EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

16 September 2009

Money Market Contact Group

Frankfurt, Tuesday 1 September 2009, 16:00 – 19:00

SUMMARY OF THE DISCUSSION

1. **Development of robust and internationally consistent approaches for liquidity supervision: The current state of international initiatives**
2. **Upcoming changes to the liquidity regulation in France**

The Chairman started the meeting by mentioning that the first and the second item of the agenda were somewhat related. He added that a Member of the group had offered an additional presentation on the new European rules on large exposures, which also seemed to fit into this broader regulatory topic. Francesco therefore proposed to have the three presentations immediately one after the other and to have a broader discussion of the topic afterwards.

Philippe Molitor (ECB) provided an overview of the current state of the various international activities for liquidity supervision. Philippe first outlined the supervisory and the central bank perspective on the liquidity risk topic before outlining recent and current policy discussions at the international level, namely at the Basle Committee on Banking Supervision, the Committee of European Banking Supervisors, the ECB Banking Supervision Committee and at the level of the European Commission. He concluded that a lot of work had already been done in the area of liquidity risk management and supervision and that the envisaged introduction of regulatory standards at international and EU level should lead to the further strengthening of the liquidity framework and should promote the convergence of different national approaches.

In her presentation Jaana Sulin (Nordea) first recalled the background for the large exposure rules and thereafter identified the most important regulatory changes in this field that are scheduled to enter into force by the end of 2010. She focussed on the potential implications for the interbank money markets and the treatment of intragroup liquidity exposures of cross-border financial institutions. Jaana concluded that, in her view, the proposed regulation had the potential to lead to a decline in interbank money market liquidity and might possibly cause a renewed decentralisation of liquidity management in cross-border groups.

Michel Robert (Calyon) provided a presentation on the upcoming changes to the liquidity regulation in France. Michel started by providing some background on the current French regulation before spelling out the general principles of the envisaged new liquidity regulation, which foresees a standard approach and an advanced approach. After giving some insight into the procedures of the standard approach Michel provided a rather detailed overview of the advanced approach, which the major French banks are likely to adopt. He then highlighted some possible implications of the new regulation, which should, in his view, have a positive impact for retail banks and lead to a strengthening of French banks' liquidity management. He closed by mentioning that the new regulation would, however, not change the lack of harmonisation of liquidity regulation at the EU level, which remains a major issue.

The following discussion revealed that many Members were dissatisfied with the current rules for banks' liquidity management. Several Members said that they were also disappointed with the little progress that had been made over the recent months, stating that it appeared that international committees moved too slowly, which provided incentives to national authorities to move quicker, resulting in a scattered and heterogeneous approach throughout the EU. This situation was, according to some Members, leading to a more decentralised approach to liquidity management within cross-border groups, which seemed contrary to the ideas of a single currency and a single market.

The banks also disagreed with the Chairman's claim that they might not have pushed hard enough for harmonised rules in the past and argued that they found it sometimes difficult to understand which body (i.e. an international, European or national one) was exactly in charge for establishing such desired harmonised rules.

Regarding the large exposures it appeared that many Members were not fully aware of the upcoming changes. There was still an agreement that those, if implemented along the lines as presented by Jaana, might indeed have a significant impact on cross-border groups' liquidity management (especially, if organised in subsidiary structures) and the interbank market more generally.

The Chairman concluded that this discussion had been very useful for better understanding the link between the regulatory environment and market functioning and that he would take this up in his regular contacts with his colleagues in the ECB Directorate Financial Stability and Supervision.

3. Review of the initial findings of the latest ECB Money Market Survey - postponed

4. Review of the initial phase of the ECB's Covered Bond Purchase Programme

Lars Dalitz (ECB) presented a review of the initial phase of the ECB's Covered Bond Purchase Programme (CBPP). He first recalled the various ECB announcements and the objectives of the programme before having a closer look at the eligibility criteria. Thereafter he presented a number of charts illustrating the evolution of the purchased amounts and the market impact of the purchase programme on issuance volumes and spread developments.

