EUROPEAN CENTRAL BANK

EUROSYSTEM

“Reserves were not so ample after all”: Paper discussion

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The views expressed are those of the discussant and do not necessarily reflect those of the ECB or the Eurosystem

Overview

Main points of the paper

- Analyses the relationships between the total reserve balances of the largest dealer banks and of other large banks, intraday payment timing delays, and repo rate distortions
- Time period: Between 2015 to 2019 with emphasis placed on the Fed’s balance sheet ‘normalisation’ phase (2017- September 2019)

Main Findings

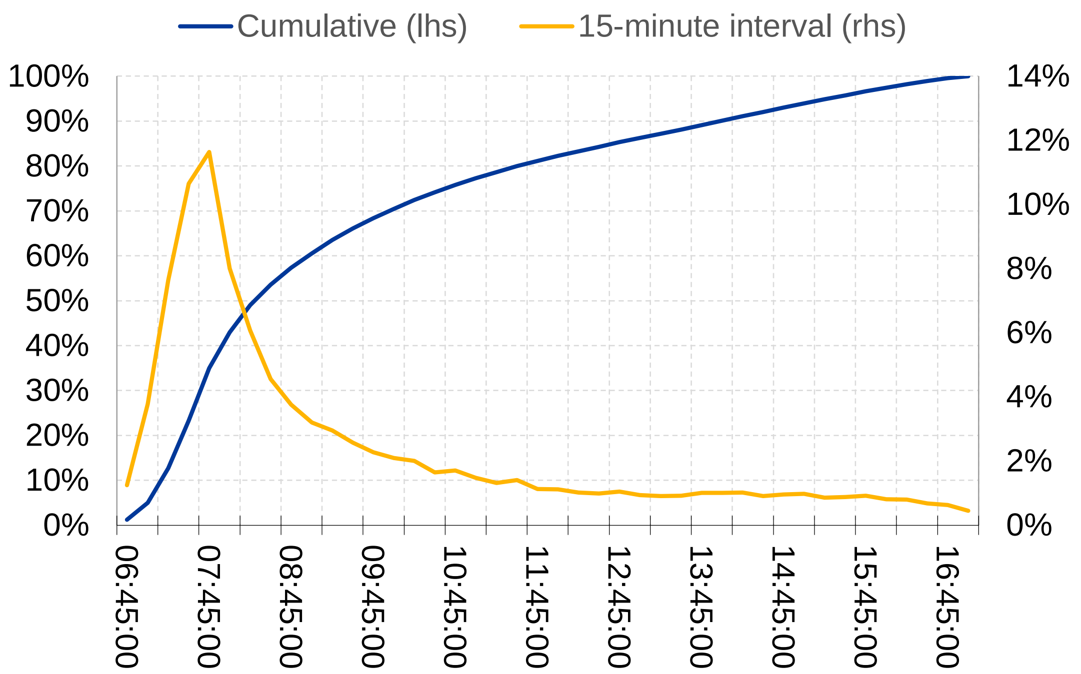
- Reduction in aggregate reserves and new liquidity regulations resulted in intraday payment delays to the large repo dealers who were then less willing to intermediate and quoted higher rates
- Early-morning settlement of Treasury debt issuances can increase intraday payment timing stresses
- Higher aggregate levels of reserves in period leading up to September 2019 may have alleviated the majority of payment timing stresses and repo rate spikes

Further questions the paper raises

- Are intraday liquidity requirements so unclear (Dimon – "That cash, we believe, is required …") to banks that payment delays lead to overreaction?
- Why does a GSIB fear "loss of reputation" for using daylight overdrafts?
- Dealers increase their reserves when anticipating delays of incoming payments …
- … but the cause of the delays or the anticipation is not clear
- Reserve distribution matters, but policy conclusions on how to affect distribution would help (this is generally an unresolved question)

Intraday distribution of repo trading volumes

- Repo market liquidity is concentrated in the early morning
- Based on a 2016 analysis of data from the two largest euro area platforms, 82% of the volume is conducted before noon



Source: MTS, BrokerTec (pre-APP)

Overview

1. Main findings and the euro area perspective
2. **Concentration of central bank reserves**
3. Market infrastructure
4. Liquidity regulations and bank supervision
5. Reflection on suggested policy options

Concentration of central bank reserves

When Fed reserves of the dealer-bank are higher, the concentration of balances among dealer banks tends to rise. The paper argues that the concentration of Fed balances among the 10 selected dealer banks affects repo rates.

