



EUROPEAN CENTRAL BANK
EUROSYSTEM

DG MARKET OPERATIONS

12 October 2007

Money Market Contact Group

Frankfurt, Thursday 27 September 2007, 16:00 – 19:00

SUMMARY OF THE DISCUSSION

1. The use of credit claims and ABS as collateral in ECB operations

Isabel von Köppen-Mertes (ECB) provided an update on the use of credit claims and ABS as collateral in ECB operations. Her presentation showed that the amounts of credit claims and ABS in use as Eurosystem collateral have increased substantially recently. Indeed, based on market values before haircuts, the use of credit claims has more or less tripled from the end of 2006 until July 2007, whereas the use of ABS has surged by around 40 percent in the month of August 2007, with the latter apparently closely related to the tensions in the money markets.

Isabel also mentioned that credit claims are currently not used in some euro area countries, although the respective NCBs are able and ready to accept credit claims, as there has been no demand from counterparties so far. Moreover, she clarified that the Eurosystem's collateral framework does not per se exclude ABCP, as currently 35 ABCPs from two different issuers are eligible.

When opening the discussion, the Chairman stressed that the ECB's collateral framework is not closed but a very open one. This means that whenever a security fulfils the pre-defined eligibility criteria this asset becomes eligible. Isabel clarified that from the EUR 1.3 trillion of outstanding ABS, currently around 60 percent are eligible to receive financing from the Eurosystem.

During the discussion on credit claims several members of the group shared their own experience with the use and handling of this new collateral class with the other members of the group. The main findings of this discussion were that: 1) contrary to expectations, the use of credit claims did not fully depend on the approval of IRB models, which should however provide an additional boost in 2008; 2) handling procedures still differ between countries; particularly important in this respect seems the (non-)requirement for ex-ante notification of the debtors; 3) credit claims benefited from the market environment (difficulties in the securitisation markets) and (in earmarking countries) from the increased use of LTROs.

While acknowledging the positive developments so far, some members urged the ECB to consider further steps (e.g. introduction of a single IT platform; efficient cross border use) to make the project an even greater success.

The Chairman concluded that the efforts made by the Eurosystem and counterparties seem to have been worthwhile, especially in the current market conditions, and that a further increase in the use of credit claims is to be expected with the start of the use of IRB models. He recognised, however, that there are indeed some remaining issues that the Eurosystem and national authorities will have to look at in the future.

2. Update on recent developments regarding the TARGET 2 Securities project

Helmut Wacket (ECB) provided a presentation on the recent developments regarding the TARGET 2 Securities (T2S) project. He first recalled the objectives of T2S, before outlining the expected effects on the post-trading activity. Regarding the latter, major benefits can be expected from more efficient settlement procedures, in particular on a cross-border basis. In addition, increased efficiencies are likely in securities finance and a reduction of funding and collateral management costs, which both are expected to have positive effects on liquidity. Moreover, further savings are anticipated from reduced fail rates in securities processing and the expected enhanced competition in servicing assets will help investors to reduce cost.

Thereafter Helmut presented the T2S governance structure, before elaborating on the results of the public consultation on the principles and proposals. Indeed, a public consultation on the document "T2S: general principles and high-level proposals", defining the nature and scope of T2S, has been launched on 26 April 2007 and market participants were invited to comment by end June 2007. The ECB got 57 responses, which were mostly favourable. In the meantime the T2S Advisory Group, consisting of the Eurosystem, CSDs and users, has discussed the outcome of the consultation and broad agreement has now been reached. Only two out of the 67 proposals are still under discussion and those are expected to be concluded in October 2007. Looking ahead, Helmut mentioned that there are a number of steps that need to be taken by May 2008, namely the finalization of the User Requirements; a more detailed economic analysis; the definition of the governance structure for the next phase of the project; the investigation of a number of legal topics and a market consultation on the user requirements for T2S.

In the following discussion members of the group asked whether the fact that T2S will not be mandatory may constitute a drawback for the project. This could lead to a situation where some CSDs participate, while others do not, which would obviously limit the envisaged efficiency gains. Helmut replied that it is for each individual CSD to decide whether to participate in T2S but that analysis is being conducted in order to assess how the needs of those markets could be addressed where CSDs decide not participate.

The Chairman concluded the meeting by thanking Helmut for his presentation and "warning" him that the group would welcome another update on the T2S project sometime during the course of next year.

