EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 28 November 2008

Money Market Contact Group

Frankfurt, Tuesday 18 November 2008, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Round up on market developments since the previous meeting

In his presentation the Secretary provided an update on the money market developments since the last MMCG meeting, which had taken place just before the bankruptcy of Lehman Brothers. He first presented a few slides illustrating that this event (together with a couple of others) has had a very severe impact on the broad financial markets, e.g. causing a significant further widening of corporate bond spreads, a substantial further stock market decline and an unprecedented increase in equity volatility indicators.

In the money markets the renewed wave of risk aversion led to a further increase in Euribor-OIS spreads, a widening of the spreads between the allotment rates in the ECB's main refinancing operations and the minimum bid rate, and a further decline in turnover in a number of market segments.

The ECB reacted to these developments with a series of new liquidity management measures, the most important ones being: i) the introduction of 1-month (or more precisely: maintenance period) special term operations; ii) the introduction of a fixed rate/full allotment tender procedure for MROs, LTROs and also USD liquidity providing operations; iii) the narrowing of the corridor defined by the standing facilities to +/- 50 basis points; and iv) the temporary enlargement of the pool of eligible collateral. Separately from the liquidity measures, the ECB had also lowered twice its key policy rate by a total of 100 basis points since the last MMCG meeting to currently 3.25% - and markets are pricing another 50 basis points rate cut for the Governing Council meeting at the beginning of December.

The Secretary's presentation was complemented by a presentation from Andreas Biewald (Dresdner Kleinwort) on developments in the GC repo market. Andreas showed that the spreads between Eonia rates and secured O/N rates had turned negative (for some types of collateral very significantly) since late September, meaning that O/N repo rates had declined to levels far below Eonia. In Andreas' view these developments were driven by an increased demand for top collateral (as the increased provision of credit by central banks increased the need for collateral and as cash providers in the money market generally shifted their activity into the secured market) that coincided with a reduced supply of top collateral (e.g. as there has been significant demand for this type of collateral by real money accounts that do not use these securities in the repo markets).

The following discussion revealed a number of interesting points:

It appeared that there was generally little hope that conditions in the money markets would improve much in the near term. Basically everyone ruled out such an improvement for the remainder of 2008, and several members saw also little reason to expect a marked improvement even in early 2009.

Some members were of the view that the experience that even a large bank could fail might lead to a re-definition of "normal conditions" in a sense that the unsecured money market would never return to

the state in which it had been before the start of the turmoil, especially as volumes in the unsecured market had anyway already been on a trend decline.

Another aspect mentioned several times was the significant strain on banks' capital position. At the moment basically all banks try to improve their capital ratios and it appears that only very few banks are willing to use parts of their capital for unsecured interbank lending (even if they still/again have available limits for some counterparties) as there are either more attractive investment opportunities or as they are simply not allowed to do this given the current balance sheet restrictions.

Many banks stressed again the importance of non-bank institutional investors (e.g. money market funds) for the overall market and that there were unfortunately little signs that those investors would consider lengthening their investment horizons. Moreover, some banks mentioned significant upcoming roll-over risk from maturing bank bonds or longer-term repo operations which might contribute to an even shorter average maturity of banks' liabilities.

Another important point that was made several times was that the various government schemes (guarantees/capital injections) would need more time to have a more meaningful market impact, as many details were still unclear and investors needed more time to study all the details of the different national programs. There were actually also some slightly critical voices as regards these programs, expressing substantial concerns about viable exit strategies for banks using these programs once those come to an end and one member even mentioning that he was not sure whether the various capital injections would indeed lead to a sustainable improvement of capital ratios or if they would rather be needed to cover expected future losses.

There were also some questions as regards the ECB's most recent liquidity approach, e.g. if the ECB had given up its goal of steering short term rates close to the policy rate and whether variable rate liquidity absorbing fine tuning operations might become a regular tool. In reply to these questions, Paul Mercier insisted that it would be premature to draw any far-reaching conclusions from the last couple of weeks, which should be put into perspective by comparing them to the successful approach that has been in place for many years. The Chairman added that it seemed almost natural that in the current difficult period the ECB would have to remain flexible and innovative, but that resulting differences compared to the "normal" approach in the past need not necessarily imply a significant shift in the ECB's overall liquidity management approach.

