The ECB's operational framework review formalises the status quo

The long-awaited outcome of the European Central Bank's review of its so-called operational framework nicely stays within expectations, formalising many of the current tools

The European Central Bank initiated the review of its operational framework in December 2022. It took slightly longer than expected to conclude, but today, we finally got the results.

Remember that 25 years ago, the ECB started operating a so-called "corridor" system. That system ensured banks were provided with a given amount of central bank reserves sufficient to fulfil their minimum reserves requirements and the demand from so-called 'autonomous factors'. By tailoring the amount of central bank reserves provided to the needs of banks, the ECB could steer the overnight rate close to its Main Refinancing Operations rate (MRO). As a result, the amount of excess liquidity was close to zero until 2008.

The ECB flooded markets with liquidity

With the financial crisis, the ECB had to live up to its role as lender of last resort, flooding markets with liquidity. This was achieved by basically providing banks with as much liquidity as required via the 'full allotment' system. In addition, the ECB started a long list of long-term refinancing operations (targeted and not targeted) and eventually several outright asset purchase programmes.

As a result, excess liquidity in the eurozone surged with many intentional and unintentional consequences, one of these being a shift of the overnight interest rate close to the ECB's deposit rate, making the deposit rate basically the key policy rate.

Outcome of the review

The review aimed to fully assess the changes over the last two decades, a bit like cleaning up the house, deciding what can stay and what should go. In short, here is what the ECB announced as the key elements of its operational framework going forward:

- The deposit facility rate will remain the main policy interest rate.
- Liquidity will be provided through a mix of short-term credit operations, the traditional longer-term refinancing operations and longer-term credit operations.
- Short-term liquidity will continue to be provided through fixed-rate tender procedures with full allotment.
- The spread between the interest rate for primary refinancing operations and the deposit rate will be reduced to 15bp, from currently 50bp, starting in September 2024.
- New structural longer-term refinancing operations and a structural portfolio of securities will be introduced at a later stage.
- The reserve ratio for determining banks' minimum reserve requirements remains unchanged at 1%. The remuneration of minimum reserves remains unchanged at 0%.

Implications for financial markets

This outcome largely aligns with market expectations for a demand-driven floor system with practically no impact in the near term, especially since the ECB decided to leave the minimum reserve requirement unchanged.

ESTR will continue to be steered at the deposit facility as the main policy rate. While the balance sheet will continue to shrink in the next couple of years, the ECB will likely operate with an excess of reserves and, in the more distant future, with liquidity provided through a mix of instruments, including structural longer-term operations and structural bond portfolio.

However, the Bank does foresee a more prominent role for the shorter-dated weekly (MROs) and also, to some extent, the 3m liquidity operations (LTROs). These will continue to be conducted via fixed-rate full allotment tenders (i.e., all bids will be satisfied). In order to reduce any stigma for banks participating in the liquidity tenders, the pricing of the weekly operations will be reduced to 15bp above the deposit facility rate starting 18 September.

For now, though, the banking system is still operating with €3.5tn in excess reserves, meaning demand for the liquidity operations could still be muted. Right now, for instance, the effective market rate would still be 25bp below the proposed MRO rate. Having to resort to the ECB operations amid such conditions could still be seen as lack of market access. However, it would still give weaker banks access to liquidity at less punitive conditions at an earlier stage in the ECB's balance sheet normalisation process.

Of course, excess reserves will continue to decline as remaining TLTROs and the bond portfolios run off. Things will become more interesting again once a level in excess reserves has been reached that threatens to detach €STR from the deposit facility rate. This should be the stage where the balance sheet will have to grow organically again alongside the economy, and we think that could come later in 2026.

Structural credit operations for banks

The new structural longer-term credit operations will only be introduced at a later stage, potentially incorporating climate-change-related considerations. There is no indication of the pricing or duration of these operations apart from the comment that they will be calibrated to avoid interference with the monetary policy stance. These may make longer-term (longer than 3m) funding for banks available more on a recurring basis, which could be seen as a positive for bank refinancing risks.

Availability of longer term funding at attractive terms would benefit in particular lower rated banks. As these operations may only be launched at a later stage, they do offer little help for refinancing the outstanding TLTROs though where the shorter operations remain the key for now with the tad more attractive pricing.

The big unknowns

There were two big issues on which the European Central Bank still remains vague: the introduction of structural longer-term operations and a new structural securities portfolio (the “bond portfolio”). The ECB only mentioned these two elements, making it clear that a bond portfolio would be independent of the current running-off of existing asset purchase programmes. For instance, regarding the bond portfolio, no mention is made of a possible maturity shortening or the inclusion of corporate and supranational bonds.

> *The review was an overdue clean-up of the ECB's toolkit*

The ECB has indicated that the structural liquidity provisions could also be used in pursuit of the ECB’s “secondary objective of supporting the general economic policies in the European Union – in particular, the transition to a green economy”. To us, this means that the ECB is still contemplating Green TLTROs. It's clearly keeping the door open to a wide toolkit to assure maximum flexibility in the future.

All in all, the review was an overdue clean-up of the ECB's toolkit. Very little disappeared; only the newer tools were nicely cleaned and structured.

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