EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 25 November 2009

Money Market Contact Group

Frankfurt, Thursday 19 November 2009, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Review of the market developments since the previous meeting

The item was introduced by the usual presentation of the Secretary. Ralph started by having a short background look at the continued improvements in equity and credit markets, before turning to the euro money market, where some further narrowing of deposit-OIS spreads was observed. He then showed that excess liquidity in the euro money market had declined gradually over recent weeks as had the use of the ECB'S deposit facility. At the same time this excess liquidity remained high enough to keep very short term rates close to the level of the deposit facility and to cause Euribor fixings with maturities up to 6-months to drift/stay below the MRO rate. Ralph finished his introduction with an overview of the recent developments in the covered bond market and the progress of the Eurosystem's covered bond purchase programme (CBPP).

In the subsequent discussion members generally expected the upcoming 1-year LTRO in December to be the last 12-month operation. Regarding the conditions of this operation many members had noticed President Trichet's earlier mentioning of "indexation" and attached quite some importance to it. Most of them thought that the idea of adjustable rates could be an interesting option for LTROs in 2010 rather than for the upcoming 1-year LTRO in December. Members were generally somewhat cautious as regards the demand to be expected in this operation, as corresponding 1-year market rates were relatively low, which seemed to argue for limited arbitrage opportunities and thus rather low demand. At the same time members found it difficult to assess whether the perceived last chance to get 12-month funds from the Eurosystem might generate some additional demand.

Most members were, however, of the view that the exact allotment amount in this upcoming operation was of only limited relevance for the liquidity outlook for the first half of 2010, as it seemed rather clear that the current situation of excess liquidity would prevail until the maturity of the first 1-year LTRO in mid-2010.

There was also some discussion about money market spreads and several members were quite sceptical about the Secretary's hypothesis that deposit-OIS spreads might have reached a new equilibrium level, arguing that these could actually start rising again once the ECB started to exit from its unconventional measures. Some members also mentioned in this context that the basis swaps (i.e. the spreads between longer-term interest rate swaps in which the floating leg is linked to different Euribor rates, e.g. 1m / 3m / 6m Euribor) had risen to new highs recently, which also seemed to argue against a further narrowing of deposit-OIS spreads.

While there were some positive remarks on the effects of the Eurosystem's CBPP, there was no long discussion about this topic. Finally there was also a short exchange of views about the Euribor definition and ongoing discussions to possibly introduce some changes, but this discussion remained non-conclusive.

2. The new liquidity regulation in the UK

Colin Bermingham (Barclays) provided an overview of the FSA's concept for strengthening liquidity standards, which was a kind of follow-up from the last meeting, when Michel Robert (Calyon) had presented the new French liquidity regulation.

The FSA has defined 10 liquidity risk drivers (e.g. wholesale funding, retail funding, intra group liquidity, …); some liquidity stress scenarios (idiosyncratic and market-wide) and a so-called liquidity buffer. The scenarios and the size of the buffer are individually determined for larger banks. This framework is used to define individual liquidity-adequacy standards, whereby the banks conduct their own individual liquidity-adequacy assessments, which are then reviewed by the FSA in a so-called supervisory liquidity review process. At the end, the FSA issues an individual liquidity guidance, which determines for each bank the size of the liquidity buffer and the funding profile that is supposed to ensure that the firm passes the stress tests. From 1 December 2009 there will be a phased introduction of the individual liquidity adequacy standards and from 1 June 2010 the new regime of individual liquidity guidance will take effect.

The discussion centred on two key details of the FSA concept: First, the stress test assumption that there would be no access to central bank facilities for a certain period of time. The FSA apparently assumes that central bank financing may be unavailable to certain banks (either because they are excluded from the central bank's counterparty list, or because they fail to secure allotment in a variable rate tender operation). A number of members of the group viewed this as a too restrictive assumption. Second, the composition of the liquidity buffer (mainly government bonds), which was also seen by some as too restrictive and not in line with the ongoing discussions at the international level. The latter was also seen as introducing significant costs to the banks, which would ultimately be passed on to their customers.

At a more general level, members were very concerned that the apparent lack of international harmonisation of liquidity regulations, for example evidenced in different definitions for assets that would be eligible as liquidity buffers, would lead to a situation where it becomes impossible for international banks to centrally manage their liquidity. This would not only cause inefficiencies, but could also lead to a segmentation of the euro money market. Against this background several members asked the ECB to support the case for truly European liquidity rules more strongly, also because this should be in its own interest.

