from various government guarantee schemes targeted at these maturities. Some support on the longer maturities would also allow banks to better re-structure the liability side of their balance sheets.

On the issue of whether the ECB should buy in the primary or in the secondary market, there initially seemed to be some preference for the secondary market, as such purchases would have positive spill over effects on the primary market. Some members cautioned, however, that it might be difficult to buy EUR 60 billion in a secondary market with currently rather limited liquidity and thus argued that the most effective way seemed to be a combination of purchases both in the primary and in the secondary market. Somewhat linked to the point of the limited secondary market activity, members generally thought that it would be a good idea, if the ECB repoed its covered bond portfolio back into the market, once it had reached a large enough size. Moreover, some members made the point that the low liquidity would also argue in favour of spreading the purchases over a longer period of time.

Regarding the practical implementation of the purchases only few members saw some merit in an auction process, whereas more members thought that this might be too complex from an operational point of view, favouring direct purchases from counterparties on the basis of competitive quotes.

3. Update on the latest developments in the repo market

Johan Evenepoel (Dexia Group) provided a presentation on the findings of the 16th semi-annual ICMA Repo Market Survey that was conducted in December 2008. This latest survey asked a sample of financial institutions in Europe for the value of their repo contracts that were still outstanding at close of business on 10 December 2008.

The total value of repo contracts outstanding on the books of the 61 institutions who participated in the latest survey was EUR 4,633 billion, compared to EUR 6,504 billion in June 2008 and the peak of EUR 6,775 billion reached in June 2007. This is the most severe reduction in the headline number since the survey began in 2001, reflecting the acceleration of de-leveraging by banks since the collapse of Lehman Brothers in September 2008.

There was a significant increase in the share of outstanding repo contracts that were negotiated anonymously on an ATS and settled with a central clearing counterparty (CCP) to a record 17.6% from 12.7% in June 2008, confirming the importance attached by the market to the creditworthiness and automatic netting facilities of CCP.

The trend decline in the use of government bonds as collateral was reversed. The share of government bonds increased to 83.6%, compared to the record low of 81.0% in June 2008. The share of government bonds in tri-party repos fell back from a corrected 47.3% in June 2008 but remained historically high at 41.8%. There was an increase in the use of German government bonds as collateral, and also a large increase in the use in triparty repo of German collateral other than government bonds or pfandbrief.

The seasonal need of banks to lock in term funding over the year end was evident in a significant increase in business with remaining terms of 1-3 months and there was a reduction in the concentration of the repo market, suggesting bigger banks have tended to de-leverage faster.

Following Johan's presentation there was a (rather short, due to the lack of time) discussion that centred on possible reasons why the decline in the repo market activity had been so severe. The main reason seemed to be, according to several members that the decline in repo market activity was a direct reflection of banks' de-leveraging efforts (as repos were a classical leveraging tool). The fact that repos on non-ECB eligible collateral were still highly impaired in late 2008 might also have contributed to this finding.

4. Upcoming changes to the liquidity regulation in France

This item had to be postponed to the next meeting due to time constraints.

5. Planning of the next meeting

The next meeting is scheduled for Tuesday, 1 September 2009. The following potential topics were identified: the regular review of recent market developments; the presentation on upcoming changes to the liquidity regulation in France, which had to be postponed in the current meeting and a presentation on liquidity regulations in the euro area; potentially an initial review of the impact of the non-standard measures; and, if the agenda would not become too crowded, a presentation on the impact of T2/T2S/CCBM2 on banks' liquidity management.