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ECB Research

Understanding ECB's tiering system

- At the meeting yesterday, the ECB announced a tiering system for reserve remuneration (starting 30 October 2019) to support the bank-based transmission of monetary policy. The system allows banks to place a multiple of their minimum reserve requirements at an upper tier, which is 0%, while leaving the non-exempted at the deposit rate or 0% (which of them are lower). This only applies to the current account.
- The ECB has set the multiple at 6 but is ready to adjust the multiplier so that the 'euro short-term money market rates are not unduly influenced'. The remuneration rate of the exempt tier and the multiplier can be changed over time. The tiering system has features of the Swiss tiering system.
- The system is relatively simple in itself as it is based on the already computed reserve requirements. However, given the rather heterogeneous euro area banking sector, it may be rather complex for the market and have side effects such as for the Italian bond market. The system is foreseen to give a sizeable relief to in particular core banks. We highlighted further reflections in *Watchers conference: is a tiering system really the answer?*, *Mitigating side effects – gauging the tiering premium* and *New ECB call - rate cut and restart of QE*.
- Ultimately, markets did not receive the tiering system favourably, as both money market rates and short end government bond yields rose sharply after the announcement of the tiering system modalities. December 2019 Euribor rose 7bp after the announcement.
- The introduction of the tiering system is set to result in the weighted deposit rate at the ECB being around -28bp, which effectively is tighter than the current rate just shy of -40bp. That also means that despite the 10bp cut in the deposit rate, the banks' weighted deposit rate overall in the euro area is set to rise.

Exemption thresholds for ECB's tiering

Jul 19 (in bn EUR)	DF	CA	DF+CA	Reserve requirements (RR)	Exemption threshold (6*RR)	CA and DF holdings at -50bp	-50bp (with tiering)	-40bp (no tiering)	-50bp (no tiering)	Free upper tier threshold
DE	157	474	631	31	189	442	-2.2	-2.5	-3.2	0
FR	234	304	538	27	161	377	-1.9	-2.2	-2.7	0
NL	9	161	170	9	54	116	-0.6	-0.7	-0.8	0
LU	65	59	125	4	21	103	-0.5	-0.5	-0.6	0
ES	7	93	99	13	76	23	-0.1	-0.4	-0.5	0
FI	37	56	93	2	11	82	-0.4	-0.4	-0.5	0
IT	7	71	78	18	109	-31	0.2	-0.3	-0.4	31
BE	36	31	68	6	35	32	-0.2	-0.3	-0.3	0
AT	1	37	38	4	22	17	-0.1	-0.2	-0.2	0
IE	8	18	26	2	15	11	-0.1	-0.1	-0.1	0
PT	0	12	12	2	12	0	0.0	0.0	-0.1	0
Other	6	32	38	4	22	17	-0.1	-0.2	-0.2	0
Total	567	1,350	1,916	121	727	1,189	-5.9	-7.7	-9.6	0

Note: Most recent country breakdown is end-July. The other figures for excess liquidity in this piece are more up-to-date. Source: ECB, Danske Bank

ECB meeting 12 September

- *ECB Research: Open-ended QE and tiering. Now, over to you, fiscal policies*, 12 September 2019

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The basic framework: the definition of excess liquidity

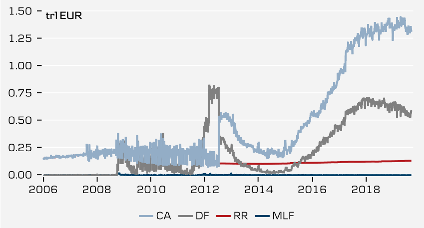
To understand the drivers of the new tiering system, it is important to understand the concept of excess liquidity and its components. ECB's definition of excess liquidity is the sum of the recourse to the deposit facility (DF) minus marginal lending facility (MLF) plus current account holding (CA) minus reserve requirements (RR), i.e.

$$\text{excess liquidity} = (\text{DF} - \text{MLF}) + (\text{CA-RR}).$$

Most recently, the surge in excess liquidity has led the cost of negative rates to euro area banks to rise to around EUR7.5bn/year (assuming no pass-through and TLTRO2 deduction), which has stemmed from the rise in DF and CA. The surge has been sizeable since the introduction of the fixed rate full allotment measure and QE was introduced.

