Central bank lending

Published: February 21 2008 09:42 | Last updated: February 21 2008 20:57

All central banks are facing difficult choices in how to deal with the credit crunch. The European Central Bank is widely regarded as having responded effectively. But worries are growing that its success at easing liquidity constraints has come at the price of accepting low-quality assets, particularly mortgage-backed securities, as collateral.

Europe's banks have pledged increasing amounts of asset-backed securities (ABS) as collateral against borrowing from the ECB. By the end of September, ABS represented 17 per cent, or €215bn, of €1,300bn total eurosystem collateral, up from 12 per cent in 2006 and zero in 2003. The Bank of Spain, one of the few national central banks to provide updated information in advance of the ECB itself next month, says net lending by the ECB to Spanish banks, much of it presumably ABS-collateralised, has increased from €18bn in August to €40bn in January.

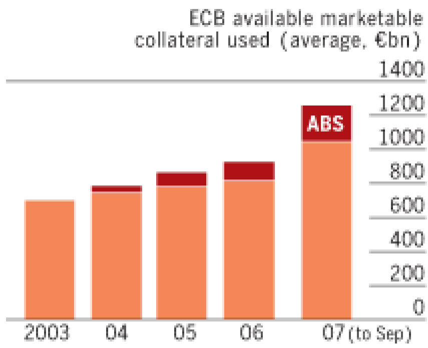
The ECB itself points out that, compared to other central banks, it accepts a high volume of "private label" ABS, which are not government-guaranteed. The Fed has even looser eligibility criteria, but the BoE is stricter – although it did temporarily ease the rules in September and December. All three central banks apply a "haircut" to securities which subtracts a percentage of their market value according to maturity and type. And if collateral, which is revalued daily, no longer meets the eligibility criteria, borrowing banks must stump up an acceptable substitute. What happens, though, if other collateral is unavailable, is moot.

The ECB, to a certain extent, is a victim of its history and the need to amalgamate eligibility criteria from 17 national central banks. It is clearly aware of the dangers of its approach – in 2006 it tightened up the criteria for structured finance products, for example allowing only the most senior ABS tranches to be eligible. But the ECB is caught between a rock and a hard place – if it does not tighten the rules, it could face losses on low-quality collateral. But if it does, liquidity could well seize up again.

The quality of the ECB's collateral falls

Eligible collateral rules for money market activity*

	ECB	BoE	Fed
National government	✔	✔	✔
Other government debt	✔	✔	✔
Non-domestic currency debt	✘	✔	✔
Securities rated below Aa3/AA-	✔	✘	✔
Securities rated below A3/A-**	✘	✘	✔
Asset-backed securities	✔	✘	✔
Corporate commercial paper and bonds	✔	✘	✔
Commercial, consumer and mortgage loans	✘	✘	✔



*All categories are subject to additional eligibility restrictions
**Fed does not accept non-dollar municipal and corporate bonds or international agency debt below Aaa/AAA

Sources: Bank of England; European Central Bank; Federal Reserve

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