
EURIBOR Money Market & Liquidity Working Group

Sept 27th 2007

FRANKFURT

SUMMARY MINUTES

1. Liquidity Risk Management for cross-border banking groups in the EU

Fatima Pires from the ECB's Directorate Financial Stability and Supervision gave a presentation on the ESCB's Banking and Supervision Committee's (BSC) report on *Liquidity Risk Management of Cross-border Banking Groups in the EU*. An abridged version of this report will be published as a special feature in the forthcoming "EU Banking Structures 2007" (scheduled for publication in the first week of October). She explained the scope of the analysis and the structure of the report and highlighted its main findings in five areas.

- *As regards regulatory framework*, despite fragmented, liquidity risk regulation is not perceived to impose undue restrictions. However, cross-border banks would like to see supervisors take a concerted approach within a banking group. Regulations pertaining to home/host arrangements for liquidity risk supervision and large exposures limits were mentioned by banks as creating potential obstacles to an efficient liquidity risk management.
- *As regards market developments*, the findings included 1) shortening of the time horizon for payment obligations: real-time world, 2) use of market-based and potentially more volatile funding sources, namely financial instruments with embedded liquidity risk and 3) increased need for high quality collateral, high concentration across funding instruments and in the interbank market. However, impact on financial stability was not deemed clear.
- *As regards pooling of liquidity and cross-border use of collateral*, it was found that high degree of interconnectivity between infrastructures permit better flow of liquidity and use of collateral across borders. But banks still identified obstacles: transaction costs, different time and currency zones, divergent standards to access central bank money (non-euro), non-connectivity of systems and legal issues. Recent initiatives by central banks recognized by industry (e.g. CCBM, SCP, Single list, T2 and T2S)
- *As regards internal organisation of liquidity risk management*, there was often direct involvement of Board of Directors in setting and monitoring limits and strategic guidance but choice between centralization/decentralization varies according to business model. Nevertheless, overall trend identified in past BSC surveys confirmed a)

centralization of liquidity management policies and procedures and b) decentralization of routine liquidity management.

- *As regards internal liquidity risk models*, there was a clear distinction between banks with sophisticated systems, which would like to use their internal models also for regulatory purposes and banks with less sophisticated systems which use, and intend to continue using, standard regulatory liquidity ratios also for internal management purposes. Though increasing, sophisticated internal liquidity risk models (e.g. LaR) are still not commonly used. There was also a wide range of diversity in methodologies and scenarios in stress-testing procedures.
- When looking ahead, two future issues were mentioned: 1) stress-testing techniques and contingency planning: review stress-testing techniques and contingency planning developed by cross-border banks and 2) liquidity risk in financial products: analysis of innovative financial instruments (including derivatives) used for funding and/or investment purposes.

In the ensuing discussion presenter mentioned that there is close co-operation between the ESCB's BSC, Committee of European Banking Supervisors (CEBS) and Basel Committee on Banking Supervision (BCBS). One member mentioned that more co-operation is needed on a global basis as market players are more global and the Institute of International Finance (IIF) Special Committee on Liquidity Risk principles could be used as a basis for global action. Another member thought that the banks' asset side should be looked more carefully and some kind of guidelines might be needed for pricing illiquid assets to prevent fire sales. This should include also modelling of embedded options. It was agreed that there is lacking transparency of conduit holdings in the market but a few members warned about too optimistic expectations of banks' benefiting from revealing their holdings; experience has shown that financial reporters easily either misunderstand or misread the information which might lead to the opposite impact than the one rationally expected. It was also mentioned that rating agencies have lost credibility and there is no longer confidence on even AAA holdings, which limits the value of transparency on the short term.

2. General discussion

a) Liquidity Management Principles by the IIF

A presentation was made on the basis of the report "Principles of Liquidity Risk Management" by the Institute of International Finance (IIF) recommendations on liquidity management in the light of current market crisis. This extensive report included several recommendations that should give guidance in a market environment that changed substantially over the past decade, with the following ones as an example highlighted to the members:

Recommendation 2: *Firms should distinguish between funding liquidity risk and market liquidity risk; The inability to monetize assets due to loss in market access or insufficient market*

depth; the inability to conduct business as a result of reduced secured- or unsecured-funding capacity and/or liquid assets. This is important starting point.

