EUROPEAN CENTRAL BANK

EUROSYSTEM

Money Market Contact Group

Frankfurt, Tuesday 18 February 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 the money market developments since the last MMCG meeting. Ralph started by recalling the significant worsening of the overall market situation that had taken place after the bankruptcy of Lehman Brothers and the ECB's reaction to the intensifying tensions in the euro money markets, in particular the introduction of the fixed rate / full allotment procedure and the narrowing of the interest rate corridor.

The Secretary then illustrated the impact of these decisions on outstanding volumes in the ECB's liquidity providing operations (large increase); the use of the deposit facility (likewise large increase), and the very short term cash market (decline in Eonia volumes and Eonia rates relative to the ECB's MRO rate). Thereafter he recalled the ECB's decision to re-widen the interest rate corridor as of mid-January, which was mainly motivated by the desire to reduce the ECB's intermediation role and to provide incentives for a re-activation of the euro money market.

Ralph then showed that the trends mentioned above had been partially reversed since the start of the year, raising the question whether this was linked to the re-widening of the corridor, or if this was more a coincidence. He finished his introduction with an overview of the recent results of the ECB's USD and CHF liquidity providing operations and the significant lengthening impact of all these measures on the Eurosystem's consolidated balance sheet.

The following discussion revealed a number of interesting points:

Members reported some gradual improvements in several segments of the euro money markets in 2009, but there were diverging views on whether these improvements could be related to the re-widening of the interest rate corridor, or not.

Based on this experience, many members recommended that the ECB should continue its current liquidity management approach (i.e. fixed rate / full allotment tender procedure; tolerate Eonia fixings significantly below the policy rate). In this case there would, in their view, be a good chance for a further improvement of money market conditions, while a premature exit form this policy might have detrimental implications.

The rather cautious assessment was justified by the following observations made by several members of the group: i) while the decline in Euribor fixings (and deposit-OIS spreads) is positive, there is extremely little turnover behind these declining fixings; ii) forward spreads have risen over the last couple of weeks; iii) the upcoming end of the first quarter might negatively affect sentiment and market liquidity; and iv) the longer-term view on the broader credit markets has not improved at all over the recent weeks and months.

Banks identified two main reasons, why the demand in the ECB's longer term refinancing operations (LTROs) came down recently. On the one hand, the re-widening of the corridor has made it more costly for banks to demand large liquidity buffers to steer their daily liquidity form a comfortable surplus position, as these surpluses can only be placed back in the market at levels slightly above the (lower) deposit facility rate (or directly at this lower rate with the Eurosystem). On the other hand, also the pricing of the LTROs has become relatively less attractive recently, as Euribor fixings continued to decline across the money market curve and both, 3-month and 6-month fixings are now below the ECB's policy rate (at which the LTROs are conducted for the time being).

There was also a discussion about the significant supply of government guaranteed bank bonds, which seemed to face good investor demand, not least because of attractive spread levels. At the same time, some members argued that these guaranteed bonds could be viewed (from the perspective of a non-bank investor) as a very strong competition vis-à-vis other money market instruments.

A short debate also emerged about possible consequences for institutional asset managers like money market funds in case the ECB were to lower rates further and retain its current liquidity management approach. Some members suggested that from overnight rates close to 0.50% (or lower) those asset managers will find it difficult to earn their fees, which could lead to significant outflows from their products. In practice this might, in their view, imply that customers will again place more money directly with banks rather than indirectly via "cash pools".

Answering to a question regarding the ECB's attitude towards the current level of the Eonia fixings, the Chairman clarified that in the current market situation, which could certainly not be classified as "normal", the ECB was willing to accept fixings significantly below the policy rate, as the ECB was of the view that this could contribute to a better market functioning. Francesco stressed, however, that this acceptance of a larger deviation from the policy rate was a temporary one, linked to the current conditions – and should not be misinterpreted as a change in the ECB's long-term approach.

2. Update on changes in the collateral framework

The scope of this item was twofold: the idea was to provide, on the one hand, an update on the recent changes of the Eurosystem's risk control measures and, on the other hand, to outline the most recent trends in the eligibility and use of collateral. Therefore there were two separate presentations from ECB experts.

