Operational framework review – Part 2

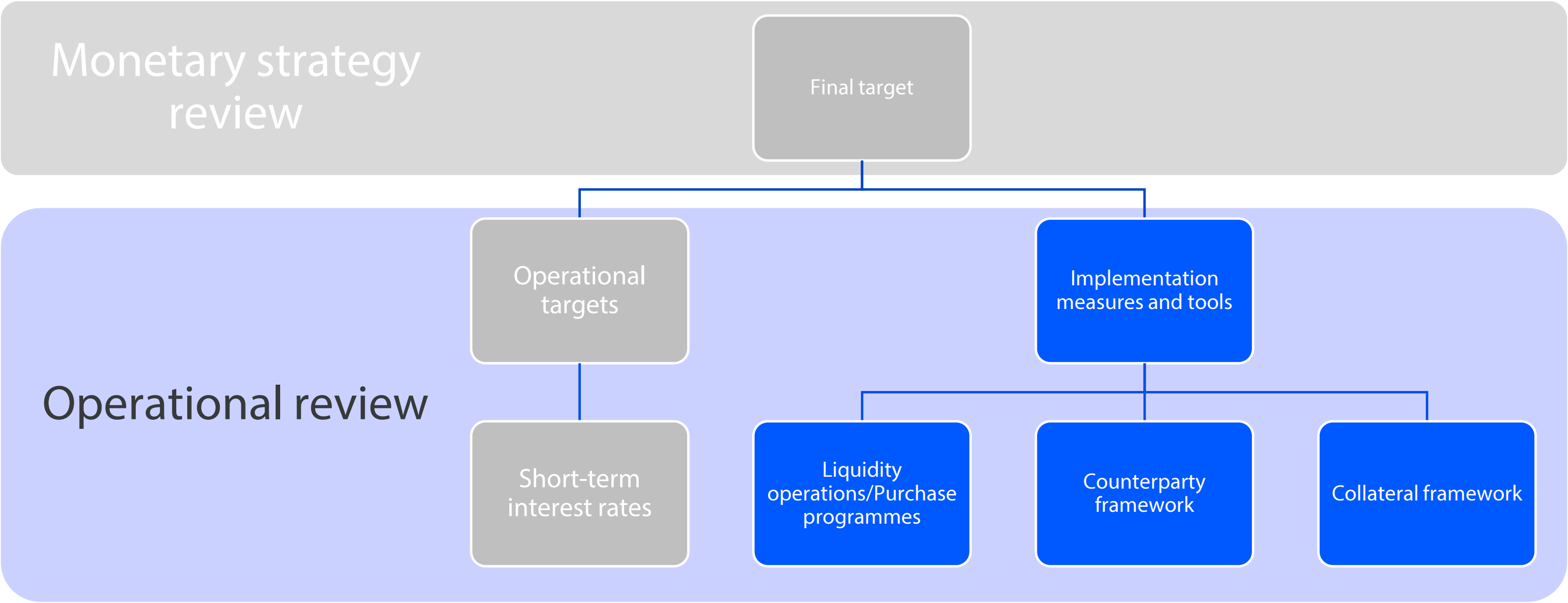
ECB MONEY MARKET CONTACT GROUP

Tuesday, December 5th 2023

de coöperatieve Rabobank

ECB framework review

High-level overview



Rabobank

The role of the ECB has changed

2010 marks a turning point

Pre-2010

- **Before the crisis mainly keeping inflation on target by setting short-term rates**
- ECB protects itself by dealing with financially sound banks, asking them to post "adequate collateral".
- Key concerns:
  a) Assets safe enough,
  b) Limiting impact of rules and other choices on market prices.
- Price of risk dictated by market-based price discovery
- Assumptions carried over to Single List (2006) from two-tier system (1998)
- Risk management strategy mainly rests on private credit ratings (External credit assessment institutions (ECAIs)) and standard practices at the time, including assumption of markets functioning efficiently

After 2010

- Risk management strategy strongly impacted by euro area crisis
  a) Asymmetric impact led to introduction of ACCs for country specific requirements and lower standards
  b) Purchase programmes APP (CSPP, PSPP, ABSPP, CBPP1,2,3) and PEPP, new both in size and type of risk
  c) Pro-cyclicality elements in Single list causing financial instability (e.g. collateral eligibility and haircuts function of ECAF (Eurosystem credit assessment framework) requirements meant downgrades can restrict volume of credit available to banks)
- Design ignoring environmental impact until recently led to carbon-intensive footprint
- **ECB is a major actor in the financial markets, its footprint is not neutral**

Source: The New European Central bank: Taking stock and Looking Ahead

Rabobank

Possible changes to the collateral framework

Risk Management strategy needs to be adapted to better support financial stability and environmental sustainability