⇒ Sharing their Fed balances more efficiently, thus more evenly, becomes less valuable to the large dealer banks as their aggregate reserves gets more plentiful.

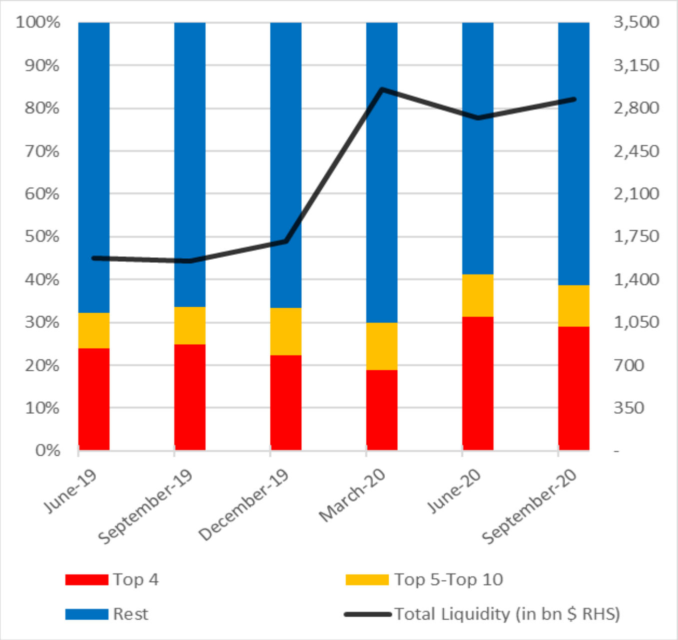
The concentration/hording or reserves in the **euro area** is somewhat lower than in the US but also raises a number of issues:

- It is fuelled by both structural and conjunctural factors,
- implies higher aggregate demand for reserves as excess liquidity is not distributed evenly across euro area countries/banking systems, and
- complicates the estimation for the demand for reserves.

Repo rates in the euro area are less affected by the concentration of reserves as the repo market is more diverse and is comprised of repo market based on national collateral of member states.

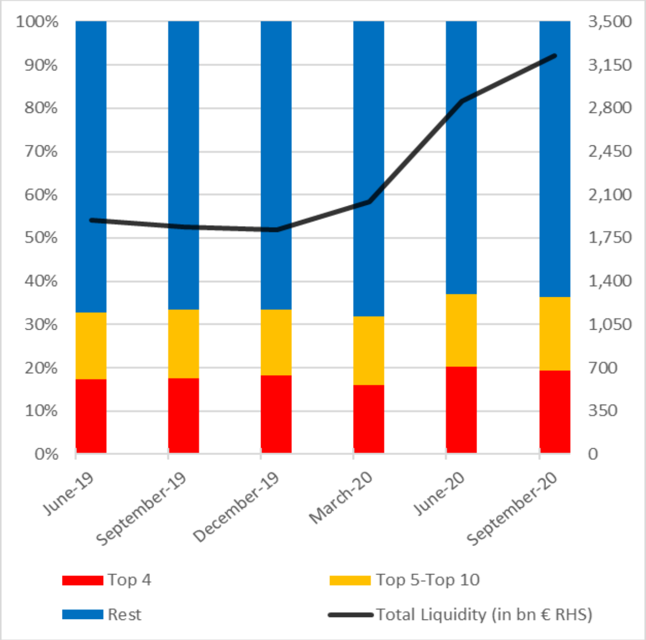
Distribution of central bank liquidity in the US and the euro area

