

EUROSYSTEM STANDING FACILITIES AND FINANCIAL STABILITY

Standing facilities are designed to provide and absorb overnight liquidity and are aimed at bounding overnight market rates. Two standing facilities are available to eligible Eurosystem counterparties on their own initiative, subject to their fulfilment of certain operational access conditions. Counterparties can use the marginal lending facility to obtain overnight liquidity from the national central banks (NCBs) against eligible assets and can use the deposit facility to make overnight deposits with the NCBs. The interest rate on the marginal lending facility normally provides a ceiling and the interest rate on the deposit facility a floor for the overnight interest rate. Under normal circumstances, there are no restrictions on the access of counterparties to these facilities, apart from the requirement to present sufficient underlying assets when using the marginal lending facility. Counterparties must fulfil certain eligibility criteria defined with a view to giving a broad range of institutions access to the standing facilities, whilst ensuring that certain operational and prudential requirements are taken into account: institutions must be subject to the Eurosystem minimum reserve system; they must be financially sound (subject to supervision by national authorities); and they must satisfy operational criteria defined by the respective NCB.

Even if not designed with a view to ensuring financial system stability, standing facilities may contribute to it in at least two different ways. First, the standing facilities define an interest rate corridor bounding the volatility of overnight interest rates and, by arbitrage, also the volatility of other short-term interest rates. This provides insurance against extreme (and unexpected) spikes in money market rates, and thereby also contributes to reducing the term premium along the entire yield curve. This insurance mechanism is inversely proportional to the width of the interest rate corridor. A caveat for a very narrow corridor is that interbank overnight activity may dry up, and for a very wide corridor, that the stabilising role may be insufficient, in particular on the last day of the reserve maintenance period (RMP). The optimal width from a financial system stability viewpoint will depend on the balance between these considerations.¹ Second, the marginal lending facility provides automatic liquidity insurance for individual institutions. In fact, as long as the institution has collateral, it can always run a daylight overdraft with an NCB (i.e. intraday credit), which will be automatically transformed by the NCB into an overnight credit via a recourse to the marginal lending facility. Given that the Eurosystem accepts a wide range of collateral for marginal lending (e.g. marketable and non-marketable assets which include credit claims and retail mortgage-backed debt instruments) the liquidity insurance mechanism is very effective. However, recourses to the marginal lending facility are relatively costly for Eurosystem counterparties. Thus, from the perspective of a lender of last resort, the marginal lending facility embodies the Bagehot principle (lending any amount to illiquid, but solvent institutions, at a penalty rate and against good collateral). This feature of the marginal lending facility contributes to financial system stability by making banks less vulnerable to failure due to liquidity problems, and thus mitigates the risks of contagion and bank runs.

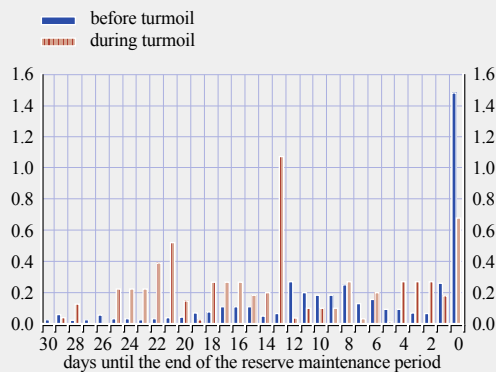
This box uses data on the daily aggregate recourses to marginal lending by all Eurosystem counterparties from 10 March 2004 until 11 December 2007 (45 RMPs) and compares the periods before and after August 2007 (turmoil period, four RMPs). The data show that, under normal market conditions, marginal lending is used mainly towards or on the last day of the RMP (see Chart A).

¹ Since April 1999 the Governing Council of the ECB has kept the interest rate corridor symmetric around the minimum bid rate (+/- 100 basis points). Since the reform of its operational framework the Bank of England has used the same interest rate corridor as the ECB except on the last day of the RMP where it is narrowed (+/- 25 basis points).

On the last day of the RMP marginal lending can be sizable but should be seen as an aggregate recourse that is necessitated by a possible increase in aggregate liquidity needs, distributed across the counterparties. On other days recourses to the marginal lending facility are infrequent and for very small amounts. At around the third week of the RMP there seems to be a temporary increase in the recourse to marginal lending which may be related to the fact that the end of the month falls, in general, around that time. This might suggest “last-minute” borrowing for window-dressing purposes. During the turmoil period, use of marginal lending occurred more frequently and for larger amounts, and it was more evenly spread throughout the RMP.

Chart A Average recourse to the marginal lending facility of the Eurosystem on different days of a reserve maintenance period

(10 Mar. 2004 – 11 Dec. 2007; 45 reserve maintenance periods; € billions; daily averages)



Source: ECB.

Overall, larger and more frequent recourses to marginal lending can be expected under stressed market conditions with the caveat that a stigma may arise under such conditions, because banks may be less willing to have recourse frequently and in sizeable amounts. The stigma may arise even if the central bank does not reveal the identity of the counterparties that had recourse to the facilities, as long as the aggregate figure is published, as is the case for the Eurosystem. Still, given that after August 2007 the frequency and the volumes of recourses to marginal lending have not decreased, there is no clear evidence of the emergence of a stigma attached to marginal lending in the Eurosystem.