The following discussion revealed that the Members generally viewed the CBPP as a big success, especially as regards the revitalisation of the primary market. Answering the Chairman's question as regards the reportedly limited improvement of secondary market liquidity, Members gave some rather differentiated feedback: On the one hand it was, in their view, true that bid-/offer-spreads remained relatively wide. At the same time they argued that this was mainly due to limited offers in the market, which contrasted significantly with the earlier situation of lacking bids. The current lack of offers seems to relate to the strong directional spread narrowing, which is widely expected to continue. One Member suggested that once the spread tightening would have run its course there was quite some probability that a real two way market with narrower bid-/offer-spreads would re-emerge. In this context there was also a short discussion about the speed of the Eurosystem's purchases (which was broadly viewed as being appropriate) and whether the Eurosystem should repo its purchased covered bonds back into the market to enhance secondary market liquidity. It seemed that most Members thought that such a repo programme could be a good complement of the purchase programme.

There was also some discussion about primary market activity, where Members seemed to agree with Lars that the decline in issuance activity observed in August was mainly due to seasonal factors and that September should see a renewed increase in issuance volumes. One Member cautioned, however, that issuance activity in Spain might remain rather low, as the Spanish property market was undergoing a severe correction, which seemed to limit the growth of assets typically underlying Spanish banks' covered bonds. Another Member noted that the legal framework for issuing covered bonds was still not in place in Belgium, but that this should be the case by the end of this year.

5. Review of the 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 significant improvements in equity markets and credit markets, before turning to the euro money market, where the most striking event of the review period had been the ECB's first-ever 1-year LTRO, which had seen an enormous demand from a record number of counterparties. He outlined the impact of this operation on excess liquidity, the use of the standing facilities, the level of short-term rates and the spill-over to longer money market rates. Ralph also mentioned a further narrowing of (expected) deposit-OIS spreads and finished his introduction with an overview of the recent results of the ECB's USD and CHF liquidity providing operations, mentioning that the discontinuation of the 28-day USD operations had taken place without any adverse market impact.

The following discussion mainly centred on the impact of the first 1-year LTRO on money market conditions and the outlook for the second 1-year operation to be conducted at the end of the month. Members generally agreed that the large allotment of EUR 442 bn coupled with the ECB's apparent stance not to actively re-absorb the resulting excess liquidity had set the conditions in the euro money markets for many months ahead. There was little doubt that the use of the deposit facility would remain high and short term rates would remain low for the remainder of this year, especially when taking into account the ongoing CBPP and the upcoming further 1-year LTROs.

There were somewhat split views regarding the question whether the ECB would/should introduce a spread at the next 1-year tender or whether this operation would/should again be conducted at the prevailing MRO rate. A slight majority of Members seemed to expect this operation to be again conducted without a spread, mainly because the introduction of a spread could be misinterpreted as a monetary policy signal and lead to a strong reaction in money market rates. A number of other Members were, however, of the view that the improved market conditions would warrant the introduction of such a spread and that unintended monetary policy signals could be avoided by appropriate communication. In spite of these diverging views, there was a large consensus that the demand in the September 1-year LTRO should be a lot lower than in the June operation – regardless of possible spread scenarios – mainly because of the general market improvement and the lower 1-year market rates, which should limit arbitrage opportunities.

Regarding the general conditions in the euro money market it was mentioned that the recent stability of the Eonia rate has had a positive impact on liquidity in the OIS market, which had apparently recovered somewhat from the earlier setback. On the Secretary's question whether currently expected deposit-OIS spreads of around 30 basis points (in the 3-month area for March 2010) could be the new long-term equilibrium for those spreads, some members expressed their hope that some further narrowing could be in the cards, firmly rejecting, however, any idea that those spreads might come anywhere near the pre-crisis levels of below 10 basis points.

The discussion about the ECB's foreign currency operations was relatively short, as Members generally agreed that conditions had improved and that the discontinuation of the 28-day USD operations had not been an issue for the market. In principle they did not see any obstacle in a further gradual decline in the ECB's provision of USD and CHF liquidity, although some Members mentioned that even operations that did not receive any bids had some value, as their mere existence was reassuring for the overall market sentiment. In a loosely related discussion, some Members expressed their concern about a recent ruling of a US Court that would oblige the Federal Reserve to disclose the names of individual banks receiving funds under the various support programs. In their view, this ruling, if implemented, might have the potential to introduce some stigma into these support programs of the Fed.

6. Planning of the next meeting

The next meeting is scheduled for Thursday, 19 November 2009. The following potential topics were identified: The regular review of recent market developments; the presentation on the ECB Money Market Survey, which had to be postponed in the current meeting, potentially complemented by a review of the findings of the latest ICMA Repo Market Survey; and a presentation on the impact of T2/T2S/CCBM2 on banks' liquidity management. Members of the group were invited to submit possible further suggestions to the Secretary over the coming weeks.