



COLLATERAL EASING WITH DISCIPLINARY DYSFUNCTION?

On the Limitations of the ECB's Covid-19 Response



Summary

The COVID19 crisis caused stress in European sovereign debt markets. The potential impact on euro resilience of rapidly increasing spreads on Italian government bonds gave rise to particular concern.

The ECB's response – ranging from the Pandemic Emergency Purchases Programme (PEPP) to several rounds of easing of its collateral policy – has been praised for quickly stabilizing government bond markets and ameliorating euro resilience concerns.

But it may not last. As has often before been the case, the ECB's crisis response seeks to strike a balance between liquidity provision and risk control, but measures launched in the name of the latter threatens to undermine the former.

From a financial stability perspective, it would be commendable if the ECB temporarily suspended key elements of its margining practices in credit operations, notably its practices of haircut differentiation and daily margin calls.

About the authors:

Jakob Vestergaard

Associate Professor, Roskilde University

Daniela Gabor

Professor of Economics and Macro-Finance,
University of the West of England - Bristol

In partnership with:



Roskilde University



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Jakob Vestergaard
Roskilde University

Daniela Gabor
University of the West of England – Bristol

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1. INTRODUCTION

“Extraordinary times require extraordinary action”, said Christine Lagarde, president of the European Central Bank (ECB), in a tweet on 18 March, when the ECB launched its Pandemic Emergency Purchases Programme (PEPP). “There are no limits to our commitment to the euro”, she continued; We are determined to use the full potential of our tools, within our mandate” (Lagarde 2020).

Although the PEPP drew more newspaper headlines, the ECB’s easing of its collateral policy was a crucial part of its response to the COVID-19 crisis. In two successive steps, the ECB loosened the terms by which it lends money to banks. On April 7, the ECB decided to reduce its haircuts by 20%, thereby substantially increasing the liquidity banks can mobilize for a given amount of collateral. And on April 22, the ECB’s collateral policy was eased further by its decision to lower the credit rating threshold for asset eligibility in ECB credit operations by two notches, from BBB- to B-.

It was largely unnoticed, however, that the lowering of the credit rating threshold was accompanied by rather high haircuts for assets in the lower-quality range (from B- to BB+). At first glance, this is hardly surprising: higher haircuts for higher risks is a core principle of ECB collateral policy. The trouble is that any asset that is downgraded below BBB- will face a drastic jump in haircuts, as we demonstrate below, which could trigger a negative collateral valuation spiral.

If such a scenario were to inflict Italian government bonds the consequences would be dire. It would put pressure on the ECB to further step up its purchases of Italian government bonds through the PEPP to prevent spreads from rising anew – at a time where such asymmetric government bond purchases are more controversial than ever (Wolf 2020).

We argue that the ECB’s insistence on and reinforcement of disciplinary differentiation of haircuts – by which high quality assets are rewarded and low-quality assets punished – risk jeopardizing its crisis response and success in stabilizing collateral markets. From a financial stability perspective, it would be commendable if the ECB temporarily suspended key elements of its margining practices in credit operations.

This would entail, notably, a suspension of haircut differentiation for government bonds rated lower than A- (i.e. in credit quality categories 3, 4 and 5), to neutralize what could otherwise easily become a trigger for collateral valuation spirals for stressed assets. Beyond that, it would be advisable to suspend margin calls on government bond collateral for much the same reason.

These measures could easily be adopted on a temporary basis, expiring by September 2021, as is the case with other COVID19 crisis measures launched by the ECB. Only if the ECB’s collateral easing strategy is modified in these essential ways, can it be expected to be robustly countercyclical in its effects?

After a brief primer on collateral policy, we depict the main features of the two collateral easing packages launched by the ECB in recent weeks (section 3). This is followed by a discussion of what we see as the Achilles heel of the ECB’s crisis response: its differentiated, disciplinary haircuts (section 4). We reflect on the curious disposition of central bankers to readily acknowledge the countercyclical role of collateral eligibility expansions but ignore the procyclical role of disciplinary haircuts and margin calls (section 5). We conclude by offering suggestions for what would constitute a robustly countercyclical collateral policy regime going forward (section 6).



2. A PRIMER ON COLLATERAL POLICY

Central banking is widely seen as first and foremost a matter of using central bank lending rates to achieve monetary policy goals. But central banks do not merely lend at a cost, as defined by the interest charged in their credit operations. Central banks lend against collateral. Lending by central banks is secured lending, in the sense that borrowers of central bank money pledge assets to access funding.

The terms, rules and conditions by which central banks accept various assets as collateral against their lending are highly pertinent to issues of financial stability. Yet the collateral policies of central banks are often afforded scarcely.

The use of assets to secure lending is not a recent invention, however. Pawnbroker practices in Ancient Greece, for instance, was an early form of secured lending where the borrower posted collateral with the pawnbroker to access a loan. In contemporary peer-to-peer (P2P) lending practices, it remains commonplace that the borrower pledges an asset to access a loan. The kinds of assets that can be used as collateral in such borrowing is broader than most would think.

In China, a new form of P2P lending has emerged, based on “nude selfies”. Having received the photos as collateral for a loan, the lender ensured swift repayment by threatening the photographs would otherwise be shared with family and friends, personal details of which the borrower had submitted when accessing the loan. Interest rates were reported to be 30 % for one-week loans, targeting women with difficulties accessing loans in other ways.

This admittedly exotic example serves to illustrate two important points. First, in secured lending, collateral is whatever asset the lender accepts to secure the loan. Second, what is accepted as collateral is by no means

constant or carved in stone but varies significantly over time.

These principles hold even for central banks, although often considered amongst the most conservative of our institutions. What the European Central Bank (ECB) accepted as collateral in its credit operations after the financial crisis, for instance, was quite different from what it accepted as collateral in those same operations before the crisis.

