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EUROSYSTEM COLLATERAL POLICY AND FRAMEWORK: WAS IT UNDULY CHANGED?

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Highlights

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GUNTRAM B. WOLFF, NOVEMBER 2014

EXECUTIVE SUMMARY

All Eurosystem credit operations, including the important open market operations, need to be based on adequate collateral. This means that when extending loans, the central bank requires collateral (assets pledged as security) to protect its balance sheet against the risk of default by the borrower (credit risk). The collateral is accepted at market price subject to a haircut. The haircut is applied to insure against liquidity risk and downward changes in the prices of the collateral.

The Eurosystem adopted its collateral framework during the crisis to accept lower-rated assets as collateral. The adaptation of the collateral framework was necessary to provide sufficient liquidity to banks in the euro-area periphery in particular, but also to some banks in the core. More than 80 percent of European Central Bank liquidity (Main Refinancing Operations, MRO, and Long Term Refinancing Operations, LTRO) is provided to five countries (Greece, Ireland, Italy, Portugal and Spain). Haircuts were increased to insure against the greater liquidity risk and greater price volatility of lower-rated assets. In crisis countries, special emergency liquidity assistance (ELA) was provided. ELA is provided by national central banks with the approval of the ECB governing council against collateral that does not meet the ECB's collateral standard. Potential losses from ELA operations would be borne by the national central bank.

In general, any collateral framework has an impact on prices and allocations. The ECB's framework aims to minimise this impact by taking collateral at market prices. Nevertheless, prior to the crisis, the ECB's collateral framework was criticised as reducing liquidity risk premia and thereby contributing to the insufficient differentiation of sov-

1. According to the 'Guideline of the ECB of 20 September 2011 on monetary policy instruments and procedures of the Eurosystem', all Eurosystem credit operations (ie liquidity-providing monetary policy operations and intraday credit) have to be based on adequate collateral. Liquidity-providing monetary policy operations include the Main Refinancing Operations and the Long-Term Refinancing Operations. The Eurosystem has developed a single framework for eligible collateral common to all Eurosystem credit operations (also referred to as the 'Single List').

tion of the ECB balance sheet. The main driver of changes in the size of the balance sheet are liquidity operations, for which collateral is needed.

The definition of what is eligible as collateral is therefore of central importance for the implementation of monetary policy in the euro area. The Eurosystem introduced a single list of eligible collateral in January 2007[2]. A collateral framework is based on a number of central considerations. Its central aim is to protect the balance sheet of the ECB and thereby its shareholders and ultimately taxpayers against undue risks. In the liquidity operations, the counterpart to the ECB is the bank that receives liquidity. The bank is required to return the liquidity after a certain period to the ECB, at which point it will recover the collateral. Only when the bank is unable to re-pay the liquidity it previously received, can the ECB use the collateral to prevent a loss. The value of the collateral should therefore reflect the amount of liquidity given to the bank. The aim of the collateral framework is to define a framework that provides the Eurosystem with adequate protection against losses, while defining enough eligible collateral so that solvent banks can access enough central bank liquidity. The framework is defined in the document 'The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures'[3] and subsequent updates.

Adequate access to ECB liquidity is of vital importance for banks and for the implementation of monetary policy. Banks need access to central bank liquidity for their daily operations. In particular, when interbank markets are under stress, the banking system relies heavily on central bank liquidity. The way the ECB regulates the access to central bank liquidity is, in turn, a central part of monetary policy. The collateral framework plays an important role in this regard.

The Eurosystem's collateral framework is from time to time subject to political and academic criticism. Buiter and Sibert (2004) were perhaps

2. Before that date, the collateral framework was divided into two tiers. The first tier consisted of marketable debt instruments that have uniform eligibility criteria for the euro-area countries set by the ECB. Tier 2 consisted of assets that were of particular importance for national financial markets. The eligibility criteria were set by the national central banks. In January 2007, the Eurosystem moved to a single collateral list. German banks were keen to include bank loans in the definition of collateral. See Bundesbank, *Monthly Bulletin*, April 2006
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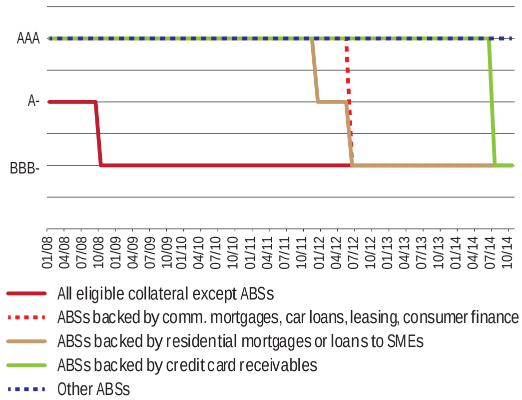
importance for national

