EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 25 September 2008

Money Market Contact Group

Frankfurt, Thursday 11 September 2008, 16:00 – 19:00

SUMMARY OF THE DISCUSSION

1. Preliminary results of the latest ECB Money Market survey

The Chairman introduced the item by mentioning that the presentation provided by Jean-Michel Meyer (HSBC) and Frederic Mouchel (JPMorganChase) on the results of the latest ECB Money Market survey was based on preliminary data from the ECB. He also announced that the official results of the survey would be published on 26 September in a short ECB press release complemented by a chart pack and that it was intended to publish the full study including the analysis of the data by the first week of December.

The main findings of the presentation were as follows:

- Turnover in the unsecured market declined slightly on the lending side, but markedly on the borrowing side. The decrease on the borrowing side affected mainly maturities up to 1 month, while longer maturities increased significantly (still accounting for a very small share, though).
- Activity in the secured repo markets also declined back to 2006 levels. Interestingly, there was a marked increase in overnight repos, which account for around 25% of the total now.
- The geographical breakdown revealed an interesting divergence: while in the unsecured market the domestic business declined less than the intra-euro area business (i.e. its share in the total rose) the opposite was the case in the secured market (i.e. the domestic share declined).
- While the overall turnover of money market products remained broadly stable, there were quite some diverging developments among the different instruments: the turnover of OIS declined markedly, while the figures for IRS and FRAs rose substantially.
- The qualitative questions revealed that a majority of survey participants deemed that liquidity in the various segments of the euro money market had worsened compared to the previous year.

The main points of the discussion were:

- The decline in interbank activity does not seem to be too dramatic (differently from what some might have expected), but it seems that the activity outside the interbank market (i.e. with other money market participants), which is not included in the survey data, declined a lot.
- The decline in short-dated OIS could be related to lower trading activity related to interest rate expectations and to the fact the OIS no longer seem to be a good hedge for positions related to Euribor. The latter could also explain the increase in FRAs and IRS, which relate to Euribor.
- There was a proposal to maybe include a separate column to capture basis swaps in future surveys, as it remained unclear whether the increased activity in these products was properly captured in the survey.

2. Update on recent developments regarding the T2S project

Helmut Wacket (ECB) provided a presentation on the recent developments regarding the T2S project, covering the developments that occurred since he gave his last update to the group, which was in September 2007.

Helmut started with a quick review of what T2S actually is, stressing in particular the expected economic benefits of the project. Then he provided a detailed overview of where we currently stand and what has already been done in the project. He concluded with an outlook on the next steps and the remaining challenges ahead.

In the discussion it became obvious that members are looking forward for this project to be realised, as it should enhance banks' cross-border liquidity management and could contribute to a further increase in repo volumes.

There was also the question whether it was foreseen to merge, at some point, the three major infrastructures for the euro market, namely TARGET2, TARGET 2 Securities and CCBM II. Helmut clarified that the services as such will not be merged as they are very distinct. However, the Eurosystem has recently launched a public consultation on a Eurosystem Single Interface which would offer one single interface to the three services. Helmut invited the members to express their views on this consultation, which will end on 28 November.

3. Collateral related issues

Isabel von Köppen-Mertes and Ulrich Bindseil (ECB) updated the members of the group on some collateral related issues.

First, Isabel recalled the developments in the types of collateral held with the ECB from 2004-2007, stating that the trends observed in that period (decline in the use of government bonds / increase in the use of ABSs and uncovered bank bonds) also seem to continue in the current year.

Thereafter, Ulrich provided a somewhat longer presentation on the outcome of the biennial review of the risk control measures in Eurosystem credit operations. He started with a review of the legal background for the ECB's collateral framework and an overview of the risk mitigation measures that the ECB applies. Thereafter he provided a detailed review of the new risk control measures that were announced in the previous week, the most important of which were the introduction of a uniform 12% haircut for all ABSs; the application of a haircut add-on of 5% to unsecured bank bonds; the application of a 5% valuation markdown for ABSs with a theoretical value; an extension of the "close financial links" definition; and higher rating disclosure requirements for ABSs. Finally, Ulrich recalled the Eurosystem's discretion to exclude or limit the use of certain assets, also on an individual bank level. He concluded by stressing that there had been no change in the overall collateral policy and that the ECB would continue to accept a wide range of collateral. The expected impact of the changes, which enter into force on 1 February 2009, on the availability of collateral is expected to be limited.