The ECB’s decisions on what collateral to accept from banks that access central bank money are political decisions. In times where money and credit markets are liquid and well-functioning, central banks usually take a conservative approach, accepting only high-quality assets as collateral. In periods of market stress, on the other hand, the central bank is in a more difficult position.

To live up to its (explicit or implicit) mandate of preserving financial stability, it must accept a wider range of assets as collateral eligible for its open market operations with banks. At the same time, however, the quality of the assets that ends up on its own balance sheet, and the risks it exposes itself and taxpayers to, may potentially become causes for concern. More will be said later in this paper about what is seemingly a difficult balancing task for central banks in periods of market stress.

A central banks’ collateral framework defines the terms and conditions of its credit operations with banks. Overall, three core factors define the contours of central bank collateral policies (BIS 2015). First, eligibility criteria set out what assets are eligible as collateral when banks seek access to central bank money; second, haircuts determine how much central bank money a bank will receive (in percentage of the market value of the collateral) for different types of eligible collateral and, third, stipulations on counterparty access define what types of



financial institutions the central bank is willing to provide lending to.¹

The haircut denotes the difference between the market value of the collateral a bank pledges to the central bank, and the loan that the central bank will give in exchange.² Haircuts for the highest quality collateral are as low as 0,5 %, reflecting that for some types of collateral the credit, market and liquidity risk associated with the asset is considered to be almost non-existing.³ For most central banks, this applies to government bonds and central bank bills, which are considered the safest forms of assets because bond-issuing governments have recourse to the tax collection capacities of the state and central banks to the issuance of money.

The haircut can be seen as the central banks' insurance against market and liquidity risk; should the borrower be unable to pay back the loan, the central bank can avoid a net loss even if it has to sell the collateral at price below the original market value:

Central banks need to be sure that the money they lend will be paid back. Of course, the first line of defense is the agreement with the borrower regarding repayment. But if the borrower fails to repay the loan, the central bank will sell the collateral. It, therefore, needs to be sure that it will be able to sell the collateral at a price that will cover the amount of the loan. But assets can go up and down in value and central banks may need some time to sell specific assets. A haircut, therefore,

provides a kind of safety buffer against any loss in value and the time it takes to sell the collateral (ECB 2016b).

Generally, haircuts are higher the less liquid the asset and the lower its credit quality. In this sense, haircuts are first and foremost a risk management technique on the part of central banks. But since the global financial crisis, it has become apparent that haircuts – and the changes central banks make to them in responding to financial crises – have important implications for market liquidity (Gabor and Ban, 2016; Chapman et al, 2011). For most central banks, however, “the main driver of their haircut policy is risk management, and not the broader goal of providing liquidity to the market” (BIS 2015: 24).

The choices a central bank makes on eligibility, haircuts and counterparty access is what defines its collateral framework – and for each dimension there is significant variation across central banks (BIS 2014). The collateral framework of the ECB is generally seen to accept a broad range of collateral and have a comparatively large number of counterparties in its credit operations. These features are closely linked, of course, to the institutional specifics of the European monetary union and the process towards merging the practices and policies of a large number of national central banks into a single, unified collateral framework prior to the establishment of the euro (Galvenius and Mercier, 2011).

¹ The range of banks and other financial institutions that have counterparty access differ across central banks. Counterparty access policy can potentially become a tool for central banks tackling financial distress, by expanding the set of counterparties that have access to central bank liquidity. Such moves in counterparty access policy will often lead central banks to also “broaden the range of eligible assets in order to be able to provide meaningful liquidity provision to new counterparties, which are often smaller institutions with limited holdings of high-quality and liquid collateral” (BIS 2015: 29).

² The term haircut has several meanings in finance, including that of a signifier for the loss of value that a

creditor takes through a debt restructuring exercise. But there is no clear etymology for the use of the word. The first uses in finance appear to date back to the 1880s. Some speculate that the loss one takes relative to market value – whether on a debt restructured or a collateral pledged – is described as a ‘haircut’ to indicate a loss of power and prestige, and ultimately (if the haircut is very large) as a shorthand for being (financially) beheaded.

³ Other assets face much higher haircuts. For instance, if a bank pledges asset-backed securities as collateral to access central bank money, they can easily face a haircut of 20 or 50 %, depending on the residual maturity of the asset and other key risk factors.



3. THE ECB'S COLLATERAL EASING STRATEGY

The ECB first responded to the COVID-19 crisis by pledging to ensure the provision of liquidity for credit institutions as well as by stepping up its asset purchases. On 12 March, it was decided to expand its existing Asset Purchase Program. But less than a week later, on 18 March, the ECB launched a new programme of emergency asset purchased, the Pandemic Emergency Purchase Programme (ECB 2020f):

Taking into account the exceptional economic and financial circumstances associated with the spread of coronavirus disease... [the ECB launches] a new temporary pandemic emergency purchase programme (PEPP)... The PEPP is established in response to a specific, extraordinary and acute economic crisis, which could jeopardise the objective of price stability and the proper functioning of the monetary policy transmission mechanism" (ECB 2020f).

At first, 750 billion euros were dedicated to these emergency asset purchases, which the ECB envisaged undertaking at least until the end of 2020, but in early June the programme was enhanced by a further 600 billion euros, reaching a total of 1350 euros, and the envisaged duration of asset purchases was extended to September 2021 (ECB 2020g).

The ECB undertook a range of other initiatives to counter disinflationary pressures, to stimulate lending, and to avert stress in government bond markets, ranging from an expansion of its long-term refinancing operations to an easing of its collateral policies. We now turn to the latter, which came in two rounds.⁴

The first collateral easing package

On 7 April, a few weeks after the announcement of the Pandemic Emergency

Purchases Programme (PEPP), the ECB announced an "unprecedented set of collateral measures to mitigate the tightening of financial conditions across the euro area" (ECB 2020a). It was stressed that the package of collateral easing measures was to be seen as "complementary" to other measures, including not least the PEPP. The collateral easing measures aimed at supporting the provision of bank lending "especially by easing the conditions at which credit claims are accepted as collateral" (ibid.).