In reply to this request Francesco made the following points: First, it was difficult to see, how a new liquidity regulation could come without some cost for the banks, given that liquidity buffers had obviously been too small in the past. Second, while stressing that the ECB is not a regulator, he agreed with the banks' assessment that national, non-consistent liquidity regulations should be avoided, as this could have negative impacts on the integration of the euro money market and on overall market functioning. And, third, he assured members that he would raise this issue again with his colleagues in the financial stability area of the ECB and that the MMCG would continue to look at this important topic also in 2010.

Other interesting points in the discussion were that the new liquidity regulations could lead to structurally steeper money market curves and that demand for central banks' longer term operations should structurally increase.

3. Findings of the latest ECB money market survey and ICMA repo market survey

Julija Jakovicka (ECB) provided a presentation on the findings of the latest ECB Money Market Survey, which was conducted in Q2/2009.

The main findings for the constant panel of banks were:

- A further decline in turnover as a consequence of the crisis. The aggregate turnover in the euro money market decreased by 5% in Q2 2009. The largest declines were recorded in the unsecured (-25%), OIS, and other IRS markets (both around -15%).

- The decline in the unsecured market has been most severe in the longer maturities and liquidity and efficiency conditions in the unsecured market also continued to deteriorate.
- Secured markets showed resilience (+4%). The overnight activity in the secured market has continued increasing, although at a lesser pace than in the past year, reaching 27% of the trades.
- The activity in the derivatives market has been affected, with a decline of 2.4%, mostly on the account of OIS and other IRS segments. Activity in the FRA market has continued to increase by 24%, possibly reflecting a larger use of the FRAs as hedging instrument.

Following Julija's presentation, Johan Evenepoel (Dexia) complemented the ECB results with the findings from the latest ICMA repo market survey (covering outstanding business on 10 June 2009).

The main results of the repo survey were:

- The total value of repo contracts outstanding on the books of the 61 institutions who participated in the latest survey was EUR 4,868 billion, compared to EUR 4,633 billion in December 2008 and the peak of EUR 6,775 billion reached in June 2007.
- Electronic trading consolidated the advance seen in the last survey, increasing its share to a record 28.5% from 28.0%.
- The share of government bonds used as collateral fell back from 83.6% to 81.2%, close to the record low of 81.0% reached in June 2008. However, the share of government bonds in tri-party repo increased dramatically to a record high of 53%, well above average.
- The seasonal pattern of the survey, in which the average duration of repo transactions lengthens in December, as banks lock in term funding over the year end, and then shortens in June, in reaction, continued to be evident. Short-dated repo (with one month or less remaining to maturity) increased to 63.8% from 55.4%.

After Francesco had expressed his gratitude for Johan's continued willingness to present the findings of this survey, he noted that the two presentations confirmed two things: First, central banks' unconventional measures have apparently compensated a decline in activity in the medium-/longer-term unsecured markets but the risk exists that they could eventually crowd-out some private transactions. Second, secured markets have, on a comparative basis, held up much better than the unsecured ones. While this assessment was shared by most members, some cautioned that it remained to be seen, how the repo markets would react to the upcoming exit from unconventional measures, which will imply that more (lower quality) collateral needs to be refinanced outside the central banks, e.g. in the private repo markets.

4. Other items

Orazio Mastroeni, the Secretary of the Operations Managers Group (OMG), debriefed the members on the last OMG meeting; mentioned that the group would get a new Chairman as of next year (Andreas Gaus, Credit Suisse); and provided an outlook of the group's work program for 2010.

Ralph informed about the creation of a CGFS study group on changes in the funding of international banks to which also the ECB participates. He announced that he would soon send a questionnaire from this study group to all members, and that this might be followed by some bilateral discussions.

Thereafter Ralph presented the draft work program for 2010 and invited members for their feedback and for additional proposals. The points raised during the following short discussion will be taken into account for a revised draft, which will be circulated to the members for their final comments.

Francesco finally mentioned that the next meeting is scheduled for Wednesday, 10 February 2010. The following potential topics were identified: The regular review of recent market developments; another presentation on changes in liquidity regulation (possibly the latest developments at the international level – alternatively upcoming changes from yet another country of common interest); and a presentation on the impact of T2/T2S/CCBM2 on banks' liquidity management.