EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 25 March 2011

Money Market Contact Group

Frankfurt, Monday 14 March 2011, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Findings of the questionnaire on organisational aspects of liquidity risk management

At the beginning of the meeting the Chairman made some remarks about the outcome of the annual rotation exercise, which allows new banks to join the group, avoids the impression of a "closed shop" and sets incentives for active participation in the meetings.

Thereafter Geert Wijnhoven (ING) presented the findings of the questionnaire on organisational aspects of liquidity risk management, which he had designed with the help of a consultancy firm. Geert thanked the members for the high return rate of the questionnaire and re-assured them once again that the compilation and aggregation of the results was done on a purely anonymous basis.

Geert recalled that the main objective of the survey was to establish the extent to which European financial institutions have resolved the issue of a potential conflict between managing liquidity risk in a prudential manner and targeting this activity as a potential profit centre. Thereafter he presented the main findings of the four areas of the survey: i) oversight of liquidity risk management; ii) MM trading responsibilities and performance measurement; iii) funds' transfer price framework; and iv) governance of resource allocation.

According to Geert's interpretation of the findings, the above-mentioned conflict seemed to still prevail. However, some members challenged the practical importance of such a conflict, as they argued that it was possible to achieve both goals at the same time, i.e. to try to maximise profits of the MM desk within the limits set by the regulatory environment.

A large part of the discussion was about the funds' transfer price (FTP) frameworks, with members generally agreeing that the process of passing the true cost of liquidity (incl. committed lines) to the customers had gained momentum but was still ongoing. In this respect it was expected that the currently rather inconsistent approach towards FTP schemes would become more harmonised in the future. At the same time many members stressed that fully homogeneous transfer prices throughout the industry should not be expected, as there is also a policy aspect to banks' internal approach to this issue (i.e. transfer prices can be a steering tool to grow or shrink certain business areas).

An interesting side-aspect of this discussion was that several banks remarked that the "ECB eligibility" of assets had become a less important criterion in their FTP frameworks, as the new relevant criterion was the eligibility for the Liquidity Coverage Ratio according to Basel III, which, while becoming binding only as of 2015, will have to be reported as of 2012.

At the end of this item it was agreed that another update on the latest developments as regards liquidity regulation could be foreseen for a meeting in the second half of 2011.

2. The money market impact of new large exposure rules

Jaana Sulin (Nordea) presented some thoughts on the money market impact of the new large exposure rules that came into effect at the beginning of the year. She mentioned that the tighter regulation in this field seemed to threaten cross-border banking models with a subsidiary structure, in particular when

subsidiaries have a limited capital base, whereas institutions with a branch structure seemed to be less affected. In her view this seemed to go against the fundamental idea of the single European market. Moreover she argued that the new rules, rather than reducing systemic risk concerns, might actually increase these risks by reducing the liquidity of the money market and thus lowering the efficiency of the European banking system.

For cross-border banks' the new rules seem to imply that liquidity management will become more complex (as traded amounts become smaller; the number of counterparties will have to increase; country specific limits will become more binding and the related reporting requirements will increase), while at the same time their credit risk exposure might even increase (as they have to spread it out to more – and potentially lower rated – counterparties than before). Finally, Jaana mentioned that, in particular, the extended scope of the rules relating to connected clients might be rather challenging to introduce in the daily business practice.

Several members agreed that the new regulation makes a centralised liquidity management in cross-border banking groups more complex. Some members also criticised that the final version of the new rules had been provided rather late to the banks and that some uncertainties regarding their interpretation in different countries remained, which added some additional complexity.

The Chairman concluded that the potentially adverse effects of the new large exposure rules for the liquidity and integration of the euro money market should be carefully monitored.

3. Update on the development of autonomous liquidity factors

Paul Mercier (ECB) provided an overview of the development of autonomous liquidity factors. The presentation was split in two parts: a first one on the composition of autonomous factors and the longer-term developments of the various components; and a second part which focused more explicitly on the developments in the second maintenance period (MP) of 2011.

In the first part Paul presented a simplified version of the Eurosystem's balance sheet and grouped the autonomous factors into three categories: i) banknotes, which to a large extent explain the broad trend of the overall development of autonomous factors; ii) government deposits, which help explain the volatility within this broad trend; and iii) other autonomous factors, which represent a residual net position and includes many different balance sheet items (including the potential provision of Emergency Liquidity Assistance [ELA] by NCBs). Thereafter he reviewed some long-term statistics of the daily volatility of autonomous factors and the accuracy of the ECB's forecasts of these factors.