In the legislative text released the same day, it was stressed that the steps taken were intended to "facilitate Eurosystem counterparties in maintaining sufficient eligible collateral in order to be able to participate in all liquidity-providing operations" (ECB 2020b). "These measures are proportionate to counter the serious risks to price stability, the monetary policy transmission mechanism and the economic outlook for the euro area posed by the outbreak and escalating diffusion of COVID-19", the legal justification elaborated (ibid.).

The 7 April collateral easing package consisted of three main measures:

- An easing of the conditions for the use of credit claims as collateral
- A general reduction of collateral valuation haircuts
- Waiver to accept Greek sovereign debt instruments as collateral

In the following, we focus on the second of these measures; the uniform reduction of collateral valuation haircuts on all assets eligible in ECB credit operations. This was, in our view, the most striking of the measure adopted by the Governing Council.

The decision was accompanied by an explicitly stated "willingness to take on risks to support the provision of credit via its refinancing

⁴ Other measures included temporarily relaxed capital requirements and international swap lines. For an overview, see Bels et al (2020). For a discussion of

international swap lines, see Gabor (2020). For more on the ECB's monetary policy strategy in response to the pandemic, see Lane (2020a, 2020b).



operations” (ECB 2020b). This was remarkable, even if although the temporary nature of the measures was stressed.

In concrete terms, the ECB decided to reduce the valuation haircuts applied to collateral “by

a fixed factor” (ibid.), more specifically by 20 %. The details of these changes can be seen in table 1, for two of the liquidity categories of eligible assets in ECB credit operations (LC1 and LC4); government bonds and unsecured credit.

Table 1 - Haircuts before and after the first collateral easing measures

		Government bonds (LC1)		Unsecured debt instruments (LC4)	
		Before	After	Before	After
CQ1+2	RM, 0-1	0,5	0,4	6,5	6
	RM, 1-3	2	1,6	9	8,4
	RM, 3-5	2,5	2	11,5	10,8
	RM, 5-7	3	2,4	13,3	12,4
	RM, 7-10	4	3,2	15,5	14,4
	RM,10+	7	5,6	22,5	20,4
CQ3	RM, 0-1	6	4,8	13	10,4
	RM, 1-3	8	6,4	26,5	20
	RM, 3-5	10	8	36,5	26
	RM, 5-7	11,5	9,2	40	28
	RM, 7-10	13	10,4	42,5	29,6
	RM,10+	16	12,8	44	30,4

Note: All haircuts are zero coupon haircuts: RM= residual maturities. CQ= Credit quality
Sources: ECB (2020b), ECB (2016a)

The haircut schedule consists of granular data, with a three-fold differentiation. In addition to the differentiation of assets according to their degree of liquidity, haircuts are differentiated relative to the credit quality of the assets pledged, as well as relative to their residual maturities.

For now, it will suffice to note that the haircut reductions are indeed uniform, to a large extent. Most reductions are at a scale of 20 %. The initial levels of the haircuts, as well as the changes made in the first package of collateral easing measures, will be subject to further analysis once we’ve discussed both rounds of collateral easing in some detail.

The press release of the first round of collateral easing measures concluded with a suggestion that further measures could well be on their way. The Governing Council has mandated the Eurosystem committees to assess, it said, “measures to temporarily mitigate the effect on counterparties’ collateral availability from rating downgrades arising from the economic impact of coronavirus” such that collateral adequacy was continuously ensured (ECB 2020a). And indeed, only two weeks later, a second collateral easing package was announced.



The second collateral easing package

The second package of collateral easing measures, announced on 22 April, was as comprehensive as the first. Most notably, the credit rating threshold for asset eligibility was lowered in an unprecedented manner. The overall aim of the new collateral easing measures was to mitigate “the adverse impact on Eurosystem collateral availability of potential rating downgrades resulting from the economic fallout of the COVID-19 outbreak” (ECB 2020c). In combination with the 7 April measures, the new measures aimed at “ensuring that Eurosystem counterparties remain able to maintain and mobilize sufficient collateral in order to be able to participate in Eurosystem liquidity-providing operations” (ibid.). The ability of banks to participate in credit operations with the ECB was seen as crucial for their ability to provide credit to the euro area economy. At the core of the new initiative was, therefore, a substantial expansion of the range of assets that would be eligible in ECB credit operations.

“The governing Council considers that the Eurosystem may temporarily continue to admit as collateral marketable assets and the issuers of these assets that fulfilled minimum credit

quality requirements on 7 April 2020”, the ECB explained, “notwithstanding a deterioration in the credit ratings decided by the credit rating agencies..., as long as the ratings remain above a certain quality level” (ECB 2020c).

Before the ECB’s 22 April decision, the threshold for asset eligibility had been an investment grade credit rating; a rating no lower than BBB-. In the new asset eligibility regime, assets with a rating lower than BBB- would be accepted in ECB credit operations on two conditions:

- that the assets had at least a BBB- credit rating on 7 April, and
- that its credit rating dropped no further than to remain above CCC level.

In terms of the Eurosystem’s harmonized scale, this meant that assets that were downgraded below the BBB- threshold (i.e. below credit quality category 3) as a consequence of the COVID-19 crisis, would remain eligible as long as they did not sink all the way to credit quality category 6. It was only assets that had been rated in credit quality category 3 by 7 April, in other words, that would maintain their eligibility even if downgraded one or two notches in the EU’s harmonized rating scale.