Both the DF and the CA are remunerated at the same (deposit) rate currently, which yesterday was lowered to -50bp but there are important differences between the two (see next section). The MLF is almost not used currently due to ample liquidity in the system (the MLF rate is 0.25%). The RR is remunerated at the MRO (current 0%) and is a fixed percentage of the bank's balance sheet (current 1% ~ EUR132bn in the Eurosystem). The RR was lowered to 1% from 2% in 2012.

The rising CA and DF



Source: ECB, Macrobond Financial, Danske Bank

Current account versus deposit facility

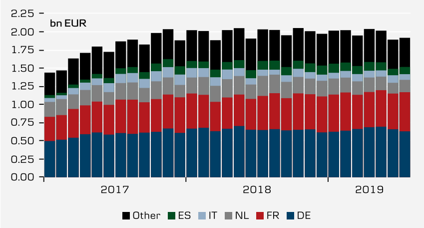
As a rule of thumb, the current account facility is an account that commercial banks have with the national central bank, while the deposit facility is with the ECB. While currently there are no differences between the two facilities, the introduction of the tiering system yesterday brought important changes to the two.

The rate of the deposit facility naturally follows changes in interest rates as it is part of one of the three key ECB interest rates. However, the CA is non-remunerated, or in practice it is the lower between the deposit facility rate (now -50bp) and 0%, which meant that when ECB cut the deposit facility rate to 0% in July 2012, there was in practice no difference between the two facilities. Going forward, with banks' possibility to use the current account allocations at the higher tier of 0%, we will see a higher usage of the current account compared to the deposit facility. A simple illustration is Italy, which does not fill its allotments.

Heterogeneous banking system

The chart on the right shows that current account holdings and usage of the deposit facility are located mostly in Germany, France and the Netherlands and to some degree also Luxembourg. Spain and Italy are low in this regard (with even Luxembourg higher than both Italy and Spain). In other words, the advantage of the introduction of a tiering system is mainly to be found in the core/semi-core.

Current account and deposit facility holdings



Source: ECB, Macrobond Financial, Danske Bank

At a banking sector level, around 70% of the total current account and deposit facility holdings is in Germany, France and the Netherlands (EUR631bn, EUR538bn and EUR170bn, respectively). Ultimately, the banks in these countries are also the ones that stand to benefit of the tiering system.

Table on front page

The table on the front page shows that the biggest beneficiary is unsurprising the country that has the highest current account and deposit facility holdings, Germany. Germany stands to avoid a fee of EUR1bn compared to a situation without a tiering system. France stands to 'gain' EUR0.8bn, while Spain stands to avoid EUR0.4bn in annual fee. However, this data is made on banking sector data, which also include intra-country banking heterogeneity, which in some countries is quite substantial.

It is noteworthy that Italy is the only country that does not stand to benefit from a tiering system due to its low CA and DF holdings. In fact, it has EUR37bn worth of 0% allotment available. As we discussed in a previous piece, this is expected to have negative implications for the Italian repo market.

The impact on government bonds…

We highlight that the sizeable impact in the short end government bond yields should be attributed to the, all things equal, less demand for government bonds as banks would rather place a larger share of their deposits at the upper tier than holding more negative yielding instruments.

… and the Italian case

In the case of Italy, the reason for the relatively low DF and CA holdings can be found in its fragile banking system. Also when banks are faced with a choice between parking the cash at the national central bank or in the market, the bank will ultimately utilise the highest rate possible. That means that Italian banks will use the repo market if the rate is higher than what the central bank facilities offer. With the potential to park additional funds at the upper tier of the tiering system, which is higher than the GC repo rate, less allocation to the repo market is to be expected until the repo rate has converged to the upper tier. In other words, with the lower demand for GC repo an increase in the GC repo (close to the higher facility rate) may be expected.

Weighted average rate to rise amid more clouded ECB pricing interpretation

With the introduction of the tiering system, the weighted average deposit rate is set to rise from its current level just shy of -40bp. With excess liquidity currently at EUR1773bn and banks possibility to park 6 times the reserve requirements (EUR132bn) at the upper tier, EUR792bn, the weighted average deposit rate is set to rise to -28bp (EUR981bn @ -50bp and EUR792bn @ 0%), which de facto is tightening the money market conditions in its traditional sense of higher rates = tighter money market conditions.

Further, we highlight that the pure ECB expectations that usually could be read from the EONIA forwards are set be clouded, not only by the shift to €str, but also by the introduction of the tiering system – which has been shown to come with a large tiering premium. Using the old interpretation, markets are pricing in a 4bp cut for the December meeting.

Disclosures

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Expected updates

None.

Date of first publication

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