EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

8 June 2007

DGM/FRO/2007/113

Money Market Contact Group

Frankfurt, Thursday 31 May 2007, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

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

The Secretary provided a short summary of the latest developments in the euro money markets, focussing on the development of interest rate expectations, the continued very low implied volatilities and the ECB's liquidity management since the previous meeting.

a. Further decline in implied volatilities

The discussion initially centred around the further decline in implied volatilities, also for maturities beyond a relatively short time horizon of three months. Members argued that the ECB stance, which is well understood also for the medium term, contributes to the observed low volatilities,. They however also recalled that the low (and declining) volatility was not necessarily only linked to the good predictability of the ECB, as low and declining volatilities were also observed in most other market segments. One member argued that the increasing popularity of structured products generated small but very constant sales of options, which put a constant pressure on implied volatilities. Many members of the group shared the perception that the current levels of implied volatility might not fully reflect the risks of a large "tail event", i.e. a sudden burst of volatility, and one member reported that his bank was trying to protect its positions by the purchase of far-out-of-the-money options.

b. ECB's liquidity management

Regarding the ECB's recent liquidity management, the discussion mainly dealt with the underbidding in the liquidity absorbing fine tuning operations (FTO) in March and May. Members mentioned the following potential reasons for the underbidding: First, they stressed that banks are not fully aware of their final liquidity position at the time of the bidding in the morning and that they might thus be afraid to give away money, which they might be missing later in the day. Members also agreed that banks generally seemed to have a short memory, i.e. that there seemed to be no real learning process that would result in a sufficiently high participation on a permanent basis. The most important factor in the view of the members seemed however to be the interest rates at the time of the bidding. When they are above the fixed rate of the FTO there seems to be little incentive for individual banks to participate. In this regard one member argued that rates often traded above the fixed rate of the FTO at the time of bidding, because of concerns that the ECB might absorb a little too much liquidity in the operation, which would cause rates to trade higher in the afternoon and a slight recourse to marginal lending facility (MLF).

Following this remark the Chairman asked, if the members felt that the ECB had a bias towards ending the maintenance period (MP) on the tight side. This was generally denied, although several members agreed that the recent evidence suggested that an end in the MLF seemed to be more likely than an end in the deposit facility (DF). The Chairman acknowledged that unpredictable structural changes might occasionally give rise to patterns in the forecast errors, which can be observed ex post. In this regard, it seemed that the dynamics of excess reserves had changed somewhat over the last year, implying that there had been more occurrences of underestimations (i.e. liquidity absorbing errors) than of overestimations (i.e. liquidity providing errors). The Chairman stressed, however, that whenever such patterns are recognized as structural, the forecasting procedure was reconsidered to maintain unbiasdness.

The group then discussed some potential changes of the features of the liquidity absorbing FTOs which might contribute to avoiding (recurring) underbiddings in the future. A number of proposals was made in this respect (change of the time of the FTO; switch to a variable rate tender; narrowing of the interest rate corridor on the last day of the MP), but all of them seemed to have their own individual drawbacks. The Chairman clarified that the ECB always has a willingness to improve its framework, but that any potential change would need a careful assessment before implementation in order to avoid a situation where the fixing of a rather small problem causes the emergence of a larger problem elsewhere.

Overall, banks did not appear to be too concerned about the underbidding episodes – a few of them were even arguing that the strong decline in the overnight rate following the underbiddings had contributed to keeping the spread between the ECB's minimum bid rate and the average Eonia rate of the MP at a relatively modest level, which was positive in their view. One bank cautioned, however, that these underbiddings, if they occurred on a regular basis, might have a negative impact on the bidding behaviour in the last MRO of the MP, as the Eonia swap rate for the last week of the MP might drift towards (and maybe below) the ECB's minimum bid rate, which might lead banks to decrease their participation in the mentioned MRO.

2. The relationship between the ECB tender rates (ECB eligible collateral) and the 1-week repo rate (Euro GC)

Colin Bermingham (Barclays) and Johan Evenepoel (Dexia) provided two presentations trying to identify whether the wide range of the pool of eligible collateral for ECB operations has an impact on the spreads between the ECB tender rates on the one hand and the repo rates and the ECB minimum bid rate on the other hand.

Johan provided a series of charts that were showing the evolution of: 1) the outstanding volumes in ECB operations, tri-party repos and bilateral repos; 2) the pool of available eligible collateral; and 3) the actual use of various types of collateral. Moreover he was presenting some charts displaying the development of the spreads between the ECB tender rates and various market instruments.

The main findings of the presentation were that both the outstanding volumes in the secured money market segments and the pool of eligible marketable collateral have grown considerably over the years. Regarding the latter, the growth was however mainly observed in the lower rated and less liquid collateral segments. The use of collateral reflects this development, as Johan's data revealed that the share of government bonds provided as collateral continuously declined in all the segments (although it still remains rather high in bilateral repos). The increased use of assets with both lower liquidity and lower rating in ECB operations has, according to Johan's charts, however not led to a systematic, positive spread between the ECB tender rates and other market rates: indeed, while showing a tendency to decrease in absolute terms, the spread between the ECB marginal rate and the Eurepo is still mostly negative, indicating that financing obtained in the MRO is, at the margin, slightly cheaper than financing on the repo market.