Table 2 - Credit quality categories and credit ratings

	Fitch and S&P	Moody's	DBRS
CQ1	AAA to AA-	Aaa to Aa3	AAA to AAL
CQ2	A+ to A-	A1 to A3	AH to AL
CQ3	BBB+ to BBB-	Baa1 to Baa3	BBBH to BBBL
CQ4	BB+ to BB-	Ba1 to Ba3	BBH to BBL
CQ5	B+ to B-	B1 to B3	BH to BL
CQ6	CCC+ and below	Caa1 and below	CCC+ and below



The press release announcing the second package of collateral easing measures ended, true to the emerging genre, with a paragraph alerting observers to the fact that further measures might well be taken; “the ECB may decide, if and when necessary, to take additional measures to further mitigate the impact of rating downgrades, particularly with a view to ensuring the smooth transmission of its monetary policy in all jurisdictions of the euro area” (ECB 2020d).

The official framing of the new measures

Luis de Guindos, Vice-President of the ECB, and Isabel Schnabel, member of the Executive Board of the ECB, provided the official rationale of the second round of collateral easing measures (de Guindos and Schnabel 2020). They articulated the main measures and objectives of the ECB’s new collateral easing strategy, seen together. Overall, they stated three primary objectives:

- Avoiding a shortage of eligible collateral
- Enabling flexibility in risk management practices at the level of national central banks (NCBs)
- Countering adverse procyclical feedback effects resulting from reduced collateral availability

It is worth stressing that de Guindos and Schnabel label the latter as the more important of the three. In their own phrasing:

The economic shock from the COVID-19 crisis is amplified through its adverse effect on the value of banks’ collateral. As asset valuations drop and ratings are downgraded across economic sectors, the resulting drop in eligible collateral may cause banks to further tighten their credit supply to the real economy. By acting swiftly, the Eurosystem can interrupt such procyclical feedback loops before they

impair funding conditions (De Guindos and Schnabel 2020).

The three overall objectives stated above are obviously intimately related, but the particularities of the framing are striking, nevertheless. The priority given to the countercyclical objective is in fact compromised in the same sentence the objective is stated:

[M]ost importantly, the measures *counter adverse procyclical feedback effects* that could emerge due to reduced collateral availability, while containing the build-up of additional risk on our balance sheet” (de Guindos and Schnabel 2020, emphasis in original).

And later in their account, De Guindos and Schnabel return to this reservation. “[F]rom a risk management perspective”, they say, collateral easing initiatives come “at the cost of additional risk on the Eurosystem’s balance sheet” (ibid.). However, “by easing collateral rules in a targeted fashion”, the ECB has taken this “trade-off into account” (ibid.).

We shall soon discuss in more detail what De Guindos and Schnabel have in mind with their notion of collateral rules that are eased in a “targeted way”. But first, it is important to note that it is a standard trope in European central banking that efforts to address market liquidity crises must always and everywhere be accompanied by strict measures to protect central bank balance sheets, even if those measures are mainly symbolical and often self-defeating.⁵

De Guindos and Schnabel stress that the collateral easing measures are ultimately directed at ensuring that banks have sufficient amounts of eligible collateral at their disposal, so that they can fulfil their crucial role of lending to the real economy. They note that

⁵ It is beyond the scope of the current Policy Paper to further substantiate this point. For more depth, see Vestergaard and Gabor (2020).



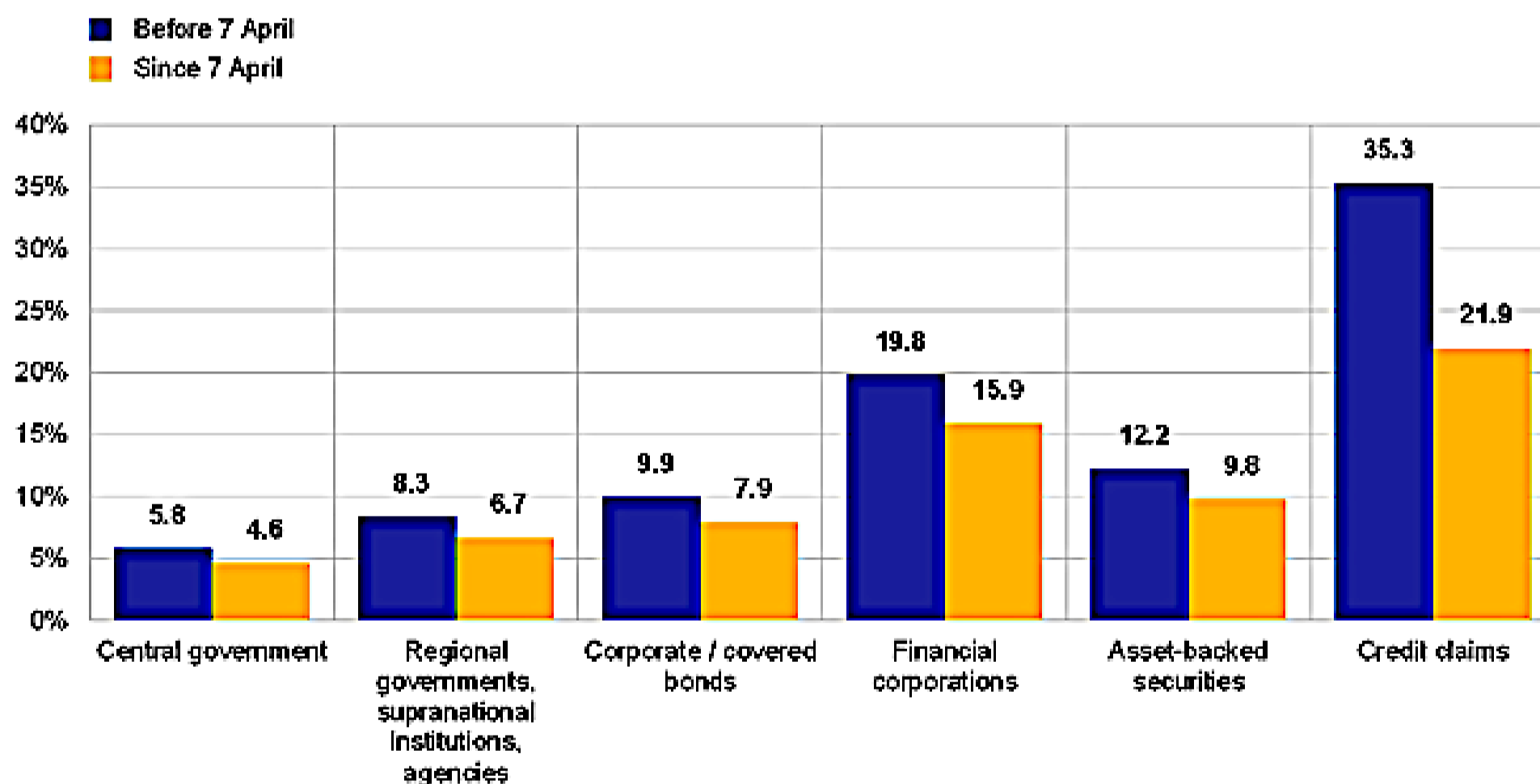
falling asset prices during the COVID-19 crisis have “already put pressure on the availability of collateral” (ibid.). In this context, the prospect of potential rating downgrades is troubling, because it would cause these pressures to increase “markedly”:

