EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS 24 February 2010

Money Market Contact Group

Frankfurt, Wednesday 10 February 2010, 13:00 – 16:00

SUMMARY OF THE DISCUSSION

1. Managing liquidity risk with an internal model

Francesco mentioned that the meeting would again have a significant focus on the liquidity risk management topic, which had already been the case in the previous two meetings. Given the apparent interest in the topic, the ECB found it useful to have two more presentations – one from Michael Schneider (DZ Bank) and one from a colleague from the ECB financial stability area.

Michael Schneider (DZ Bank) provided a presentation on his institution's internal model for managing liquidity risk. He started with an overview about the international and national requirements before explaining the details of his bank's model for internal liquidity management. The basic structure of the model centres on the "minimum liquidity surplus", which quantifies the minimum amount of cash surplus that will be available within the following year in the event of the occurrence of a specified risk scenario. The parameters for the stress tests that are also run by the model relate to the drivers of unexpected liquidity outflows and to the available funding opportunities in the unsecured / secured funding markets. On a number of occasions Michael highlighted some details of his bank's current model that might not be entirely in line with the proposal of the Basle Committee and in his summary he stressed the uncertainty that this proposal introduced for several important aspects of banks' liquidity management.

In the discussion following the presentation, there were quite a number of detailed questions on the various assumptions underlying the model. Moreover, there were some questions relating to the co-operation with the German regulator (BaFin), in particular in how far the model eventually approved still reflected DZ Banks own assumptions and preferences for liquidity risk.

2. The Basle Committee's proposal for an international liquidity risk framework

Evangelia Rentzou (ECB) provided an overview of the Basel Committee's recent proposal for an international liquidity risk framework, which has been issued for consultation in December 2009. She concentrated on providing a summary overview of the consultation paper, which was structured along the following lines: (i) first she provided some background for the proposed framework; (ii) then she provided an overview of the proposal; (iii) thereafter she presented a more detailed look at the two main components of the proposal: the liquidity coverage ratio and the net stable funding ratio; before (iv) describing the monitoring tools; and (v) giving an outlook on the way forward.

Not surprisingly, this was followed by a very lively discussion of the consultation paper, with many members of the group expressing their concerns about various specific aspects of the proposal. Members criticised in particular that (i) the proposal was not very detailed so far, thus creating uncertainty and the risk of misinterpretations; (ii) the proposal only defined minimum standards, risking the formulation of tighter policies in some countries which would be in conflict with the idea of a level playing field (such level playing field should, at the very least, be maintained in the euro area, as otherwise there was a risk of trapped pools of liquidity and challenges for the integration of the euro money market); (iii) the idea of introducing a leverage ratio seemed to conflict with the demand for higher liquidity buffers; (iv) the narrow definition of liquid assets goes against the idea of portfolio diversification and could be sub-optimal in a crisis scenario, when all banks were trying to liquidate the same few government bonds; and (v) the narrow definition of the liquidity buffer could also have unintended consequences, such as constraining the banking industry's capacity to fund the real economy.

Evangelia answered that she had quite some understanding for the banks' concerns but stressed that it had become very obvious that current liquidity regulations were insufficient and thus needed to be tightened. She added that some of the mentioned issues should also come-up in the current consultation and/or the ongoing impact analysis and might thus have the chance to still impact the final outcome of the regulation.

A key focus of the discussion was the discrepancy between the envisaged definition of "liquid assets" and the pool of securities that are eligible for refinancing operations at the central bank, with most members indeed questioning the narrow approach on liquid assets taken in the consultation. Members argued that central bank eligible paper could be transformed into central bank money by participating to regular operations or, if need be, even on a daily basis via the use of standing facilities. Not factoring in this possibility, which should certainly exist in the assumed stress scenario as confirmed by recent experience, was, according to many members, an unrealistic and thus unnecessarily tight scenario. Paul replied to these remarks by stressing that it was not central banks' primary role to support individual banks' liquidity positions and that it would thus be strange if such a support would, quasi as a standing element, be factored into the new liquidity regulation.

A further point of attention was the potential consequence for the demand in the ECB's refinancing operations. Some members were of the view that the demand in LTROs should increase (at the expense of the demand in MROs), as liquidity with maturities below 30 days would be of little value from a regulatory point of view. In reply to this assumed shift in demand Paul noted that the ECB's operational framework was flexible enough to adapt the provision of liquidity in case structural changes would make this necessary.