3. Round up on market developments since the previous meeting

Paul Mercier (ECB) reviewed the main developments in the euro money market, focussing on the ECB actions during the recent turmoil period. He recalled the various ECB operations in a chronological order, explaining the reasons underlying the ECB's liquidity management decisions at the various points in time. One issue, which he stressed in particular, was that the ECB did not provide additional liquidity over a full maintenance period, but that it 1) provided the liquidity following a different time pattern; and 2) modified the relative share of liquidity provided via 1-week and 3-month operations. In his conclusion he stressed that it was the main aim of the ECB to keep short-term interest rates close to the policy rate (i.e. the minimum bid rate signalling the monetary policy stance) with limited volatility. In pursuing this objective, the ECB also aimed at supporting the proper functioning of the money markets.

The subsequent long and lively discussion revealed that the members of the group were quite satisfied with the way the ECB had managed the difficult period in the euro money markets. At the same time, they cautioned that the turmoil was not over yet and that further challenges were to be expected in the coming weeks and months. The following three challenges seemed to be the most important ones in members' views: first, the upcoming year-end, which is expected to become quite problematic for banks' liquidity management, as illustrated by the further increase in 3-month cash rates once they included the turn of the year. Second, the bidding behaviour in the ECB operations, which is very difficult to forecast (the accuracy of the Reuters poll has suffered significantly) and which leads to almost "irrational" behaviour of the banks that need to secure funds through these operations, contributing to "higher-than-necessary" tender rates. And third, the lack of confidence among market

participants, which was seen as being at the root of the current problems, but which was also viewed as being the most difficult to address.

Regarding potential ECB behaviour over the coming months there were a lot of suggestions from the group. These ranged from rather bold suggestions (e.g. to narrow the interest rate corridor defined by the standing facilities) via slightly less bold ones (e.g. to conduct additional 1-month tender operations covering a full maintenance period, or to switch to fixed rate tenders) to more modest proposals (e.g. to roll-over maturing supplementary LTROs into the next year, or to further increase the front-loading of reserve holdings within the maintenance period).

One issue that was discussed in a somewhat controversial way was the importance of the 3-month deposit rate. While some members were arguing that this rate was crucial for the financing conditions in the euro area and that the ECB should try to bring it lower (as the current level of around 4.75 percent is far above the ECB's policy rate), others argued that this seemed to be difficult to achieve, as the elevated level mainly reflected credit risk considerations in an environment of mutual mistrust. Paul Mercier clarified that the ECB's operational target was the very short end of the money market curve and that, while also supporting the functioning of other money market segments, it was not the ECB's role to decide on interbank credit risk premia via trying to drive 3-month deposit rates lower.

Another issue that received some clarification was the ECB's attitude towards banks' use of the standing facilities. Paul Mercier clarified that the possibility of accessing these facilities should be viewed as a regular tool within the ECB's operational framework and that the ECB did not make any negative assessments on banks making use of this regular tool. Paul added that it would be a pity, if the facilities were not used because of fear that the name of a bank making recourse to these facilities was leaked and the risk that this bank was then perceived negatively by its peers.

The Chairman summarised that the three options, which seemed to have gathered the widest support among the members of the group, were: 1) an even more generous provision of liquidity, coupled with more active liquidity absorbing fine tuning operations, if needed; 2) the switch to a fixed rate tender with 100 percent allotment; and 3) the wish for more clarity and certainty as regards the ECB's liquidity management approach. He also took note of the more general desire that ECB should communicate even more frequently with the market participants in order to avoid any misunderstandings or uncertainties about its intentions.

4. Other items

- Annemieke Bax (ECB), the Secretary of the Operations Managers Group (OMG), requested the members' views on the OMG idea to issue best practices/recommendations concerning settlement issues, e.g. Standard Settlement Instructions, Trade Confirmations etc. The MMCG agreed with this approach and offered its support as the Foreign Exchange Contact Group (FXCG) had also done in its earlier meeting.

The Chairman concluded that the OMG could thus start working on these issues and keep its two parent committees (i.e. the FXCG and the MMCG) informed about the progress.

- The Secretary distributed a sheet with the proposed meeting dates for 2008 and asked the members for feedback on these dates. The final meeting dates will be agreed at the next meeting.
- Finally the Chairman mentioned that the next meeting will be on Tuesday, 4 December 2007 in Frankfurt; 13:00-16.00. Regarding potential agenda items for this meeting, the following topics were suggested (some of them will have to be postponed to the following meeting):
 - Regular review of recent market developments;
 - ECB presentation on the development of other autonomous factors (in particular government deposits) since the introduction of the euro;
 - Overview of the Italian OPTES system;
 - Presentation on the Eonia swap index;
 - The impact of Basel II on banks' liquidity management;
 - The impact of MIFID on banks' liquidity management; and
 - Quick discussion about the work programme for 2008.