As the value of eligible collateral falls, banks see their potential access to central bank liquidity reduced. In the absence of central bank intervention, banks would likely react by reducing their lending activity, which could eventually cause the crisis to become self-reinforcing. A central objective of our collateral easing packages is to prevent such procyclical feedback loops in order to safeguard and restore favourable lending conditions for the real economy (de Guindos and Schnabel 2020).

The ECB’s main objective is to provide assurance that banks will have enough eligible collateral to be able to access the central bank liquidity that is a core condition of possibility of bank lending to firms and households. The collateral easing packages thus seek to “pre-emptively forestall a potential lack of collateral”, such that liquidity strains in the euro area banking system can be avoided.

De Guindos and Schnabel don’t say much about haircuts in their essay. They do provide an illustration, however, presenting average haircuts for different asset categories before and after 7 April.⁶

Figure 1 - Average valuation haircuts applicable to eligible asset categories



The figure speaks an unmistakable language of haircut reductions across the full spectrum of asset types. But we argue that the illustration is misleading, as a characterization of the ECB’s new collateral policy regime seen in its totality. The illustration leaves out the haircut changes

launched in the second package of collateral easing measures. And in the accompanying text, there is also no mention of the new haircuts assigned to any asset downgraded from CQ3 to CQ4 or 5. This omission of the changes made to the haircut schedule in the

⁶ The average valuation haircuts given by the authors are “unweighted... across credit quality steps and maturity

brackets for assets with fixed coupon structures for each haircut category” (De Guindos and Schnabel 2020).

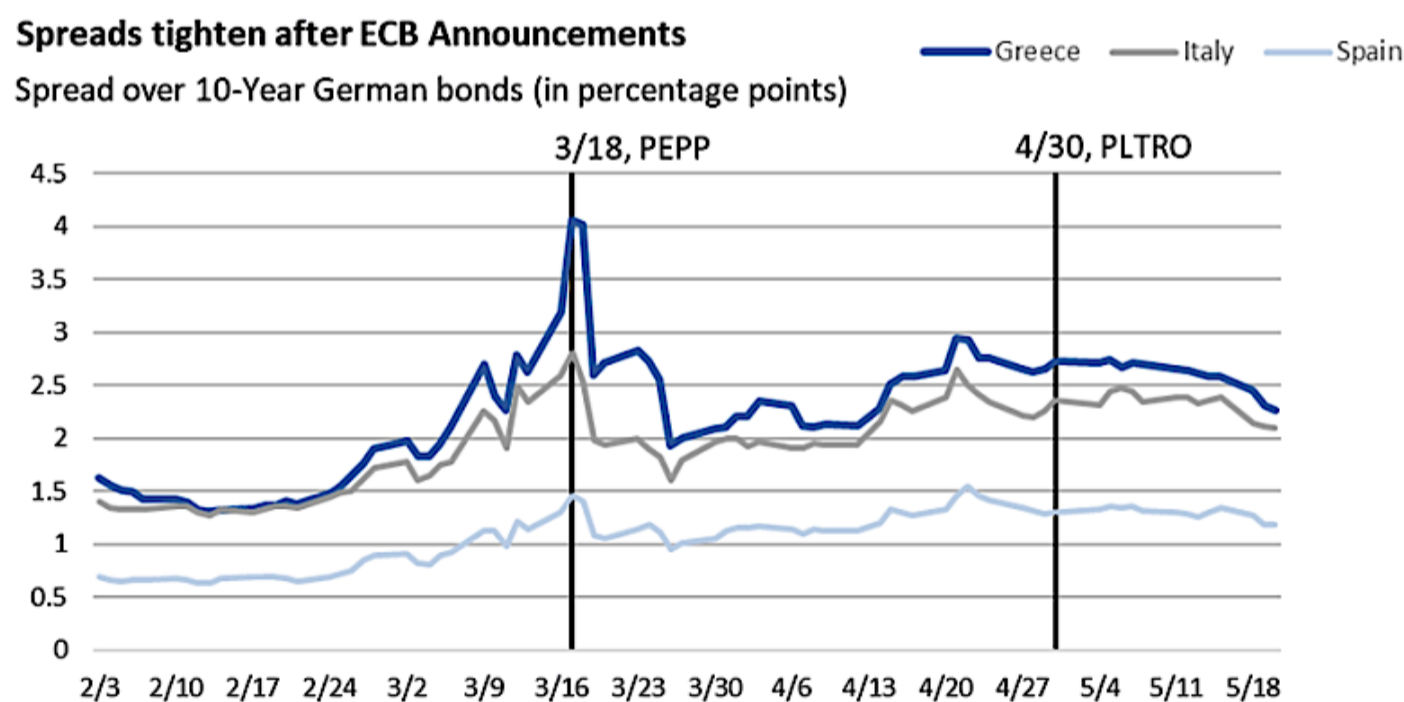
context of the second package of collateral easing measures makes quite a difference, as we shall soon see.