Following some further explanations about various relationships within the Eurosystem's balance sheet, Paul turned to the example of the second MP in 2011, which triggered quite some attention among market participants, as it included several days of exceptionally high use of the marginal lending facility (MLF) and some days with very large autonomous factors changes. Paul explained that the use of the MLF was linked to asset and liability transfers between banks in a specific jurisdiction: knowing about the upcoming transfer, the transferring banks could no longer use certain assets as collateral in the regular 1-week operation and used them on an overnight basis in the MLF instead. On the day of the transfer these assets could no longer be used by the transferring institutions and not yet by the receiving ones, so that the MLF usage decreased (as did the autonomous factors due to the corresponding increase in the provision of ELA by the relevant National Central Bank). Thereafter the receiving institutions first used these assets on an overnight basis in the MLF before subsequently increasing their participation in the next regular liquidity providing operation.

In the following discussion members wondered about the reasons for the continued increase in banknotes and Paul commented that this seemed to be related to several factors including the low opportunity costs of holding cash (due to the low interest rate environment), the growing international usage of the euro, and other technical factors.

Answering a general question regarding the provision of ELA, Paul recalled that the Statute explicitly allows NCBs to conduct transactions on their own behalf, such as emergency liquidity assistance or investments transactions, as long as these do not interfere with the implementation of the single monetary policy (i.e. the approval of the Governing Council would be needed). He underlined that

possible emergency liquidity support to local banks was not a Eurosystem activity and fell under the responsibilities of national central banks.

4. Review of the recent market developments

Ralph Weidenfeller (ECB) provided an update on the money market developments since the last MMCG meeting. The main points of his presentation were: i) a short background look at equity and credit markets (where the financial sector continued to underperform); ii) a review of the usual money market indicators, which improved somewhat (FX swaps) or remained in recent ranges; iii) a review of the development of outstanding tender volumes / tender participation / use of the standing facilities; iv) a look at the recently higher Eonia volatility; and v) a summary of the main ECB announcements since December 2010.

In the discussion it became apparent that members had a rather benign assessment of the increased volatility of very short term rates, arguing that this had, in general, not had a negative impact on overall market liquidity. Several members noted, however, that there had been a couple of days in late January / early February, when liquidity conditions had been rather tight, not least because of a persistent high use of the deposit facility, and Eonia settings had reached the level of 1.30%. On these days there was a negative spill-over to the liquidity of the repo markets, with some segments of this market becoming rather illiquid. Linked to this occurrence, one member made the point that the experience of tight liquidity situation in a fixed rate full allotment environment seemed to suggest that some form of stigma had crept into the ECB's operations, which was also a reflection of the ongoing talk about upcoming restrictions for "persistent bidders". Paul reiterated the ECB's long-standing position that the ECB's operations – and also the MLF – were there to be used and that it was not in the ECB's interest to introduce any kind of stigma in these. In fact, banks had to participate to these operations, as the banking system of the euro area is operating in a liquidity deficit. The ECB is only concerned about some banks' persistently disproportional over-reliance on Eurosystem funding.

Somewhat related to the recently higher volatility of the very short-term rates, one member asked about the likely width of the interest rate corridor, should the ECB raise rates in the future and whether there were any intentions on the side of the ECB to steer Eonia closer to the MRO rate in such a scenario. Francesco replied that these were policy decisions to be taken by the Governing Council, which would take into account several factors when taking such decisions – with the volatility of short term rates being one, but not the only factor.

In assessing conditions in the FX swap market, members reported a noticeable improvement for the EUR/USD currency pair and some made a link to the ECB's continued 1-week USD operations. Although these were priced as a backstop and attracted little or no demand lately, they served an important function, as they contribute to a generally more positive sentiment among USD liquidity providers. Members also mentioned that the modest tightening of the collateral framework has not had a significant effect on market functioning, which was generally viewed as an encouraging sign.

Feedback on the MP operations seemed to suggest that they were still being viewed as useful. Regarding the desired share of 3-month operations in the overall liquidity provision, there seemed to be some preference for a larger proportion of those LTROs compared to the share of one third that prevailed before the start of the financial crisis in 2007.

5. Other items

The next meeting is scheduled for Wednesday, 1 June 2011. The following potential topics were identified: The regular review of recent market developments; an update on the use of collateral in ECB operations; a review of the margining practices of CCPs.