In the following discussion many banks expressed their understanding for the measures that the ECB had announced, although there were also some slightly more critical voices on some of the details. Some banks for example stress that the increased haircuts are likely to become the new standards also for the interbank market and that they might thus contribute to a further decrease in liquidity. One bank mentioned that the higher haircuts might potentially also further increase the tender spreads in the ECB's operations (see also next item).

During the discussion a number of interesting questions was raised: First, some members wanted to know why the ECB does not provide the theoretical values it assumes for individual bonds. (The ECB does not pretend to know the exact value of ABSs without a traded market price.) Second, one member asked why there was no haircut differentiation between different types of ABSs. (While this might indeed make sense, such an approach would seem to be too resource-intensive for the Eurosystem.) Third, several members wanted to get some more details on the meaning of the ECB's discretion in excluding or limiting the use of certain types of collateral. Regarding the latter, Ulrich tried to calm down concerns by stressing that this discretion, while not only being a theoretical option, was probably not to be used in a lot of cases. He went on to say that this tool was in particular necessary for being able to respond quickly to new, unforeseen developments in the use of collateral.

4. Round up on market developments since the previous meeting

In his presentation the Secretary provided an update on the money market developments since the last MMCG meeting. He first recalled that the ECB had increased rates at the beginning of July, but that market prices currently implied expectations for a reversal of this move in late spring 2009. Thereafter Ralph presented the ECB's current liquidity management approach (front loading of reserves via above-benchmark allotments in the main refinancing operations / continuation of supplementary longer-term refinancing operations), which had resulted in remarkably stable short-term rates close to the ECB's policy rate.

At the same time it appeared that allotment rates in the ECB's tender operations remained relatively high compared to the minimum bid rate (in case of the MROs) and corresponding overnight index swap (OIS) rates (for LTROs). Moreover, the spreads between unsecured Euribor rates and OIS also remained at elevated levels, reaching even new highs in the longer maturities. In addition, it appeared that forward measures of these spreads also remained very high, suggesting that the tensions in the cash markets could be expected to remain for quite some time.

The Secretary also flagged a new development, which had occurred since the last meeting, namely the relative increase of secured repo rates, which started to trade systematically above OIS rates, and he asked members for possible explanations for this observation. Finally, he gave a quick summary of the results of the ECB's USD liquidity providing operations under the Federal Reserve's Term Auction Facility (TAF).

The following discussion revealed a number of interesting points: First, there seemed to be quite some concern among the members of the group about the upcoming end of the quarter and in particular about the upcoming end of the year. Some members suggested that the ECB should soon come-up with a re-assuring message for the turn of the year, in order to prevent a further increase of tensions in the term money markets in the run-up to this event. The year-end was also mentioned as an important factor contributing to the relatively low participation in the most recent 3-month LTRO and the most recent 84-day USD TAF operation: as both these operations will still mature in 2008 and market participants generally seem to have a preference for not having large maturities in December, the bidding amounts are expected to increase again, once these operations will cover the end of the year.

A second point that was mentioned was the significant differentiation of prices in the repo markets, depending on the type of collateral. This price differentiation reportedly causes increasing difficulties for banks to decide which rates to contribute to the Eurepo fixings.

A third issue that came-up in the discussion was the level of the EONIA, which, according to a number of members, seemed to be systematically higher than the O/N trading levels throughout the day. The Chairman acknowledged that this might be the perception for outside observers, but re-assured that the ECB thoroughly checks all EONIA contributions on a daily basis (as far as possible), making sure that they are in line with the rules and procedures as defined by the EURIBOR steering committee. All methodological queries should, however, be addressed to the EBF, for which the ECB assumes the role as calculation agent.

5. Other items

- *Tentative meeting dates for 2009:* The meeting folder included a sheet with proposed meeting dates for 2009. The Chairman invited the members to provide feedback to the Secretary over the coming days/weeks so that the meeting dates can be finalised at the next meeting.
- The next meeting will take place on Tuesday, 18 November 2008 in Frankfurt; 13:00-16.00. As the group expressed the wish to have more time for discussion, only two potential agenda items were envisaged for this meeting, namely the regular review of market developments and a discussion about the impact of the market turmoil regarding banks' internal organisations.