Before proceeding, it is important to briefly note a central dimension of the political rationale underlying the ECB's interventions. De Guindos and Schnabel note that the effectiveness of the ECB's monetary policy response to the COVID-19 crisis is all the more important because of the "heterogeneous size of the fiscal packages implemented at a national level to alleviate the impact of the crisis" (ibid.). The ECB acknowledges, in other words, that Eurozone countries are highly asymmetrical in terms of the space they have to pursue expansionary fiscal policy – and acknowledges that this redoubles the importance of an accommodative monetary policy response in support of "a sustained economic recovery following the pandemic" (ibid.).

Immediate impact of collateral easing measures

The collateral easing measures constituted a massive boost for government bonds at the lower end of the CQ3 category, that is, for those on the brink of a rating downgrade, such as Italian and Portuguese government bonds. The expansionary collateral policy had an immediate effect on spreads, as had been the case with the announcement of the PEPP in mid-March. It may be worth noting that the first round of PEPP purchases proved insufficient to calm stressed government bond markets. From late March until late April, spreads on Italian government bonds, for instance, climbed back up again, reaching 2.5 percentage points on 20 April. It took, it seemed, a combination of large-scale asset purchases and an expansionary collateral policy to narrow the spreads for more than a week or two.

Figure 2 - Spreads on Italian, Greek and Spanish government bonds



Source: WSJ and Hutchins Center on Fiscal and Monetary Policy at Brookings

The gentle interpretation would be that spreads only started climbing upwards towards the end of March on account of market concerns over potential collateral shortages following looming rating downgrades. With those fears now stoked – aka the second collateral easing package – there is no further reason for concern, this logic would suggest.

We are not entirely convinced, however. While the collateral easing (in combination with government bond purchases through the PEPP)

has been successful in stabilizing spreads, it is necessary to reflect on the likely longer-term effects: Is it safe to assume that the dampening effects on government bond markets will outlast the COVID-induced economic and financial crisis?

We suggest that key elements of the ECB's new collateral regime could easily cause renewed fragility and financial instability if not swiftly addressed.



4. THE ACHILLES HEEL: HAIRCUT HIKES FOR STRESSED ASSETS

The untold story of the ECB's countervailing haircut adjustments

Most of the commentaries on the ECB's collateral easing strategy has so far focused on the initial reduction of haircuts and the subsequent lowering of the credit rating threshold for asset eligibility.⁷ On the few occasions that haircuts have been addressed in the context of the second package of collateral easing measures, it was mentioned only in passing. "Fallen angel assets will be subjected to haircuts to reduce their value as collateral based on their latest credit rating", noted

Arnold in just one sentence, at the very end of his depiction of the new collateral easing measures, almost as if merely an afterthought (Arnold 2020a).

It is this link between haircuts for downgraded assets and their credit ratings that constitutes the Achilles heel of the ECB's new collateral easing strategy, however. It is this problem that must be addressed, we argue, if the collateral policy regime is to continue to contribute to stable financial markets in Europe.

But let us first take a look at the haircuts introduced for assets in credit quality categories 4 and 5, in concert with the lowering of the credit rating threshold.

Table 3 - Haircuts for downgraded, eligible assets

		Government bonds (LC1)	Unsecured credit (LC4)
CQ4	RM, 0-1	6,4	20
	RM, 1-3	10,4	30
	RM, 3-5	12	37,2
	RM, 5-7	13,6	40,4
	RM, 7-10	14,4	44,8
	RM,10+	16,8	46,8
CQ5	RM, 0-1	8	24
	RM, 1-3	12	34
	RM, 3-5	14	42
	RM, 5-7	15,6	46,8
	RM, 7-10	16,4	51,2
	RM,10+	18,8	53,2

The haircuts listed above, assigned to haircuts for assets in credit quality categories 4 and 5,

may seem undramatic at first glance. One needs to compare them with haircuts

⁷ For a discussion of whether the ECB went far enough when it lowered its credit rating threshold, see van't Klooster (2020).



applicable to assets in credit quality category 3 to appreciate what is at stake.

The assigned haircuts mean that the 20 % haircut reductions enacted on 7 April would effectively be more than reversed for any asset that was to be downgraded. Table 4 and 5

below show this dynamic for government bonds and unsecured credit, respectively. For a government bond downgraded to CQ4, the haircut would jump by roughly 50 %, depending on its residual maturity, relative to its level before the ECB's COVID19 measures.

Table 4 - Haircuts for a downgraded government bond (LC1, net change in %)

	Before downgrade	First downgrade	Second downgrade	Net change
RM, 0-1	4,8	6,4	8	67
RM, 1-3	6,4	10,4	12	88
RM, 3-5	8	12	14	75
RM, 5-7	9,2	13,6	15,6	70
RM, 7-10	10,4	14,4	16,4	58
RM,10+	12,8	16,8	18,8	47

Table 5 - Haircuts for downgraded, unsecured credit (LC4, net change in %)

	Before downgrade	First downgrade	Second downgrade	Net change
RM, 0-1	13	20	24	84,6
RM, 1-3	26,5	30	34	28,3
RM, 3-5	36,5	37,2	42	15,1
RM, 5-7	40	40,4	46,8	17,0
RM, 7-10	42,5	44,8	51,2	20,5
RM,10+	44	46,8	53,2	20,9

The upshot is that if both rounds of collateral easing are included, it is only the high-quality assets (CQ 1 to 3) that are subject to lower haircuts; the opposite is to be the case for any asset in the lower credit quality categories (CQ4 and 5).

