

## Collateral Frameworks

Central bank collateral frameworks are an often-overlooked feature of monetary policy that play a key role in the monetary and financial system. Readers will discover how central banks conduct and implement monetary policy beyond merely setting interest rates, and develop their understanding as to how collateral policies may affect financial markets, financial stability, and the real economy. This book studies the collateral framework in the euro area in detail and levers this analysis to provide an account of the euro crisis from the perspective of collateral policy. Readers gain access to a wealth of institutional and economic data and information with a level of density and accessibility unavailable elsewhere. This book, the first of its kind, is a valuable read for academic monetary and financial economists, those working in banking and policy-making financial institutions, and anyone who wishes to learn more about the role of central banks in society.

**Kjell G. Nyborg** is Chaired Professor of Finance at the University of Zurich, Senior Chair of the Swiss Finance Institute, Research Fellow of the Centre for Economic Policy Research, and Fellow of the Royal Society of Arts. He is also a former Director and the current Vice President and President-elect of the European Finance Association. Nyborg studied mathematics and economics at the University of Chicago before going on to do a PhD, with a specialization in finance, at the Graduate School of Business, Stanford University. He has previously taught at London Business School, UCLA, and the Norwegian School of Economics.

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## The Open Secret of Central Banks

KJELL G. NYBORG

*University of Zurich  
Swiss Finance Institute  
and Centre for Economic Policy Research*



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Contents

|   |           |
|---|-----------|
| List of Figures   | page viii |
| List of Tables  | ix        |
| List of Exhibits  | xi        |
| List of Examples  | xii       |
| Preface   | xiii      |
| Acknowledgments   | xv        |
| 1 Background and Motivation   | 1         |
| 1.1 Money Matters in Financial Markets                                      | 3         |
| 1.2 The Market for Liquidity  | 6         |
| 1.3 The Financial Crisis and Unconventional Monetary Policy                 | 7         |
| 1.4 Central Bank Balance Sheets and the Increasing Importance of Collateral | 11        |
| 1.5 Collateral  | 14        |
| 2 Collateral Frameworks: Overview   | 18        |
| 2.1 Potential Impact  | 19        |
| 2.2 Collateral Eligibility and Usage  | 23        |
| 2.3 Collateral Values, Haircuts, Ratings, and Guarantees                    | 26        |
| 2.4 Overview of Findings  | 29        |
| 2.5 Rest of Book  | 32        |
| 3 Monetary Policy Implementation in the Euro Area over Time                 | 35        |
| 4 Evidence on the Production and Usage of Collateral                        | 52        |
| 5 Haircuts  | 59        |
| 5.1 Documentation and Overview  | 59        |
| 5.2 Detailed Haircut Rules and Main General Observations                    | 63        |
|   | v         |

## VI CONTENTS

|      |  |     |
|------|--|-----|
| 5.3  | Haircuts over Time   | 79  |
| 5.4  | Extraordinary Haircuts   | 85  |
| 5.5  | Evidence on Collateral Eligibility, Ratings, and<br>Haircuts in Primary and Secondary Repo Markets | 87  |
| 6    | Ratings and Guarantees   | 94  |
| 6.1  | Rating and Guarantee Rules over Time   | 96  |
| 6.2  | Exemptions   | 112 |
| 6.3  | Ratings and Haircuts: Two Examples   | 115 |
| 6.4  | Fundamental Liquidity  | 118 |
| 6.5  | Sovereign Ratings and the Impact of DBRS   | 119 |
| 6.6  | Evidence on Guarantees   | 132 |
| 6.7  | Government Guarantees: Italy   | 136 |
| 6.8  | Government Guarantees: Germany   | 142 |
| 6.9  | Government Guarantees and Irregular Haircuts: Greece   | 143 |
| 6.10 | Corporate Guarantees and Access to Cheap Funding   | 146 |
| 7    | Market and Theoretical Prices  | 149 |
| 7.1  | Eligible Marketable Collateral   | 149 |
| 7.2  | Pledged Collateral   | 162 |
| 7.3  | Summary  | 166 |
| 8    | Collateral “Own Use”   | 168 |
| 9    | Non-regulated Markets, Unsecured Bank Debt, and<br>LTRO Uptake                                     | 171 |
| 10   | Market Discipline  | 178 |
| 10.1 | Market Discipline Impairment   | 178 |
| 10.2 | Biases and Systemic Arbitrage  | 183 |
| 10.3 | Potential Costs  | 185 |
| 10.4 | Introducing Market Forces  | 189 |
| 11   | Bailing Out the Euro   | 192 |
| 11.1 | Unconventional Monetary Policies: Broad Patterns<br>and Key Issues                                 | 194 |