US



Source: US Federal Deposit Insurance Corporation (FDIC), Federal Reserve System

Euro area



Source: Eurosystem

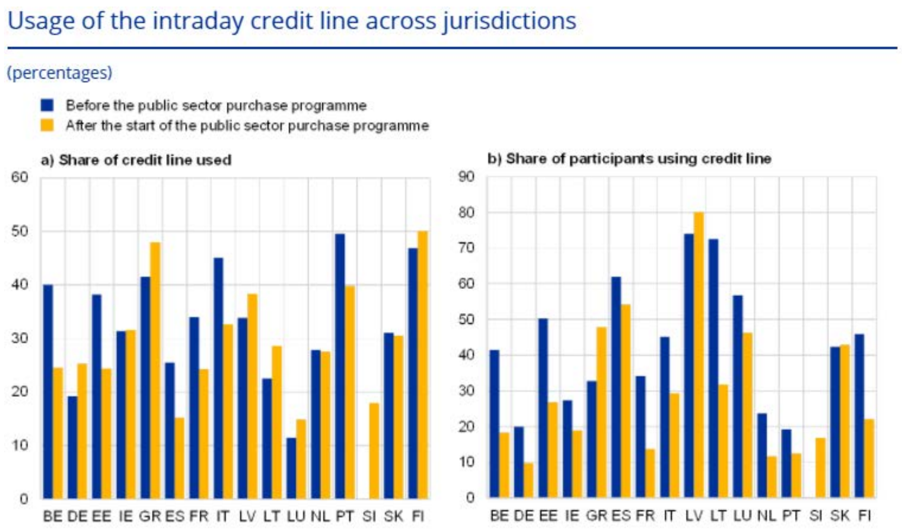
Overview

The importance of market infrastructure issues

- We must recognise the importance of efficient payment and settlement infrastructure to aid the transmission of monetary policy stance and ensure financial stability – Darrel’s paper brings this point across very well.

TARGET2 - Intraday Credit Line (ICL)

- The usage of ICL not uncommon in the euro area
- … but rising excess liquidity has reduced the need
- December 2020: Intraday credit line: EUR 1.6 trillion
- Average settlement times are not impacted by usage of ICL



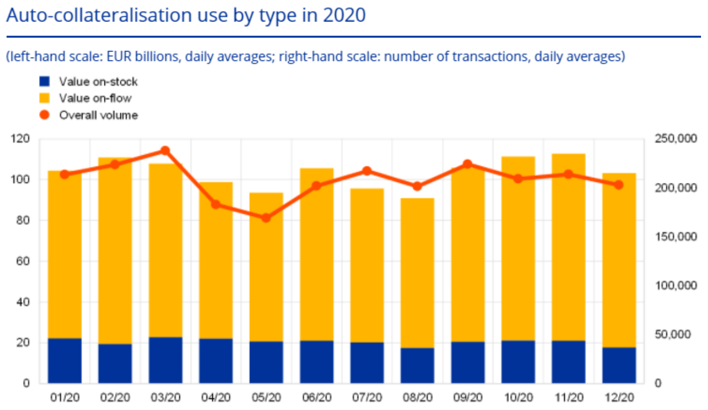
Source: ECB Economic Bulletin, Issue 5/2020

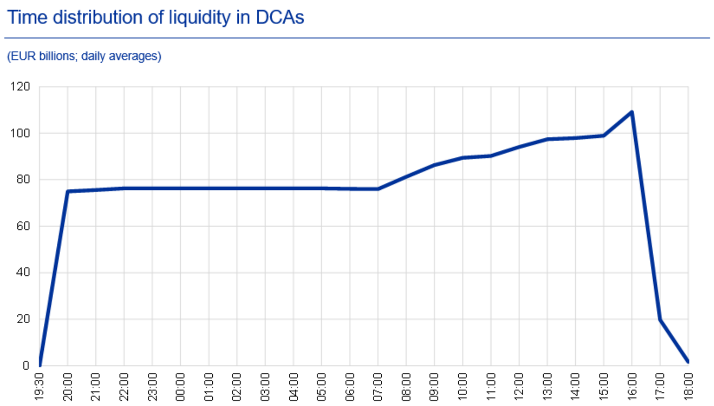
Fed consultation on the provision of intraday credit

- On 28 May, the Fed launched a public consultation on policy governing the provision of intraday credit
- The changes would expand the access to collateralised intraday credit and clearer terms for accessing intraday credit
- Overall the goal is to increase the intraday credit capacity

Securities settlement in the euro area

- Security settlement is predominantly real-time (62% by value)
- Daily average settlement of EUR 673 billion (TARGET2-Securities)
- Daily average auto-collateralisation of settlements: EUR 103 billion
- EUR 80-110 billion support this process (peak at 16:00)





Source: ECB (Target2, T2S Annual Report 2020)

Overview

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What was the role of banks' internal liquidity governance framework?

- *The paper claims* that **post-crisis liquidity regulations'** unintended consequences may have contributed to the squeeze in repo interest rates;
- However, it comes short in addressing bank management responsibility in exercising discretion over the framework for intraday liquidity management in a stressed scenario;
- *What was the role of internal liquidity governance practices?* The paper would benefit from addressing/controlling for it;
- *The paper claims* that the **Federal Reserve's balance sheet normalisation** may have contributed to stressing BHCs intraday reserve management;
- Propose an alternative hypothesis: 'Reserves were ample but not so *mobile* after all';
- How to facilitate that reserves circulate to where they are needed and when they are needed during the day?
- Is it a sufficient condition to solve the seemingly imperfect fungibility between reserves and HQLA (UST)?

