

Money Market Contact Group

Frankfurt, Tuesday 4 December 2007, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. The main findings of the ECB Euro Money Market Survey

Benjamin Sahel (ECB) provided a presentation on the main findings of the most recent ECB euro money market survey, which was published on 19 November 2007. After quickly recalling the improved methods of compilation, Benjamin summarised the main findings of the survey as follows: The aggregate turnover of all money market instruments increased slightly further, with the largest increase seen in the repo market, which also remains the biggest market segment. The turnover in deposits, repos and FX swaps is still highly concentrated in the very short-term maturities and overall market concentration also remains rather high.

Afterwards, Holger Neuhaus (ECB / Statistics) raised the question of what could be done to make the sample result of the survey even more meaningful so that the ECB could not only conclude on trends but also on the overall level of activity. Although, according to balance sheet data, the banks participating in the survey represent more than 45% of the inter-bank positions in the EU, the ECB cannot reliably conclude on the overall level of market activity, because the estimated error remains too high. Following a small discussion it was agreed that the ECB should ask the money market study participants for relevant counterparties that are not yet part of the reporting population. Frequently mentioned banks would then be requested to also participate in the next survey with a view to further increase the relevance of the sample.

In the following general discussion one member stressed that the share of unsecured interbank lending transactions with maturities beyond 1 month was extremely small, which seemed to question the widespread view that a dry-up of the interbank market was behind the significant increase in unsecured rates witnessed since the beginning of the turmoil. In his view, this development was rather due to the unwillingness of other money market players (such as money market funds, pension funds, etc.) to provide term funds to the banking system. Other members seemed to confirm the idea, although some cautioned that comparing turnover without adjusting for different maturities (i.e. comparing outstanding amounts) might be somewhat misleading.

There were also some requests for collecting additional data in the future, in particular the request to gather figures on banks' activities in other currencies. Most members agreed that this would be useful information, but given that such an approach would raise a number of detailed questions, the Chairman concluded that the ECB would further investigate the issue and come up with a detailed proposal at some time in the future.

2. The impact of Basle II on banks' liquidity management

Michael Schneider (DZ Bank) presented an overview on the regulatory impact of Basel II on treasury instruments. Michael started with an overview of the regulatory structure, stressing that, due to the necessary implementation of the EU law on the national level, Basel II need not necessarily mean a

full harmonisation of banking supervisory standards throughout the whole EU. He also raised some level-playing-field issues as regards the timing of the implementation given that, in 2007, reporting can either be done under the Basel II rules or still according to the old regulations. Moreover, it seems that US banks will have to follow the Basle II rules only from 2009 onwards.

In the main part of his presentation Michael compared the regulatory treatment of various treasury instruments under the new rules with the previous one, having a separate look at activities allocated to the banking book and to the trading book. The conclusion of his detailed comparison was that Basel II leads to an increase in the complexity of the regulatory treatment of treasury instruments, as well as to an increased cost of capital.

The following discussion mainly focussed on the impact of the new regulatory rules on committed credit facilities, where members were curious to see whether the increased cost of capital for such facilities would eventually translate into higher prices for providing such commitments. Members were of the view that if this were the case it might have an adverse impact on overall market liquidity. The Chairman thanked Michael for his interesting presentation and signalled that there might be a similar presentation on the impact of the Mifid at the next meeting.

3. Update on the Eonia Swap Index and the launch of an Eonia FRA product

Achim Krämer (Deutsche Bank) provided the group with an update on the Eonia swap index. First, Achim recalled the reasons for creating this index as a derivative reference rate. Thereafter he outlined the opportunities for new products, before sharing some spread observations with the group.

Regarding the opportunities, which were the focus of his presentation, Achim mentioned that the Eonia swap index serves as a reference rate for the OIS market, a key product in short-term markets, and thus also provides a controlling tool for revaluing Eonia swaps. Moreover, the Eonia swap index enables the launch of an Eonia forward rate agreement, which is currently foreseen for 1 February 2008, although this date might still be subject to change depending on market conditions. At some point in the future it might also be possible that an OTC option market based on the Eonia swap index would develop, as the missing reference rate was one of the main obstacles for such a development in the past. Finally, Achim mentioned that the Eonia swap index was contributing to an expansion of the basis swap market.