|      |  |     |
|------|--|-----|
| 11.2 | Full Allotment, Fragmentation, and Inefficient Bailouts  | 199 |
| 11.3 | Buying Time and Sovereign Free-Riding                    | 207 |
| 11.4 | Bailing Out the Euro: Who Benefits? General Observations | 212 |
| 11.5 | Event Study: September 4, 2014                           | 214 |
| 12   | The Endgame of the Euro Crisis                           | 224 |
| 12.1 | Background   | 225 |
| 12.2 | Eurosystem Purchases of Sovereign Bonds: Legal Issues    | 231 |
| 12.3 | The Expanded Asset Purchase Program                      | 233 |
| 12.4 | Issues and Scenarios                                     | 236 |
| 12.5 | The Importance of Buying Sovereign and Bank Bonds        | 242 |
| 13   | Restoring Credibility                                    | 245 |
| 13.1 | Organized Hypocrisy                                      | 248 |
| 13.2 | Secure Sovereign Debt and Modify Haircuts                | 256 |
| 14   | The Problem with Collateral                              | 263 |
| 14.1 | The Fundamental Problem                                  | 263 |
| 14.2 | The Interbank Market                                     | 266 |
| 14.3 | Full Reserve Banking                                     | 269 |
| 15   | Concluding Remarks                                       | 274 |
|      | Appendix: Haircut and Rating Rules Updates               | 281 |
| A.1  | Headline Changes   | 281 |
| A.2  | The Harmonized Rating Scale                              | 282 |
| A.3  | Haircuts   | 284 |
| A.4  | Rating Rules   | 288 |
| A.5  | Greece and Cyprus  | 288 |
|      | References   | 293 |
|      | Index  | 313 |

Figures

|      |   |     |
|------|---|-----|
| 1.1  | EURO STOXX Index and Euribor–Eonia swap spread (three months)             | 8   |
| 1.2  | Central banks’ balance sheets over time                                   | 12  |
| 2.1  | Determination of collateral values in the collateral framework            | 27  |
| 3.1  | MRO and LTRO daily outstanding amounts and the monetary base              | 47  |
| 4.1  | Eligible assets and collateral used                                       | 57  |
| 6.1  | Number of government-guaranteed issuers and collateral                    | 137 |
| 9.1  | Number of eligible collateral by country and liquidity category           | 174 |
| 11.1 | Euribor–Eonia swap spread (three months) and usage of standing facilities | 200 |
| 11.2 | Eurosystem liquidity injections vs aggregate liquidity needs              | 201 |
| 12.1 | Euro-area sovereign yield spreads over Germany (ten years)                | 229 |



## Tables

|     |   |     |
|-----|---|-----|
| 3.1 | Main Eurosystem monetary policy instruments over time   | 36  |
| 3.2 | Refinancing operations and monetary base  | 46  |
| 3.3 | Consolidated Eurosystem balance sheet (asset side, in billion EUR)  | 50  |
| 4.1 | Eligible marketable collateral across asset classes   | 53  |
| 4.2 | Usage of collateral across asset classes  | 55  |
| 5.1 | Haircuts and liquidity categories from March 8, 2004, to October 24, 2008   | 66  |
| 5.2 | Haircuts and liquidity categories from October 25, 2008 (Temporary framework), and February 1, 2009 (General framework), to December 31, 2010 | 69  |
| 5.3 | Haircuts and liquidity categories from January 1, 2011, to September 30, 2013   | 72  |
| 5.4 | Haircuts and liquidity categories from October 1, 2013 (and November 1, 2013, for own-use covered bonds)                                      | 75  |
| 5.5 | Greece and Cyprus: extraordinary haircuts   | 86  |
| 5.6 | Distribution of collateral and comparison of haircuts in primary and secondary repo markets   | 89  |
| 6.1 | Credit quality and ratings rules  | 98  |
| 6.2 | Ratings for euro-area countries by year and rating agency   | 120 |
| 6.3 | Yearly average DBRS ratings and rating differentials to other agencies  | 127 |
| 6.4 | Extra collateral value from DBRS's pivotal ratings (or credit quality exemptions)   | 129 |
| 6.5 | Distribution of collateral with guarantees  | 133 |
| 6.6 | Extra collateral value to unrated Italian bank bonds from DBRS's pivotal rating and government guarantees                                     | 140 |

x LIST OF TABLES

|      |  |     |
|------|--|-----|
| 7.1  | Incidence of market and theoretical prices for<br>determining collateral values      | 154 |
| 9.1  | Number of eligible collateral: impact of<br>“non-regulated markets inclusion clause” | 175 |
| 11.1 | Event study of ECB announcements on September 4,<br>2014                             | 217 |
| 12.1 | Euro-area member state fiscal indicators   | 226 |
| A.1  | Harmonized rating scale  | 283 |
| A.2  | Haircuts and liquidity categories from May 1, 2015                                   | 285 |
| A.3  | Credit quality and ratings rules   | 289 |

Exhibits

|     |  |     |
|-----|--|-----|
| 6.1 | Harmonized rating scale: long-term ratings per step                                      | 110 |
| 6.2 | Issues with German government guarantees, August 15, 2013                                | 142 |
| 6.3 | Irregular haircuts of Greek government-guaranteed unsecured bank bonds, December 8, 2011 | 145 |
| 6.4 | Long-term rating scales and scoring system   | 148 |
| 7.1 | Pricing rule 2: incidence of theoretical and stale prices, January 13, 2015              | 160 |
| 7.2 | Collateral usage by collateral value (billion EUR), 2014Q4                               | 163 |
| 7.3 | Collateral usage by count  | 165 |
| 9.1 | LTRO by country (billion EUR)  | 176 |