How much emphasis do BHC regulators and supervisors put on positive intraday balances?

- The stigmatisation of the DW has been documented and is acknowledged by the Fed;
- What is less clear is how much emphasis there is on positive FedWire balances;
- Overdrafts became notably smaller since the GFC, but…
- this period also coincides with ample excess reserves;…
- where payment timing mismatches that lead to reserve hoarding and strategic payments' management are less likely to happen;
- Put differently, the level of reserves may be a more important determinant of FedWire balances than stigma;

=> *How endogenous is regulators' emphasis on positive intraday balances to the level of reserves?*

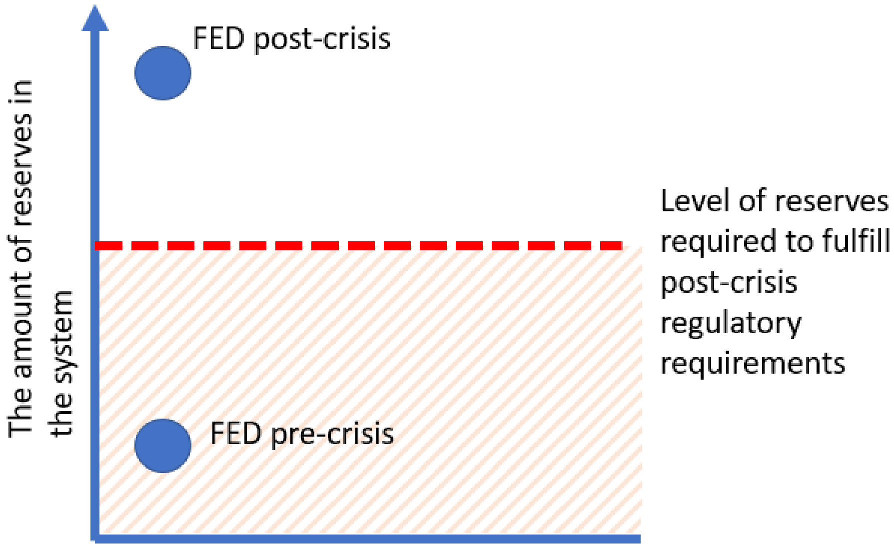
Overview

Reflection on suggested policy options

The paper provides the following policy options for the Fed to adjust to challenges in the ‘new normal’:

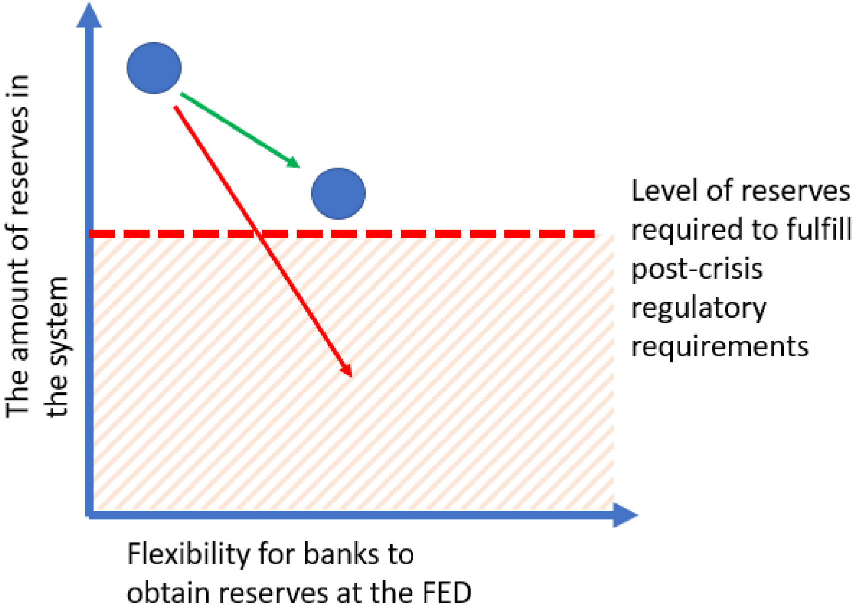
1. Maintain a balance sheet that achieves clearly abundant reserve balances
2. Establish a standing repo facility
3. Relax post-crisis liquidity rules and supervision (including discount window option)