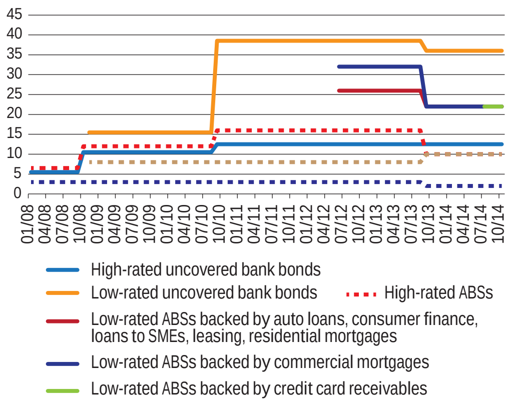
be subject to a minimal haircut of 1.5-2.5%. Government debt rated between BBB* and BBB-, in contrast, would be subject to a haircut of 9-10%. During the crisis, the Eurosystem substantially adapted its collateral framework to ensure adequate access to liquidity. The ECB had to adapt the collateral standards in order to be able to provide sufficient liquidity to banks that were experienc-

    - All ABS: credit rating threshold at AAA
- 22 October 2008: credit rating threshold of all eligible collateral except ABS lowered to BBB- as a temporary measure. It was decided on 8 April 2008 that this measure was to be made permanent (ECB/2011/14).
- 8 December 2011: credit threshold of ABS based on either only residential mortgages or only loans to SMEs reduced to A- at issuance and at any time subsequently (ECB/2011/25).
- 20 June 2012: credit threshold of ABS based on auto loans, leasing, commercial mortgages, consumer finance, residential mortgages or loans to SMEs reduced to BBB- at issuance and at any time subsequently.
- 9 July 2014: credit threshold of ABS based on auto loans, leasing, commercial mortgages, consumer finance, residential mortgages, loans to SMEs or credit card receivables reduced to BBB- at issuance and at any time subsequently (ECB/2014/31).

Figure 2: Credit rating thresholds of the ECB's collateral framework



Source: Bruegel based on European Central Bank. Note: Credit ratings following Fitch and Standard and Poor's rating system.



The ECB significantly changed the haircuts it applies to several types of collateral. Figure 3 shows the changes in the haircut for a number of marketable assets. The haircuts for high rated uncovered bank bonds (with 5-7 year residual maturity) and ABS were increased by about 150 percent to 12.5 percent and 16 percent respectively in September 2010. As already mentioned, the credit threshold of all eligible collateral except ABS was lowered to BBB- in 2008, conditional on an additional 5 percent haircut. Certain types of low-rated ABS became eligible as collateral only in 2012 or later. With the recent improvement in market sentiment, the size of the haircuts applied to uncovered bank bonds, high-rated ABS and some types of low-rated ABS was reduced again.

For government bonds, the Eurosystem modified the applied haircuts only slightly. At the start of the crisis only high-rated government debt instruments were accepted as collateral (remember that the minimum threshold on all marketable assets except ABS was A-). These were given a valuation haircut of 3 percent for assets with a 5-7 year residual maturity. When lower-rated government bonds became eligible, it was at an additional 5 percent haircut, at 8 percent. These haircuts remained constant until September 2013 when the haircuts of high-rated and lower-rated government bonds were changed to 2 percent and 10 percent respectively. However, for crisis countries, the ECB changed its collateral framework a number of times to allow government debt to become acceptable as collateral again. Greek government bonds became eligible despite being below the BBB- minimum rating subject to a special haircut in December 2012[4]. In May 2013, a

4. In the case of Greece, Greek government bonds were falling below the rating threshold necessary to be accepted as collateral. The ECB therefore announced a change to the eligibility criteria for Greek government debt specifically and applied a special haircut on 19 December 2012. See http://www.ecb.europa.eu/press/pr/date/2012/html/pr121219.en.html.

instruments and procedures of the Eurosystem (recast)' (ECB/2011/14)

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Table A1: The ECB's liquidity categories (1)