

## Box 4

**THE EUROSISTEM'S BALANCE SHEET IN TIMES OF FINANCIAL MARKET TENSION**

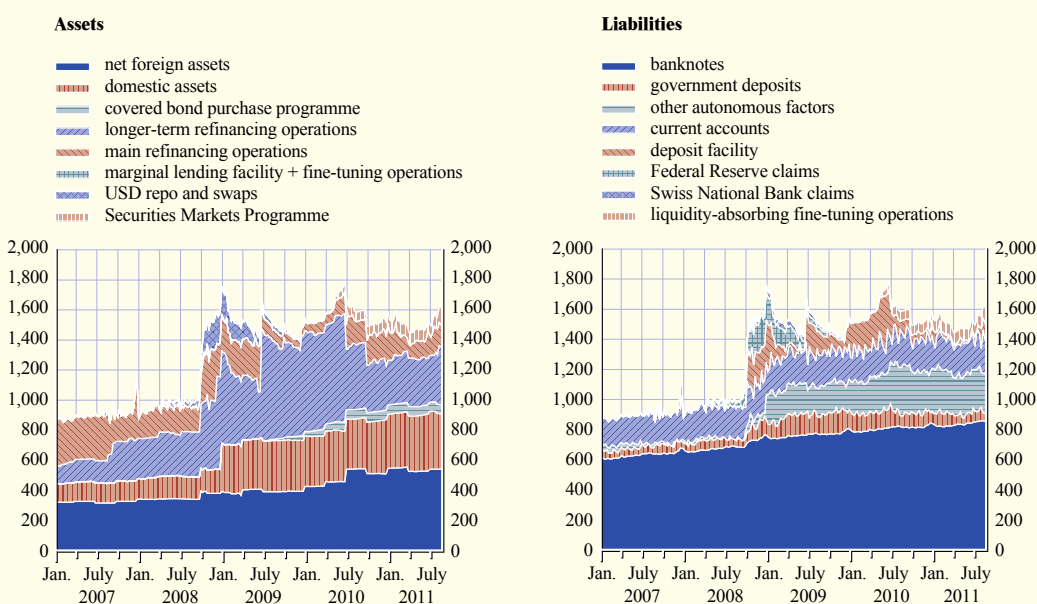
In response to the financial crisis, the ECB has introduced a wide range of non-standard monetary policy measures. The aim of all of these measures has been to sustain financial intermediation in the euro area, foster the flow of credit to households and firms in the euro area and support the monetary policy transmission mechanism. These objectives have, in particular, been pursued through the easing of banks' funding conditions – in order to foster the provision of credit to the private sector – and support for the functioning of relevant financial market segments. The Securities Markets Programme and the provision of unlimited liquidity at various maturities with fixed interest rates in exchange for eligible assets are the most prominent examples of the ECB's non-standard monetary policy measures in these difficult times.<sup>1</sup> Ultimately, all measures are designed to be temporary in nature and are guided solely by the ECB's mandate to maintain price stability over the medium term in the euro area as a whole.

As a consequence of the non-standard measures adopted in response to the severe financial market tensions, the composition of the Eurosystem's balance sheet has changed and its size has increased substantially. On the basis of a simplified version of the balance sheet, its size rose from €913 billion prior to the crisis (on 29 June 2007) to €1,763 billion at its peak (on

<sup>1</sup> Further information on these measures and their impact can be found in: the box entitled "Financial markets in early August 2011 and the ECB's monetary policy measures" in this issue of the Monthly Bulletin; the article entitled "The ECB's non-standard measures – impact and phasing-out", *Monthly Bulletin*, ECB, July 2011; the article entitled "The ECB's response to the financial crisis", *Monthly Bulletin*, ECB, October 2010; and the article entitled "The implementation of monetary policy since August 2007", *Monthly Bulletin*, ECB, July 2009.

## Developments in the simplified balance sheet of the Eurosystem

(EUR billions)



Source: ECB.

25 June 2010), before declining to stand at €1,609 billion on 26 August 2011 (see the chart).<sup>2</sup> Note that the balance sheet referred to here is that of the entire Eurosystem, not just the balance sheet of the ECB. The decentralised structure of the Eurosystem means that monetary policy operations are conducted by both the ECB and the participating NCBs, so singling out the ECB's balance sheet or those of individual NCBs is not appropriate.

On the asset side of the Eurosystem's simplified balance sheet, assets (both domestic and foreign) and liquidity-providing operations are major items. The main liquidity-providing operations are main refinancing operations, longer-term refinancing operations, the Securities Markets Programme, the covered bond purchase programme, and US dollar repo and swap operations. On the liability side, banknotes are by far the largest item. Other items on the liability side include fine-tuning operations absorbing the liquidity stemming from purchases under the SMP and the funds that banks place in the ECB's deposit facility overnight.

In line with balance sheet developments, risk exposure has also increased. Central banks always have to take on some financial risks when conducting market operations necessary for the implementation of monetary policy decisions. Such risks typically increase in times of financial crisis, as extraordinary circumstances cause central banks to take exceptional steps. At the same time, such measures need to be designed in such a way that a central bank's risk management decisions do not exacerbate the pro-cyclicality of financial systems.