The following discussion revealed some diverging views as whether the cash settlement of the Eonia FRA at the fixing date was really to be seen as an advantage of the product, as it contributed to a detachment of traders' positions from the underlying instrument and might thus open the door for questionable trading strategies. Another discussion point was the accuracy of the Euribor / Libor fixings in the current market environment, which was questioned by many members of the group. While Achim, who mentioned a potential change of the definitions of these indices in his outlook, did not have any concrete proposals for an improvement, he said that the expected wider discussion about these indices was a positive development as it raised the awareness of their drawbacks among all involved parties. The Chairman thanked Achim for his interesting presentation and asked him to keep the group updated on the launch of the Eonia FRA product.

4. Round up on market developments since the previous meeting

In his presentation the Secretary first recalled the situation that prevailed at the time of the last meeting, reminding members that the ECB had not been satisfied with the high volatility of short term rates prevailing at that time. Against this background the ECB implemented a more systematic approach in the maintenance period which started on 10 October to deal with the consequences of the financial turmoil. This new approach, which was also communicated to market participants, foresaw providing as much liquidity as needed in regular operations to prevent rates from rising too high, while being ready to absorb excess liquidity, in case rates would decline significantly below the policy rate. Overall, this approach seems to have worked reasonably well, as fluctuations of short-term rates around the minimum bid rate were more limited since the start of October.

Ralph stressed, however, that tensions seemed to have re-emerged again since the middle of November. This could be seen in the renewed widening of the spread between the unsecured deposit rates and overnight index swap rates (notwithstanding the ECB's announcement to roll-over the two

supplementary LTROs), the increasing allotment rates in the ECB's MROs and in the surge in 1-month deposit rates, once they included the turn of the year. Regarding the turn of the year, Ralph also mentioned the ECB's decision to lengthen the maturity of the main refinancing operation settling on 19 December 2007 to two weeks, so that it will mature only in January 2008.

A number of issues was raised in the subsequent lively discussion. Most members seemed to agree that there were two main factors behind the increasing deposit-OIS spreads and the increasing tender rates, namely banks ballooning balance sheets (as many of them were forced to take on the assets of their conduits/SIVs) and money market investors' continued reluctance to provide term funds, especially funds covering the end of the year. Several members also reported that the bilateral repo market was not functioning properly and that the interbank liquidity distribution seemed to be less efficient than before, which both seemed to contribute to an increasing demand (with a rather limited price sensitivity) in the ECB tender operations.

One member mentioned that there was some speculation in the market that increased demand from subsidiaries/branches of UK banks might also have contributed to the observed increase in tender rates, but this idea was firmly dismissed by the Chairman. The Chairman also stressed that the ECB was only in the position to steer very short-term rates reasonably well. He added that all the other rates/spreads were of course important to monitor very closely for the ECB, but at the same time the ECB was not in the position to actively control them.

Banks generally welcomed the lengthening of the maturity of the 19 December MRO, but several members mentioned that this decision might not be sufficient to fully address banks' year-end related concerns. Some banks repeated the ideas of conducting an additional 1-month tender or narrowing the interest rate corridor defined by the ECB's standing facilities, which had already been mentioned in the previous meeting. Several members also said that the 2-week MRO should be conducted as a fixed rate tender. They argued that the ECB's commitment that *"the allotment amount in this operation will be decided in full consistency with the aim of keeping interest rates close to the minimum bid rate"* was not definite enough to make banks feel comfortable to bid at relatively low rates. Indeed, several members argued that the main concern of banks' treasuries (as well as risk managers and top management) was not so much the rather high rates, but more the issue of making sure that the bank receives the necessary liquidity. This could, according to their view, be reflected in a very aggressive bidding behaviour in the MROs covering the turn of the year.

Finally, there was a short debate about the use of (or rather the perceived disincentives to use) the ECB's marginal lending facility (MLF) during which Paul Mercier stressed once again the the ECB viewed the MLF as a normal tool within its operational framework and would not draw any negative conclusions, when banks made active use of this tool.

5. Other items

- The Chairman introduced René Steenhart, Senior Vice President and Head of Global Financial Markets Operations at Rabobank, as new Chairman of the Operations Managers Group. René presented himself to the group, debriefed on the last OMG meeting and outlined the priorities of the OMG's work for the coming year.
- A draft work programme for 2008, which was based on the "remainders" of the 2007 work programme was distributed to the members of the group. The Chairman asked the members for further suggestions/comments and indications who would like to contribute to the different topics. This should be done within the next week, so that it would be possible to circulate the final version of the work programme before the end of the year.
- Finally the Chairman mentioned that the next meeting will take place on Friday, 29 February 2008 in Frankfurt; 13:00-16.00. Potential agenda items for this meeting are the regular review of recent market developments; an update on the CCBM 2 project and a presentation on the impact of MIFID on banks' liquidity management; and maybe another item from the 2008 work programme.