EUROPEAN CENTRAL BANK

DG MARKET OPERATIONS

22 February 2006

Money Market Contact Group

Frankfurt , Thursday 16 February 2006, 13:00 CET

SUMMARY OF THE DISCUSSION

1. A comparison of internal organisations of banks' money market management - Part 4

Michel Robert (Calyon), Michael Schneider (DZ Bank), Michael Santer (Erste Bank) and Frederic Mouchel (JP Morgan Chase) provided a short presentation covering their banks' organisation. They gave a description of the liquidity management and the working relationship between desks and, in line with previous findings, the organisational structures of the four banks seemed to be quite diversified.

Pier Mario Satta then again presented an updated summary of the overall findings of the questionnaires he had received. The most recent observations did not significantly change the findings identified so far, but rather seemed to confirm some earlier trends.

The discussion following the presentations mainly centred around collateral management issues and some members enquired how they could best address the remaining shortcomings of the collateral management framework of the Eurosystem. The Chairman committed to raise the issue with the Payment and Settlement function in the ECB.

Some members of the group questioned the ranking of the Collateral Management function as regards its proximity to the desk in charge of participating in the ECB operations (second lowest ranking). The subsequent discussion showed that the questionnaire left some room for interpretation and it was therefore decided to circulate a brief supplemental questionnaire on this topic.

Given that there seemed to be some demand for a final round of presentations, it was concluded that a last instalment of this series would be given in the next MMCG meeting. By that time Pier Mario will also have prepared a brief report summarising the final conclusions of the survey. This report, which will only reflect general findings and not touch upon any individual bank's setup, will be discussed at the next meeting with the aim of finalising a version that could be published on the new website of the contact groups.

2. Round up on market developments during the last few months

Ralph Weidenfeller, the new secretary of the group, provided a short introduction to the latest developments in the money markets. He first focussed on the development of interest rate expectations following the ECB's rate hike on 1 December 2005, which was the first rate hike since October 2000. Thereafter, he reviewed the ECB's liquidity management since the last meeting of the MMCG, focussing in particular on the developments around Christmas and New Year, and their implications on the development of short-term euro rates.

The subsequent discussion dealt with the following four issues:

- *<u>First</u>, the reasons for the low bidding volume in the MRO covering the end of the year.*
  Members explained that the reasons were mainly of a technical nature, as banks generally try to keep their balance sheets as short as possible over the year-end and thus participate in the MRO only for the amount of liquidity they really need. One member said that this low bidding volume could also be seen as a reflection of a smooth functioning of the system, as it showed that banks felt comfortable enough to submit bids only for their actual liquidity needs. In the discussion some banks enquired, if it would be an option to have a two week tender at the end of the year, which would cover both Christmas and the turn of the year. While this seemed to be an interesting idea, it would probably create other problems, e.g. a higher uncertainty as regards the forecasts of autonomous liquidity factors.

- *<u>Second</u>, the reasons for the higher O/N volatility on the Fridays before the end of the maintenance period.*
  The discussion did not reveal a straightforward explanation for this observation – a tentative reason put forward was that the Friday counts for three days in banks' reserve holdings, as it is covering the weekend. Anticipations of a loose or tight end of the maintenance period might thus be amplified, possibly also via positioning in the Eonia swap market.

- *<u>Third</u>, the increase of the size of the LTROs from EUR 30 billion to EUR 40 billion.*
  Members generally welcomed the fact that this increase in the LTROs allotment volumes would lead to a corresponding decrease of the MRO amounts by a total of EUR 30 billion. Some members however cautioned that the decrease in the MRO volumes would be only temporary, given that autonomous factors (in particular banknotes in circulation), and thus banks' liquidity needs, are expected to continue to grow at a rapid pace.

- *<u>Fourth</u>, the persistently high spreads between the Eonia rate / tender rates against the current minimum bid rate.*
  This issue had already been discussed in earlier meetings and there were little new explanations. Some members mentioned that banks with liquidity needs are generally willing to pay a slightly higher rate in order to be sure to receive the liquidity. As soon as the percentage of allotment at the marginal rate declines below a certain threshold (say 50 percent), they tend to submit their bids at the next higher rate in the following MRO. As many banks seem to apply this behaviour, these dynamics might help to explain the renewed upward drift in tender rates (and also the related upward drift in the Eonia rate). Some members also mentioned that the possibility to use lower rated collateral in the ECB operations might also contribute to the upward drift in tender rates. According to their reasoning, banks try to avoid unsuccessful bids in the MROs (thus submitting bids at slightly higher rates), as the lower-rated collateral they provide to the Eurosystem could not easily be mobilised within the same timeframe for adequate volumes. Furthermore, this collateral could only be mobilised at less favourable (i.e. even higher) rates in the market, because of the lack of a sufficiently developed lower-class tier 1 repo market for short-term maturities. Finally, some members mentioned that the ECB's policy to provide EUR 1 billion more than the benchmark allotment in all MROs except the last one in the maintenance period seems to be insufficient to break this upward spiral.