The discussion finally touched upon the US Commercial Paper Funding Facility (CPFF), on which Mirco Brisighelli (Unicredit) had prepared a short presentation. Since the start of this facility in late October the total issuance of CPs with a maturity of more than 81 days was almost USD 360 billion, which is a very substantial amount. Moreover, the CPFF accounts for 72% of all currently outstanding term notes and the facility also contributed to a substantial increase of the average maturity of the CP market to 42.6 days.

Mirco's suggestion that, given the positive market impact of the CPFF in the US, the Eurosystem should maybe consider something similar for the euro area was supported by a large number of his colleagues. Indeed, some members mentioned that such a facility would help them in the fulfilment of their regulatory and/or internal liquidity requirements (which the LTROs apparently do not) and a few others added that such a facility could also contribute to a narrowing of the Euribor-OIS spread as had been the case for the respective USD spread.

Paul Mercier replied that such a facility is obviously designed to provide central bank money directly to non-banks. To introduce such a facility would break with existing practices and thus be a much more severe decision than all the earlier measures that the Eurosystem has taken in response to the crisis. The Chairman added that there are also some statutory differences between the Federal Reserve and the ECB that would certainly make the introduction of such a facility in the euro area somewhat more complicated. Nevertheless, the Chairman summarised the discussion by saying that the ECB had understood from the various contributions that market participants viewed the CPFF as an important facility contributing to a better overall functioning of the USD money market.

2. Update on changes in the collateral framework

Jens Tapking (ECB) updated the members of the group on the recent changes to the Eurosystem's collateral framework. The most important changes are the inclusion of i) marketable and non-marketable assets with a credit threshold below A- but at least BBB-; ii) debt instruments issued by credit institutions and traded on acceptable non-regulated markets; iii) marketable debt instruments in USD, GBP and JPY issued by EEA issuers; and iv) euro syndicated loans governed by English law. It was stressed, however, that all these new types of collateral must, of course, fulfil all the other general eligibility criteria.

Jens explained that the temporary expansion of collateral had been driven by the significant increase of the amounts of credit provided by the Eurosystem and the desire to avoid a shortage of collateral on the side of its counterparties. The concrete decision about which types of assets should be added to the list was guided by two principles: first, the aim to add assets that are available in significant sizes and second, the goal to protect the Eurosystem as far as possible from potential credit losses as well as excessive operational and legal costs.

According to the ECB's analysis, these measures increase the value of eligible marketable collateral by almost 10% to now EUR 11.4 trillion. It should be noted, though, that the ECB does not know how much of the newly eligible assets are actually held by counterparties. Moreover, the use of non-marketable assets (without syndicated loans governed by English law) increased by 26% due to the lowering of the credit threshold to BBB-.

The discussion revealed that the members of the group generally welcomed the temporary extension of the list of eligible collateral. One member also provided some positive feedback on the actual handling of the inclusion of newly eligible assets in the list, with Paul Mercier commenting that this process should actually improve even further, after the initial peak demand for new inclusions will have been dealt with.

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

This item was postponed to the next meeting due to the lack of time.

4. Other items

- *Debriefing from the last OMG meeting:* This item was also postponed to the next meeting – the Chairman just asked Members to think about potential topics that they would like to suggest for the OMG's work programme for 2009.
- *Work programme for 2009:* The Secretary presented a tentative draft of a work programme for 2009. In the following short discussion Members suggested a couple of additional items. These will be included in the draft work programme, which will then be circulated for final comments and feedback from Members by the end of November. It is envisaged to finalise and circulate the work programme ahead of the end of the year.
- *Meeting dates for 2009:* Members were informed about the meeting dates for 2009.
- *Planning of the next meeting:* The next meeting is scheduled for Wednesday, 18 February 2009. Potential topics are: The regular review of recent market developments; an analysis of the impact of the turmoil on banks' internal organisations (which had to be postponed this time); and a presentation on the impact of T2/T2S/CCBM2 on banks' liquidity management. The latter presentation could be postponed to a future meeting, if other, more urgent topics arise in the meantime.