Risk management strategy to support financial stability and environmental sustainability

- Neutrality principle may lead to suboptimal resource allocations with efficiency principle. (e.g. Nicholas Stern described climate change as "the greatest market failure the world has ever seen.")
- Speech Mme Schnabel "to position ECB as a catalyst and thought leader to an orderly transition to a green economy (...) Include innovative financial products as eligible collateral

Possible risk Management strategy adaptations

- Enhance principles linking policy objectives and risk management to achieve greater transparency on decisions (e.g. waivers on minimum credit ratings)
- Adopt an attentive/vigilant attitude to climate-change related risks and to pro-cyclical market practices. (e.g. (e.g. Impact of ECB eligibility on a firm's leverage and default risk). Risk equivalent treatment across asset classes is (only) a guiding rule.
- Enhance internal credit rating framework to better assess impact of credit ratings used in its operations and potentially decrease reliance on private credit ratings
- Target greater uniformity across Eurosystem

Sources: The New European Central bank: Taking stock and Looking Ahead
https://blogs.worldbank.org/allaboutfinance/how-do-central-bank-collateral-frameworks-affect-non-financial-firms

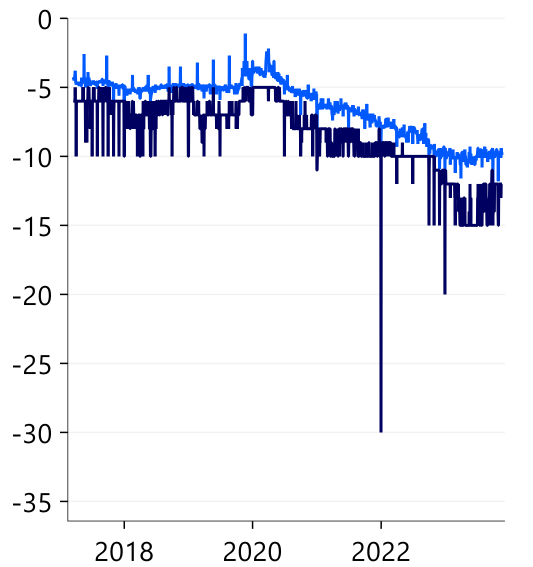
Possible change to the counterparty framework

A new reverse repo facility for NBFIs and governments to place excess cash addressing the “leaky” floor and potential spread volatility?

Current Securities Lending Facility rules

- Originally Designed to access specific collateral
- Eligible counterparties are Primary Dealers and market-making institutions
- Borrowing limits per individual counterpart
- Tickets split in 50M size
- Max of 200M per issue capped at 2.5% of total amount outstanding on issue
- Counterparty limit may be reviewed

The floor leaks – 25th percentile not worsening yet



A new reverse repo facility

- Legally challenging but not insurmountable
- Eligible counterparts would be NBFIs and governments
- Pricing must be tailored to maintain level playing field with MFIs- lower than DFR, punitive enough to act as backstop (e.g. DFR -25bp?)
- Aggregate limit to guard against disintermediation of the banking sector
- ECB to issue short-term bills to avoid limitations of Securities Lending Facility