Examples

|     |  |     |
|-----|--|-----|
| 6.1 | Two Spanish government bonds, March 21, 2014 | 115 |
| 6.2 | Two Italian government bonds, March 21, 2014 | 116 |

## Preface

This book seeks to inform about a feature of monetary policy that is largely overlooked yet occupies a central role in the monetary and financial system, namely central bank collateral frameworks. They are much like G.K. Chesterton's famous "invisible" postman in that, like him, collateral frameworks are out in the open and utilized every single day of the year, but nevertheless go largely unnoticed.<sup>1</sup> Unlike the postman, however, collateral frameworks are obscured by opacity. Those that care can look up the nitty-gritty of how collateral frameworks work by studying the relevant official documentation, but it is not trivial reading. Furthermore, to understand how collateral frameworks actually function, it is not sufficient to merely read the official rules, it is also necessary to supplement these with empirical facts that shed light on how those rules are implemented and what their consequences are. This book does both. Its main objective is to bring the importance of collateral frameworks more out into the open.

I do this through an in-depth study of the collateral framework of the euro area. This is an especially interesting case because of the banking and sovereign debt problems in the euro area and the ongoing efforts of the European Central Bank (ECB) to, in Mario Draghi's words, preserve the euro. The Eurosystem's collateral framework provides a novel and useful frame of reference for looking at the unfolding crisis. The book shows that the collateral framework is integral to the unconventional monetary policies pursued by the ECB in its bid to stave off the crisis. The book also lays out the general pattern of the ECB's unconventional policies to preserve the euro and shows that these involve indirect bailouts of banks and sovereigns, with some countries benefiting more than others.

<sup>1</sup> Chesterton (1911).

## XIV PREFACE

As I thought I was nearing completion of this book in January 2015, several “euro events” occurred in rapid succession that I felt compelled to incorporate into my analysis because they reduced uncertainty with respect to future ECB actions to preserve the euro. This has led to a chapter on the endgame of the euro crisis to go along with a chapter on the euro’s fundamental credibility problem and what to do about it. These chapters expand the scope of the book so that it can also be read as an analysis of the euro crisis that branches out from a detailed study of the Eurosystem’s collateral framework.

The discussion of the euro crisis also serves to deepen the understanding of collateral frameworks provided by the book by illustrating, in part, their potential reach and, in part, how their design may ultimately be influenced by political forces. I believe this is especially relevant with respect to understanding the Byzantine structure of the Eurosystem’s collateral framework.

The general picture that emerges from my research is that a collateral framework is a monetary policy tool that can be used, by design or inadvertently, to impinge on the role of markets. It can be used to nudge financial markets and the behavior of banks and sovereigns this way or that and, by implication, the real economy as well. A message of the book is that to gain a more complete understanding of the monetary and financial systems, it is essential to understand the structure, functionality, role, reach, and implications of collateral frameworks. The book shows that collateral frameworks are central to the operations and activities of central banks and the monetary and financial systems built up around their money. They can be used as part of a package of unconventional monetary policies to address crises or near-crises situations, but they can also cause market distortions and contribute to a misallocation of resources and to financial instability.

## Acknowledgments

The work in this book represents a continuation of a line of research I have been carrying out over many years with several co-authors. Our joint research addresses issues in the market for liquidity, central banking, bank bailouts, and the role of money in financial markets. Studying collateral frameworks, the micro-foundation of the monetary and financial systems, is a natural progression from this. Thus, I would like to give a special thanks to these co-authors: Sudipto Bhattacharya, Ulrich Bindseil, Falko Fecht, Per Östberg, Ilya Strebulaev, and Jörg Rocholl.

The final draft of this book has benefited from the comments of four anonymous reviewers and the participants in a handful of seminars, including one at the ECB. In particular, I was invited by the ECB to give the keynote lecture in their September 2013 workshop on “Structural Changes in Money Markets: Implications for Monetary Policy Implementation” and used the opportunity to present some of my thoughts on their collateral framework. I argued that it should be viewed as an integral and important part of their monetary policy and pointed to some of the same issues that I discuss at more length in this book. I am thankful to the ECB for affording me this opportunity and for the useful feedback I received at that workshop. In addition, I would like to thank the ECB’s legal department, outreach division, and collateral team for clarifying some issues relating to the Eurosystem’s collateral framework.

I have also benefited from the comments of seminar participants at the Central Bank of Ireland in April 2014 and, closer to the finishing line of the book in the spring of 2015, at the University of Chicago, the University of Wisconsin, and the Swiss National Bank. The final touch-up in the fall of 2015 benefited from comments and clarifying remarks from Ulrich Bindseil and an anonymous reviewer

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In writing this book, I have benefited greatly from the research assistance of my team: Lilia Mukhlynina, Cornelia Rösler, and Jiri Woschitz. Magnus Nybø also chipped in toward the end. I am grateful for their commitment to the project and for their many helpful comments on the manuscript itself. The responsibility for any errors is mine.