EUROPEAN CENTRAL BANK

DG MARKET OPERATIONS

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Money Market Contact Group

Frankfurt, Thursday 23 November 2006, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Preliminary findings of the ECB Money Market Study

Mark Dearlove (Barclays Capital) and Jean-Michel Meyer (HSBC France) presented the preliminary findings of the most recent ECB Money Market Study.

The main points were:

- Unsecured borrowing and unsecured lending rose further and reached new record high levels. At the same time the gap between the reported borrowing and lending also increased further.
- The repo market activity also continued to grow. The nominal traded volume increased by 96% between 2002 and 2006. The bulk of the repo activity remained in the "Tom/Next up to 1 month" bucket, although its proportion of the overall volume has decreased. The "Overnight" bucket is steadily increasing in nominal and relative terms since 2003.
- The FX swaps turnover jumped by 34% (Q2 2006/2005). 85% of the turnover is below 1 month (75 % below 1 week) and the average maturity is now only 18 days (26 days Q2 2005).
- All markets are highly concentrated. In triparty repos and CD's, 80% of the market is in the hands of only 4% of the players. In all other segments, the concentration trend was confirmed.
- FX swaps and cross-currency swaps are the most "international" products, while short-term papers are the product with the highest national bias.
- The share of electronic trading is the highest for repos, reaching 45 percent, while it is below 10 percent for FRAs, OIS, IRS and cross-currency swaps.

In the subsequent discussion the members of the group generally agreed that the findings underlined the continuing growth of the euro money markets and the ongoing integration of these markets on a euro area level.

In spite of the growth of the repo market and of the outstanding ECB operations, which both call for more collateral, it seems that the availability of collateral is no reason for concern. This is mainly due to the fact that the collateral pool is also growing, and as non-ECB eligible collateral is more and more frequently used in repo transactions.

Members agreed that the evidenced high concentration in some market segments does not seem to raise any competition issues, i.e. these market segments appear to be highly competitive nevertheless.

Market participants also discussed the fact that the volumes underlying the Eonia fixings have remained broadly stable, while the volume of unsecured lending has increased steadily over time. Therefore the Eonia panel seems to capture a decreasing share of the overall O/N market. This was however not seen problematic, as long as the fixing remains representative, which is still the case.

The Chairman floated the idea of publishing the list of the banks participating in the ECB Money Market Survey, which was generally supported by the members of the group. The ECB will contact also the other participants in the survey with a view to include such a list in the publication of the Money Market Study that is currently being finalised.

After the general discussion, Javier Huerga from the ECB Directorate General for Statistics raised two methodological questions regarding next year's survey, which had been circulated to all MMCG members ahead of the meeting. Regarding the possibility of dividing the inter-bank market population in strata, MMCG members argued that in principle different variables should be chosen for different money market segments given the differences between segments and that some further thinking on the criteria for dividing the banks into groups might be needed. On the second issue, members generally welcomed the idea to report the results of the questionnaire on a centralised basis, with the head office reporting consolidated results for all the subsidiaries and branches, as the current survey results were sometimes missing activity in some segments, which might have been centralised in one specific branch or subsidiary of a group.

The Chairman invited the banks to provide further feedback on these questions to the Secretary.

2. Update on the Target 2 Securities project

Marc Bayle from the ECB Directorate General for Payment Systems and Market Infrastructure updated the members on the latest developments regarding the Target 2 Securities project.

Marc outlined that the ECB started this project, because cross-border securities settlement in the EU is up to 6 times more expensive than domestic settlement and that it appeared that the market would need many more years before it would find a suitable solution for the whole euro area. He also described the way in which the Target 2 Securities project would make the infrastructure for securities settlements in the euro area less complex, before stressing that no final decisions had been taken yet and that the Eurosystem was still exploring the issue. The decision of the ECB's Governing Council on the project is expected for February 2007, based on the result of an internal feasibility study, which is currently being prepared.

In the following discussion banks revealed a strong interest in the topic, not least because it might have implications on their internal organisational structures. They asked to be closely involved in the process and Marc announced that there would be a public consultation, once the Governing Council would have given its final "OK". Marc also clarified that the scope of the project was not only limited to ECB eligible securities, but included all securities, including equities.

The Chairman thanked Marc for his presentation and stressed again that the group would be interested in receiving some periodic updates on the project, should it be endorsed by the Governing Council.

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

The Secretary provided a short summary of the latest developments in the money markets, focussing on current interest rate expectations and the ECB's liquidity management during the review period.

In the discussion several banks expressed their satisfaction with the way the ECB had recently managed the liquidity situation in the euro area. They welcomed the "new flexibility" in the ECB's allotment strategy. With this expression banks referred to the fact that the ECB had, in the middle of a maintenance period, reacted to a renewed increase in the spread between the Eonia rate and the minimum bid rate and increased the MRO allotment to the benchmark amount +EUR 1 billion. Banks pointed out that this decision had contributed to a narrowing of the above-mentioned spread. They underlined that this immediate reaction of the spread was different from the behaviour observed some months ago, when the ECB had to increase the "excess allotment" to +EUR 2 billion before having an impact on the spreads. This might be a reflection of a learning process on the side of the banks.

Other issues mentioned in the discussion were the level of excess reserves and their volatility; the request to conduct a fine-tuning operation earlier in the maintenance period, if the liquidity imbalance is very large; and the outlook for the upcoming Christmas and end-of-the-year period.

As regards excess reserves, Paul Mercier stressed that these tend to be built very late in the maintenance period and that they are thus difficult to forecast. Their importance should, however, not be over-emphasised, as their volatility does usually not translate into increased recourses to the standing facilities.

Regarding fine tuning operations before the last day of the maintenance period, he stressed that the ECB views their use as being exceptional and therefore tries to keep it to a minimum. Conducting fine tuning operations before the last day of the maintenance period would entail the risk that autonomous factors change again in an unforeseen manner and thus trigger the need for an additional fine tuning (possibly even in the opposite direction of the first operation), which would not be in the interest of the ECB.

For the upcoming Christmas and end-of-the-year period it was clarified that the ECB's liquidity forecasts do, of course, take the seasonal increase of autonomous factors, in particular banknotes, into account. Moreover, market participants should take comfort from the fact that the ECB is fully aware of the special situation that this time of the year also represents for banks' liquidity management, and that it has proven this awareness in the past.

4. Other items

- The Secretary presented the draft work program for next year, which has been circulated to the members of the group ahead of the meeting. Overall, the members of the group agreed with the suggested topics. The Chairman invited the members to provide any further comments by the beginning of December and also to indicate to which topics they would like to contribute, in order to be able to finalise the work programme by the end of the year.

- As there were no comments on the tentative meeting dates that had been circulated to the members of the group, these are final now.

- The next meeting will be on 14 February 2007 in Frankfurt from 13:00 to 16:00 CET.

  The following agenda items were tentatively agreed:

  - Regular review of recent market developments
  - Presentation on the peculiarities of the Spanish repo market
  - Presentation on the development of autonomous factors
  - Initial feedback on banks' use of credit claims