Recommendation 17: *Firms should have asset and funding diversification strategies. It was noted that even though this is a valid point, securitisation did not live up to the expectations in current crisis. This might happen to other assumptions too under different circumstances.*

Recommendation 26: *Firms should ensure that asset liquidity is assessed based on a demonstrated ability to obtain liquidity, and firms should only take credit for active and ongoing programs for sale, securitization, or secured borrowings. Stressed market situations should be considered; a wish that the recent market circumstances have clearly emphasised.*

In the ensuing discussion it was mentioned that the liquidity management principles by IIR could be used as a basis for more globalised approach. Some members mentioned that the use of different central banks' standing facilities has gained lot of negative publicity, even though this might not be intended by the central banks. Some mentioned the EUR 3.9 billion recourse to the ECB's marginal lending facility some day's earlier. However, most members noted that occasional recourses are quite common in the Eurosystem and do not, and neither should, gain much attention unless high recourse takes place on several consecutive days or it would occur just before the end of the maintenance period. The ECB observer confirmed that the marginal lending facility as well as deposit facility is there to be used at the initiative of any eligible counterparty with adequate eligible collateral at any point in time and for a duration (on a daily basis) which is entirely up to the relevant counterparty. Naturally, in order to be able to understand market and liquidity developments, the ECB is interested to know the reasons for the use of standing facilities, for example in order to prevent any manipulation attempts. But this is a standard monitoring practise that has been in place since the adoption of the euro.

b) Euribor fixings

A chart was shown about the spread between

a) 3 month Euribor and 3 month Eonia swap and

b) 5 year credit spread of financial companies, using iTraxx 5 year Financials index.

The former spread has risen and remained close to its peak levels but the latter has fallen back to about half of its widest level in late July. It was noted that if banks can transfer increased costs of their liabilities to asset side, rising rates do not pose a problem for them. Of course the transfer process takes some time. In general considerably more transparency is required before the situation in the money markets will normalise. Nevertheless, it seems that bond investors' appetite has remained quite high and one can place paper in good amounts quite easily if one is ready to pay the price.

As regards the Euribor fixings, members agreed that they are high but some questioned whether one can call them too high. They agreed that for some time there have been very little real money transactions behind longer-term Euribor rate fixings, which has also made individual Euribor contributions volatile. It was also noted that there does not seem to be available same type of history on individual bank contributions than what can be found on LIBOR rates. It was furthermore mentioned that no bank is willing to lend over the year-end even at current Euribor

rates, but on the other hand all assets are priced on Euribor curve. There seems to be inconsistency between high Euribor rates and reduced credit spreads; either one is too cheap or another too expensive. Finally, members foresee that banks have to start changing their credit pricing where margins have been driven too low due to intense competition. A change is occurring in retail credits but the process is slow. Some members called for closer integration between liquidity and credit management as credit risk is evident also in money market products.

3. Reports from other working groups

Derivatives Working Group

ACI STEP

Euribor Steering Committee

Thierry Cazaux informed the group that from Sept 17th, Godfried De Vidts from ICAP has become the President of the Euribor ACI Board, Andreas Hauschildt from Commerzbank its vice president, Thierry Cazaux its secretary and Paul Mercier from the ECB an observer. He thanks the ECB for its commitment within Euribor ACI.

Thierry also mentioned that the European Banking Federation (EBF) is negotiating to license the brand name EONIA/Euribor and that all other global indices have been licensed to trademarks, in order to receive a fee against its use by various user institutions. The principals that might be set up are those of a free use for all information purposes (giving the index itself) and a license for all commercialized products using the names EONIA/EURIBOR. EBF is the legal owner of the EONIA and Euribor trademarks so it has the full legal right to negotiate such an agreement, but has engaged the negotiations in cooperation with Euribor ACI. Regarding the EONIA, the opinion of the ECB has been asked.