Sharpening asset hierarchies: increasing haircut differentials

The inescapable implication of lower haircuts for high-quality assets and higher haircuts for

lower quality assets is that haircut *differentials* – understood as the difference between the lowest and highest haircuts (in the same liquidity category, for given residual maturities) – are higher today than they were before the COVID-19 crisis measures by the ECB.

Put differently, the new collateral regime may well be more 'inclusive' because of the lowering of the credit rating threshold, but the



asset hierarchy is sharper, as measured by the haircut differentials (see Table 6).

For government bonds with a residual maturity of less than a year, the haircut differential has increased from 5,5 percentage points before the COVID-19 collateral easing measures to 7,6 percentage points now. For government bonds with long residual maturities, it's the same pattern at higher levels: the haircut differential was 9 percentage points before the collateral

easing packages, but now it's 13,2 percentage points.

In both cases, the initial 20 % narrowing of the haircut differentials, were more than offset by the haircuts assigned to prospective downgraded assets in the second package of collateral easing measures.

Table 6 - Haircut differentials (in percentage points) - for assets with highest vs lowest rating

	Government bonds (LC1)		Unsecured credit (LC4)	
	RM, 0-1	RM, 10+	RM, 0-1	RM, 10+
Before	5,5 (6-0.5)	9 (16-7)	6,5 (13-6.5)	21,5 (44-22.5)
After 1 st package	4,4 (4.8-0.4)	7,2 (12.8-5.6)	4,4 (10.4-6)	10 (30.4-20.4)
After 2 nd package	7,6 (8-0.4)	13,2 (18.8-5.6)	18 (24-6)	32,8 (53.2-20.4)

For less liquid assets it's the same overall trends that can be observed. The haircuts assigned with the second package of measures more than offsets the narrowing of differentials achieved with the first package. The haircut differentials we see now are quite dramatic, ranging between 18 and 33 percentage points for assets in liquidity category 4 (unsecured credit).

Are high haircuts for lower-quality assets a financial stability concern?

The question that remains is whether a hike in the haircuts on the debt of a downgraded sovereign matter much from a financial stability perspective? Is the main issue not the lowering of the credit rating threshold, which ensures the eligibility of downgraded government bonds in ECB credit operations?

The short answer to the latter question is yes. And the market reaction so far certainly suggests that the lowering of the credit rating threshold was the main issue: yield curves have

shifted downwards for both Italy, Portugal and Greece in the wake of the announcement.

But although the collateral easing seems to have worked in the first instance, can we be sure that we are home safe? We suggest not. It is hard to predict how a downgrading of, say, Italian debt, would play out in the new collateral regime, but there is reason to be concerned.

Before we elaborate on these concerns, however, it is worth stressing that a downgrading of a sovereign is by no means a far-fetched scenario. First, if such a downgrading was not on the horizon of the quite imaginable, the ECB would not likely have felt compelled to declare its willingness to accept collateral of below 'investment grade'



quality in the first place.⁸ Second, do note that Italy's credit rating actually deteriorated in the weeks after the ECB's collateral easing initiatives.

Two of the four main rating agencies, Fitch and DBRS, lowered their credit assessment of Italy;

on 29 April, Fitch downgraded Italy from BBB (negative outlook) to BBB- and on 11 May DBRS followed suit by assigning a negative outlook to its BBB+ rating (see details in Figure 3 below).

Figure 3 - Italy's credit ratings, 2017-2020

Timetable of Italy credit ratings by S&P, Moody's, Fitch and DBRS agencies.

Symbol ● means a positive outlook assigned by the rating agency.

Symbol ● means a negative outlook.

Date	S&P	Moody's	Fitch	DBRS
11 May 2020				BBB (high) ●
29 Apr 2020			BBB-	
27 Oct 2018	BBB ●			
20 Oct 2018		Baa3		
31 Aug 2018			BBB ●	
25 May 2018		Baa2		
27 Oct 2017	BBB			
21 Apr 2017			BBB	
13 Jan 2017				BBB (high)

Source: www.worldgovernmentbonds.com

If Italian debt was to be downgraded to BB+ status, the haircut on Italian government bonds would jump from 8 to 12% for bonds with residual maturities between 3 and 5 years (see Table 6). That's a 50% increase.

Could such a haircut hike trigger a negative collateral valuation spiral? We would say that the risk of a negative spiral triggered by haircut adjustments is real. Indeed, the Committee on the Global Financial System identified the "practice of linking haircuts... to credit ratings" as one of the key features contributing to procyclicality (CGFS 2010: 11).

A negative spiral of declining credit ratings, increasing haircuts and margin calls, lower collateral valuations, and increasing bond yields would be vicious. It is imaginable that an initial downgrading of a sovereign to BB+ status could be self-reinforcing, a slippery slope that leads to further downgrades, with resulting severe pressure on bond yields.

⁸ Arnold cites the ECB for claiming that their lowering of credit rating threshold was not targeted at sovereigns, but rather at corporates; if the main concern had been with sovereigns, they could just have extended the Greek

waiver, they claimed (Arnold 2020a). We remain convinced, however, that concerns with the stability of government bond markets loomed large for the ECB, whether they are willing to fully admit to it or not.



5. SHOULD MARGINING PRACTICES BE SUSTAINED IN TIMES OF CRISIS?

At its very core, the ECB's collateral policies are concerned with ensuring that liquidity is provided to banks only in proportion to the market value of the assets they pledge. If the market value of an asset pledged by a bank to access central bank liquidity falls, the ECB will demand that the bank pledges more collateral – so as to continuously ensure that the market value of the collateral pledged to the ECB matches the liquidity provided to the bank. In the words of the ECB itself, these mark-to-market and margin call practices are adopted to “protect the Eurosystem against the risk of financial loss if underlying assets have to be realised owing to the default of a counterparty” (ECB 2017a). These practices are operated to ensure that the amount and quality of collateral are continuously adapted to reflect changing market perceptions of credit, counterparty and liquidity risk.