Francesco closed this part of the meeting by summarising the discussion in the following way: First, banks should fully accept the idea that they have to adjust their liquidity management to tighter rules. Second, in implementing such tighter rules there is a need to find some proper balances: (i) on the one hand, between the aim to reduce liquidity risk and the goal to preserve market functioning/integration; and (ii) on the other hand, between commercial banks' self reliance as regards their liquidity position and central banks' support measures in systemic liquidity crises. And third, these balances should be found during the consultation procedure and banks are therefore strongly encouraged to provide feedback (also via the relevant market associations) to the Basle Committee.

3. Review of the market developments since the previous meeting

The item was introduced by the usual presentation of the Secretary, who started with a short background look at equity and credit markets, where the earlier improvements seemed to have reversed somewhat recently, which was not least due to increasing concerns about sovereign credit risks. Thereafter Ralph recalled the ECB's most recent announcements, reviewed some spread developments in the euro money market and then showed that excess liquidity in the euro money market had remained very large. This excess liquidity had resulted in a continued high usage of the ECB's deposit facility, in very short term rates staying close to the level of the deposit facility and in continued low turnover in the overnight market. Ralph finished his introduction with an overview of the recent developments in the covered bond market and the progress of the Eurosystem's covered bond purchase programme (CBPP).

The subsequent discussion revealed that there were slightly diverging assessments of the current situation in the euro money market. A number of banks cautioned that the recent increase of concerns about sovereign credit risk had had a negative market impact in the sense that market liquidity had worsened again – for example as regards repo market access for banks from the countries affected by the mentioned concerns, depending on the type of collateral they were offering. Against this background, those members were of the view that there was little hope for a re-opening of previously closed credit lines – in the current environment an evolution in the opposite direction seemed even more likely. This could, in their view, further increase some banks' reliance on the ECB as ultimate provider of liquidity and might also have negative long-term consequences on the funding conditions of some states and the banks from those states. This group of banks concluded that the ECB should be very careful when deciding further steps in its exit from non-conventional measures, in order to avoid the risk of potentially engineering a severe setback.

Some other members were, however, of the view that the ECB should continue its exit strategy irrespective of the recent emergence of sovereign risk concerns, although those certainly added new complexities. They argued that the reduced participation numbers in the MROs were a good sign and showed that concerns about insufficient market access were apparently justified only for a small number of banks. In their view, this issue should not be addressed by a potential slowdown or pause in the ECB's exit strategy, but should rather be treated as a completely separate issue. These members also made the point that there was currently only very little demand for funds in the market and that a gradual move away from the full allotment policy could actually improve market turnover.

Overall, there was quite some eagerness to learn more about the ECB's liquidity management approach for the second quarter of this year and members generally looked forward to the press conference following the Governing Council meeting at the beginning of March.

There was also some discussion about the CBPP and some members expressed concerns that conditions in this market segment might deteriorate once the Eurosystem would come closer to the overall pre-announced ceiling of EUR 60 billion. They argued that, although the program as such was relatively small, its signalling impact was very important and allowed banks to tap relatively cheap funding while at the same time restructuring their balance sheets.

Some members remarked that the discontinuation of the provision of liquidity in foreign currencies was well received. At the same time they did not rule out that there might be renewed pressures in the USD funding market (especially for non-US banks) once the Federal Reserve would begin to absorb the USD excess liquidity.

When concluding the discussion Francesco and Paul repeated that the ECB would take a gradual approach in its exit from non-conventional measures and that this gradualism also implied a continued cross-checking of the effects of the earlier decisions and of the financial conditions.

4. Other items

Francesco informed the group about an idea of organising a joint workshop between the contact group on euro securities infrastructures (COGESI) and the MMCG on potential initiatives to further improve the technical infrastructure of the repo markets. Members were generally interested in the idea, provided that this workshop would be organised as a separate event and not crowd-out discussion time of the regular MMCG meetings. Further information will follow in the coming weeks.

Francesco finally mentioned that the next meeting is scheduled for Tuesday, 18 May 2010. The following potential topics were identified: The regular review of recent market developments; another follow-up presentation on changes in liquidity regulation (possibly the result of the current consultation on the Basel Committee's proposal); and some focus on the latest developments in the repo markets.