Colin addressed the topic from a slightly different angle, looking closer at the market rates for the various types of collateral in comparison to the ECB's tender rates. He showed some calculations looking at the theoretical weighted average market rate of the pool of eligible collateral at different points in time (2002, 2005, 2006). The spread of these (theoretical) average rates against the minimum bid rate has slightly increased over time due to the shift in the pool of eligible collateral and so has the (actual) spread between the marginal rates in the ECB MROs and the minimum bid rate. Nevertheless, it would always have been cheaper to refinance such a theoretical collateral portfolio in ECB tenders rather than using it in the market.

The Chairman summarised the following discussion, saying that while there seemed to be tentative evidence that the low quality/low liquidity collateral accepted in Eurosystem refinancing operations has slightly pushed up the rate prevailing in these operations, the effect can be quantified in very few basis points as a maximum and that the cost of financing from the Eurosystem remains very close to the cost of repo financing. This finding might, however, be somewhat affected by the ECB's recent allotment policy of providing more liquidity than the benchmark amount, which has contributed to compressing the spread between the tender rates and the minimum bid rate. Finally, he mentioned that the trend for a declining use of government bonds in the ECB operations was expected to continue because of two factors: the introduction of credit claims as eligible collateral in the whole euro area and the expected move from earmarking systems to pooling systems.

3. Update on the latest developments regarding the STEP initiative

Michael Schneider (DZ Bank), who is also a member of the STEP Market Committee, updated the members of the group on the latest developments regarding the STEP initiative. He first reviewed the history and the goal of the STEP initiative and recalled the governance scheme. Then he presented the latest developments and provided some charts on the distribution of issuers and the development of outstanding volumes. After taking a look at the STEP statistics he continued with a recollection of the benefits of the STEP label for issuers and investors. Finally, he gave an outlook at the next "steps".

The discussion revealed that there was a lot of interest in a further improvement of the available statistics. However, it also showed that there are still some hurdles, especially of regulatory and tax nature, in some large euro area countries that need to be overcome in order to fully achieve one of the main goals of the STEP initiative, namely to foster the integration and the development of the short term paper market throughout the whole EU.

4. Presentation on the principles for the development of a common platform for Eurosystem collateral management (CCBM II)

Dirk Bullmann (ECB) provided a short presentation on the CCBM II project. First, he recalled the drawbacks of the current CCBM system, which had already been discussed in several earlier meetings of the MMCG. Thereafter he defined the objectives and core principles of the CCBM II project. Based on this, he outlined the potential benefits for market participants and invited the members of the group to provide feedback in the current public consultation phase that ends on 27 June.

While the members generally welcomed the initiative, some concerns were also raised. The first one related to the envisaged time horizon of the project. As it is, on the one hand, foreseen to work on the CCBM II project in parallel with Target 2 Securities (T2S), in order to exploit synergies between the two projects, and as it was, on the other hand, decided to base CCBM2 on already existing systems such as that of the NBB/DNB, it remains to be assessed whether CCBM2 could be implemented prior to T2S. Several members requested the Eurosystem to introduce some "quick-fixes" to the most striking drawbacks of the current CCBM system, especially should a go-live before the envisaged implementation of T2S in 2013 not be possible. A second concern was the fact that the participation of NCBs in the CCBM II is voluntary, which seemed to imply that, even with the introduction of CCBM II, there would still not be a fully harmonised euro area wide system for the cross border transfer of collateral. Dirk replied that the final decisions about the time horizon could only be made after the current consultation phase, but that the ECB was well aware of the market's desire to have a quick improvement of the current situation. He added that CCBM II has the potential to become a fully harmonised euro area wide system, but whether this is possible right from the start remains to be analysed, given the different life cycles of NCBs' domestic systems.

5. Other items

- *Upcoming collateral management workshop*
  Dirk Bullmann (ECB) reminded the members of the upcoming collateral management workshop in Brussels (Tuesday, 19 June), to which the MMCG members had already been invited.

- *Feedback on the OMG Global Conference / other OMG issues:*
  Annemieke Bax (ECB) provided some feedback from the OMG Global Conference, which took place on 23/24 April, also thanking the MMCG members who had contributed to the success of the conference. Moreover, she invited the MMCG members to consider a possible participation of their institutions in the OMG, as this group is currently considering a rotation of its members.

- *Planning of the next meeting*
  The next meeting will take place on Thursday, 27 September 2007, in Frankfurt, 16:00-19.00 followed by the annual dinner. Mr. González-Páramo will attend the end of the meeting and the dinner.

  The following potential topics were suggested for the agenda:
  - The regular review of market developments.
  - An update on the use of credit claims (by the ECB and some members of the group)
  - Potentially another update on the T2S project.
  - A presentation on the development of other autonomous factors (in particular government deposits) since the introduction of the euro.
  - Along these lines: an overview of the new activities of the Italian Treasury
  - The impact of Basel II and MIFID on banks' liquidity management

  The Chairman closed by saying that the ECB would welcome active contributions from all members of the group to the preparation and presentation of the various topics of the agenda, avoiding to concentrate the burden of presentations on a limited number of participants.