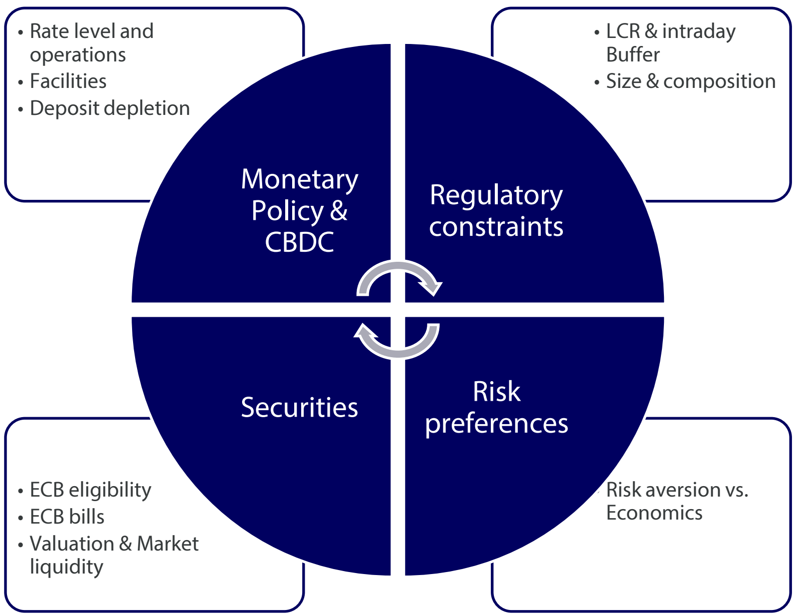
Source: RaboResearch

Rabobank

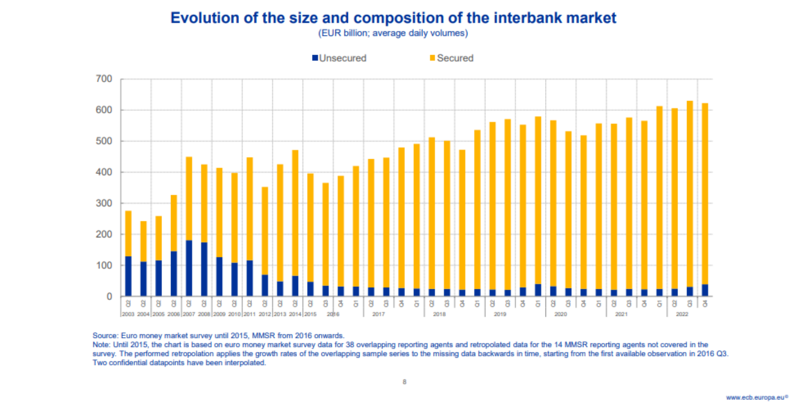
Steering short-term money market rates

Two key changes

The reserve demand function is more complex



Unsecured Interbank market is a shadow of its former self



Rabobank

Steering short-term money market rates: supply vs. demand

A different effectiveness for the Eurosystem? Relevance of MRRs questioned in both.

Supply-driven: the danger of hitting the kink

- The key hurdle is the uncertainty around the reserve demand curve
- Requires a significant structural bond portfolio which
  a) May adversely affect monetary policy transmission and volatility of secured rates through collateral scarcity
  b) Keeps ECB's balance sheet inflated in size, costs, and risks. This can lead to unexpected P&L efficiency measures which in turn impact financial markets (e.g. MRRs)
- Convenience of holding reserves relative to securities (e.g. valuation, market liquidity, credit risk) creates uncertainty as risk preference may change
- Reserves in Eurosystem are fragmented. Impact on demand curve is unclear.
- Introduction of CBDC may lead to deposit depletion and increased uncertainty on reserve demand
- Are MRRs still relevant as a monetary policy transmission tool?

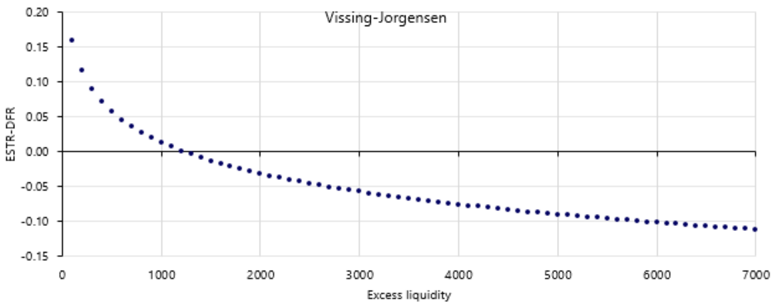
Demand-driven: beware of the stigma

- The key hurdle is that accessing the operation should have no stigma
- The pricing should be attractive in an environment with short-term rates trading near DFR, and communication should aim to minimise stigma
- The tenor of operations should be short-dated to cater for liquidity needs and retain existing longer-dated operations
- In that context, the refinancing operations
  a) Allow for a small(er) structural bond portfolio
  b) Support better allocation of reserves across institutions and jurisdictions than a structural bond portfolio alone (P. Lane)
- The smaller footprint has less impact on secured rates monetary policy transmission and volatility
- Are MRRs still relevant as a monetary policy transmission tool?

Volatility in short-term money market rates

Under which conditions with what tolerance?

- The supply-driven framework may be more prone to bouts of volatility events due to the complexity of the demand curve (e.g. change in bank's preferences, CBDC adoption)
  a) The impact could be on the upside as well as the downside, albeit more limited
  b) It could affect both unsecured and secured markets
  c) Tolerance between MLF rate and reverse repo facility rate for unsecured
  d) Secured more complicated due to diversity of collateral
- The demand-driven framework may be less prone to such bouts of volatility but may worsen lack of liquidity in unsecured markets, notably the interbank market



Looking at the fit above one could question the plausibility of such a low spread as excess liquidity dries up. Additionally, the relationship between the reduction in excess liquidity and the reduction in deposits is unclear. i.e. How much QE supported lending drives the assumptions on deposit reduction.

Sampling goes back to 2013 , which captures a low level of excess liquidity but cannot account for change in regulatory drivers of reserve demand, e.g. LCR

Source: RaboResearch

Rabobank