While they are the backbone of the collateral policies of central banks in normal times, these margining practices are often also at the core of collateral policies strategies in times of crisis. From a money view perspective, however, a key role of central banks in a liquidity crisis is to loosen the link between market valuations of collateral assets and access to central bank liquidity. This makes it all the more paradoxical that the ECB is so insistent on preserving a close link through disciplinary haircuts.

The conventional wisdom for central bankers points to a narrower form of countercyclical collateral policy. In crisis times”, the Bank of International Settlements (BIS) notes, “collateral acceptance typically becomes more conservative in private markets, and the pool of assets deemed suitable as collateral shrinks as the perceived risk of assets and counterparties rise” (BIS 2015: 5). Under circumstances of financial distress, the very point of central bank operations is to accommodate the “greater scarcity of

collateral”, by introducing, for example, “facilities that allow banks to post *illiquid* collateral assets in place of liquid securities that, in turn, can be used to obtain funding in the private market” (BIS 2015: 2, emphasis added). If, on the other hand, central banks replicate the conservatism of markets, the effect will be profoundly procyclical.

While countercyclical collateral policy is standard procedure for central banks, when it comes to collateral eligibility, such reasoning seems to be neglected territory when it comes to haircuts. The ECB is a case in point. Its collateral policies are essentially ambivalent in that they consist of vastly expanding collateral eligibility, while sharply raising haircuts on lower quality assets. Although a dual strategy – of safeguarding financial stability while at the same time pursuing risk management of the ECB's own balance sheet – seems common sense, in fact one undermines the other, in a period of financial distress. Such a strategy amounts to pushing in opposite directions at the same time. In money view terms, enhancing collateral eligibility corresponds to increasing the “elasticity” of the credit system, whereas higher haircuts for lower quality assets correspondingly decrease elasticity. A central bank cannot expand and contract liquidity at the same time. If it tries to do both, it will achieve little else than launching two effects working against each other, at worst cancelling each other out, with the predictable result that the crisis will likely linger on.



6. CONCLUSION: HAS THE ECB ADOPTED A COUNTERCYCLICAL COLLATERAL POLICY?

On the background of our analysis, how may we characterize the ECB's collateral easing strategy? Have the collateral easing packages launched in response to the COVID19 crisis marked a radical shift? Can it be said that the ECB adopted a new collateral policy regime, characterized by countercyclical measures and strategies?

The initial reduction of haircuts was substantial (20%). The ECB has estimated that it corresponds to an expansion of eligible collateral to the scale of 140 bn euros (de Guindos and Schnabel 2020). This uniform haircut reduction surely constituted an expansionary collateral policy measure.

In the second round of collateral easing measures, however, high haircuts were assigned to low quality assets. The net result was that the haircut differential between the strongest and weakest assets ended up *higher* than it was before the COVID19 crisis measures were launched.

This can hardly be said to constitute countercyclical collateral policy. At the very least, to qualify as countercyclical the new collateral regime would need to entail a narrowing of the haircut differential between strong and weak assets, not least for the government bonds that are at the heart of European collateral markets.

Ironically, the ECB's insistence on differentiated, disciplinary haircuts has increased the likelihood of a collateral valuation spiral. If CQ3 haircuts had been maintained for downgraded assets – i.e. if grandfathering had been applied not just with respect to asset eligibility but also for haircuts – then a negative collateral valuation spiral would be much less likely. Absent a haircut trigger, collateral valuation spirals would likely be short-circuited.

The expansion of the collateral eligibility through a lowering of the credit rating threshold, on the other hand, is clearly and substantially countercyclical. The coupling of this lowering of the credit threshold with high, disciplinary haircuts, however, countervails its expansionary impact on collateral supply and may eventually undermine its countercyclical effect, if a negative collateral valuation spiral is triggered.

Conceptually, we suggest assessing collateral easing strategies along four dimensions, before jumping to conclusions about the degree of change that has occurred:

- expansion of asset eligibility
- reduction of haircuts (how big? distributed how? sustained over time?)
- narrowing, or suspension, of haircut differentials across credit quality categories (between strongest and weakest assets)
- suspension of margin calls

On three out of these four dimensions, the ECB's collateral easing falls short. For ECB collateral policies to become countercyclical in a robust manner – and hence persistent in their stabilizing effects on financial markets – they would need to short-circuit, or at least significantly ameliorate, prospective collateral valuation spirals. The only way to achieve that, we argue, is by suspending two key features of otherwise 'standard' collateral policy regimes: daily margin calls and, importantly, the disciplinary differentiation of haircuts.

The ECB has said, we noted, that it is prepared "to take additional measures to further mitigate the impact of rating downgrades. Our worry is that such further measures could easily become another instance of "too little, too late" in matters of euro area macro-financial governance, leaving it to increasingly asymmetrical government bond purchases to stave off a renewed liquidity crisis in European collateral markets.



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ABOUT THE AUTHOR



Jakob Vestergaard, Roskilde University

Jakob is associate professor at Roskilde University; his research cuts across the disciplines of economics, politics and philosophy of science. Empirically, he focuses on financial crises and financial regulation, emphasising how and to what extent competing narratives shape subsequent policy responses.

Jakob's publications include *Discipline in the Global Economy? International Finance and the End of Liberalism* (Routledge, 2009) and *Central Banking at a Crossroads* (Anthem Press, 2014, co-edited with Goodhart, Gabor and Ertürk).



Daniela Gabor, University of the West of England – Bristol

Daniela is Professor of Economics and Macro-Finance at the University of the West of England – Bristol (UWE Bristol). She is the lead-scientist for research projects supported by the Institute for New Economic Thinking and FEPS. She is expert and regularly publishes on shadow banking, transnational banking models, capital controls, central banking and IMF conditionality.

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