Policy option 1



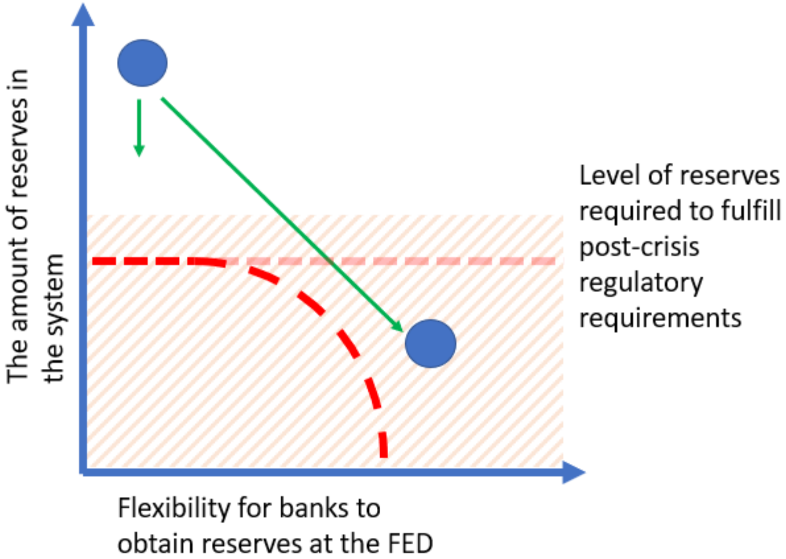
1. Ensuring large enough balance sheet/surplus of reserves to prevent spikes in repo rates
2. **Exceeds** desired level of reserves by banking system due to regulatory requirements but also due to uncertainty / frictions
3. Would come at the costs of operating an **unnecessarily** large balance sheet; relatively large footprint in financial markets and potential ‘misuse’ by government

Policy option 2



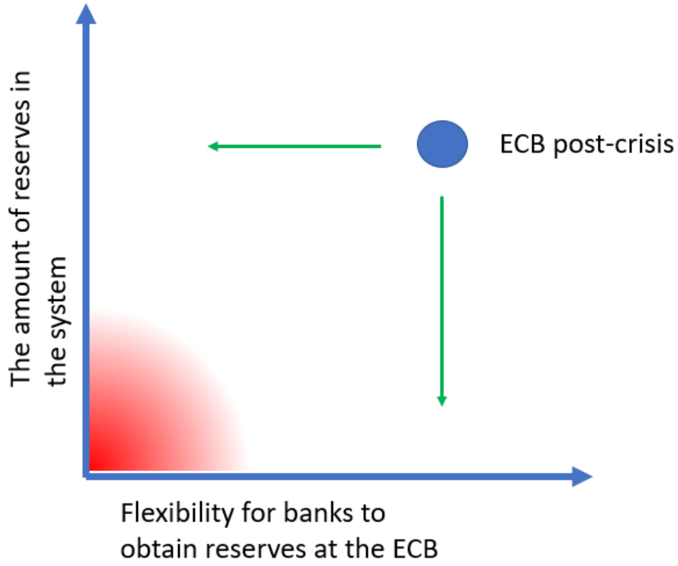
1. A stigma free repo-facility alleviates banks’ demand for reserves driven by uncertainty and frictions allowing for smaller CB balance sheet
2. Bringing the required size of the balance sheet **closer to what is required from a regulatory** perspective, but cannot result in an even smaller balance sheet
3. **Trade-off** between costs of increased intermediary function with the banking sector and draw-backs of a large balance sheet.
4. Can we **calculate** the volume strictly required by regulation and the additional buffer needed?

Policy option 3 & 4



1. Relaxation of post-crisis liquidity rules lowers the required size of the balance sheet and provides the Fed the possibility to **shrink** it's balance sheet by **ensuring flexibility** for banks to obtain reserves
2. Requires **willingness from regulators** to accept lower amount of reserve holdings and/or take eligible collateral into account
3. Requires **commitment from the Fed** to provide banks with reserves at their demand – also when banks are in stress
4. Alignment may introduce moral hazard considerations

Policy conclusions - Euro area perspective



1. Reserve concentration less driven by corresponding banking, but more by home-bias in local government bonds
2. As far to our knowledge **no strict regulatory requirements on the level of reserves**, but there are linkages to ECB's collateral framework (EBA-stress tests, intraday credit monitoring) and preferences in terms of HQLA (euro area bonds subject to credit risk)
3. **Access** to (free of charge) intraday-credit and credit operations (fixed rate full allotment), for **all banks** against **broad collateral**

Policy conclusions

- The intermediary role of central banks will most likely remain larger in comparison to the pre-crisis situation
- The Fed faces a trade-off between a larger balance sheet and providing more flexibility to the banking system
- There is a clear need for dialogue between central banks and regulators on the alignment of frameworks and possible interlinkages