EUROPEAN CENTRAL BANK

DG MARKET OPERATIONS 22 May 2006

Money Market Contact Group

Helsinki, Wednesday 17 May 2006, 16:00 – 19:00

SUMMARY OF THE DISCUSSION

1. A comparison of internal organisations of banks' money market management – Final part

In this fifth and final session of the review of member banks' internal organisations, Jean Michel Meyer (HSBC France) and Patrick Chauvet (BNP Paribas) provided a short presentation covering the set-up of their banks' money market management. As the presenters in the previous rounds they gave a description of the liquidity management and the working relationship between desks.

Thereafter the Chairman asked members for their comments on the draft summary report, which had been prepared by Pier Mario Satta (Banca Intesa) and which had been circulated to the members ahead of the meeting.

The main findings of the survey, which aggregates the results of the questionnaires completed by the members of the MMCG are:

- The results on the "organisational proximity" show that the money market deposit desk is closest to the tender desk. The repo desk only appears in the fourth position, which looks strange, considering that the tender itself is a repo transaction. However, it has to be remembered that in most banks the repo desk was historically part of the fixed income desk.
- The surprisingly low ranking of the "collateral management" activity seems to be explained by the organisational distance of very administrative components of the collateral management tasks from the tender desk.
- The ranking of market instruments according to their perceived relevance as a reference for the decision to participate in the weekly ECB tender revealed that the 1-week Eonia swap rate and the 1-week repo rate are the most important benchmarks, although the results differ quite substantially between individual institutions.

There were only a few comments on the draft report. The Chairman thanked Pier Mario for his efforts and asked the members to provide any additional comments by the end of the following week, so that the report could be finalised and published on the upcoming website.

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

The Secretary provided a short introduction to the latest developments in the money markets. He focussed on two main issues: first, the development of interest rate expectations following the second ECB rate hike on 2 March 2006 and second, the ECB's liquidity management since the last meeting of the MMCG. Regarding the latter, he particularly recalled the recent change in the ECB allotment strategy and the corresponding communication provided via the wire services.

The subsequent discussion mainly centred around the reasons for the persistently high spreads between the Eonia rate / tender rates and the current minimum bid rate (in spite of the recent change in the ECB's allotment strategy) and potential ways to contribute to a narrowing of those spreads.

Regarding the reasons, members' views seemed to be somewhat split:

Several banks argued that the widening of the spreads seemed to be of a structural nature. They argued that the size of the tender operations had grown significantly over the years and had now reached a level that seemed to become somewhat problematic. They argued that the liquidity needs for individual banks are now so high that the banks can no longer risk to receive no money in the tender operations. This would, in their view, favour a behaviour by which banks rather increase their bidding rates by a basis points than risk to "drop out" and not to receive any money from the ECB, as the latter would mean that they would have to fund very large amounts in the market.

Moreover, a number of banks argued that the pool of eligible assets might also contribute to the widening of the spreads, as the ECB accepts collateral that cannot be easily mobilised in the market. They said that for banks, which use such low liquidity collateral in the ECB operations, the alternative is either to make sure that their tender bid is successful or not generating any liquidity based on this collateral. As a result, these banks are less price sensitive and submit their bids at relatively high rates.

Several other banks did however not entirely share these views. While they acknowledged that the tender size might have become too big and that the composition of the collateral pool might be an issue, they argued that these factors are long-known and cannot explain the most recent dynamics in the widening of the spread. Instead they argued that the ECB's liquidity management should be more pro-active and accommodate banks' desire for more generous liquidity conditions particularly in the first part of the minimum reserve maintenance period.

These banks generally appreciated the ECB's latest efforts to contribute to a narrowing of the spread by allotting the benchmark amount +EUR 2 billion also in the last MRO of the period. They argued, however, that in order to also have an impact on the very short-term rates at the beginning of a maintenance period a significantly larger excess allotment would be necessary.

The Chairman thanked the members for the very interesting and stimulating discussion. He asked those banks that had put forward the idea that the wide range of eligible collateral might "distort" the tender rates to provide some data series that might support such argumentation.

3. Prime Brokerage

Mark Dearlove (Barclays Capital) introduced the item and provided a presentation.

Mark explained that the increasing importance of the prime brokerage business is closely related to the strong growth of the hedge fund industry. Mark provided an overview on the main providers of prime brokerage services, the different services that are provided and the different market segments that are covered. A large part of the presentation dealt with the risks that the increasing importance of hedge funds (and therefore the continued growth of prime brokerage services) might imply for the financial system.

The discussion following the presentation also centred mainly around these risk aspects. For example, several members noted that the prime brokerage market seems to be quite concentrated with a small number of providers accounting for a very large share of the overall business. There was also a discussion about valuation procedures: while it seems that "portfolio valuation" is usually not among the services provided by a prime broker (as the hedge fund investors request an independent valuation from a third party), there was agreement that the prime broker should nevertheless be fully aware of their hedge fund clients' positions and corresponding valuations.

As prime brokerage seems to be a very profitable business, there was also some concern that the competition for attractive mandates might lead to a slippage of service providers' prudential standards (e.g. lower haircuts; higher ability to leverage). Regarding the MMCG's focus on money markets some members said that the main impact of prime brokerage on this area seems to come from hedge funds' strategies, with so-called "carry trades" being mentioned as an example.

The Chairman thanked Mark for his very interesting presentation and asked him to try to summarise his talk and the main findings of the discussion into a brief report that could then be published on the upcoming website.

4. Latest developments regarding the eligibility of bank loans

The item was postponed to the next meeting due to time constrains.

5. Other items

- The Secretary asked the members to check the accessibility of the list of eligible assets on the new ECB website. The ECB would be very interested in members' feedback and proposals for improvement, if any. At the same time he gave a quick update on the Contact Groups' website project that has made some progress since the last meeting. It is foreseen to present a prototype of the website at the next meeting and to go live soon thereafter.

- The Secretary updated the members on the preparations for next year's Global Operations Managers Conference and asked them for their feedback on the tentatively agreed topics for the agenda.

- The Chairman informed about an upcoming change in the participation of the NCBs. The idea is that from 2007 onwards only 4 NCBs will participate on a rotating basis as full members of the MMCG.

- The next meeting will be on 20 September 2006 in Frankfurt from 16:00 to 19:00 CET.

  The following agenda items were tentatively agreed:

  - Regular review of recent market developments
  - An update on the eligibility of "credit claims" (previously indicated as "bank loans")
  - Initial assessment of the kick-off of the STEP initiative
  - Presentation of the prototype of the new webpage