3. Comparison between the ICMA Repo Survey and the ECB Money Market Study

Danielle Sindzingre (Societe Generale) and Johan Evenepoel (Dexia Bank) introduced the item and provided a presentation with many interesting charts.

Their main conclusions from the data were that

- concentration levels remained largely stable, with the top 10 banks accounting for around 55 percent of the overall market (similar figures for the ECB and ICMA).
- EUR-denominated transactions remain dominant in the ICMA survey, accounting for 70 percent of the volume.
- the maturity analysis revealed a very high concentration of the activity in very short-term maturities in the ECB data, while this was only to a lesser extent the case for the ICMA data.
- the repo market continues to grow at a rapid pace according to both ECB and ICMA data. The ICMA growth rate is around 16 percent, while the ECB growth rate is slightly lower at +13 percent (both little changed compared to one year earlier).
- the ICMA repo survey shows a decline of the share of electronic trading from 24 percent to 21 percent. This contrasts substantially with the ECB data, showing a further increase from 41 percent to 43 percent. This difference might be explained by the fact that shorter maturities, which are more frequently traded electronically, play a larger role in the ECB data.
- the share of triparty repo did not grow further according to the ICMA repo survey, staying slightly above 10 percent (in line with the ECB findings).
- the ERC survey offers a more detailed breakdown on the type of collateral used in repo transactions. Regarding the country of origin of the collateral, the euro area remained dominant with an unchanged share of around 68 percent of overall collateral. The share of government bonds still dominates, but it has decreased further in 2005, while the share of lower rated collateral has increased.

In the following discussion members generally agreed that the data revealed some interesting developments and that this comparison should remain a recurrent item on the MMCG agendas.

As regards the follow up, it was agreed that the two presenters would prepare a short document highlighting the main findings of the comparison. This document and the presentation could then be published on the contact groups' new website, provided that the ICMA would have no objections against such a proposal.

4. Other items

- Fabiola Ravazzolo gave a quick presentation regarding the preparation of the ECB Euro Money Market Study 2006. She outlined the somewhat more ambitious timetable of this year's study and asked the members for their views as regards the potential inclusion of some questions on derivatives. After a brief discussion it was agreed to include a new qualitative question on options, but to otherwise keep the questionnaire unchanged. It was further agreed that banks would from now on receive their individual ranking per market segment as a feedback from the ECB.

- Paul Dillon (AIB), the new Chairman of the Operations Managers Group (OMG), introduced himself to the members of the MMCG and presented the OMG's work programme for 2006. The focus of the OMG's work will be on contingency planning, trade confirmations and the preparations for the Global Conference to be hosted at the ECB in 2007. It was agreed that the OMG would present a short report reflecting its work on contingency planning issues to the MMCG in the November meeting. Paul also underlined the OMG's willingness to deal with any other issues which might be of interest for the MMCG (or the FXCG).

- Ralph Weidenfeller gave an update on the current status of the website project. He briefly presented the planned structure of the website and the items that would be published in the future. The focus of the latter will be on documents and reports reflecting the work of the MMCG, with the aim of having at least one new publication per meeting. Ralph also informed the group that the market contact groups of the ECB Directorate General Payment Systems and Market Infrastructure might join the website initiative. Regarding the timeline it is planned to have the website fully operational by summer. Finally, Ralph informed the members about the recent change in the password giving access to the existing restricted webpage of the three groups and asked the members to verify their contact details included in this page.

- The next meeting will be on 17 May 2006 in Helsinki from 16:00 to 19:00 (Helsinki time).

  The following agenda items were tentatively agreed:

  - Regular review of recent market developments
  - Final round of presentations on internal structures / finalisation of the summary report
  - Latest developments regarding “bank loans”
  - Prime brokerage in money markets