<sup>2</sup> For a more detailed explanation of this simplified Eurosystem balance sheet, see the article entitled "Recent developments in the balance sheets of the Eurosystem, the Federal Reserve System and the Bank of Japan", *Monthly Bulletin*, ECB, October 2009 (particularly the box in that article). See also Chart 9 of the article entitled "The ECB's non-standard measures – impact and phasing-out", *Monthly Bulletin*, ECB, July 2011.

From the policy-maker's perspective, maintaining – and even increasing – a central bank's risk exposure in times of financial distress is justified by the potential for greater risks to financial and macroeconomic stability were the central bank to remain inactive. This fundamental willingness to accept additional financial risk in times of crisis helps the central bank to preserve its capacity to fulfil its price stability mandate and comply with its institutional responsibilities as a policy-making institution serving public interests.

Indeed, as the monopoly supplier of central bank money, the central bank has the task of preserving price stability and thereby contributing to the welfare of its citizens. In the case of the ECB, the price stability mandate is enshrined in the Treaty on the Functioning of the European Union. This reflects the broad consensus in society that price stability is the main contribution that monetary policy must make to economic growth, job creation and financial stability. All actions taken by the ECB are geared towards this primary objective. Thus, the ECB, as a public institution with a public mandate, is very different from a private, profit-making commercial bank, the actions of which are driven mainly by considerations relating to profitability, liquidity and risk. In this sense, the criteria used to assess the actions of a central bank that pursues public objectives need to be different from those underlying assessments of the behaviour of private financial institutions. This means that a central bank entrusted with a public mandate has to take much broader considerations into account.

Central banks' risk-taking must thus be weighed against the benefits that it is expected to bring to society. The key question, therefore, is whether additional financial risk is acceptable and in the public interest. In this respect, the Eurosystem's carefully designed risk management framework enables the central banks of the euro area to provide effective support to the economy by optimising the relationship between policy efficiency and risk-taking.<sup>3</sup> Risks are constantly monitored and assessed against available financial buffers at the Eurosystem level. The efficiency of that risk management framework is also evaluated on an ongoing basis.

Furthermore, as a system of central banks, the Eurosystem funds a major share of its assets by banknotes, capital and financial buffers.<sup>4</sup> These liabilities are substantial and thus provide a solid buffer. Furthermore, issuing banknotes does not entail significant financial costs, while the assets on the Eurosystem's balance sheet are remunerated. Such remuneration generates substantial recurring net income ("seignorage"), which ensures a strong capital position and the long-term viability of central banks. Thus, central banks have a number of specific features, reflecting, among other things, their privileged status as the issuer of legal tender (i.e. banknotes). Others include the central bank's privileged status as an institution without liquidity constraints and, in the specific case of the Eurosystem, the prominent role played by revaluation accounts as financial buffers.

As regards liquidity-providing monetary policy operations, the framework for the management and control of financial risk ensures adequate protection of the Eurosystem's balance sheet by accepting only counterparties deemed to be financially sound. Furthermore, the Eurosystem requires that its counterparties provide adequate collateral. This collateral is revalued on a daily

<sup>3</sup> More details concerning the specific features of central banks' risk management frameworks can be found in Bindseil, U., Gonzalez, F. and Tabakis, E. (eds.), *Risk Management for Central Banks and Other Public Investors*, Cambridge University Press, 2009.

<sup>4</sup> On 26 August 2011 these accounted for 60% of total assets, as banknotes in circulation totalled €850.2 billion, revaluation accounts totalled €316.7 billion, the capital and reserves of the Eurosystem totalled €81.5 billion, and the total assets of the Eurosystem stood at €2,072 billion.

basis using observed market prices or appropriate theoretical pricing methods where reliable daily market prices are not available. In addition, haircuts are applied in order to protect the ECB from financial losses in the event of sharp declines in the price of an asset. This framework ensures a high recovery value in the event of a counterparty defaulting, so losses will normally occur only in the event of defaults by both the credit institution acting as the counterparty to the Eurosystem and the issuer of the asset being used as collateral.<sup>5</sup>

As regards the Securities Markets Programme, which was introduced in May 2010 in order to address the malfunctioning of securities markets and thereby support the monetary policy transmission mechanism, risks to the Eurosystem are safeguarded by prudent risk management policies. Interventions target only securities with credit risk deemed tolerable by the Eurosystem. In the case of countries which are subject to an EU-IMF programme, the assessment of credit risk is supported by constant monitoring and evaluation of the progress made in the implementation of the programme. In this context, it should be emphasised that it is normal for many items on the Eurosystem's balance sheet to entail some risk – including the Eurosystem's foreign and domestic assets, as well as liquidity-providing operations, as explained above.

Overall, the Eurosystem manages its exposure and risk-taking in a way that ensures the fulfilment of its primary mandate, the maintenance of price stability.

<sup>5</sup> For details of the risk management framework applied to Eurosystem credit operations, see *The implementation of monetary policy in the euro area – general documentation on Eurosystem monetary policy instruments and procedures*, ECB, February 2011 (<http://www.ecb.int/pub/pdf/other/gendoc2011en.pdf>).