Ulrich Bindseil from the Risk Management Division first recalled the changes that were announced on 4 September 2008 and that had become effective on 1 February 2009. Thereafter he explained in more detail the additional measures that were announced on 20 January 2009 and which will generally become effective on 1 March 2009 (with some grandfathering until 1 March 2010 however applying for certain cases).

Jens Tapking from the Market Operations Analysis Division first recalled that the temporary expansion of eligible collateral (announced in October/November 2008 and effective until December 2009) has led to a significant increase in the nominal value of eligible marketable assets. Interestingly, this significant increase, around EUR 2 trillion, occurred in two waves: first there was an immediate effect of the new eligibility criteria accounting for about EUR 1 trillion, but thereafter there was another EUR 1 trillion of collateral added, which seems to represent new issuance that has been undertaken (also) with the aim to generate ECB-eligible paper. After this review, Jens shared some interesting observations about the use of newly eligible collateral before he finally said a few words about the impact of the recent tightening of the collateral rules presented in the first part of Ulrich's presentation.

The discussion centred on two relatively technical points:

First, some members suggested that the ECB should provide a list of banking groups that fulfil the new close link definition, as the criterion of “direct or indirect 20% ownership” was usually not closely monitored by banks, which tend to focus their monitoring on majority stakes. Without such list, the 10% cap for uncovered bank bonds issued by an issuer group might, in extreme cases, imply the need to reduce the holdings of all uncovered bank bonds to only 10% of the collateral pool.

Second, the exclusion of ABS on ABS would, according to some members, also affect the ABCP structures that are commonly used to finance French corporates and should therefore be reconsidered.

The Chairman accepted that some further consideration of these two issues might be warranted.

3. The impact of the financial crisis on banks’ internal organisations

Three members of the group agreed to provide a short presentation on different aspects of the effect of the financial crisis on banks’ own internal organisations. This item, which was postponed from the previous meeting, loosely followed up from a series of earlier presentations made in 2005/2006.

The presentation of Marco Antonio Bertotti (Intesa SanPaolo) focussed on money market deposits and CPs/CDs as a funding source. One of his key points was that the management of liquidity risk and counterparty risk had become incredibly important in the daily money market trading activity. He also stressed that for Intesa, as a large retail bank, the monitoring of flow dynamics in their depository base has become relatively more important than the traditional intra-day dealing activity.

Frederic Mouchel (JPMorgan Chase) centred his presentation on collateral management issues and implications on funds’ transfer pricing policy. Regarding the first point he mentioned the dramatic decline in market liquidity for repo transactions in lower quality assets as a major source for concern and as a factor that contributed to an increasing reliance on central bank financing. As regards transfer prices he mentioned a long list of factors that made the appropriate pricing of bank internal cash-flows very challenging and reactions from the group suggested that this feeling was widely shared.

Johan Evenepoel (Dexia) finally looked at links of the treasury with other business lines, how to organise a banking group’s market access and the pros and cons of a centralized versus a decentralized liquidity management. Among a number of other interesting things, Johan mentioned that Dexia group had significantly reduced the number of entities with direct market access, while at the same time retaining the access to the National Central Bank for all of them. Moreover, Johan is of the view that in spite of some current organisational difficulties with their centralised liquidity management model, this will be the only possible set-up for an integrated group in the long run.

While the discussion touched upon a number of different issues, there was one topic that emerged again and again, namely the importance of liquidity regulation for treasuries’ internal organisation and processes. Several members stressed that the uncertainty about the planned/ upcoming changes was unfortunate; and it would be particularly disappointing, if these expected changes would not result in a (more) level playing field throughout the European Union.

The Chairman thanked the three presenters for their work and willingness to share internal information and mentioned that the focus of the discussion on liquidity regulation issues nicely introduced the final topic of the agenda, namely the planning of the next meeting.

4. Planning of the next meeting

The next meeting is scheduled for Tuesday, 19 May 2009. The following potential topics were identified: The regular review of recent market developments; a presentation on liquidity regulations in the euro area; and a presentation on the impact of T2/T2S/CCBM2 on banks’ liquidity management.